A Blueprint for the Future of Japan's Financial System

Yasuyuki Fuchita

1. Producing a Medium-Term Blueprint for Japan's Financial System

In their joint policy document "Measures to Boost the Economy," published on 17 June 2002, the government and the ruling Liberal Democratic Party agreed the following measures to reinvigorate and stabilize the country's financial system: (1) to press ahead and resolve the bad loan problem; (2) to reform the country's securities markets; and (3) to stabilize the financial system and produce a medium-term blueprint for its future.

Similarly, the policy document "Basic Policies for Managing and Reforming the Economy,"[1] approved by the Cabinet on 25 June, talks about "reforming the capital markets " (Section 2: Strategy for Reinvigorating the Economy) and sets the following four objectives for financial policy: (1) to resolve the bad loan problem once and for all and help the corporate sector to recover; (2) to stabilize the financial system; (3) to reform the country's capital markets; and (4) to produce a medium-term blueprint for the financial system.

In the debate about the country's financial system the issues of how to resolve the bad loan problem, how to help the corporate sector to recover and how to reinvigorate the country's capital markets have constantly appeared in recent years, and a number of policies have been adopted to deal with them. These issues are also identified as policy objectives in the above two documents. Of particular interest this time, however, is the decision to produce a medium-term blueprint for the financial system.

One cannot help feeling that the debate about Japan's financial system has been dominated by pressing issues such as the need to resolve the bad loan problem. However, it is possible to argue that short-term problems can only be dealt with properly once more general policies (such as how to organize and control the financial system) have been decided, as the approaches adopted need to be compatible.

---

1 This is also known as the "Second Set of Basic Policies" (the "First Set" having been published in June 2001).

Moreover, public concern about the financial system would appear to extend beyond immediate issues (such as how to resolve the bad loan problem and whether the country faces a financial crisis) to a more general concern about the medium- to long-term future of the banking system and such everyday essentials as deposits, loans and remittances.

Therefore, although the decision to produce a medium-term blueprint for the financial system is welcome, it is perhaps unfortunate that it was not made sooner.

2. The Report by the Minister for Financial Services' Study Group

1) The debate at the heart of the medium-term blueprint

This is not to say that there has been no debate on a blueprint for the future of the financial system before. The Minister for Financial Services' Study Group on a Blueprint for the Future of Japan's Financial System has met on 10 occasions since October 2001[2] and it presented a report (entitled "A Blueprint for the Future of Japan's Financial System") to the Minister, Hakuo Yanagisawa, on 12 July.

As the study group is an unofficial body, the report is simply a compilation of its members' freely expressed views. However, now that it has been decided that producing this blueprint should be a matter of national policy, the Financial Services Agency, with the help of the Financial System Council, will have to do this as quickly as possible, using the report as a starting point.

In order to understand the arguments in this debate, we shall now take a look at the views expressed in the report.

2) Shifting from an industry-based to a market-based financial model

The report's basic premise is that financial intermediation in Japan is shifting from a system based on deposit-taking and lending (i.e., an industry-based financial model) to one based on prices formed in the marketplace (i.e., a market-based financial model).

---

2 The study group's 18 members consisted of university professors, economic commentators, media representatives, company representatives, consultants, bankers, life insurance company representatives and financial researchers, including the author.

The reason for calling Japan's traditional financial system an industry-based financial model is that priority was given to the corporate sector when allocating scarce capital. The main source of capital was bank lending instead of securities markets.

When Japan was going through a period of rapid economic growth from the end of the Korean War to the First Oil Crisis, it was able to use the same business model as the other industrialized economies it was trying to catch up with, and it is generally accepted that this enabled Japanese companies to invest aggressively without having to expose themselves to the same degree of risk as their rivals in these economies. For their part, banks lent to companies on the basis not so much of specific project risk but of general credit risk (with a particular eye to the growth prospects of the companies concerned). At the same time, banks would cement these relationships by (1) holding borrowers' property as security, (2) taking an equity stake in them and (3) demanding positions on their boards.

This model should have changed after the First Oil Crisis when this period of rapid economic growth ended and Japan's leading companies found themselves on the front line of international competition, facing all sorts of risks. With plenty of retained earnings, they were no longer dependent on the banks. However, in the process of shifting their focus from lending to big companies to lending to service companies and for property transactions, the banks retained their old business model of relying on relationships and security in the form of property.

