Tightening Financial Regulation While Loosening Monetary Policy : A Risky Policy Mix

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I. Side effects from financial reregulation and from monetary easing

1. Tougher capital requirements from the EBA versus LTRO from the ECB

The longer-term refinancing operations (LTRO) announced on 8 December 2011 played a critical role in temporarily defusing the crisis mentality that had enveloped European markets[1]. As many observers have pointed out, however, such a policy is just "buying time," and the real urgency lies in meeting the fundamental challenges of beefing up the EU's safety net and reducing fiscal deficits.

With the focus on more fiscal austerity, the stagnation of European economies is becoming quite clear, while there are also concerns over another Greek default and a deepening of the crisis in Portugal and Spain.

What cannot be ignored here is that the assorted harsh financial regulations imposed to deal with the euro zone's problems and stabilize the financial system, far from contributing to a solution, are actually having the effect of making things worse.

The quarterly report released by the BIS in March 2012 noted that the European bank recapitalization that the Euro Banking Association (EBA) requested in October 2011 (a core Tier 1 ratio of 9% by June 2012) wound up amplifying the market instability affecting euro zone financial institutions that had emerged in H2 2011.

According to the EBA, applying that same standard, the 31 leading banks had an aggregate capital shortfall of €84.7 billion as of end-September 2011. It was within this context that the ECB decided to implement LTRO.

In other words, the strengthening of financial regulations had a negative impact on market stability and sentiment, and monetary policy had to be made unusually accommodative in order to offset this impact.

[1] Implemented on 21 December 2011 and 29 February 2012.

2. Monetary policy tasked with offsetting the side effects of financial reregulation

Not only in Europe but globally, as well, the need for a further strengthening of financial regulations was taken as a given after the financial crisis, and amid a tendency to silence those expressing concern over the adverse impact that would have on the market and economy, monetary policy moved deeper and deeper into nontraditional areas, to the point where it now plays a major role in stabilizing markets and propping up economies.

The quarterly BIS report described above noted that while the high capital ratio requirements demanded of European banks increased market uncertainty, they did not actually trigger a major deleveraging, and even when those banks affiliates' in the US and Asia started selling some of their businesses and assets, local banks stepped up to the plate, thereby offsetting any negative impacts.

Nevertheless, a fairly onerous financial regulatory framework, including Basel III and SIFI regulations, is scheduled to go fully into effect worldwide. There are fears that as the negative impacts from this financial reregulation emerge throughout the globe, it will become harder to find financial institutions to fill the role of offsetting those negative impacts. Because shadow banking regulations will also be strengthened, not much can be expected from alternative forms of financial intermediation either. Although there should not be a problem if the economy is able to follow a self-sustaining recovery path, if it is not there is a possibility that monetary policy will be expected to do that much more.

3. The limits and side effects of accommodative monetary policy during balance sheet adjustments

Within this context, it is only natural that the limits and side effects of monetary policy would start to take center stage. The limits of monetary policy have long been pointed out, including the liquidity trap, the zero bound on interest rates, and the inability to push (as opposed to pull) on a string. Of course, there is always a concern that inflation could result from taking monetary policy too far.

One could certainly argue that in the immediate aftermath of the most acute symptoms of the financial crisis, bold monetary easing is both effective and critical. FRB researchers have in the past argued that if the BOJ had swiftly and strongly eased monetary policy at an early stage after the bursting of the bubble, it probably could have avoided the advance of deflationary conditions.

Masaaki Shirakawa, prior to his return to the BOJ, responded with the argument that it would have been difficult to fathom in a timely matter the major impact that the bursting of the bubble would have and then explain the need for substantial monetary easing, but that even if the BOJ had implemented such easing the stagnation of economic activity was unavoidable[2]. The path that US monetary policy and the US economy have taken since the financial crisis suggests that Shirakawa is correct in his assessment.

