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JAPAN'S LOST DECADE:
LESSONS FOR THE UNITED STATES

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P R O C E E D I N G S

RICHARD BUSH: Good morning, ladies and gentlemen. I think we should go ahead and get started. Thank you all for coming on this slightly chilly and slightly rainy morning. I think we're going to have an excellent program today. In putting on this program, a number of people have made a contribution and I would like to acknowledge them -- first of all, our communications department, my own staff, Bill Gale, the Vice President of the Economic Studies Program here, and Gordon McDonald of his staff. In particular though, I'd like to acknowledge the support of Nikkei Media who have helped us a great deal in putting on this program and in particular I'd like to thank my friend Tsuyoshi Sunohara for all his help.

The theme today is Japan's Lost Decade and Lessons for the United States. No one needs to be told that we're in the midst of a serious and complex economic crisis. Although history never repeats itself exactly, some people believe they've seen this movie before -- or something like it. The Japanese meltdown in the early 1990s bears a canny resemblance to what's been happening in the United States since the real estate bubble began deflating two years ago. So our purpose is to examine what happened in Japan and its relevance today.

To help us start our morning and frame the discussion, we could have no better person than our keynote speaker, Professor Heizo Takenaka. He's one of Japan's most distinguished economists and he played a huge role in ending Japan's Lost Decade and in carrying out former Prime Minister Koizumi's reform program. Professor Takenaka is a Professor and Director of the Global Security Research Institute at Keio University in Tokyo.

In 2001, Prime Minister Koizumi named him Minister for Economic and Fiscal Policy and in that position he chaired the Council on Economic and Fiscal Policy, which was the key engine for reform. Over the next five and half years, that's exactly what he did. In 2002, he became Minister for both Financial Services and Economic and Fiscal Policy and it was in that capacity that he accomplished the disposal of the nonperforming loans of Japanese banks.

In 2004, he was elected to the House of Councilors and was named Minister for both Economic and Fiscal Policy and the Privatization of the Postal Services. In that latter position, he achieved the sort of centerpiece of Prime Minister Koizumi's reform program -- the Privatization of Japan Post. In 2005, he was named Minister for both Internal Affairs and Communication and Privatization of Postal Services. He's written an account of those events -- The True Story of Japan's Structural Reform. So without further ado, I would like to welcome Professor Takenaka.

HEIZO TAKENAKA: Well, thank you, Richard, for very kind introduction and good morning, ladies and gentlemen. It is my great pleasure to speak in front of such a distinguished group of people. First of all, I'd like to say thank you very much to all people in Brookings and Nikkei whose effort made this conference possible.

By the way, last year -- year 2008 -- was a very special year for us Japanese. One hundred and fifty years ago, Japan for the first time concluded the Treaty for Amity and Trade with the United States and some European countries. And this treaty served as something like a trigger for Japan's modernization -- the time of Meiji Restoration. Well, based upon the treaty, Japan's modernization started actually. For your information, my university, Keio University, had also on the year of 1858 -- 150 years ago -- we last year celebrated the anniversary -- 150th anniversary in my university. This is indicating it is not too late for you to make donations to my university maybe.

[Laughter]

The year 2008, however, became a very difficult year as you know. The world economies are now facing serious risk factors and Japan and other Asian countries are also involved, more or less, in this unstable financial and economic environment. We are very much influenced by U.S. economy and economic policy, so this is indicating policies decided here in Washington, D.C. would affect a lot on our economies. Also, we understand that Japan is watched by many people in the world. It is because we still have the second largest GDP in the world. Also it is because we had a very serious financial crisis about ten years ago and long period of economic stagnation called Lost Decade. Our experience to stop financial crisis and economic slump should be assessed positively or negatively in this occasion.

So today, I'm given a very important and interesting topic to speak about -- that is Japan's Lost Decade: Lessons for the United States. Recently, we hear a lot of bad news about Japan -- especially Japan's politics. Japanese political administration is very unstable. In the past 20 years, we had 14 prime ministers actually. And maybe in several months we'll have a new one I'm afraid.

However, eight years ago we had a very special Prime Minister named Junichiro Koizumi. Under his leadership, we terminated -- stopped Lost Decade. As was mentioned by Richard, I worked in the government from 2001 to 2006 to support former Prime Minister Koizumi. Koizumi was a very special and unique prime minister in the history of Japan's politics. How unique and how special he was. First, he nominated me as a minister. He's very unique actually. Second, he continuously supported my policy for more than five years, though many influential politicians were against my policy. He's very special in that sense. Anyway, owing the leadership by Prime Minister Koizumi, the Japanese economy has come back -- financial crisis was over.

So let me quickly review the trend of the Japanese economy and the economic policy responses. Then I will discuss some lessons from our experience to stop financial crisis and the lost decade. It is needless to say that U.S. financial trouble and Japanese trouble were different a lot. Still I believe that we can discuss some implications.