As a result, the banks found themselves with a mountain of bad loans when the boom of the late 1980s turned to bust in the early 1990s. The banks therefore need not only to dispose of their bad loans but also to change their business model (one of the causes of the problem) as soon as possible.

If the banks are to change from an industry-based to a market-based financial model, they will have to take more account of financial markets. That is why the report emphasizes the need for them to take account of credit risk and return on equity when setting lending rates. Nor is the problem solely one of lending practices. Banks also need to reconsider the way in which they offer services at unprofitable margins as this violates the principle of proper price formation.

The report also emphasizes the need for public-sector financial institutions to reconsider their lending practices if private-sector institutions are to set fees and lending rates at market levels.

3) The need to make greater use of securitization and to reform Japan's capital markets

While it is particularly important for banks to allow for credit risk when setting lending rates, that in itself will not be enough if they are to solve all the problems inherent in the industry-based financial model. Basically, the risks that Japanese companies now face are both more serious and more varied than when they were still trying to catch up with their foreign rivals. It would be unrealistic for them to expect to be able to rely too much on the banks not only to assess but also to manage and bear these risks.

Financial intermediation therefore needs to encompass the markets as well as deposit-taking and lending, with risks also being assessed by the market and spread thinly and widely in the form of securities among a broad range of investors.

The report therefore emphasizes the need to expand both the traditional capital markets and the markets for securitized products. If the market for securitized loan assets can be expanded, credit risk can be borne by investors rather than just the banks. Similarly, it has been pointed out that this market can serve to bridge the gap between the corporate bond market and bank lending.

If these markets are to expand in this way, however, the reforms to Japan's capital markets that began with the Big Bang program must be taken one step further. The report therefore advocates the creation of one-stop shops for deposits, insurance, investment trusts, bonds and equities in order both to expand the scope of market-based finance and to improve customer service. Meanwhile, as a near-term measure under the current system, the report recommends that firewalls should be lowered so that banks and securities brokers can open their counters in the same premise.

In addition, in connection with distribution channels, it recommends that the following areas be reviewed: the provision of comparative information on investment products; the solicitation methods used by registered representatives; and the methods used to sell investment trusts.

In connection with other areas, it mentions the following issues: lifting the ban on discretionary trading accounts; issues to do with stock exchanges; relaxing the requirements on private placements aimed at professional investors; and reforming the government bond market.

4) The need for financial intermediaries to shed some of their functions and be more specialized

The transition from an industry-based to a market-based financial model would also break down some of the traditional barriers between different types of financial intermediaries. The report points out that, as securitization progressed, banks would come to depend less on holding loan assets in their portfolios and more on their ability to form loan syndicates, while the function of bearing credit risk and the back-office function of securitization might be split off. The creation of one-stop shops would also blur the distinction between different types of financial service companies (e.g., banks and securities companies). Similarly, the report alludes to the possibility that financial service companies could split into separate "manufacturing" (i.e., product creation) and "service" (i.e., marketing and IT) operations, while settlement services could become independent operations.

The report also points out that, if the various functions of financial intermediaries are to be split off, financial service companies will have to change their traditional approaches to personnel and organization while the agencies responsible for regulating and supervising these companies will have to focus more on separate functions than on separate types of company.

Although the study group did not reach any conclusions about how to deal with the bad loan problem, the Minister's attitude was consistently that of respecting corporate independence and of wishing to minimize interference by the authorities. For example, he was cautious about issues such as the use of public money to recapitalize ailing financial institutions and the exercise by the government of the voting rights it has acquired in such institutions. This attitude applied not only to the bad loan issue but also to the report's basic premise—that banks need to change their business model. In other words, the report's emphasis on the importance of such a change has not been matched by any government commitment to put this into practice.

3. Points That Need to Be Remembered When Producing a Medium-Term Blueprint: (1) The Need to Restore the Financial System to Health

The above is an outline of the study group's report on a medium-term blueprint for the future of Japan's financial system. The report represents the views of all its members, and there are many issues on which it was impossible to reach agreement. The author, who was just another member of the group, therefore agrees with some aspects of the report but not with others, while there are some aspects he feels were not dealt with adequately. He would therefore like to take this opportunity to give his own views about the points he feels need to be remembered when producing an official medium-term blueprint for Japan's financial system, taking the report as a starting point.