Now that he is the BOJ Governor, Shirakawa has continued to press these arguments, including at a speech in London in January 2012[3] and at the FRB conference held in March 2012 described later in this paper.

Ultimately, with the leading economies having apparently fallen into a chronic state of continuous balance sheet repair, more attention is being paid to the limitations and side effects of loose monetary policy during such a period.

For example, at the conference held by the FRB in March 2012 entitled Central Banking: Before, During and After the Crisis, both BIS General Manager Jaime Caruana and BOJ Governor Shirakawa emphasized exactly that at the final panel discussion entitled Challenges for the Future.

Governor Shirakawa pointed out four limitations and side effects of monetary policy following the financial crisis, citing Japan's pioneering experience in trying to craft monetary policy during a time of balance sheet repair.

(1) Easing has limited impact when balance sheets are being repaired and reduces the incentive to shed excess debt

When still in the process of repairing their balance sheets, the holders of excess debt are not going to increase spending or aggressively take on risk until they return their debt to appropriate levels, even within an accommodative monetary environment. Even for those without excess debt, the impact from rate cuts does not last very long during a sustained period of balance sheet adjustments.

Monetary easing also has another cost, which is that it lowers the incentive to reduce excess debt and ultimately delays needed balance sheet repairs. The same is true of government debt.

(2) Decline in the overall economy's productivity and growth potential

There is also a possibility of negative impacts on the supply side. Specifically, it risks encouraging investments that are only profitable because of unusually low interest rates, and therefore risks making capital allocation inefficient. This would have the knockon effect of reducing the overall economy's productivity and growth potential.

2 Shirakawa, Masaaki, *Gendai no Kin'yū Seisaku* (Modern Monetary Policy in Theory and Practice: Central Banking and Financial Markets), Nihon Keizai Shimbun-sha, 2008 (in Japanese), written during a stint in academia.

3 Shirakawa, Masaaki, Deleveraging and Economic Growth, speech at London School of Economics and Political Science, 10 January 2012

(3) Weakening of the financial intermediation function

Sustained ultra-low interest rates reduce spreads at financial institutions, thereby weakening the banks' critical financial intermediation function of maturity transformation (supplying medium- to long-term funding using short-term liabilities), which ultimately makes resource allocation less efficient and reduces the economy's growth potential. They create a similar problem for institutional investors, causing their return on assets to drop below their assumed rate of interest on long-term liabilities.

(4) The global spillover from monetary easing and feedback to the home economy

When the home economy is in a balance sheet adjustment phase, monetary easing has a stronger tendency to exert an impact through global investors' search for yield and consequent weakening of the exchange rate than it does to encourage spending increases by the private sector at home. The negative impact that actions by global investors have on the home economy by pushing up global commodity prices also needs to be taken into account.

BIS General Manager Jaime Caruana pointed out the risks that loose monetary policy will block the supply of funds to more productive investments by reducing the need for balance sheet adjustments and allowing the survival of unproductive businesses and businesses that would otherwise fail, and also worsen the profitability of the financial sector and push them into greater risk-taking to make up for that. Caruana warned that although "extraordinarily easy monetary policy certainly can buy time... it also makes it easier to waste that time."

Both thus expressed concern over the negative impacts of allowing businesses and firms with low productivity to survive by way of super accommodative monetary policy. This is essentially the same problem created by the banks when they continue to extend loans to these types of firms and businesses, known as "zombie lending" or "evergreening." [4] Traditionally, however, the criticism has been directed at the financial institutions that continued such lending to avoid having to realize losses, particularly those that were poorly capitalized, and it is only recently that the easy monetary policy reinforcing this trend has been criticized.

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[4] Albertazzi, U and D Marchetti : “Credit supply, flight to quality and evergreening: An analysis of bank-firm relationships in Italy after Lehman”, Banca d’ Italia, Temi di discussione, no 746, April 2010 and Caballero, R, T Hoshi and A Kashyap; “Zombie lending and depressed restructuring in Japan”, American Economic Review, vol. 98, December 2008, among others.