Well, in the second half of 1980s, we had so-called bubble economy. Tokyo stock price hit its peak in December of 1989. Before its peak, stock price had been increasing for eight years or so and Nikkei average became 5.5 times during this period. This capital gain, however, disappeared very quickly after the burst of the bubble. For your information also, U.S. stock price also has been increasing up to the recent two years, but in this case, compared with its previous peak, the stock price in the United States became twice -- around twice. So I dare to say the Japanese bubble was much bigger than the U.S. one on this point.

Anyway, since the burst of the bubble, the Japanese economy faced many troubles. For example, in 1990s, Japan's GDP growth rate turned to only one percent though Japan grew at an annual rate of 4.5 percent in the '80s. I say in the '80s, the growth rate of 4.5 percent -- but in the '90s, growth rate was only one percent. In '90s, the Japanese government made a kind of misjudge in macroeconomic management. After the burst of the bubble, so-called balance sheet adjustment was needed. However, the government had mostly increased government expenditures for public works, while ignoring the supply side adjustment.

This policy created a new vested interest or a new political environment in the society -- namely construction companies enjoyed high profit through this policy, increasing of public works, and these companies donated a lot to government party. Recently we found that these companies donated not only to the government party, but to the opposition party. Mr. Ozawa, head of the leading opposition party, has now trouble on this issue.

Anyway, for nearly 10 years, the Japanese government continued this kind of fiscal expansion policy. A total amount of additional stimulus package reached 133 trillion yen. This is about 26 percent of GDP. Still, an average growth rate in the '90s remained only around one percent.

Anyway, in the '90s, the Japanese economy was stagnant and the balance sheet adjustment had been postponed, so in late '90s, this caused a serious financial crisis in Japan. A delay of balance sheet adjustment meant the banking sector suffered from huge amount of nonperforming loan and business sector suffered from excess debt problem.

In 2001, I was nominated as Minister for Economic and Fiscal Policy and then I completely changed the framework of macroeconomic management. In the year 2002, I had additional job as Minister for Financial Services. Then I challenged banking reform. When I started a program of dispose of nonperforming loan in the year 2002, the ratio of nonperforming loan to the total outstanding loan was 8.4 percent. The ratio of nonperforming loan was 8.4 percent. I set a numerical target to cut in half this ratio in three years. At that time, my counterparts in the U.S. government continuously encouraged me and supported my policy. Fortunately, the ratio of nonperforming loan decreased from 8.4 percent to 1.5 percent now and the Japanese economy restored its normal growth path around two percent level.

From the year of 2003 to 2006, the Japanese economy grew at the annual rate of two percent and a little bit higher. The economic expansion continued more than five years or so. This was the longest expansion in the history of Japanese economy. For your information also, during this period, about 70 percent of the growth came from domestic demand growth.

Here I'd like to say that there were two kinds of reform needed to develop the economy. One is reactive reform and a symbol with this reactive reform was the disposal of nonperforming loan. On the other hand, proactive reform is also needed. Japan is heading for a serious aging society and the total population started declining already four years ago. Under such circumstances, it was very urgent for us to create a smaller government. Otherwise, a tax burden or social insurance burden on younger generation will be huge. For that purpose, a privatization of Japan Post was realized. Privatization of Japan Post was so a symbol of proactive reform. Today, I'll not discuss the details of this postal privatization, but let me repeat that both reactive and proactive reform were needed to revitalize the Japanese economy at that time.

Now then, let me discuss more details about financial crisis or nonperforming loan problems in Japan -- especially banking sector. As I mentioned, Japan's stock price hit its peak in 1989. But, land price hit its peak two years later or around 1991. After that, nonperforming loan problem became one of the most serious economic issue in Japan. However, politicians ignored this point. Mr. Miyazawa, our Minister of Finance at that time, once pointed out the importance of disposing of nonperforming loan in the banking sector, but this was completely ignored by many political powers. At that time, politicians in Japan were mostly committed with the battle over the reform in election system. Election system was the most important one at that time, so they ignored this nonperforming loan problem.

Anyway, solving nonperforming loan problem was postponed to around 1998 -- amazingly, nine years after the burst of the bubble. In the year 1997 -- in the previous year I say -- Yamaichi Securities, the second largest security companies, went bankrupt. Also, Hokkaido Takushoku Bank -- one of city banks at that time -- went bankrupt. Under such circumstances, in 1998, the Diet approved a new law under which public money can be used for capital injection to troubled banks.

Around 1997 and 1998, there was a loss of confidence in policy and in -- really in the political process of policy making. This crisis was special which could be called confidence crisis -- more than financial crisis -- confidence crises we had. Government failure compounded market failure I say. I understand that's kind of the situation of the United States. It's also this type of confidence crisis.

Once a confidence crisis starts, there's only one thing to do. Both the government and the central bank must take all possible actions in order to quell the crisis. Crises demands, so government activism -- government activism is needed.

Anyway, in Japan, that Diet session convened in autumn of 1998 -- nine years after the burst of the bubble -- concentrated on financial issue. This session was labeled “financial Diet” and prepared the basis for public funds injections. Then in 1999, a total of 7.5 trillion yen was injected to major banks. This amount accounts for 1.5 percent of GDP. A huge amount of money was injected to major banks. However, it was not enough. This should be stressed. A crisis of confidence continued until other measures were taken, indeed Japan’s crisis subsided only in 2003 -- four years after the capital injection.