1) Need, above all else, for the financial system to be nursed back to health

The first thing that should be emphasized about producing an official medium-term blueprint for Japan's financial system is that the main concern, both in Japan itself and overseas, is how Japan is going to resolve its bad loan problem and restore its financial system to health.

Some may take the view that a whole range of measures to restore Japan's financial system to health have already been adopted (e.g., the decision to dispose of the bad loans and the decision to introduce a new inspection system) and that, provided these measures prove successful, the situation should, in the medium term, improve. In other words, although this may be the most serious problem facing Japan at the moment, the issues have already been thrashed out and appropriate action taken; so, in the medium term, the problem should be resolved. Those who take this view therefore believe that it would be a waste of space for a medium-term blueprint for Japan's financial system to concern itself with short-term problems such as this.

In the author's opinion, however, this view is mistaken—for two reasons. First, even if considerable progress is made in setting up an inspection system to identify bad loans and in provisioning for and writing them off, the problem will remain unless its structural causes are also addressed. The "structural causes" of the bad loan problem are the fact that Japanese banks continue to lend at rates that do not reflect the risks involved and the fact that the profit structures of these banks are fragile. Therefore the issue that a medium-term blueprint for Japan's financial system needs to address is how Japanese banks should change the way they do business.

Second, even if the issues of unrealistically low lending rates and fragile profit structures were resolved, it would not restore the banking system to health. This is clear from the fact that even in the United States, where bank lending rates do reflect risk and where profit structures are much sounder than in Japan, the Federal Reserve still has to spend a considerable amount of its time trying to ensure that the banking system remains sound. It is therefore particularly important that Japan, which has experienced a more serious banking crisis than any other industrialized economy, takes into account the efforts of regulators in other countries when trying to establish a framework of its own for ensuring the soundness of its banking system.

2) Specific measures needed to help banks change their business model

The fact that the report's basic premise is that the banks need to change their business model is to be welcomed for the first of the two reasons we have given above. However, the problem is how to change this model.

Unfortunately, the report simply leaves this to the efforts of individual banks. Such a half-hearted approach is hardly guaranteed to ensure that these efforts are successful.

It should be the responsibility of the financial authorities to intervene on behalf of the banks to help to restore them to health. However, the report records the Minister's view that the banks should, as far as possible, be left to put their own house in order as the authorities do not have the know-how to run a bank.

While such a view may be correct in the case of a normal private-sector company, banks require a greater degree of public intervention—as is reflected in the fact that governments require them to be licensed. Moreover, most of the leading banks in Japan have received injections of taxpayers' money. It is therefore only right and proper that such banks should be subject to a greater degree of public intervention than normal banks. However, the Minister has shown himself to be extremely reluctant to do this—as illustrated by the fact that he has not shown any willingness to make forceful use of the government's right to vote as a shareholder in these banks.

While it is quite correct to say that the authorities do not have the know-how to run a bank, what depositors need is a financial regulator that is willing to exercise its right as a public shareholder to ensure proper governance. This is not to say that the regulator should attempt to run the banks on a day-to-day basis.

In South Korea, one of Japan's neighbors that has experienced a financial crisis in recent years, the government showed strong initiative in one respect: by replacing the management of troubled banks with capable outsiders. The new management then became responsible for ensuring that the banks were restored to health.

The report records that it was the consensus of the study group that it was not the job of the authorities to set each bank a precise target (in terms of return on equity or return on assets) and to bring in a new management team if a bank was unable to meet its target. In the author's view, however, while it may or may not be desirable to set banks a precise target, simply leaving them to manage for themselves will not make it any easier for them to change their business model and possibly even threaten the chances of restoring the financial system to health. One of the key questions in producing a medium-term blueprint for the financial system will be to what extent the authorities are able to come up with detailed policies on this issue.

3) Need to consider the shape of a new financial system and a new regulatory framework

There is also a need to consider the second point raised above. In other words, even if Japanese banks did succeed in changing their business model, the question how Japan, like other industrialized economies, could reduce the risk to its financial system would still remain.

At the study group's first meeting on 1 October 2001 the Minister indicated that the decision to produce a medium-term blueprint for the financial system was motivated by similar decisions in Britain and the United States.