II. Monetary policy and macroprudential policies

1. Macroprudential policymaking has just begun

Because of the financial crisis, nontraditional monetary policy was seen as necessary not only to stabilize prices, but also to stabilize the financial system, and we think the reason no exit is in sight can be traced to problems in ascertaining the respective roles of macroprudential policy and monetary policy.

Macroprudential policies go beyond merely looking at the soundness of individual financial institutions (microprudence) to focus on conditions, including the development of bubbles, that affect the soundness of the financial system as a whole, and attempt to devise the necessary solutions. The need for macroprudential policies was exposed by the financial crisis, and a framework for such policies is in now the process of being formally implemented in Europe and the US.

For example, the development of an asset bubble during boom times increases the capital at individual financial institutions, reduces the historical volatility that is input into VaR models, and raises the value of the assets serving as collateral, all factors that tend to encourage excessive risk-taking and accelerate the bubble's formation.

If these trends toward bubble formation and excessive risk-taking within the financial system are discovered through the microprudence of individual financial institutions, by moving early with such policies as raising capital requirements, restricting real estate lending, and setting higher margin requirements, the overshoot can be reined in, thereby deflating the bubble and preventing the financial crisis from ever occurring[5].

Governments are still at the beginning stages of incorporating macroprudential policies, however. At the global level, countercyclical buffers are incorporated into Basel III, but their effectiveness is an unknown quantity.

2. Monetary policy and macroprudential policy for deterring bubbles

Within this context, the argument that monetary policy plays an important role in bubble deterrence has become compelling. The main advocate of this approach has been the ECB and others associated with the euro zone's central bank, whereas the FRB and mainstream economists in the US have been opposed to conducting monetary policy based on the trend in asset prices[6]. Those on the FRB's side were of the view that prudential policy, including via bank supervision, rather than monetary policy, should play the central role in dealing with the danger posed by asset bubbles.

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5 One way to approach this is for administrators to implement measures at their discretion, the other is to have measures that automatically go into effect based on preestablished rules.

6 Shirakawa, Masaaki, *Gendai no Kin'yū Seisaku* (Modern Monetary Policy in Theory and Practice: Central Banking and Financial Markets), Nihon Keizai Shimbun-sha, 2008 (in Japanese).

It is difficult to deny, however, that monetary policy has some impact on reining in bubbles, compared with as yet unproven macroprudential policies. In fact, some argue that the US housing bubble was caused by the FRB keeping interest rates too low for too long[7]. Consequently, the idea that it is important for monetary policy to "lean against the wind" during periods of credit expansion has been gaining adherents[8].

For example, in a speech at Jackson hole in August 2009, then ECB president Trichet rebuffed one at a time the three arguments always used by those who say monetary policy is ineffective in containing bubbles (i.e., that it is difficult to know in real time whether a bubble is forming, that it is difficult to contain a bubble with a rate hike, and that it is sufficient to engage in aggressive monetary easing after the bubble bursts), emphasizing the best way to deal with a crisis is to prevent it from ever happening (Figure 1)[9].

In addition, in a speech in New York in April 2010, BOJ Governor Shirakawa made the point that the experience of Japan's bubble showed that the economy can experience wide swings even when prices are stable, and thus "when a central bank becomes too fixated on short-term price stability, this may complicate the attainment of the ultimate objective of sustainable growth."[10]

This thinking does not automatically lead to the argument that asset prices must be used as a direct benchmark for monetary policy, however. It can be argued that

Figure1: Is monetary policy effective in containing bubbles?