Japan's bitter experience of fighting the crisis of confidence has lessons for the rest of the world, I think. So let me point here two concrete lessons. First, public fund injections alone did not solve the problem. Rather, second thing was important. Above all, there must be precise and strict asset appraisal and asset assessment at financial institutions. Only then should the necessary capital be injected. Lack of trust in balance sheet was the most important source of concern in financial market.

Unfortunately, at the end of the 1990s, Japan injected public fund while bad assets were still being concealed. As a result, the financial crisis continued even after the capital injection. The solution came only after year 2002 when the financial revitalization program was introduced under Koizumi Administration. Under this program, very strict bank inspections were carried out and then necessary capital injections were made additionally. There was a capital injection into Resona Bank in the year 2003 and then the solution -- sorry, the situation began to improve.

The second lesson is that activism of the government -- activism of the government can go too far. Government activism is essential in a crisis, but there are some steps to avoid I'd like to say. When excessive protection is given to one, impact on others can worsen the crisis of confidence. In this context, world trend toward reversing market to market accounting is troubling in my understanding.

In order to prevent the financial condition of institution from appearing to worsen, the idea is to temporarily reverse some rules of accounting. But this is a mistake, I think. Reversing market to market rules increases investor's worries about balance sheets. Confusion stemming from uncertainty over the true state of balance sheet would worsen confidence crisis.

The accounting issue is particularly hard when a crisis hits at the time of election. This combination pushes politics toward indiscriminate activism I say. Actually, this issue triggered a major debate also in Japan, we had this kind of experience. In year 2003, when election coincided with financial crisis, many politicians and industry groups called for suspension of market to market accounting. These people saw suspension as a way to stop banks for falling into capital shortage. In the end, the Japanese government under the leadership by Prime Minister Koizumi, rejected this kind of idea. If we had done this, investors would have been even more confused and would have lost even more confidence in financial statements. If we had reversed market to market accounting at that time, the bad loan disposal and economic recovery would have taken even longer.

In this regard, people in the world are very carefully watching the U.S. Government action towards three major auto makers. If over protection on these companies are taken, this will cause of course moral hazard. Also this will ignite various protectionist movement in other countries I'm afraid.

In Japan, we had a very similar discussion regarding some leading companies ten years ago or so. A typical case was Daiei, which was the biggest supermarket chain in Japan. Some political powers insisted to rescue Daiei through government support. It was because negative impact of its failure would be very serious. But Koizumi government did not rescue these damaged companies. On the contrary, we took a policy so-called "managed bankruptcy" – "managed bankruptcy."

To be specific, the government established Industry Revitalization Corporation Japan -- IRCJ -- and this IRCJ was a kind of government bank, but this was given some special legal power like judicial court to restructure debtors and creditors relations. Under IRCJ, about 50 companies -- 50 major companies, including Daiei, Kanebo were once bankrupt and then restructured.

A disposal of nonperforming loan in the banking sector is one issue and reduction of excess debt in damaged business is another one. However, these are both sides of the coin. IRCJ, which was established in 2003, finished its historical role and was successfully dissolved last year.

Anyway, when facing a crisis of confidence, both flexibility and boldness are crucial. That said, urgency is no excuse to be reckless. Big three issues -- auto maker issue will test the restraint and wisdom of political leaders, I think.

By the way, if we compare current U.S. situation and the Japanese situation of 10 years ago, there are a lot of difference as well as similarities. What is the similarity and what is the difference between these two countries?

At the very beginning, I recognized that U.S. problem is different from what Japan experienced about 10 years ago. However, today I noticed that the similarity between these two cases has been increasing. What is very similar is a slow and poor action in politics maybe. Let me talk on this point.

Japanese financial crisis was a typical banking crisis. Because of the burst of the bubble around 1990, asset deflation started. As a result, banking sector had a huge amount of nonperforming loan. However, in the case of the United States, banks already -- some already sold out. Some are lending assets after securitization. So Japan had the banking crisis, but U.S. faced money market crisis I'd like to say.

Of course, banking sector in the U.S. is also damaged, but the basic nature is a little bit different between Japan and the United States. In the case of banking crisis, direct negative impact on market economy is very serious. While direct damage prevails among general public, it is because bank deposit accounts for the social infrastructure for financial settlement. On the other hand, in the case of banking crisis, it is relatively easy for the government to handle the situation because banking authority, like financial service agency, has very strong power to control banks.

On the contrary, in the case of money market crisis, an infrastructure for financial settlement is not directly damaged. However, price change in capital market is very rapid and wild. Also, it is very difficult for financial authority to control the situation. It is because various kind of financial assets were held by various type of financial institutions here in the case of the United States. So technically speaking, asset assessment is much more difficult than the case of the banking crisis.

Another different factor is ten years ago Japan could depend mostly on external demand to support macro economy -- aggregate demand. A cheap yen at that time also helped the aggregate demand growth. However, now almost all countries are more or less damaged, so U.S. cannot expect too much on external demand. This is also a difference.

