Japan's Financial and Corporate Systems Move in New Directions

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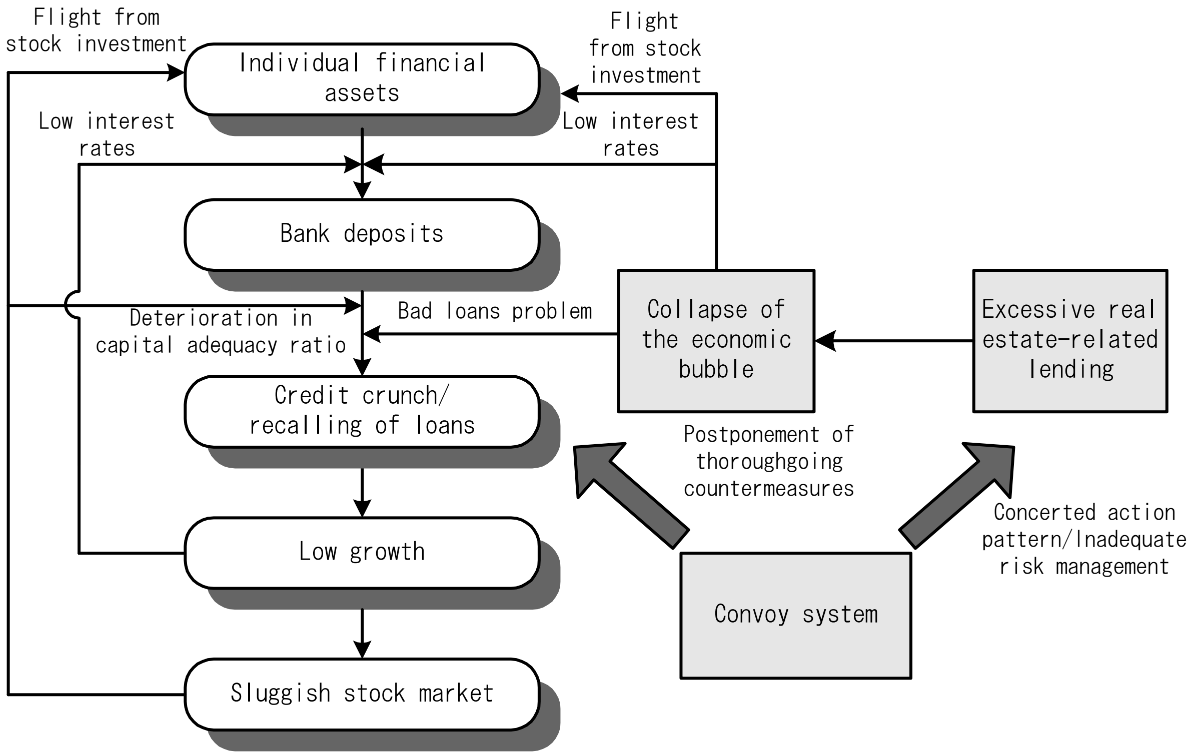
1. The Direction Has Changed

In line with the injection of public funds into major banks and their announcements of plans to achieve sounder management operations which emerged in March 1999, the stock market in Japan swung into a recovery phase. Many experts still feel that caution is needed. Some say that the financial system problems have not yet been solved at all, others feel that the problems have been solved to a certain extent, and some individual banks still have several major problems to solve.

However, it is certain that Japan's financial system has achieved a historical change in direction. That is to say, it has changed direction from the convoy system (in which firms all act in the same way at the same time) to a market competition-driven mechanism. Figure 1 shows the course taken by Japan's financial system up to now. As this was a convoy system configuration, the banks all increased lending to real estate related projects in a concerted movement without fully realizing the risks involved. As a result, the bubble economy overheated. The creation of a thoroughgoing solution for the problem of bad loans which emerged after the collapse of the bubble continued to be put off. This is because both the public sector and the private sector still maintained the convoy system way of thinking and they wanted to avoid the bankruptcy of any of the banks, and so none failed.

The problem of bad loans which emerged as a result of this policy caused the credit crunch on the part of banks and the recalling of loans, resulting in a sluggish economy and a lackluster stock market. Since Japanese banks hold other companies' shares and the unrealized gains from these holdings are partially counted as Tier 2 capital, the fall of share prices worsens their capital ratios. Thus, Japan fell into a vicious cycle in which the depressed state of the stock market brought about a worsening of the equity capital position of the banks and this accelerated the credit crunch. This has been the position of Japan's economy up to very recently.

Figure 1 The Sluggish Economy and Lackluster Stock Market Spiral Brought About by the Conventional Financial System