The US blueprint the Minister was alluding to was presumably the report by Robert E. Litan and Jonathan Rauch that was commissioned by the US Treasury at the behest of Congress,[3] while the UK blueprint was presumably the Cruickshank Report, written for the Chancellor of the Exchequer, Gordon Brown.[4] Both reports focus on (1) the need to maintain a sound financial system and on the special status that this confers on banks and (2) the need to strike a balance between this special status and the need to make financial service companies (just like normal private-sector companies) more efficient (by encouraging competition) and more customer-oriented.

In the past, many countries imposed tighter controls and offered more protection to banks than to normal private-sector companies because of the supposed need to ensure the soundness of the financial system. More recently, many of these regulations have been eased in the name of deregulation. However, this has not been at the expense of the soundness of the financial system. Deregulation has taken place because it has been felt that, just as regulations and protection may not have been the best way to maintain the soundness of the financial system, they may also have hindered competition unnecessarily.

No definitive solution to this dilemma has been found by any of the industrialized economies, so it is only right that Japan (like Britain and the United States) should redouble its efforts to find one.

---

3 Robert E. Litan with Jonathan Rauch, *American Finance for the 21st Century*, The United States Department of the Treasury, November, 1997.

4 Don Cruickshank, *Competition in UK Banking-A Report to the Chancellor of the Exchequer*, The United Kingdom for the Stationery Office, 2000.

While the study group's report suggests that firewalls should be lowered as one way of improving efficiency, it has no precise and specific suggestions how the financial authorities should set about trying to deal with the existing bad loan problem and the need for banks to change their business model, although it does recognize these as important issues.

If anything, the report gives the impression (as suggested by its emphasis on leaving banks to manage for themselves) that the authorities are reluctant to take any action. Moreover, it has little to say about the basic issue of how to maintain the soundness of the financial system—an issue that will remain even if the bad loan problem is solved and Japanese banks succeed in changing their business model.

If, in such a situation, progress is confined to promoting one-stop shopping of financial products and neither the bad loan problem nor the business model problem is solved, the risks to the financial system as a whole may even increase.

4. Points That Need to Be Remembered When Producing a Medium-Term Blueprint: (2) The Position of Smaller Financial Institutions

1) LCBOs versus SSBOs

As we have seen, the first thing that is needed when producing a medium-term blueprint for the financial system is a full airing of the arguments about how to maintain the system's soundness. The next thing that is needed is some indication of how to make the system more efficient and more customer-oriented.

In its indication of what a blueprint for the future of Japan's financial system would look like, the report gives top priority to the need to facilitate economic growth and improve customer service. In addition, the report mentions as one of the key areas of reform the desirability of being able to offer one-stop shopping (either directly or, at least, indirectly via in-store agencies) for products such as deposits, insurance, investment trusts, bonds and equities, provided this does not compromise the soundness of the financial system.

However, what people in Japan want from their banks more than anything else is not the ability to buy a wide range of financial products but the reassurance, for example, that their deposits are safe and the banks' computer systems working properly. In other words, they want to be able to take the most basic banking services for granted. For their part, what the authorities need to produce is a blueprint of how these basic services can be provided in a way that increases customer satisfaction.

As we have also seen, the way in which financial service companies are becoming increasingly specialized is making life increasingly difficult for the financial authorities. This is the result not only of the growth of financial engineering but also of the spread of financial conglomerates and an increasing number of mergers and acquisitions.

Financial authorities have a name for such financial conglomerates: "large complex banking organizations" (or LCBOs). Trying to regulate them is a nightmare. As well as deciding how to deal with them, financial authorities need also to consider, in view of the problems they cause, how far they should allow such organizations to develop without a good reason.

The development of LCBOs in Japan (see below), which would appear to be a deliberate government policy, therefore needs to be the subject of much more debate.

First, Japanese banks continue to move into new business areas. For example, in December 1998 they began to sell investment trusts directly to their customers (i.e., not via subsidiaries), and sales have gradually increased. In October of this year they will start selling life insurance policies directly. In addition, the report recommends that firewalls should be lowered to allow banks to sell equities in the same way.

While one can understand this as a way of extending the benefits of deregulation or of increasing investor access to Japan's capital markets by increasing the number of channels for distributing equities, allowing banks to move into new business areas in this way also means that their operations are becoming complicated to an unprecedented degree.