Anyway, the United States is facing a serious problem which was held also in Japan ten years ago. The -- both in the United States and Japan, we need to fight against populism. For this purpose, two factors are needed -- a strong political leadership is needed and also so-called public intellectuals role are very important to persuade the general public. If there is a strong public support for bailout, for example, politicians have no reasons to stop that policy.

In this regard, I'd like to touch upon the reason why the action of the Japanese government was so slow in the 1990s. Japan's Lost Decade of the '90s was in a sense a decade for finance related scandals. Security companies had some illegal actions and were accused in the early '90s. Financial institutions had accepted amakudari bureaucrats at that time who golden-parachuted in after retirement from Ministry of Finance and the Bank of Japan. Then, there were some wining and dining scandals for bureaucrats on Ministry of Finance and Bank of Japan.

In 1998, Minister of Finance and the Governor of the Bank of Japan were forced to resign for these reasons. So -- also as a result, financial policy part and banking policy part of Ministry of Finance were separated because of this scandal. Under such circumstances, general public had a strong sense of anger to financial institutions and the government. This made it very difficult to have a reasonable policy discussion on capital injections and so on. We cannot ignore a sense of anger of the general public of financial issue. Maybe in the United States you have a similar experience, I am afraid.

Well, so time is limited so I'd like to touch upon the very final point -- that's the current situation of the Japanese economy. Well, Japanese financial sectors -- banking sectors -- not so damaged directly because of this current subprime related issues. Relatively speaking, the balance sheet of the Japanese financial institutions are sound. Still, very interestingly, the growth rate of the Japanese economy is the lowest among major countries. In the first quarter of last year, the growth rate was amazingly minus 12 percent. And many economists are expecting -- predicting -- in this quarter, the growth rate will be again minus 10 percent or so.

Why we have this kind of very poor performance in a macro economy? There could be several reasons. However, in my understanding, the biggest, the most important reason is the momentum -- political momentum -- for the reform declined so rapidly after the retirement of Prime Minister Koizumi. And so under such circumstances, people's expected rate of growth declined sharply for the past two years and consequently, the growth of the domestic demand and business fixed investment went down. Under such circumstances, the external demand was also damaged through the global recession now.

So it is quite important for Japan to per se increase again the political momentum for the reform. We have very good example. Please remember the year of 2005. On this year of 2005, postal privatization was decided. We had a general election over this issue and Japanese people strongly supported the idea of privatization of Japan Post. At that time, many people -- investors in the world expected, well, the Japanese reform will advance and competiveness with the Japanese economy will be strengthened. Under such circumstance, in the year of 2005, stock price in Japan increased 42 percent annually.

So, since we have technology, we have savings, we have money, we have human resources -- so, what is required is to again to enhance the momentum of further reform. So, we are waiting for a new leader to realize this type of proactive reform.

So, sooner or later a general election will be held in Japan and according to the opinion poll -- judging from the current opinion poll, the leading opposition party -- sorry -- Democratic Party will have very strong opportunity -- high opportunity to win. But still we are not sure what would happen to the new government. What will be the new policy taken by this new party? Still everything is very uncertain. But anyway, some people in LDP are reformists and some people in DPJ are also reformists. So many general public in Japan expecting a kind of political realignment will occur. The party framework itself will be changed. But, anyway, sooner or later we will have this kind of political realignment.

We had a very serious nonperforming loan problem and the U.S. is now fighting against this nonperforming loan problem. So NPL -- nonperforming loan. It's one of the key words. But, now we have another key word in Japan. That is, new political landscape. This is another important task to be reached. I really appreciate your comment and questions. Thank you very much.

DR. BUSH: Thank you very much, Professor Takenaka, for that revealing and comprehensive analysis. We now have time for a few questions. If you have a question, wait for the mic. Then identify yourself and keep your questions short. We'll start back in the back with the gentlemen in the gray suit and the light blue tie.

QUESTION: Thank you. I'm Krishna Guha, the U.S. Economics Editor of the Financial Times. Thank you very much for your presentation, Mr. Takenaka. When I look at these parallels between Japan and the U.S., one of the questions that I try to understand is, to what extent do the different microeconomic structures in the two countries mean that the optimal policy frameworks would differ in response to a crisis? I would be interested in your thoughts, as to how the different micro-economic arrangements will influence what the optimal macro-economic policies should be.

DR. TAKENAKA: Well, I’m not sure whether I understood correctly what you are going to discuss, but anyway, macro-economic frame and micro are related issues. Well, as far as macro policy framework is concerned.

Anyway, under that situation of demand shortage, yes, even Japan and the United States need some additional demand. This could be created by maybe fiscal expansion.

As I mentioned, in the case of Japan in the 1990s, we had a huge amount of fiscal expansion, but the result was very miserable, as you -- as already mentioned. This is indicating, yes, fiscal expansion is needed temporarily, but this is a very temporary policy to support the demand shortage, to make up for the demand shortage. During this period of a fiscal expansion, supply side adjustment should be realized. The combination of macro-extremity and structure reform, or supply side adjustment, this combination is the most important point. Otherwise, I am really afraid, there is also the possibility that the U.S. economy and the Chinese economy will have another lost decade, if you focus only demand expansion. Demand expansion is important, but if you focus only on demand expansion and ignore the supply side adjustment, you have the very similar problem like Japan in the 1990s.