What the skeptics say	Counterarguments from proponents
It is difficult to accurately identify bubbles in real time.	Many economists pointed out prior to the latest crisis that credit expansion had gone too far.
It is difficult to contain a bubble without extremely large rate hikes.	Even small changes in the policy rate can affect behavior in the private sector and have a major impact on asset prices.
By engaging in aggressive monetary easing after the bubble bursts, the negative impacts of the bubble can be dealt with.	The major contraction of economic activity after a bubble bursts limits the effectiveness of monetary policy. In addition, the expectation of monetary policy action creates a moral hazard and increases instability.

Source: Nomura Institute of Capital Markets Research, based on Trichet (2009)

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7 Taylor, John, Getting Off Track, How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis, Hoover Press, 2009.

8 Borio, Claudio, “Rediscovering the macroeconomic roots of financial stability policy: journey, challenges and a way forward”, BIS Working Papers No. 354, September 2011. Another new argument on the relationship between financial stability and central banks says that one cause of bubbles is the lack of control over money creation through shadow banking, and central banks need to apply policies similar to reserve requirements to the shadow banking sector. Stein, C. Jeremy, “Monetary Policy as financial stability regulation,” Quarterly Journal of Economics, February 2012.

9 Trichet, J. Olaud, “Credible alertness revisited”, remarks at the Federal Reserve Bank of Kansas City symposium on Financial Stability and Macroeconomic Policy, Jackson Hole.

10 Shirakawa, Masaaki, “Revisiting the philosophy behind central bank policy”, speech at the Economic Club of New York, April 22, 2010.

although there is nothing wrong with continuing to focus policy on price stability as before, the time horizon for monetary policy must be extended to take into account the fact that imbalances build up over a period of time.

For example, the BIS has argued that even when aiming for price stability, it is not good enough to target an inflation rate over the relatively short time horizon of two years, and that extending the time horizon of the price stability goal will also contribute to financial stability[11].

The latest research shows that monetary policy not only affects demand through interest rates, it affects the nature of risk taking. In addition, the effectiveness of tighter financial regulations in preventing bubbles may be weakened through regulation arbitrage, while monetary policy has the advantage of having impacts that extend throughout the market[12].

3. Monetary policy and macroprudential policy after the bubble bursts

Meanwhile, the recent financial crisis and its aftermath already provide evidence of the importance of monetary policy as a tool to keep a crisis from deepening following the bursting of a bubble when there are concerns over continued financial system instability, a sustained period of balance sheet repair, and a deflationary spiral. At the same time, however, it also highlighted the need to be aware of its limits and side effects, as already noted.

It is precisely because of this that we think it is appropriate to expect macroprudential policies to supplement monetary policy during such times. In the real world, however, there is always a rising chorus calling for tighter financial regulations after a financial crisis.

The idea that during boom times, capital requirements should be raised and additional reserves over what is actually needed should be required, while during slumps these buffers should be removed, has in some respects also been adopted in Basel III.

Thus far not enough buffers have been built up in the past to remove, however, and therefore this safety valve cannot function. Far from it, the focus has been on substantially raising soundness requirements from their previous levels, and this is amplifying the down swings in both the economy and the credit cycle.

There have been some regulators who have been reluctant to tighten financial regulations in light of economic conditions. For example, Andy Haldane, Executive Director Financial Stability for the BoE argued that the central bank's Financial Policy Committee needs to moderate the credit cycle by pursuing different policies depending on whether that cycle is in an expansion or contraction phase[13]. When

11 BIS, "Macroprudential Policy and Addressing Procyclicality," 80th Annual Report, 28 June, 2010.
12 Borio 2011.
13 Andrew G Haldane "Risk off", 18 August 2011.

credit is contracting, regulations should be set to encourage greater risk-taking by financial institutions.

One example of this approach given by Haldane was when President Roosevelt announced a relaxation of prudential[14] and valuation standards[15] for US banks. The result was a resumption of lending and growth.