Source: Nomura Research Institute

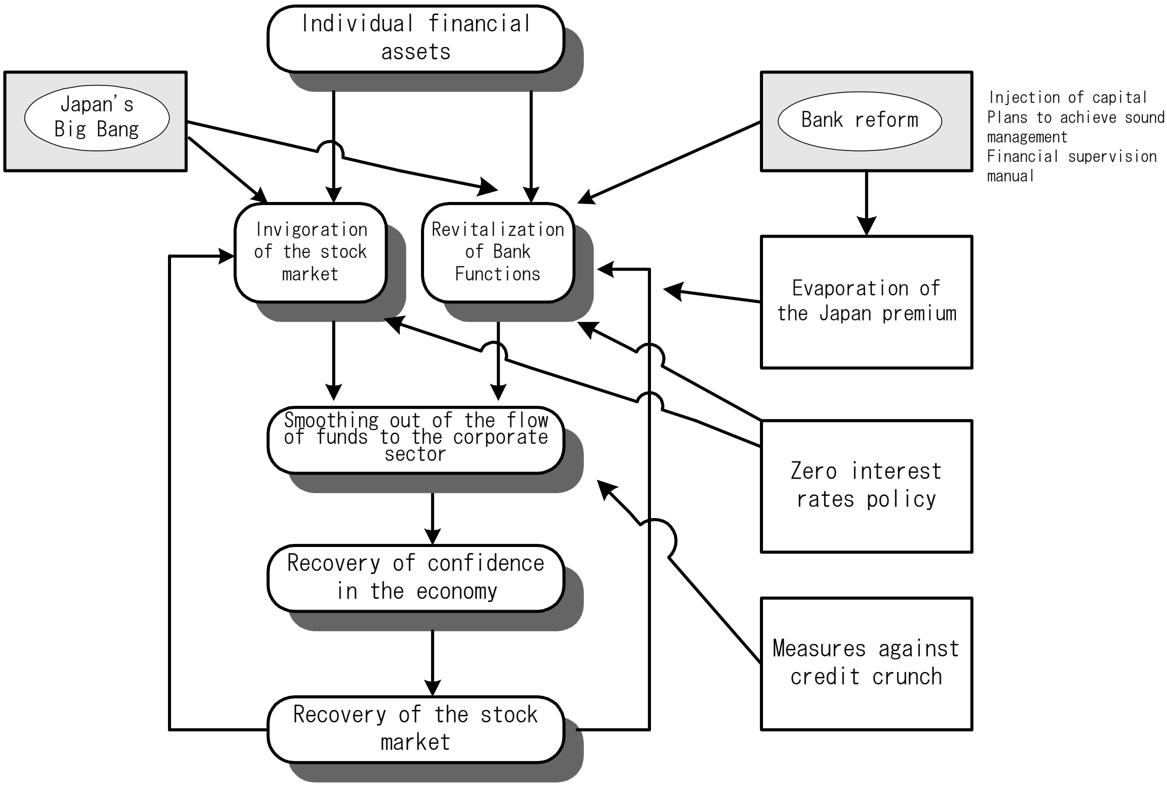
If it had been possible for companies to procure funds smoothly through routes other than the banks, there would have been no problem. However, the trauma of the collapse of the economic bubble and the depressed state of the stock market resulted in a situation where almost all individual financial assets remained locked up in the banks. Thus, there was no opening up of a path to supply risk capital to the corporate sector.

However, now Japan's financial system has changed direction and set sail on a new course. Japan's Big Bang was declared in November 1996 and more or less implemented in December 1998. It has brought about a revitalization of the stock market and an increase in the freedom of the banking sector's activities. Moreover, above all, through the introduction of the principle of competition, it has formed an environment able to provide a basis for the new financial system.

Naturally, this alone was not sufficient. It was also necessary to tackle the problem of bad loans, an issue which is a negative inheritance from the past. In March 1999, this was finally realized through a full-scale injection of public funds in major banks and their submissions of plans to achieve sound management operations. Of course, the injection of public funds, which occurred in March 1999, was not the only factor at play. The change in direction was made more definite by winding up several banks and the movement towards mergers and alliances. The strong stance of the Financial Revitalization Commission and the Financial Supervisory Agency took the form of seeking a revitalization of the financial sector and an escape from the convoy administrative system. This was also reflected in the compilation of a financial supervision manual, etc.[1]

In addition to the above, the Japan premium has more or less disappeared, a zero interest policy has been introduced and an unprecedented measures to cope with credit crunch has been put in place as typified by the special credit guarantee system. At the present time, these measures appear to have resulted in the start up of a positive circulation as shown in Figure 2. That is to say, the fund flow situation to the corporate sector has improved and the negative feeling about the economy has bottomed out. As a result, stock prices have risen and the problems besetting the financial system have been alleviated. In addition, the supply of funds to the corporate sector has been smoothed out.

Figure 2 A Spiral towards Financial and Economic Revitalization



Source: Nomura Research Institute

The elimination of the Japan premium shows the confidence placed by the market in the financial revitalization stance of the Japanese financial authorities. It is true that some of the major banks still have individual problems remaining, and the engagement in the solution of the problem by the regional banks, small and medium financial institutions and the life insurance firms has yet to be implemented. Nevertheless, the market has acknowledged the change in direction of Japan's financial system and this has led to a recovery in stock prices.

1 For details, see. "Injection of Public Funds and Bank Management" by Shinichi Iimura, *Capital Research Journal*, Spring 1999.

It is not the purpose of this paper to debate whether this level of stock prices is already an excessive evaluation or still an underestimate of the true value. However, in order to decide on this, it is necessary to closely examine the nature of this change in direction, to grasp what problems remain unsolved and how they should be resolved. The following is an examination of these points.