Micro-related issue said, well, it is still important to make use of the power of the market, or the vitality of private sectors. So, as I mentioned already in my speech, government activism is needed in such circumstances, but over-activism is very dangerous. This will create the moral hazard. In the case of Japan, anyway we had -- at that time, we had a very strong Prime Minister, and based upon his leadership, we rejected this kind of over-protectiveness movement. So in that sense, I again would like to say that the role of leadership, leadership by Prime Minister, leadership by the President is very important, to stop the over-protection, to persuade the general public.

QUESTION: Hi. I am Tom Oku, Bank of Tokyo Mitsubishi UFJ. My questions is, I want to know what your comment about what Richard Koo, the economist at Nomura Research Institute, said. He said, in D.C. a couple months ago about responding to a question from the floor; the question was, when the U.S. piles up the Treasury bond issuance, in response to fiscal stimulus, for the purposes of fiscal stimulus and the financial recovery, the question was, how the China and Japan can purchase, continue to purchase the U.S. Treasury bond? But, the reply of the Richard Koo was the United States will be able to fund domestically, because the demand investment -- I mean, consumption, or investment by corporation decreases, then that means more savings domestically, in the United States. So, Richard Koo said, you don’t want -- you don’t have to worry about this, but what’s your opinion about this?

DR. TAKENAKA: Well, thank you for the question. He -- he is my good friend – but he always says, fiscal expansion will solve everything. Regrettably, it’s not true maybe. As I mentioned, for the time being, fiscal expansion is very important. This is -- however, this will not solve everything. And, in the case of the United States, partly what he mentioned is correct, I think, the saving rate. The investment saving balance is under the important part; what’s happening the savings balance in the country. Japan Center for Economic Research made a very interesting research on this part. I would recommend you read this paper. But anyway, in this country also, the saving rate, the household saving rate become a little bit, and this will help to finance this saving of the government. The fiscal expansion we created, this saving, another this saving in the government sector, so this will help to some extent. But still, I think the financing from foreign countries are needed. In this regard, the China and Japan will continue to play an important role, especially China, I think, is ready to purchase a Treasury bond of this country.

Several months ago I had a discussion -- I have a chance to discuss on this issue with Premier Wen in Tianjin, and yes, I think he is considering this kind of financing, the role -- the role of China. As you know, now 20 percent of the U.S. TB is held by Japan and 21 percent is held by China. These two countries account for 41 percent -- more than 40 percent -- this is an important source of the finance of this country. But this role should be continued actually.

QUESTION: Hi. My name is Atsushi Yamakoshi. I am Director of Keidanren USA. Thank you very much for your comprehensive, very interesting explanation.

Well, I think recent situation in Japan show that -- as many people argue, Japanese economy is still dependent on external demand, and many people argue that we need to expand the domestic demand, and -- but, how is very important. So, Minister, would you suggest to us how we can expand domestic demand, which you explained that we succeeded in early 2000s. Thank you.

DR. TAKENAKA: Well, domestic demand -- external demand discussion -- we have a lot historically, as you know, quite well. Well, however, important factors like that I already stated in my speech. Between 2003 to 2006, this is the period of the Koizumi Administration, the growth rates recovered to a little bit higher than two percent, and this growth was mostly realized by domestic demand; 70 percent of this growth came through domestic demand expansion. So, why?

Well, expected rate of growth is very important. We have households and business, which is behaved based upon their expected rate of growth. We have some question and survey done by Cabinet Office on this issue. Around that time, year 2005 or so, the expected rate of growth was two percent, 2.5 percent, and growing to three percent. But now, according to this questionnaire survey, the expected rate of growth of the Japanese community is now less than one percent. You can easily imagine, if this expected rate differs so much, your consumption, your business fixed investment differ a lot. Actually, around that year of 2005, business fixed investment growth rate was seven percent or so.

So, first of all, it is quite important for business -- political leader to make, to create this kind of expectation through the effort of the reform. And, of course, we need much more detailed effort this. For example, we could focus some so-called promising industries. Of course, we have a lot of discussion whether the government can find out the promising industry or not. But anyway, in the case of Japan environment-related industry, health-care-related industry, education-related industry, all are strongly controlled or regulated by the government. So, if we did regulate this kind of some rules in this field, this would automatically create some demand. We already have a discussion. So, the question is whether this kind of policy can be taken by new political leader or not.

DR. BUSH: Rust Deming.

QUESTION: Thank you. Rust Deming, at SAIS. Thank you very much for your very interesting comments. I would like to put you on the spot and ask you to offer a report card on the steps that the Obama Administration has taken, and proposes to take, in response to the U.S. financial crisis, including fiscal stimulus; including the very expansionary budget; including the regulatory reform that Tim Geithner was talking about today? Thanks.

DR. TAKENAKA: Well, what kind of policy should be taken in this fiscal expansion? The answer is, in a sense, very simple, I think. We need to expand sometime in the future for something. This money should be spent now, maybe earlier, and some people say this kind of new type of automobiles are very promising, and so R&D should be strengthened, such and such.