This relaxation of standards was announced[16] after two months of deliberation by financial regulators at a conference put together by President Roosevelt. At that conference, the FDIC and OCC argued for a strengthening of prudential regulations out of concern over an increase in bank failures, while the FRB argued for a change in bank examinations and in fair value accounting of bond holdings out of concern over a further shrinkage of bank lending. The FRB ultimately won the day. This agreement opened up the possibility of banks investing in unrated and unlisted bonds issued by local companies.

It was the double-dip recession experienced by the US at the time that paved the way for these measures. The US economy had started looking like it was recovering from the serious depression that lasted from 1929 until 1933, but then went into reverse and started accelerating backwards in the summer of 1937, resulting in a credit crunch. The FRB wanted to deal with the credit crunch by revising harsh banking controls[17].

Another period in which a difficult macroeconomy prompted a rethinking of financial regulations was in the early 1990s. The first Bush administration started asking for a change in the way banks were examined in the mid-1991 to cope with the credit crunch that was going on at the time. In November 1991, the credit approval standards for commercial real estate loans were revised.

These examples show that the question of whether it is appropriate to temporarily subordinate financial administration to monetary policy is one that has long been asked[18], and framed within today's debate it can be seen as a question about what the relationship should be between macroprudential policy and monetary policy after a financial crisis.

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[14] Previously loan assets categorized in either the doubtful or loss category had to be fully written off, but the new rules allowed for a 50% write off of loans in the "doubtful" category, which were renamed Category III loans. See Masayuki Kobayashi, *Furyousaiken to Koutekishihon (jou)*", (Nonperforming loans and public capital (Part I)), Hokkai-Gakuen University Journal of Economics, Volume 50, No. 3, December 2002.

[15] The banks' investment-grade assets are carried at book value rather than at market value, while their non-investment-grade assets are carried at their long-term average market value. See Andrew G. Haldane, "Fair value in foul weather," 10 March 2010.

[16] This is known as the Uniform Agreement on Bank Supervisory Procedures.

[17] In fact, when the FRB raised the reserve ratio from August 1936 until May 1937, it led to a contraction of the money supply. The FRB's easy money policy was a key catalyst for the economic recovery that began in mid-1938.

[18] Simonson G. Donald and George H. Hempel, “Banking Lessons from the Past: The 1938 Regulatory Agreement Interpreted”, Journal of Financial Services Research, Volume 7, Number 3, 1993.

Figure2: The respective roles of monetary policy and macroprudential policy

	When the bubble is forming	After the bubble bursts
Monetary policy	△ One side says monetary policy is important for deterring bubbles, while the other argues that it should be confined to stabilizing prices. The former argument has gained a slight upper hand recently.	○ The argument that aggressive monetary easing is effective in deterring deflation. The role becomes even more important during balance sheet adjustments. Its limits and side effects are pointed out, however.
Macroprudential policy	◎ There is now a consensus that it is important for deterring bubbles. Now in the process of being introduced both globally and at the national level.	? Currently, the introduction of strict financial regulations is favored, and it is a minority who argue that regulation should be loosened to avoid market instability and an economic contraction.

Source: Nomura Institute of Capital Markets Research

As already noted, it appears that most people have not learned from past examples that financial regulation should be loosened when the macroeconomy weakens, and instead the choice has been to tighten financial regulations and, partly to offset the side effects of that, to use monetary policy to deal with balance sheet disrepair (Figure 2).

III. Economic policy when balance sheets are being repaired

1. Why the dependence on monetary policy?

There has long been a tendency to rely on easy money policies because they do not require any explicit sacrifice from the people. The most extreme example of this is an increase in the underwriting of government bonds by the central bank. Acquiescing to a program of expanding government spending without paying for it winds up creating a huge burden on the populace in the form of hyperinflation.

The same argument could be applied to financial regulation. As a result of the financial crisis there has been a groundswell of anti-banking and anti-market sentiment. Although some of this strengthening of financial regulations is appropriate based on lessons learned from the crisis, there is no doubt that some of this reregulation is driven by a populist agenda that panders to this anti-banking, anti-market sentiment.

