

December 15, 2006

Japan Economics

A Hint from Nietzsche: Imperatives in Japan's Redesign of the Financial Sector

Prepared for:

**The Second International Conference on Financial Systems:
Competitiveness of the Financial Sector**

Sponsored by:

The Financial Services Agency, Government of Japan

Research
Japan

Japan Economics

December
2006

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A Bit of Philosophy

The most fundamental form
of human stupidity is
forgetting what we were
trying to do in the first place.

Nietzsche

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Too Many Accidents

- **Too many accidents:** (1) Derivatives sales problem at a major bank; (2) non-payment by life insurers; (3) pension payment irregularities; (4) auditing irregularities; (5) market disruption from ill-timed sanctions; (6) postal savings system irregularities; (7) Horie/Murakami Fund problems; (8) stock manipulation by a railroad company; (9) Yubari Municipal problems; (10) TSE trading system problems; (11) consumer finance fiasco; (12) insider trading at a branch of a securities company; (13) insider trading by a member of the media;
- **Why so many?** Because regulators are tougher and more aware? Because systemic flaws remain rampant? Because police/ regulator/ political incentives favor grandstanding?
- Investors at home and abroad see Japanese financial regulation as uncoordinated “**mogura-tataki**” (mole hunt). Example: Dividend tax debate vs. consumer finance actions. Ad hoc nature of decisions destroys confidence in fairness and stability.
- Japan needs a principles-based financial system. But **what principles?**

The Economic Problem: Productivity Is the ONLY Solution to Demographics

- Demographics, energy, and globalization are the three big challenges for the Japan's economic future. All require much more productive and flexible use of labor and capital.
- The financial system is an essential part of achieving higher productivity. It must allocate labor and capital to the most productive uses. Under the current regulatory structure, this is not happening.
- Non-financial sector deregulation is key to enhancing financial sector opportunities. (You cannot securitize a zero income stream!) Key opportunities lie in agriculture, medical care, housing, government outsourcing, etc.
- The real measure of success for financial reform in Japan will be whether it contributes to higher productivity growth. This is the **mission**.
- There are two basic principles in accomplishing this mission

Principle 1: Resource Efficiency

- All decisions about financial sector structure and regulatory design must foster **efficient resource use**. Otherwise, Japan's standard of living will fall. sub-principles are:
 - 1. **Competition.** Financial structure and regulation must enhance competition. Entry/exit barriers and vested interests must be destroyed.
 - 2. **Accurate information, disseminated fairly.** Information supplied to markets by firms, regulators, and intermediaries (both analysts and media) must be accurate and balanced, and must be available on an equal basis. Leaks from both private and public sectors must stop.
 - 3. **Equal treatment.** Distinctions among players and products should be made only on the basis of sophistication and potential contagion, not on such distinctions as region/center, private/public, regulator/intermediary, foreign/domestic.
 - 4. **Minimum cost.** Technology and organizations, both private and regulatory, should minimize costs. Artificial barriers and overlap should be eliminated.
 - 5. **Self-Responsibility.** Distinguish between amateur and professional investors, and enforce appropriate self-responsibility for both. Excess protection destroys efficiency.

Principle 2: Recognize Market and Regulatory Failure

- **Market failures** must be recognized. Such failures arise from asymmetric information (insider information), public goods (accounting systems), economies of scale (IT applications), and externalities (e.g. contagion).
- **Regulatory failures** must also be recognized. These include lack of transparency, lack of accountability, lack of expertise, narrow incentive structures, information manipulation, short tenure of key officials.
- **The financial system is highly vulnerable to both** kinds of failures. All participants must approach these issues with humility.

Implementing the Principles

- With financial markets subject to both market failure and regulatory failure, the only solution is open, trusting **communication** between markets and regulators. Japan is short on both trust and communication.
- There are **success cases** of communication between regulators and markets in recent Japanese financial sector history. Such cases include creation of the IRCJ, creation of the new Corporate Law, the Takenaka Plan, and the Advisory Council on Government Debt Management.
- In the financial sector two elements are lacking, **trust** and **policy competition**.

Trust Is Low Everywhere

- Trust follows the following formula:

$$\text{Trust} = [\text{Expertise} + \text{Reliability} + \text{Empathy}] / \text{Self-interest}$$

- Do the regulators trust the markets? No.
- Do markets trust the regulator? No. Many market participants are afraid to tell regulators anything, for fear that the information will be used against them in inspections and supervision.
- Both sides must raise their ratings in the numerator and lower their rating in the denominator of the trust equation.