As I mentioned, the environment related expansion are important, such and such. In the case of England, for example, sort of a creative industry, are very promising, so let's use money for that, on that. So it depends on the country, the situation in each country.

But, of course, this is quite difficult, judgment is quite difficult, especially some issues related to technology. We cannot easily judge which is the very promising technology, et cetera, et cetera. In the case of Japan, relatively speaking, it is very easy to judge, because, for example, if we say the expansion of Haneda Airport is necessary, then many people agree to that, sooner or later we have to expand that function.

And also, let's reduce the corporate tax rate. The corporate tax rate in Japan is among the highest in the countries, and so I am not in the right position to judge the detailed policy in the United States, but anyway. Anyway, some strong need, fiscal need, in the future, this should be spent at this moment, earlier.

DR. BUSH: Thank you, very much, Professor Takenaka. I think we should move on to the next part of our program, and I would like to invite the panelists to come up, and I'll yield the Chair to my colleague, Barry Bosworth.

But, before -- as they are coming up, would you please give Professor Takenaka a round of applause. Thank you very much.

[Applause]

BARRY BOSWORTH: Thank you very much. My name is Barry Bosworth, of the Brookings Institution. It took us a little while here to get this sorted out in terms of languages, but I think everything will work okay.

I think that this session is an excellent idea. Maybe Americans are not used to trying to learn things from other countries, but -- and are resistant to some of these ideas -- but the resemblance between what happened in Japan in the last decade, and what is going on here in the United States is certainly striking, and I think it is an excellent opportunity for the U.S. to sort of learn what has worked and what hasn't worked in the past.

The other aspect I can only say to this, I think it is an interesting time for doing this. I've just come back from Asia, where most of the discussion, of course, is about the U.S. crisis. And it is surprising, I think, to see the extent to which this disaster here, in the United States, has impacted all the rest of the world. It has been completely disrupting in Asia and in Europe. I think the contrast is, in Asia, the financial institutions are all very strong, not just in Japan, but even outside Japan.

To a large extent, the financial effects have been minor in Asia. The transmission mechanism has been trade, and the trade has just collapsed around the world. I think most Americans are unaware that the biggest source of decline in our GDP in the fourth quarter was exports. We are no different than other countries; it's just that it got off-set by an equally large decline in our imports, so we might say it was a wash. But, the decline in the trade around the world is truly remarkable.

In the United States, this is mainly a financial crisis. I think, in Europe, it's mainly a financial crisis. But, Asia has been impacted more than many economists expected because of this trade mechanism. So, I think it's both increasingly clear that it's going to be a much bigger crisis than people anticipated, and it's going to have enormous impact on the global economy, but it is a good opportunity to sit back and look at what happened in the bubbles of Japan in the prior decade, and compare Japanese policy responses to American policy responses.

So, in this panel, what we would like to have are some initial remarks from each one of the panel members. I think we will start on the right and just move on down. And, second, then after that, we can have a general discussion period, okay? Our first speaker is Mr. Okabe, who is with Nikkei.

NAOAKI OKABE: Thank you, Mr. Chairman. I am very proud that I will be the first hitter, like Ichiro of the WBC, thank you for the WBC. And, I would like to state the similarities and the differences between the U.S. and Japanese financial crisis.

At the Davos Forum last year, where I attended a meeting, then Minister of State for Financial Services, Yoshimi Watanabe, pointed out that the similarity between the Japanese and the U.S. financial crisis, using the French term, déjà vu, this was a warning to the United States. But I recall Professor Summers, at the session, said that U.S. banks are totally different from Japanese banks. Today, I would like to state three déjà vu points.

First, both Japanese financial authorities and U.S. financial authorities permitted the failure of large financial institutions forgetting the "too big to fail" principle. This amplified the credit crunch, and made the economic crisis more serious. In Japan, the Yamaichi Security Corporation, Hokkaido Takushoku Bank, the long-time credit bank of Japan, and the Nippon Credit Bank failed one after another. A bigger factor in Japan being able to emerge from its financial crisis for the Minister of the State for Financial Services, Heizo Takenaka, forced financial institutions, to clear their bad debt, and then rescued Resona Bank, by effectively nationalizing it.

On the other hand, one big impact that made the current global financial crisis more serious was that U.S. financial authorities led by the Secretary Paulson allowed Lehman Brothers to fail. From this, a string of financial crises erupted throughout the world, and with the automobile crisis tied in as well. The world fell into almost like a great depression. Following that, the U.S. authorities came back to the "too big to fail" principle by bringing AIG and Citigroup under government control. However, the wages of this historical failure by U.S. financial authorities proved to be large indeed.

The second déjà vu was "too little too late." The reason for this is the democratic states, like Japan and the U.S., there is a strong allergy in using taxpayer money among ordinary citizens and politicians. In Japan, the allergy to public funds spread following problems, as housing loan companies during the mid-1990s; that is because the injection of public funds into financial institutions was overdue. The U.S. resembles this, in particular, under the Republican Administration, which emphasizes free market economics, injection of public funds, while late, even as the crisis was becoming actualized, the Republican Party, at present, remains half-hearted about bailing out financial institutions.