Even that regulatory tightening that appears justified does not seem to be fully thought out in terms of degree or timing. The fact that a number of countries have important national elections coming up is one reason why regulatory changes have been both slapdash and excessive.

The costs of this overreaching reregulation of the financial sector prompted by public opinion are born not only by the financial sector but also by the people who use it. To keep these costs from surfacing, monetary policy is being stuck with the huge bill.

This allows the politicians to avoid having to confront voters with the pain of tax increases and spending cuts, and is a problem in the same way it is a problem asking central banks to engage in expansionary monetary policy. Even if this does not lead to hyperinflation, it brings with it various evils, as already described.

Precisely because of concerns over becoming dependent on monetary policy and past lessons learned , a premium is now placed on central bank independence, but strictly adhering to such a policy clearly brings exposure to one challenge after another.

In light of the above, when managing economic policy at a time of balance sheet repair, it would probably be wise to avoid rushing into financial reregulation on ideological grounds, while keeping in mind the risks inherent in too much reliance on monetary policy. We also think it essential to rely not only on monetary policy and financial regulations, but also on policies aimed at resolving the structural problems of the corporate, household, and government sectors.

Next, we look at these ideas from the prism of Japan's experience with financial crises and deep balance sheet adjustments in the 1990s.

2. The need for realistic regulation of the financial sector

Japan has also already experienced a phase in which financial institutions were increasingly saddled with onerous regulations in the aftermath of a financial crisis. When resolution of Japan's housing lenders (jusen) was an issue from mid-1995 until mid-1996, for example, the predominant view was against the idea of using public funds to cope with a financial crisis. Consequently, when an even larger financial crisis developed in 1997-98, the government could only respond in a way that wound up being criticized as "too little, too late."

Three financial laws were passed in June 1996, and one of those, following the US lead, gave regulators the power to require banks to take prompt corrective action, effective in April 1998[19]. Each bank had to do a capital assessment of its assets and either write them down or set aside reserves as appropriate. This is followed by a deep inspection by an auditing firm of the banks' balance sheet optimization, and if the announced capital ratio that resulted from that was below a certain level, the prescribed administrative mechanisms would promptly be triggered.

As concerns over the financial system grew starting in mid-1997, however, regulators became less inclined to assess and disclose business conditions at individual banks, out of concern that publicizing inconvenient truths would make

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[19] Nishimura, Yoshimasa, *Kin'yuu Sisutemu Kaikaku Gojuunen no Kiseki* (50 years of financial system reform), Kinzai Institute for Financial Affairs, 2011 (Japanese).

things more difficult for them. With Basel regulations also being introduced at the time, this sparked criticism that prompt corrective action and Basel regulations were making financial institutions less willing to lend.

When Sanyo Securities failed in November 1997, financial regulators approved resolution under the Corporate Reorganization Act even while knowing ahead of time it would result in defaults in the interbank market. This caused money markets to tighten, however, leading to the failures of Hokkaido Takushoku Bank and Yamaichi Securities.

In Japan, however, when Yamaichi Securities failed it was voluntary closure rather than court-ordered resolution that applied, and with special loans from the BOJ also available, an orderly resolution was achieved. When Long-Term Credit Bank and Nippon Credit Bank failed the following year, the government sought to keep the financial crisis from growing through temporary nationalization.

Although these measures were pushed through quickly under duress, a subsequent amendment of the Deposit Insurance Act in 2001 established procedures for resolving financial institutions, including preventative injections of public capital during times of systemic risk.

As pointed out by BOJ Governor Shirakawa, a major difference with the recent financial crisis rooted in the US and Europe is that in Japan, the necessary measures were taken to prevent a domestic crisis from propagating globally[20].