2. The Nature of the Changes

1) Changes in the Banking System

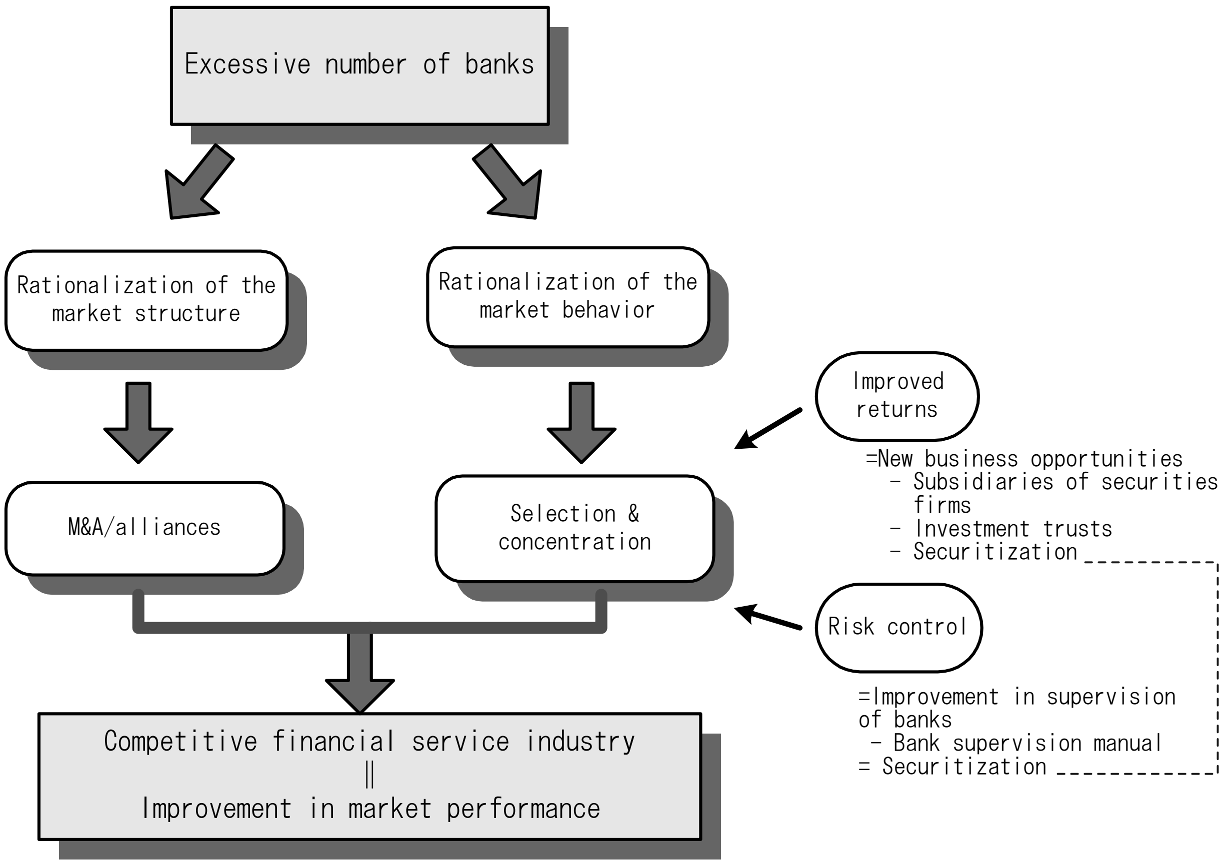
In the reform of the banking system, the authorities were aware of the need for a solution to the problem of the existence of an excessive number of banks. One approach to the question of if there are too many or too few banks and financial institutions with banking functions within the economy of a nation can be termed in economics as if there is excessive profits or not. If there is an excess of profits and if there are no problems of regulation or monopolies, the result is more banks are formed. If there is a lack of profitability, some banks go out of business. As a result, there should be neither too many banks nor too few. In Japan, under the convoy system existing up to now, there were restrictions on new entries and on retiring from the field, and banks were promised profitability. To ensure this did not result in excessive profiteering, regulations were imposed on operations and prices.

From this form of balance, Japan is seeking to achieve a new balance point in an age where the new entry to and exit from the sector and regulations on operations and prices have been deregulated. It cannot be said that the number of banks will increase or decrease as a result of this. Due to Japan's Big Bang, deregulation of entry, exit and other aspects has been achieved. Thus, the quest for the ideal number of banks should be left to market forces.

However, the reason that the authorities came up with the idea of the existence of an excessive number of banks is based on anxiety regarding various points. These include the fact that all the banks are engaged in the same type of operations in Japan. If in the future the banks all persist in engaging in the same kind of activities, eventually there will have to be a massive exodus from the banking sector due lack of profitability and this will become a problem threatening the stability of the financial system. If these practices under the old form of the mechanisms continue, and things are left in this state, moving the balance point will involve a major risk or at least require a very long period of time. Based on this kind of decision, the measures shown in Figure 3 were introduced to regulate the banking industry.

First is a reform of the "market structure." Based on the decision that there are too many banks, the authorities are seeking to make them merge or enter alliances. At the same time, they are also engaged in a reform of "market behavior." Here, the key words are "selection & concentration of business lines." However, first it is important to create an environment allowing action to enhance profitability.

Figure 3 Structure of Banking Reform



Source: Nomura Research Institute

In this respect, measures have been taken through deregulation to enhance the freedom of operations of firms such as the expansion of the operations scope of subsidiaries of securities companies and the sale of investment trusts at the bank's premises. However, if the pursuit of high return is only achieved through accepting high risk, this may lead to a re-inflation of an economic bubble or an increase in the instability of the banking system. Consequently, measures to control risk have been introduced, as can be seen in the introduction of the financial supervision manual. The measures taken to promote securitization improve the profitability of banking operations in the form of the securitization business. At the same time, as will be mentioned later, the promotion of securitization is useful in risk control. Thus, through these market structure and market behavior reform measures, Japan's banking sector is aiming to improve its economic performance, that is to say, the realization of a competitive financial service industry.

2) Changes in the Securities Market

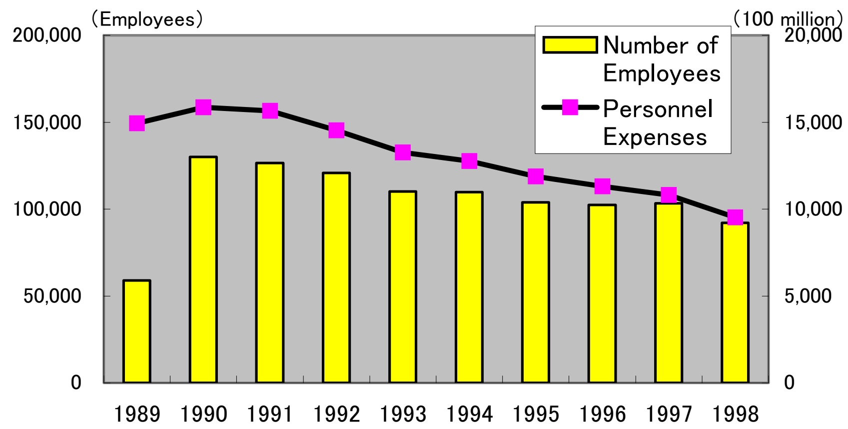
In terms of a change in the structure of the industry, in the securities sector drastic adjustments are already underway before policy-driven intervention occurs. For example, in the securities sector, the number of employees has decreased by 72,000 from 167,000 (as of the end of June 1991) at the peak period to 95,000 (as of the end of 1998). Compared to the peak, this is a drastic change down by 43%. Wages have dropped by about 30% from 1.3 trillion yen in the term to March 1990 to 900 billion yen in the term to March 1998. (Figure 4)

In addition to these quantitative changes, there are also qualitative changes occurring in the securities industry due to the effects of Japan's Big Bang. That is to say, in line with the switchover from a licensing system to a registration system, this has become an industry where there is much coming and going of players. Brokerage commissions will be completely deregulated. However, unlike Mayday in the U.S. and Big Bang in the U.K., the impact of this deregulation of commission is occurring amidst the background of an active upsurge in Internet trading and it will not be easy.