The 700 billion dollar government-funded package by the Obama Administration is too small compared to the depths of the financial crisis. It would appear that the U.S. reaction has been swifter and more massive than Japan's, but considering that it is the epicenter of the global economic and financial crisis, it is truly too little, too late.

During Japan's financial crisis, losses of financial institutions reached about 20 percent of GDP. Some calculations suggest losses at U.S. financial institutions could climb to four trillion dollars. If that is accurate, a 750 billion dollar rescue package is too small.

The third déjà vu point is the danger of a lost decade. Japan stumbled into its lost decade, in the form of a chain of financial crisis and deflation due to mistakes in handling the post bubble situation. Monetary policy and fiscal policy during that period could be called a history of failures. In particular, there were numerous mistakes in monetary policy, where their interest rate policy was lifted when the economy was still weak, and in fiscal policy, where there was reluctance to tax cuts, and increased fiscal expenditures. There was an example of government failure overlapping market failures. What was particularly troublesome for the crisis in the banking system became linked to the crisis of deflation. Federal Reserve Board Chairman Alan Greenspan took Japan's financial crisis linked with deflation, as a lesson from Japan. However, the Fed Chairman over-learned from Japan's mistakes worried about deflation, he went farther and longer than necessary, in monetary easing. This caused the asset bubbles in the U.S. housing and stock prices, and we are now suffering from a crisis caused by the collapse of those bubbles.

Pessimist economist, Steven Walsh, and Professor Paul Krugman warning that the U.S. is in danger of falling into a lost decade, like Japan. The world economy is now facing the deflationary trend; freeing the economy from deflation will not be easy. The difference between the Japanese and the U.S. financial crisis are also large.

First, the Japanese crisis was simple, while the U.S. crisis is complex. Bank lending was at the center of the Japanese bad debts. In contrast, the U.S. bad debts are derivatives, such as CDS and securitized products, by the subprime mortgage; asset adjustment and lost confirmation are not transparent.

Secondly, the Japanese crisis did not involve the mega banks, while the U.S. crisis has hit directly at the center of Wall Street. Numerous financial institutions failed in Japan, but most were second-class companies, while the so-called top banks survived. In contrast, in the U.S. investment banking motto involved the core of Wall Street has collapsed, and leading banks and the insurance companies, like Citigroup and AIG have come under government control. This is -- this difference is enormous.

Thirdly, Japan's crisis was a local phenomenon, contained entirely in Japan. On the other hand, the U.S.-sparked financial crisis rippled outward to become globally -- a global crisis; that is partially because of the progress in globalization and multiplizations, and it could be said, to illustrate, how a crisis in the key currency country can shake the entire world. There is an enormous difference between the local crisis and the global one.

Thank you.

DR. BOSWORTH: Thank you very much for those remarks. Why don't we turn directly to Mr. Arai, who is the Chairman of the Japan Center for Economic Research. I was actually there about a decade-and-a-half ago, for a period of time when I was in Japan studying there, and I quickly learned, to the Americans, our first translation of it was Japan Economic Research Center, but that translated as JERC, and so we had to learn to change it to be Japan Center for Economic Research. Thank you very much.

JUNICHI ARAI: (Interpretation; original remarks in Japanese) Thank you very much. I will be making my remarks in Japanese rather than English. I am at the Japan Center for Economic Research, my name is Arai. And it so happens that Professor Takenaka is one of our members.

So, the theme that we have before us is Japan's Lost Decade and what lessons there might be there for U.S. economic policy. Ten years is not a long enough time for a historian but it is more than sufficient for an economist, and so I think that there are plenty of significant cases both good and bad in our lost decade that could serve as a reference to the U.S.

So we have various panelists speaking, and Mr. Okabe has already taken the floor. But I think that it can be said that, without absolutely simultaneously addressing both the financial system and the real economy, that we will not see positive evolution in the economy.

The Japanese Government engaged in various fiscal measures beginning in the early '90s, but why did this not lead to economic recovery? It is because the financial system did not stabilize.

And what must the Government do in order to stabilize financial systems? Bad loans have to be separated, removed if you will. To use a medical analogy, I would say that surgery is required.

For recovery in the real economy, I am not sure if this is an appropriate analogy, but perhaps a nutritional supplement should be provided, and fever should be controlled. This would be more analogous to internal medicine.

I think that the lost decade was focused too much on surgery rather than internal medicine.

Beginning in 2002, was it, or should we say around 2003, the economy began to get better in Japan. And this was not just because the Koizumi

Cabinet had success in the surgery, in the stabilization of the financial system, but also because it just so happened that capital investment began to increase at the time, and thanks to a good economy in the U.S., for example, we had export growth. And so it just so happened that the internal medicine portion was going well at the same time. Without both, you cannot see improvement.

If you just focus on the financial system and the treatment of bad loans, then you run the risk of seeing your economy go into atrophy. It becomes a very difficult question in terms of expanding the real economy and the timing of it. This will no doubt be a terrific challenge facing the U.S.