Ryozo Himino, an FSA official, said that "allowing Lehman Brothers to fail without ensuring its resolvability was the most fateful decision made this century," and in regards to new regulations in Europe and the US that bar the use of public funds to bail out financial institutions, he warned that "until full resolvability can be ensured, it is important to continue to seek taxpayer understanding in regards to using tax revenues as a last resort."[21]

Japan's experience as noted above suggests that the strengthening of prudential regulations when a crisis is in train, including the implementation of Basel rules and prompt corrective actions, can have serious secondary effects, even when that regulation is reasonable.

Charles Dallara, Managing Director of the Institute of International Finance, noted that he expects deleveraging to continue until July 2012 as a result of the EBA requiring banks to raise their Tier 1 capital ratio to 9% by end-June 2012, and argued that "a continuation of halfway compulsory asset sales would make it difficult to continue recovering funds at sufficient levels within the euro zone, and thereby weaken the real economy. Most important now is that financial regulators, not only in Europe but worldwide, loosen somewhat their timetables for introducing the new capital requirements (Basel III)."[22] Given that it is early yet to declare an end to the

[20] See Governor Shirakawa's January 2012 speech referenced earlier.
[21] Ryozo, Himino, “Rethinking banking supervision”, Risk, March 2012.
[22] Nihon Keizai Shimbun, 6 April, 2012 (in Japanese).

crisis, it is probably worthwhile to listen to those pointing out the need for a more cautious response.

3. Business restructuring, industry restructuring, and growth strategies

The heightening of leverage during a bubble leads to problems with bank-held nonperforming loans and nonperforming assets once the bubble collapses, and simply rushing through a resolution package that places its biggest priority on restoring financial institutions to health runs the risk of putting the sectors on the funding side of the equation—corporations, households, and governments—into an even worse predicament.

In Japan, another argument for placing a priority on the soundness of financial institutions is that encouraging the exit of the several dozen large "zombie corporations" that are saddled with excess debt would help resolve the problem of surplus supply that many of Japan's industries are dealing with.

Nevertheless, encouraging a turnaround rather than forcing a hard-landing, i.e., trying to revive those firms with room for improvement, incurs less economic and social costs while also helping to restore financial institutions to a sound state, and it is this approach of reviving both industry and finance that has come to be emphasized in actual policy.

The emergency stimulus package proposed on 6 April 2001 called for reviving both the financial and industrial sectors, and the Resolution & Collection Corporation was charged with restructuring corporations. The Financial Revival Program announced on 30 October 2002 included the establishment of the Industrial Revitalization Corporation (IRC), which began operating on 16 April 2003. The IRC, managed by private-sector turnaround specialists to ensure that problem companies were not simply given life support, clearly laid out standards for productivity and financial soundness that had to be met at the conclusion of the revitalization plan, and then made decisions on whether to provide support based on the potential for those standards to be met.

The Financial Revival Program also included measures to promote relationship banking. The concept behind this was to deal with the regional financial institutions differently, not setting a deadline for fully writing off nonperforming loans as was done with the major banks, but rather seeking those financial institutions' commitment to the revival of the local economy and local firms while at the same time restoring them to a healthy state.

It used to be commonly understood in Japan that bankruptcy spelled the end of a company, but the idea of revitalizing businesses by using the Civil Rehabilitation Law, by setting guidelines for private debt workouts, or by changing the nature of collateral and personal guarantees has gradually caught on.

Because of its success in providing assistance, the IRC was dissolved on 15 March 2007, before it reached its 5-year limit, but the expertise and talent that it developed is helping to improve Japan's ability to revive businesses.

Furthermore, the relationship banking program was initially formulated as a temporary action plan, but in response to a report by the Financial System Council in April 2007 it was made permanent, and since August of that year it has been included in the FSA's integrated guidelines for supervising smaller and regional financial institutions.

Thus the lesson learned from the financial crisis that began in Japan in the 1990s is that it is important to pursue the revitalization of both business and industry while at the same time restoring soundness to the financial system.