In addition, since December 1998, off-floor trading involving order execution by an individual brokerage firm (rather than going through a securities firm to place the order at the stock exchange) has become an everyday activity. Thus, the stock exchanges are also hurriedly implementing changes in their structures. Tokyo Stock Exchange abolished trading on the trading floor in April 1999. Changes, which just two years ago were unimaginable, are actually taking place.

Also, changes that were considered necessary for many decades but were never attained have been realized in one fell swoop. These changes include the abolition of the securities trading tax and the stock exchange tax, the implementation of public offering of TBs and FBs and the abolishing of withholding tax on government bonds for non-residents.

Figure 4 Personnel Expenses and Number of Employees of Securities Companies



Note: Personal Expenses are as of the end of March, and number of employees is as of the end of December.
Source: Compiled by Nomura Research Institute based on data from the Securities Dealers Association of Japan

3) Changes in Corporate Behavior

The changes in the financial system of Japan mentioned above naturally bring about changes in corporate systems. In particular, the effects of the changes in the banking system, an industry which has dominated fund procurement by the corporate sector, are very substantial. If the banks implement their plans to achieve sound management, they will also seek an improvement in the profitability of extending loans. However energetically public funds are pumped into the banks, the age of supplying sufficient funds to the corporate sector under a low spread is over. The cross holding of stock between banks and companies and among the companies themselves is heading for a reduction.

Thus, the corporate sector is placing more and more emphasis on financing strategies with a keen awareness of the potential of the securities market. In the market, accountability in management is required. The movement towards the introduction of international accounting standards is promoting this accountability requirement. Corporate governance is no longer just a subject for discussion. As has occurred in many other countries, in Japan too, the demand for governance can no longer be met by the voluntary efforts of companies, and more systematic demands are approaching. On April 2, 1999, in the name of the Governor, Tokyo Stock Exchange requested the listed firms to explain their commitment to an engagement in corporate governance and to submit future plans. This indicates that this kind of trend has taken concrete form in Japan, too.

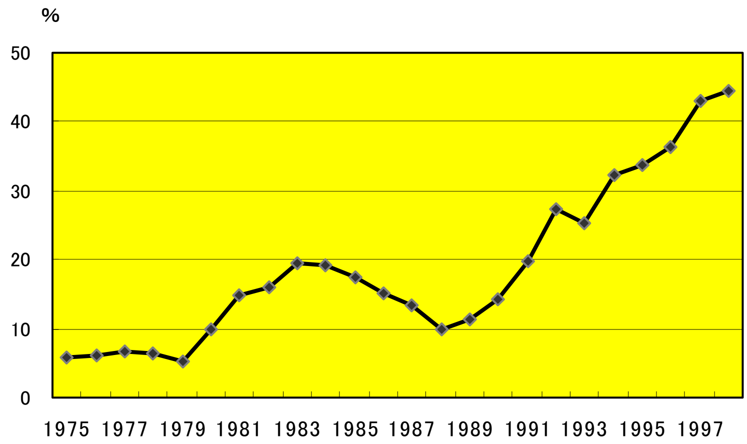
There is a rapid increase in the awareness of pension funds and management companies that they must place emphasis on fiduciary responsibility. Amidst this movement, there will be corrections in the practice of holding other firms' shares for the purpose of enhancing business relationship with them instead of investment performance. In addition, according to the media, many of the major asset management firms have declared a policy of placing emphasis on the exercise of voting right at shareholders' meetings.[2]

Another movement that should not be ignored is the active nature of investment by foreign investors. As shown in Figure 5, the trading share of foreigners in first section TSE trading (excluding broker-dealers' proprietary trading) reached nearly 50%. As can be seen in Figure 6, the share held as of 1997 was close to 10%. The increasing importance of foreign investors is making major changes in the way Japanese investors view and evaluate companies.

This phenomenon was also seen once in the past in 1967. As a result of the deregulation of capital flow, investment in Japanese stock commenced. At a time when emphasis was placed on dividend yield in the Japanese market, foreign investors brought in the viewpoint of growth of profits. This can be thought of as a revolution in valuation of share prices. At that time, Sony was a company that suddenly leaped into fame. Today, 30 years later, Sony is again attracting the attention of foreign investors. This time, this is not a question of profit growth but due to the announcement of far-reaching management restructuring. Subsequently, the stock price of companies which came up with thoroughgoing management reform plans were revised upwards due to buying by foreigners. Foreign investors are fixing their sights on how well Japanese firms can make drastic corrections of their excessive facilities and excessive employee levels which expanded during the bubble era, and correct the nature of the management which led to this state of affairs. We have entered an age in which management seeking to reach the status of a global firm cannot afford to ignore them.