Second, Japanese banks are tending to become ever bigger. Although the report says that it is a mistake for local financial institutions to regard mergers as a cure for all ills, the attitude of the authorities tells another story. Many of the larger banks have already merged, but the policy of the Financial Services Agency is to encourage smaller banks to follow suit. An example of this is the policy document "Strengthening Japan's Financial System" which the Agency published in April of this year. In it the Agency called on the country's financial institutions to improve their profit structures in order to strengthen the country's financial system and for prompt action (especially mergers) to enable local financial institutions, in particular, to lend more to smaller companies, thus making mergers between financial institutions one of its main policies. This was followed on 10 July by a policy document "Encouraging Mergers, Especially among Local Financial Institutions" with proposals for more specific action.

Figure 1 shows the distribution of Japanese financial institutions according to their total deposits (in terms of the number of banks and their percentage share of total bank deposits), while Figure 2 shows the distribution of US financial institutions according to their total deposits. It is clear from the figures that there are many Japanese banks that are much bigger than any banks in the United States and that these giants have a very big share of total bank deposits. Moreover, the fact that these banks have an overwhelmingly large share of the financial system as a whole and are all saddled with bad loans means that they have a major negative impact on it.

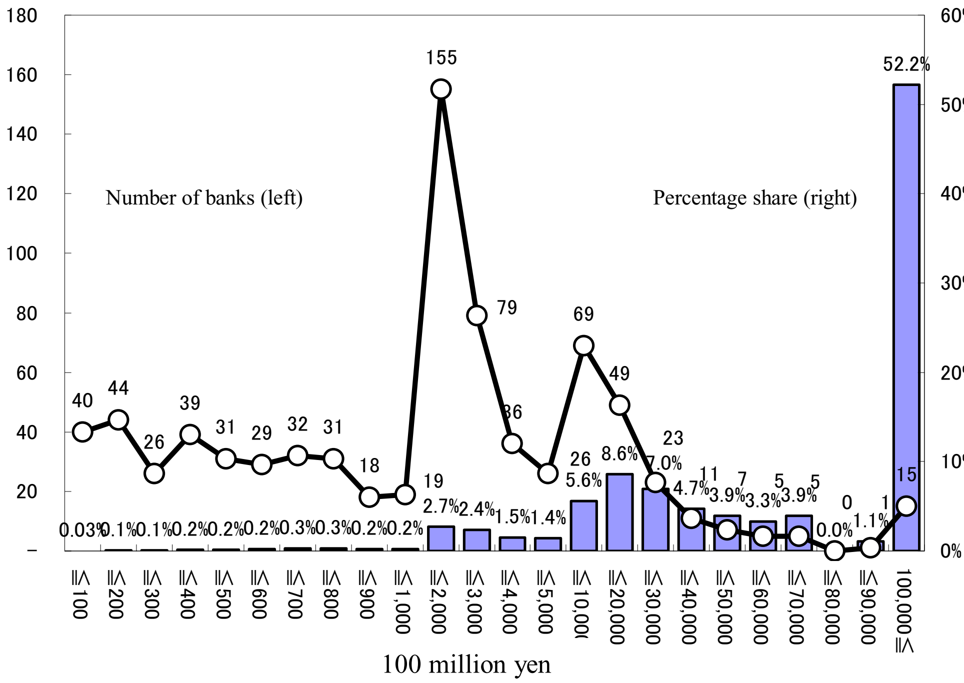
In contrast, there are nearly 5,000 community banks in the United States with total deposits of less than $100 million. Although mergers have reduced the number of such institutions, their distribution pattern (i.e., the smaller the figure for total deposits, the greater the number of institutions) remains basically the same.

These institutions, which have close ties with their local communities and provide basic banking services such as payments, deposits and basic loans and fund management, could be called "small simple banking organizations" (or SSBOs).

The policy of the financial authorities in the United States has basically been to limit the spread of the power of the country's leading financial institutions. Similarly, their cautious pro-competition merger policies have prevented individual institutions from capturing too large a share of the local market. Their traditional bias in managing the financial system has therefore been towards SSBOs rather than LCBOs.