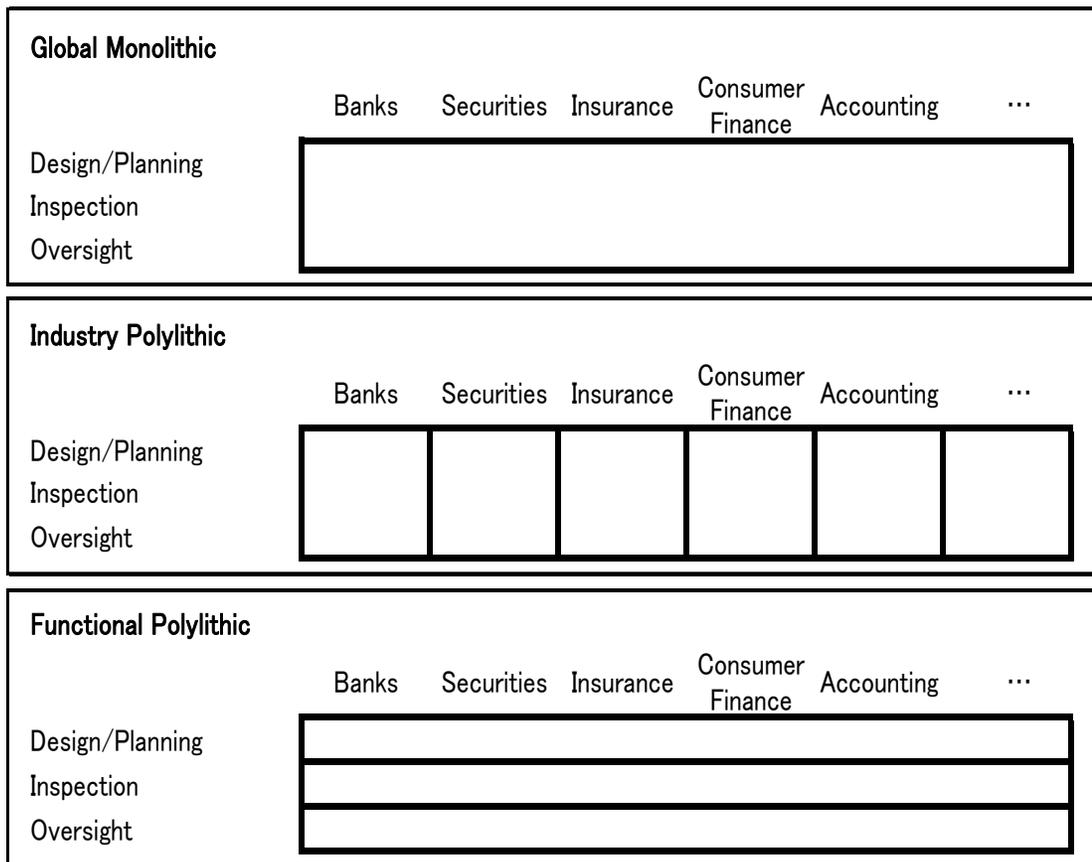
Policy Competition

- Under the old system, the Financial System Council and the FSA were the only design authorities for the financial system. The results of this monopoly were seen in the many financial system troubles of the 1990s and slow response to crises.
- Today, the FSC and the FSA are still be bureaucratic home for financial system design, but competition has emerged. The Asia Gateway initiative, which resides in the Cabinet Office, is a cross-ministry initiative, and includes Japan's competitiveness as a financial market as a theme.
- The financial reform plans of the FSC/FSA and the Asia Gateway committee will now compete in the public debate over financial sector reform. The ultimate decisions will be made by the Cabinet and the Diet.

Communication Improvement Proposals

- 1. Create cross-industry (banks, securities, insurance, asset managers) industry associations, in order to identify common interests, to create common reform plans, and to give feedback to the FSA/government on financial regulatory matters. These associations could follow the models of Keidanren and Doyukai.
- 2. Ease the rules on entertainment (*settai*) between financial system regulators and the private sector. Current rules are unduly restrictive, hamper communication, and ignore progress toward a transparent regulatory system.
- 3. Enhance policy debate by mandating competing financial reform plans from different groups, both public and private.
- 4. Create a media equivalent of the *Gaimu-in* (US Series 7) and supervisory analyst (*shinsa tanto*, US Series 16) qualifications. Require by-lines by qualified reporters for coverage of financial news.

Regulatory Structure: Separation of Powers



The design/planning function is basically legislative.

The inspection function is basically administrative.

The oversight function is basically judicial.

When all three functions are concentrated, the regulatory agency is sheriff, judge, and jury – along with being city council. Such a system leaves targets no recourse to appeal decisions, and thus invites abuse.

A well-designed system separates the three functions, but ensures communication between them for system design and implementation.

Regulatory Redesign: Proposals

- Solve the mogura-tataki (mole hunt) problem with principles-based regulation. The main principles should be (1) resource efficiency and (2) recognition of market and regulatory failure.
- Solve the intimidation problem with separation of powers in the regulatory system.
- Solve the “who watches the watchers” problem with pan-industry trade associations, which would give feedback to the FSA and other regulatory bodies.
- Abolish the FSA Press Club. Replace it with open press briefings, and admit only qualified financial reporters. Prohibit contact of the minister, senior vice-minister, and parliamentary secretary with the press, except at formal press conferences.
- Regulatory actions should specify what market failure is being addressed, and cost-benefit analysis of why regulatory action is better than no action.

The Police Problem

- Leaks from the police/prosecutors should stop. Such leaks violate both the letter of the law and the rights of those under investigation. This is particularly important, now that juries are being introduced in Japan.
- The lack of action by police/prosecutors against fraud and intimidation in the consumer finance industry should be subject to Diet inquiry.

Issues in the Equity Market

- Global consolidation among exchanges is accelerating. Japan will become a mere regional market if left out of current trends.
- Clearing and settlement of equity and derivative trades is going global. Japan must align clearing and settlement with global practices.
- Off-exchange trading must be made transparent (true for US and Europe too).
- Derivatives are booming around the world. Japanese equities will lose competitiveness unless Japan adapts to global practices. Costs of capital in Japan will rise, relative to other markets.
- The TSE should take a more active role in inspecting non-financial public companies, just as the FSA inspects financial institutions.
- Third-party allocation rules must be reviewed, to prevent their abuse as a tool to entrench management.
- Triangle mergers with foreign firms must be on an equal footing with those by domestic firms.

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