Even with these efforts, however, it is not easy to restructure the economy and raise productivity at the same time. Although the legacy problems of nonperforming loans at financial institutions and excessive debt held by corporations have basically been eliminated, government debt, aging demographics, population shrinkage, yen appreciation, and the rise of emerging markets have all become even bigger problems. On top of this, there has been a global financial crisis followed by an earthquake, tsunami, and nuclear power accident.

Recent moves in Japan have gone beyond the level of revitalizing corporations in trouble to encompass growth strategies and revitalization strategies aimed at the nation as a whole, including the New Growth Strategy announced in June 2010 and the Strategy for the Rebirth of Japan unveiled in December 2011.

4. US version of a savings to investments shift

Japan's experience therefore shows that during a period of balance sheet repair following the bursting of a bubble, the downward pressures on the economy brought by financial instability and deleveraging must be taken into account, and that, rather than demanding the rapid restoration of financial system health, financial regulations must be realistic. In addition, there is a need not only to reform the financial sector but also to reinforce those policy measure aimed at reforming the sectors that suffered from the bubble's collapse.

Achieving the latter requires a supply of growth money that leads to innovation and the creation of new businesses and new industries, and this makes it essential to find ways to keep financial sector reforms from falling into the trap of focusing exclusively on regulatory tightening.

One example of this in Japan is the shift from savings to investment called for in the Basic Policies 2001, released in June 2001. Although the government has since changed hands from the LDP to the DPJ, it has retained its focus on reforming the nature of Japan's money flows and encouraging the supply of growth money and risk money, and even the Strategy for the Rebirth of Japan calls for revitalizing financial and capital markets through new fund flows.

These efforts have seen little success over the past 10 years, however, as evidenced by the growing share of individual financial assets accounted for by cash and deposits since the outbreak of the financial crisis. It is within this context that central banks have taken on the role of supplying risk money, including the BOJ's program of fund-provisioning to strengthen economic growth foundations launched in June 2010. We think such a program may be better viewed as an encroachment on industrial policy than as nontraditional monetary policy.

This program, rooted in the desire to reinvigorate risk-taking in the private sector, probably came about as a result of the lack of success of traditional approaches and as a consequence of the search for new policies to avoid an even greater dependence on the BOJ.

Even in Europe and the US, where they have just now begun to deal with their post-bubble economies, there is growing interest in some quarters in the concept of shifting money out of savings and into investment. For example, Blackrock CEO Larry Fink notes that investors are increasing their bank deposits and other short-term savings while corporations hold large amounts of liquidity on hand, and notes that these dormant funds need to be reawakened to stimulate the long-term investment that leads to growth[23]. Specifically, he said "To meet our global challenges in this new world, we must, at every level, turn savers into investors."

He also pointed out the need for people to understand that there was a cost associated with putting funds into savings rather than investments. At the financial institution level, he argued there was a need to revise anachronistic and overly restrictive investment management guidelines to ensure that beneficiaries take responsibility for both public and private pension funds.

He also noted the need to form a consensus between the financial community and the government on financial regulations, specifically on what constitutes realistic regulations that raise market confidence and encourage long-term investment.

The December 2011 McKinsey Global Institute report, "The emerging equity gap: Growth and stability in the new investor landscape," analyzes the future supply-demand for equities and expresses concern that investment in equities on a global basis is insufficient. It proposed the increased use of automatic enrollment in defined contribution pensions, a revision of those portions of the tax code unfavorable to equity, and other policies to incentivize a shift from savings to equity investment.

The debate in Japan over shifting from saving to investing has used the nature of individual financial assets in the US as a model. In this sense, it will be interesting to see the sort of policies implemented in the US once there is recognition there of the importance of shifting from saving to investing.

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[23] Fink, Lawrence D., Its a New World, So What Should We Do?, Foreign Affairs Report, April 2012. The article is in Japanese, but the speech in English upon which the article is based can be viewed on the US Council on Foreign Relations website.