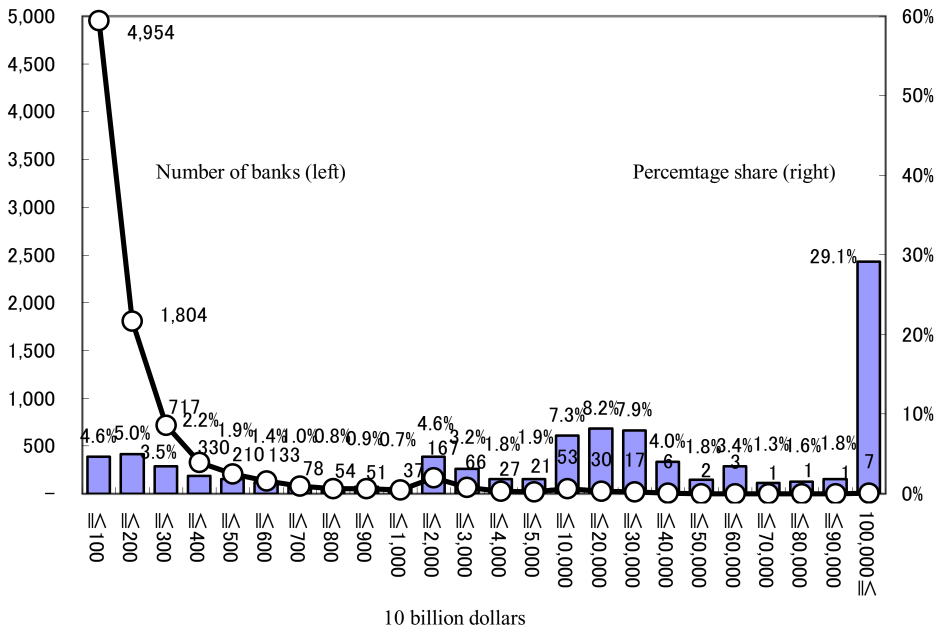
In Japan, on the other hand, financial crises and the economic controls of the Second World War have reduced the number, but increased the size, of the country's financial institutions.

Figure 1 The Distribution of Japanese Financial Institutions According to Their Total Deposits (as of end-March 2001)



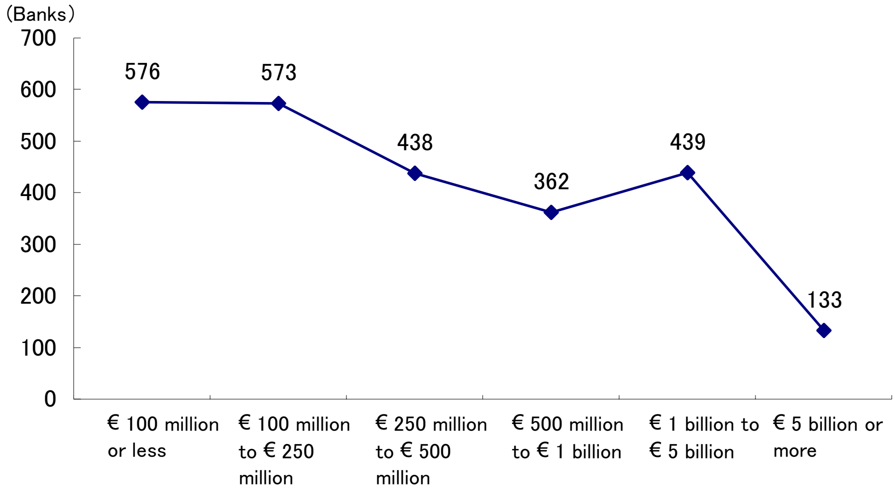
Source: Japan Financial News Co.

Figure 2 The Distribution of US Financial Institutions According to Their Total Deposits (as of end-2001)



Source: Federal Deposit Insurance Corporation.

Figure 3 The Distribution of German Financial Institutions According to Their Total Assets (as of end-2001)



Source: Deutsche Bundesbank.

It is ironic that, whereas during other periods of structural reform Japan has tended to make much of the fact that it has adopted US-style systems, this time it should be adopting a policy of promoting LCBOs—in complete contrast to the US financial system with its plethora of smaller financial institutions.

Figure 3 shows the distribution of financial institutions in Germany. Although there are not as many small financial institutions as in the United States, there are far more than in Japan. Japan's financial system would appear to have developed in a highly unusual way compared not only with the system in the United States but also with that in Germany.