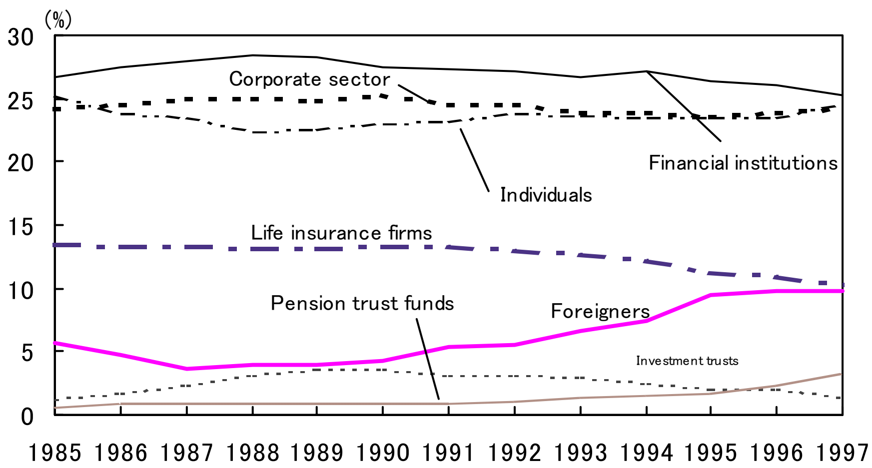
2 Article in the Nikkei Financial Daily of April 16, 1999.

Figure 5　Share of Foreign Investors (Trading value at the first section TSE, excluding broker-dealers' proprietary trading)



Source:　Tokyo Stock Exchange

Figure 6　Shareholders of listed Companies



Source:　Survey on stock distribution

3.　Is There Sufficient Impetus?

1) The speed of changes is the problem

As we have seen here, Japan's financial system including the banks and the securities market has achieved a clear change in direction. This has also caused a change in the direction being taken by Japan's corporate system. It is easy to be pessimistic, and when we look at the reality of the current economy, it would not be strange to reach the conclusion that there are no signs of movement. However, when a large ship changes course rapidly, it appears that it is not moving forward. But when the required direction has been reached, the ship moves forward to a new world at full speed. Before criticizing and saying that nothing has changed, it is necessary to look carefully at the truth of the changes in direction we have mentioned previously. The investors of the world first became aware of these changes and recognized them and then proceeded to buy Japanese stock. The problem is not whether changes have been made or not. Changes in direction have already occurred. The real problem is just how fast Japan can move forward. As to speed, the author feels the need for acceleration.

2) Problems Relating to Banks and Securities Companies

Let's first look at banks. In the previous edition of this journal, the author criticized that top management of Japanese financial institutions often shakes hands first before thinking about the details of the alliance.[3] Also, almost all the bank offices engaged in the sale of investment trusts simultaneously. This shows that the behavior pattern of acting in concert has not been cured. The adverse reaction of some banks to the financial supervision manual exposed a lack of awareness of global banking regulatory regime. These banks said that this is an age of splitting up companies and decentralized corporate decision making process, and so the requirement that the bank executive officers should be aware of all the risks is going back in time.

However, among those involved in finance in the U.S., there is an awareness that the division of responsibility in an organization is one of the factors that contributed to the expansion of the bad loan problem of the US financial institutions at the beginning of the 1990s. Based on reflection on this experience, in the U.S., both the public and private sector are engaged in strengthening risk control systems. This involves not only ALM which means looking at the assets and deficits on the balance sheet, but also the management of off balance sheet and equity capital. In this context, the demand is now for a shift to ERM (Enterprise Risk Management) and this involves total understanding of risk. This does not just mean the balance sheet, but includes all transactions. Aiming at splitting up the company or becoming a financial holding company without a clear improvement in the risk control systems is a one-sided approach. The plans vital to achieving sound management on the part of the Japanese banks are shown in Figure 7 and the paper in this journal by Mr. Shinichi Iimura. However, these plans are subject to the criticism of being insufficient compared to the restructuring implemented by other sectors.

In the securities sector, some small and medium sized securities companies wanted to ask the Securities Dealers Association of Japan to formulate a brokerage commission table to be used among them after the complete deregulation of these commissions. Whatever business they are in, the first step is to decide on the pricing of the products and services they sell. Thus, there are still firms in some parts of the securities sector that cannot achieve the most basic essentials required of a private sector firm.

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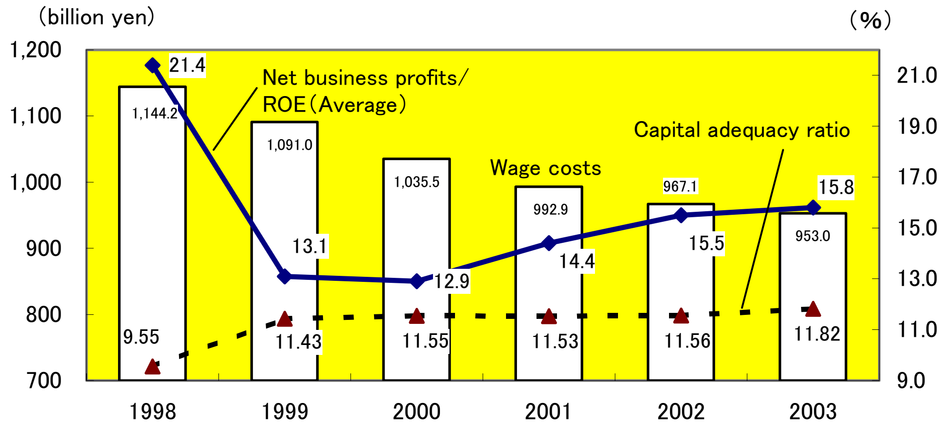
3 For details, see "Upsurge in Alliances and Mergers among the Financial Institutions" by Hiromi Hayashi and Yasuyuki Fuchita, *Capital Research Journal*, Winter 1999

Figure 7　The Plans to Achieve Sound Management of the Eight Major Banks Accepting Injection of Public Funds



Source:　Compiled by Nomura Research Institute based on the data of each bank

3) Problems related to the Corporate Sector

In the corporate sector, some of the major firms are openly asking the government for various forms of rescue measures. Debate on the subject of debt equity swaps has also emerged. However, in the U.S. debt equity swap is a method mostly used by companies which have declared bankruptcy or firm which cannot meet their payment commitments as a way of rehabilitating themselves. However, in Japan there is a strong tendency for debt equity swap to be considered as a method to effect an easy alleviation of debt burden without declaring bankruptcy or insolvency.