Japan would do well to consider adopting a more US-style approach by fostering the development of SSBOs that would provide basic but reliable payment, deposit and asset management services and support the local community and local businesses—not just to improve customer service but also to create a sounder financial system—even if it does not go so far as to restrict SSBOs to narrow banking.

Any medium-term blueprint for Japan's financial system will have to make a clear choice between whether to continue to favor LCBOs or to pay more attention to SSBOs.

2) Need for a blueprint for smaller financial institutions

There are a number of reasons why the role of smaller financial institutions within the financial system as a whole—in addition to the main objective of trying to stabilize the system (see above)—needs to be defined more clearly.

For many small local businesses small local financial institutions are a lifeline—part of the national infrastructure, as it were. As we have seen, Japan's financial authorities are encouraging these institutions to merge. We therefore need to consider whether this action threatens to change the role these institutions play in their local communities.

Empirical studies carried out in both Japan and the United States indicate that bank mergers tend to reduce the share of loans to small businesses.

The above suggests that the policy of encouraging smaller financial institutions to merge may have a negative effect on loans to small businesses. There is a risk that this policy could reinforce the trend towards LCBOs in Japan, where, as we have seen, there is already more of a bias towards big banks than in the United States. The existence of such risks raises the question whether there is really any reason to encourage banks to merge. The usual reasons given are the following.

First, mergers are supposed to make banks less vulnerable to economic downturns and more profitable. However, there is no evidence from any of the empirical studies that have been carried out in Japan, Europe and the United States that mergers do make banks more profitable as a result of economies of scale or scope.

Second, there is supposed to be a need to stabilize the banking business by reducing the number of banks and easing the overcompetition caused by "overbanking."[5]

The first thing that needs to be said about this argument is that "overbanking" refers not to the number of banks but to the fact that too many loans are made at unprofitable margins.

As we have seen, there are actually fewer banks in Japan than in the United States, so the number of banks alone cannot be the main problem. In fact, there are very few small financial institutions in Japan. Therefore it would make more sense to argue that there are too many large banks in Japan. In that case, however, the policy of encouraging banks to merge should be focused on encouraging more restructuring among the big banks rather than, as is the case at present, on smaller financial institutions.

The most serious problem facing the Japanese financial system is the fact that Japan has many large banks with much bigger total deposits and lending shares than any banks in the United States and that these banks have lent vast sums of money at unprofitable margins. Given that the authorities' policy initiatives for dealing with this problem are vague, it is difficult to understand why they should be giving priority to a policy (i.e., that of encouraging smaller financial institutions to merge) the effects of which are, at best, doubtful, and, at worst, negative.

3) Competition between smaller financial institutions and both large banks and public-sector financial institutions

This is not to say that smaller financial institutions do not face any "overcompetition" at all. However, this is less the result of their numbers than the competition they face from large banks and public-sector financial institutions.

First, as we saw above and unlike the situation in the United States, in Japan large banks have a large share of the market for loans to small businesses. When large banks in the United States lend to small businesses, they tend to use efficient and objective statistical techniques to assess the credit risk. Smaller financial institutions, on the other hand, tend to take advantage of the better access to information they enjoy as a result of their close links with the local community and local businesses. The two types of institutions are therefore able to coexist. Or, to use the terminology of the report, large US banks adhere to the market-based financial model while smaller institutions use a relationship-based model.

The problem in Japan would appear to be that large banks, instead of adopting the market-based financial model, are still using the relationship-based model in their struggle to compete with local financial institutions in the regions. The main thing, therefore, is for large banks to change their business model as soon as possible, because, otherwise, it is difficult to see how local financial institutions can enjoy any stability.

Another problem is the fact that banks that have received injections of taxpayers' money have to meet targets for lending to small businesses. Although this policy is intended to protect small businesses, there is a risk that in the medium to longer term it could have the opposite effect.

This is because, by lending to small businesses at unprofitable rates in order to meet their lending targets, large banks are poaching the customers of smaller institutions. If the result of this is that smaller institutions become weaker and, in the worst case, are forced either to exit the market or merge with similar institutions based in other areas, they risk losing their local identity. And it is a moot point whether that would be in the interests of small businesses.