In Japan there is a problem in that the current procedure for corporate rehabilitation tends to make the continued existence of the firm difficult. However, debate on reform of the bankruptcy laws is already underway and is taking this problem into account. It is scheduled to propose a reform bill during the ordinary session of the Diet (Japanese parliament) in the autumn of 1999. In this case, even under the new laws, debt equity swaps should only be allowed under the strict supervision of the creditors and new stockholders.

In Japan, directors are often involved in day-to-day operations of a firm and there are few outside directors. But recently, many firms are turning some directors into executive officers. In 1997, when Sony first introduced this change it was emphasized that this was to strengthen the supervisory role of directors and to facilitate an independent check function. However, unlike in the case of Sony, recently the introduction of this system is being effected to streamline the board of directors and as a measure to counter lawsuits against directors mounted by the shareholders.

Thus, as we have seen, the systems of the Japanese financial and corporate sectors have both achieved changes in direction. However, there is still anxiety felt as to if they have enough impetus to move forward. This is the next area which global investors will fix their interest on.

4. Toward More Competitive Financial and Corporate Sector Systems

1) The most important basic rule for improving competitiveness

How seriously should we take the problems that still beset the competitiveness of Japan’s financial and corporate systems? The points that should be emphasized include the fact that when we use the phrase the competitiveness of Japan's financial and corporate sector systems, this no longer means advances are being made by Japan's convoy system nor by Japan Inc. To put it a different way, in addition to the fact that the direction of the ships has changed, the race among ships has also started using the rules of market forces. At the moment, there may not be major difference between the firms which have not achieved an adequate degree of course change and those which have made drastic changes in direction. However, in a few years time, these two groups of companies will be in totally different worlds.

It is not necessary to have concerns as to if the existing banks and securities firms will be able to achieve smooth development. There is a smooth flow of new entries coming into the market including foreign firms and firms outside the sectors. Thus, if the existing firms cannot adequately respond to the needs of the consumers and issuers, the new entry firms will do it for them. It is important to ensure that the mechanism of competition functions smoothly. There are frequent discussions on the subject of improving the competitive edge of Japan's financial and corporate sectors. However, if there is no competition, there can be no improvement in competitiveness. It should be considered that the most powerful measure to improve competitiveness is measures to promote competition.

2) Reform of the Risk Capital Supply Structure Is Needed

Although this is a major measure, the Japanese government must also place emphasis on a reform of the risk capital supply structure among other measures. The most important reason for Japan to be plunged into this crisis is the fact that an industrial financing mechanism existed which was heavily biased towards borrowing from banks under the convoy system. Fund procurement by the corporate sector has reached 862 trillion yen, while the value of cash and deposits, trust funds and insurance held by individuals amounts to 1,118 trillion yen. That is to say, this means that from viewpoint of the overall economy risky investments by firms are financed by instruments with no risk or almost no risk perceived by fund providers. (Figure 8) The banks and insurance sectors played the role of filling the gap and connect the corporate sector and the individuals. The risk existing in the economy of this nation is almost all being borne by the banks and insurance sectors and this led to the inflation of the economic bubble and its subsequent bursting.

Consequently, it is important that the overall economic structure should bear the risk associated with the investments by companies rather than just the banks and insurance sectors. Thus, it is essential that the fund procurement activities of companies should shift from borrowing to issuing securities to the public market. Naturally, companies have issued securities up to now. However, a large proportion of this has been held by the corporate sector and banking and insurance sectors as cross holdings or policy investment and this did not lead to real risk dispersion. A revitalization of the securities market is necessary in accordance with the reduction of cross holding and policy investment. In addition, it is necessary to promote the securitization of the credit of banks, etc. as well as that of corporate assets and real estate.

The revitalization of the securities market is an urgent objective not only from the viewpoint of risk sharing but also from the following aspects.

1) The banks are now gradually rationalizing their loans to corporations, which necessitates firms to seek for alternative ways in funding.

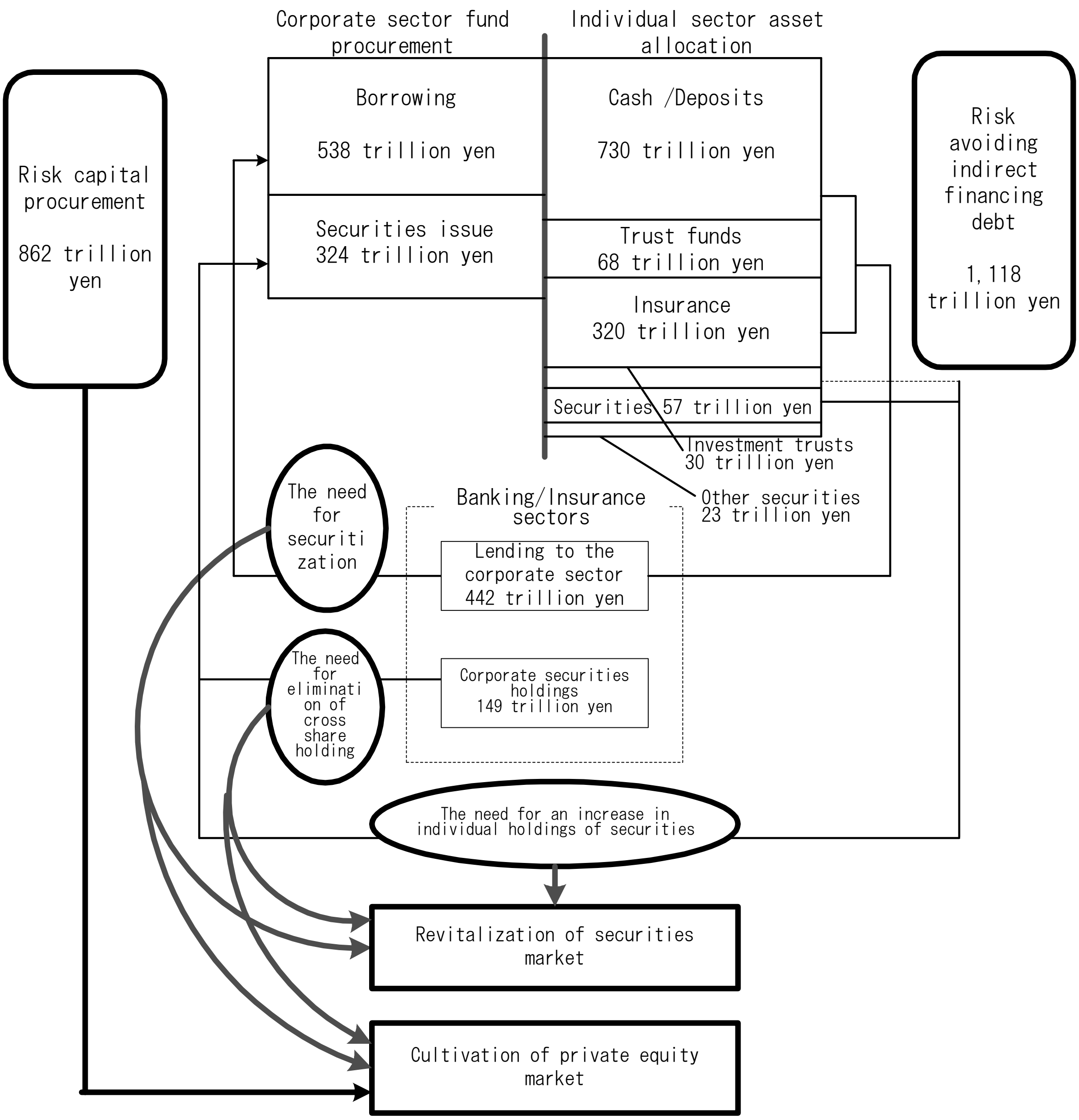
2) Under the market mechanism prevalent in securities market, the investors will be more selective and larger amounts of low cost funds are supplied to prime firms. As a result, in the overall economy, a mechanism is at work under which innovative companies achieve development and advances and the reform of companies is also promoted and firms that do not engage in reform become extinct. As a capitalist country, Japan should ensure that this natural selection working through market mechanisms is functioning. Moreover, as far as possible it is desirable to avoid a mechanism of selection or rescue of companies by the state.

3) The functioning of governance through the securities market also results in the promotion of the selection of firms and the reform of management.

4) It is only when an excellent stock market exists that stock options function as an incentive to employees, management and for the revitalization of the economy.

5) Japan has reached the state of its second massive issuance of government bonds. To insure that these government bonds do not crowd out industrial financing, it is essential to form a stock market in which individuals and overseas investors actively participate.

Figure 8 The Necessity for a New Risk Sharing System



Note: the amounts shown are as of the end of September 1998
Source: Flow of funds, BOJ/Nomura Research Institute

3) Problems Remaining in the Securities Market

The revitalization of the securities market has already been accomplished to a considerable degree by the reforms introduced in line with Japan's Big Bang. However, there are still problems to be solved. For example, the U.S. is aiming to achieve T+1 by June 2002 through the efforts of both the public and private sectors. However, Japan is almost totally lacking in an awareness of this problem. Problems such as the settlement risk of the securities market is an area where far more public sector intervention should be implemented and it should not be left to free competition. If Japan does not immediately take action, by the beginning of the 21st century, Japan's securities market will be considered as a market posing high settlement risks compared to the European and US markets which will have already switched to T+1. It is necessary to rapidly effect thoroughgoing reforms in the securities settlement infrastructure in Japan.

In addition, there are many things still left undone such as a reform of CPs, tracking stock issuance, promotion of the utilization of SPC and the introduction of real estate investment trusts (REITs). The necessity of these developments has frequently been stated, but mostly they have not yet been realized. In Japan, there are two factors causing a delay in the revitalization for the securities market. One is the need to start from the reality that indirect financing is far superior. In addition, there is a strongly rooted preference in Japan to engage in risk avoidance savings behavior that is promoted by the entire economy as can be seen in the idea of postponing the termination of unlimited government guarantees of deposits.

4) The Significance and Limitations of Private Equity

In terms of the supply of risk capital, it is not enough to utilize the normal securities market in which there is a high degree of liquidity and where information is readily available. If we look at the U.S. where the securities market is extremely well developed, the recent dynamism in the U.S. economy is supported by the generation of venture companies such as the Internet-related firms and the drastic corporate acquisitions, mergers and restructuring going on. In terms of funding, these are all promoted to a considerable extent by the existence of a mechanism of investing in areas without liquidity and lacking in information, which is known as private equity, rather than funding through the ordinary securities market. Through this route it becomes possible to supply risk capital to the high-risk high-return sectors which cannot be covered by the normal securities market.

There are already important developments in Japan in terms of measures to promote the private equity market such as the enforcement of the Limited Partnership Act for Venture Capital Investment, venture capitalist training and debates on the changes in the system to promote smooth management buyouts.[4]

However, private equity is basically an area of high-risk and high-return. The investment of funds in private equity requires a higher IRR than ordinary investments. Conversely, for the side which receives the investment, in order to achieve a high hurdle rate, they are required to achieve a significant increase in cash flow. In the U.S., entities able to receive fund injections from venture funds are a very small group of extremely elite venture firms. Thus, an economy will not be rapidly revitalized by this mechanism alone.

In most cases in Japan, unless there is a considerable degree of restructuring an adequate return will not be forthcoming for the buyout funds. This restructuring is a logical move for each individual firm. However, seen from the macro viewpoint, it leads to an increase in deflationary pressures and it can also lead to increasing the overall difficulties corporate sector. Thus, the promotion of private equity is extremely desirable. However, we should not pin excessively high hopes on this area.