There is no guarantee that large banks, having increased their lending to small businesses in accordance with the authorities' demands, would still be so keen to lend to them if no longer obliged to do so. It is now accepted wisdom that large banks should use a market-based rather than a relationship-based financial model. In addition, banks in general and large banks in particular are increasingly charging interest rates that reflect the risks they face. It is quite possible that large banks, with their international shareholders and demanding profitability targets, may seek to reduce their exposure to small businesses or even withdraw from local banking altogether in order to maintain their margins. If that were to happen at a time when local financial institutions had already trimmed their sails after losing the race to the large banks, local small businesses could find themselves in a serious predicament.

In such a situation it is easy to imagine that the views of those who are currently demanding that financial institutions should be legally required to contribute to local economies could gain the upper hand. However, rather than compel large banks to make a greater commitment to local economies when economic rationality is pushing them in a different direction, it would seem more sensible to concentrate on trying to ensure that smaller banks, which already have close business links with local communities, are healthy enough to continue to serve them.

Similarly, there is an urgent need to review the role of public-sector financial institutions, which also compete for business with the banks. Complaints are frequently heard from local financial institutions that public-sector financial institutions are lending to low-risk customers at cut-price rates. Their role therefore needs to be reviewed in order to ensure that they do not overstep the mark and compete with (rather than simply complement) private-sector institutions.

It is rather short-sighted either to set targets for lending to small businesses or to emphasize the importance during a recession of the role played by public-sector financial institutions without having a blueprint for the role of smaller financial institutions in the country's financial system. Although the report emphasizes the need for Japan's financial institutions in general to change to a market-based financial model, it is clear (not least from the situation in the United States) that banking has a more important role to play than the securities markets in lending to small businesses and local communities. Therefore it is absolutely essential that any medium-term blueprint for Japan's financial system in general incorporates a blueprint for this business area in particular.

Another point to consider in this connection is the question the Minister put to himself at one of the study group's meetings: Were the Japanese financial authorities right to impose the same capital adequacy requirement on cooperative financial institutions as on normal banks, given the differences in the nature of their business? The answer must surely be "no," at least in some cases, not only for cooperative financial institutions but also for smaller financial institutions in general, given the latter's particular needs and the needs of smaller businesses. Indeed, there is a separate edition of the Financial Services Agency’s bank inspection rules for loans to small businesses in recognition of the fact that these need to be dealt with differently from other types of loans.

Clearly, the desire not to damage the interests of smaller financial institutions should not allow efforts to strengthen their capital to be compromised. For example, the financial authorities should consider the possibility of adopting a tailor-made approach that would allow them to achieve this by varying the tests of financial soundness according to the situation in which a financial institution found itself. This could be done, for example, by having a regulatory framework that would allow financial institutions to select a menu of regulations appropriate to them.

5. Conclusion

No matter what blueprint is produced for the future of Japan's financial system, there is unlikely to be any recovery in the health of its financial institutions or any shift towards a market-based financial model so long as the economy remains in the doldrums. By its very nature, the work of financial regulators in ensuring that banks are financially sound and investors' interests protected should be done unobtrusively whatever the economic situation. A blueprint for the financial system should be a compass to help regulators keep to the right path.

However, even if such a blueprint is produced and financial regulation in Japan improves, it is no guarantee that the problems confronting Japan's financial system will be solved. Or, to put it the other way round, even if Japan's bad loan problem continues to weigh on the economy and Japanese households remain reluctant to increase their exposure to the stock market, that may simply be the result of deflation, the stockmarket slump and low interest rates. If so, it would be wrong simply to blame the financial blueprint and the financial regulators just as it would be wrong for the financial regulators to adopt policies for the sake of the economy or the stock market simply because they were afraid of criticism. It is the job of the central bank and government agencies other than the Financial Services Agency to come up with solutions to Japan's economic woes.

It is therefore rather strange to include policies such as "reforming the country's securities markets" and "stabilizing the financial system and producing a medium-term blueprint for its future" in a policy document such as "Measures to Boost the Economy." Unless the financial regulators rethink their approach, financial regulation in Japan, far from ensuring that banks are financially sound and investors' interests protected, looks set to remain dominated by attempts to boost the stock market.

In some respects, financial markets mirror the real economy. What Japan needs besides a blueprint for the future of its financial system is action to turn the economy around. The former is neither an alternative to nor an enhancement of the latter—a point that is sometimes forgotten.