At the beginning of the 1990s, a study was conducted to boost the competitiveness of U.S. firms by Harvard Business School and the Council on Competitiveness over a period of several years. According to the report, management buyouts increase the influence of the

4 For details, see “Private Equity Market in Japan" by Yasuyuki Fuchita, *Capital Research Journal*, Summer 1999

investors over the firm involved and the system has the merit that the institutional investors who seek short-term investments do not affect management. However, the study points out that the motive of the investors is to generate profits through the transaction and not the long-term prosperity of the firm. The hurdle rate for investments by firms is raised, and as a result, there is a drop in the real investment rate.[5]

5) Public Sector Mechanisms to Supply Risk Capital

In terms of the supply mechanism for risk capital, the securities market still has only a minimal role to play and there are still many unsolved problems. Even if the securities market were to be adequately revitalized, unless there is development in the private equity market too, adequate risk capital will not be generated. However, as already mentioned, there are limits to the private equity market. Thus, it is well worth considering the introduction of some form of public sector mechanism which both avoids hampering the market's competition as far as possible and also promotes the supply of risk capital.

Various measures can be envisioned to revitalize the securities market such as public sector organisms making some sort of commitment and promoting the securitization of lending and investment in high yield bonds. Regarding measures that would lead to the promotion of a private equity market, various measures have already been introduced in Japan to support venture companies. However, there is still plenty of leeway to consider measures leading to the cultivation of private equity funds which perform an important role on the private equity market.

The reason for this is there are almost no Western-type private equity funds in Japan, and the firms needed to manage such funds are still only at the venture company stage. In this case, it is also important to not limit things to venture capital, and to have the vision to support mechanisms which promote the restructuring of Japanese companies such as buyout funds and mechanisms to deal with bad debts and bad asset problems such as distressed funds. Through such support, we can expect to assist the revitalization of the economy through the supply of risk capital within the framework of private equity even in cases in which IRR on the high level required by normal private equity cannot be expected.

Public sector mechanisms to supply risk capital are not rare overseas. The FPCR (Fonds Public pour le Capital Risque) established in France in July 1998 is quite literally a public fund existing to supply risk capital. This FPCR was established by an investment of 600 million dollars by the Government of France (by dipping into France Telecom privatization funds) and 300 million dollars invested by The European Investment Bank. It is a scheme in which investment is made in funds managed by private sector venture capital firms. However, it must meet various conditions such as investing 50 or more percent of the fund in French companies that are in sectors considered to be innovative within seven years of its creation. From its inception up to the present time, it has invested 400 million franc in 10 different funds.

5 For details, see Porter, M. *Capital Choices: Changing the Way America Invests in Industry*, A Research Report Presented to the Council on Competitiveness and Co-Sponsored by the Harvard Business School, 1992

In Japan, it would be better not engage in debates inside the administration and some of the related financial institutions on the subject of easy rescues of individual companies or individual industries. Rather, Japan should aim at the cultivation of venture companies, support the buyout of large firms, take measures to promote the liquidity of bad debts and bad assets, and promote the private equity market.

For this, it should plan a scheme involving a "public sector fund for risk capital" which utilizes the know-how of private sector investment bankers, corporate analysts, consultants and private equity firms to the full. This would be far more concrete and effective.

Conclusion

An improvement in the industrial competitiveness of Japan will not be achieved by a reform of the financial and corporate sectors alone. When the problem of competitiveness emerged in the U.S., extremely comprehensive measures were discussed. At the beginning of the 1990s, in America it was said that the U.S. was going into decline. According to public opinion surveys conducted at the time, there was a sharp decline in the response to the question of whether the respondent thought that his/her children would enjoy a better lifestyle than themselves, down from 59% in 1989 to 34% in 1992. Under this climate, the Council on Competitiveness was set up as an advisory committee to the federal government and various discussions were held. The Competitiveness Policy Committee was also set up under an initiative of the private sector due to anxiety about the competitiveness of the U.S., and it engaged in joint research with Harvard Business School. A committee of the Senate on banking, housing and urban issues held hearings on the US. Economy and the position of the U.S. in terms of international competitiveness, and the policy committee of the Democratic Party announced an economic leadership program. During a six-month period in fiscal 1992 it is said that 547 bills on boosting competitiveness were presented to congress. Looking at the themes taken up by the Council on Competitiveness, we can see that the range was very broad including savings and investment, education and training, technology, corporate governance and the financial markets, medical costs, and trade issues.

In one sense, it may well be that, seen from a broad perspective, measures to improve the competitiveness of Japan were discussed including the six big reforms conferences during the Hashimoto administration and the Conference on Economic Strategy. Thus, the next important requirement is for leadership to integrate the various debates and theories, coordinate the various proposed reforms and implement them.

Another lesson that can be learnt from the U.S. is to carefully avoid picking winners and losers, that is to say avoiding the situation in which the state selects the industry and firms it will support, and firmly maintaining the stance of placing utmost emphasis on market forces.

Looking back on the 1990s, in spite of the fact that the decade started with a massive chorus chanting the mantra that the U.S. was going into decline, the United States was able to climb back and achieve the longest boom in its history. Moreover, the boom has continued up to the present time. Things have improved to such an extent that today the U.S. is considered to have recovered to become the most powerful nation in the world.

The thing that has changed most during this period is that the U.S. government was able to implement a thoroughgoing solution to the banks' bad debt problem through the RTC (Resolution Trust Corporation) and bring the national budget into the black. Another achievement is the continuing efforts in the form of reforms in the education field. However, if these achievements are excluded, there are no other examples of major achievements in implementing the government intervention measures discussed to boost the economy. Basically, it is the private sector that has made the efforts and implemented the restructuring required. At the same time, the U.S. earnestly adopted the good points of the business models provided by outstanding Japanese companies, etc.

The root cause of the problems faced by Japan today is that market forces did not adequately function. The market is not all-powerful, and some policy intervention can be justified. Nevertheless, I hope that efforts will be made to solve these problems without losing sight of the necessity of introducing market forces, and that is the major course that Japan must take. We must studiously avoid putting off the solution of the bad debt problem and the introduction of measures that would lead to a worsening of the budget deficit situation.