So we have been asked to talk about the recent decade, which is important, but I would like to also focus on something that goes back a bit further. We are looking at a once in a century in a crisis perhaps, and if you look at the 1930s, specifically from 1931 to 1936, there was someone, a figure in our country, who is very well known there, named Korekiyo Takahashi. He came to the U.S. to study, under difficult circumstances, and worked very hard. Almost like a slave, if you will. And his fiscal policy, even though he knew nothing of Keynes, was something that we should take a good look at now.

I think there are particularly three similarities for the Japanese economy between the 1930s, the early 1930s, and now.

The first is that the previous decade had an overall deflationary trend. The Nikkei Center is predicting negative economic growth of 3.7 percent, which is the worst we have seen since the war. It will perhaps get worse. However, this was a typical figure during the 1930s -- 1920s, rather. This is what it was every year.

The second similarity is that there was a long period of a strong yen. A year before Mr. Takahashi became the Minister of Finance, Japan returned to the Gold Standard. The European countries had returned earlier, Japan was late. But in that year the yen appreciated 8 percent against the U.S. dollar.

And the third similarity is certainly that there was a great depression then that started in the United States in 1929.

So, what did Minister Takahashi do? As soon as he took office he came out with a large number of measures in rapid succession. He was quick.

So, he took office in December of 1931. Only a month later, in January of 1932, Japan officially withdrew from the Gold Standard. This was a measure designed to counter the strong yen. And a couple of months later, in March, for the first time he saw to it that the Bank of Japan purchased directly government bonds. This is not allowed in Japan currently. And within the space of a year he lowered the key policy interest rate four times. So it went down from 6.57 percent to 3.05 percent. So you can see that his implementation of policy was very quick.

Further, it is important that the scale of his policy measures was large. The amount of government bonds issued was 8 percent of GDP. And as to increase in public expenditure for fiscal 1932, it represented 10 percent of GDP. And by having the Bank of Japan buy government bonds, he sought to counter the problem whereby GDP nominal growth was minus 10 percent. This he did through monetary easing. Thanks to this, prices began to increase in 1932, and there was positive growth in 1933 and 1934.

So, certainly there were many differences then compared to now. Some may question the relevance of something that happened roughly 90 years ago. But the main points that I would like to point out are that his policies were quick and on a large scale.

The demand supply gap in the fourth quarter of 2008 was 20 trillion yen in Japan. And since we are having negative economic growth, for the first quarter of 2009, it is likely to be 30 or 40 trillion yen.

Let’s say it were to grow to, 40 trillion yen this would represent 8 percent of our GDP. So I don’t know exactly what the demand supply gap was when Minister Takahashi was in charge of Japan’s finances, but it may be that our GNP gap will be at the same level that he faced. Certainly taking fiscal measures on that scale are difficult given our current public finances. Also, a simple program that is based on mere public works would no doubt be insufficient, but it does seem to me that large scale measures are called for.

Minister Takahashi’s policies did lead to economic growth, but he has been criticized also. Because the Bank of Japan was buying government bonds, this is something that Minister Takahashi did for the first time. The military used these funds in order to -- for building up Japan’s arms, and this is something that it was difficult to stop.

So I believe that Mr. Takenaka earlier said that fiscal stimulus is necessary but they are not to be temporary once the economy improves. So I would like to agree by saying fiscal stimulus can be effective, but it has its dangers.

So, in conclusion, in order to deal with our large demand supply gap, I think that fiscal stimulus is important, but we ought to be thinking now about how to exit once the economy does recover, and I think this is a lesson that applies both to Japan and the U.S.

I’m sorry. I have taken quite a bit of time.

DR. BOSWORTH: Well, that was very interesting. Here in the U.S., we do see the return of the name “Keynes” frequently mentioned. So this morning I have learned that there is a Japanese and English, maybe we should refer to “Keynes” and Takahashi.

(Laughter)

Our next speaker is Alice Rivlin, who is at Brookings but was formerly with the Federal Reserve Board in one of her prior incarnations.

ALICE. RIVLIN: Thank you. It seems to me that this is a very interesting opportunity to learn from prior experience.

I am actually glad that we are talking about Japan, which is another large, complicated economy, and one that has made some mistakes. It’s nice to learn from mistakes as well as from what was done well.

In recent months, many of us have been subjected to the example of Sweden and how it handled its financial crisis of the early ‘90s. They did extremely well, and Americans should learn from Sweden, but it is always tempting to point out that it is a very small country, that it had only four or five banks, that the crisis was much simpler, and that it is hard to apply those lessons here. I think the lessons from Japan are much more relevant.

As several speakers have pointed out, the U.S. situation is extremely complex, and it did not have a single reason for happening. We had lax lending standards. We had a bubble in real estate and stocks. We had an inflow of capital from all around the world that exacerbated both our lax lending standards and our bubbles, especially in real estate.

We had been an under-saving economy for a long time, and the Chinese and other emerging nations were over-saving. And a flood of capital was coming into the United States, looking for a place to go, something a little better than in terms of yield than treasuries, but just as safe, and mortgage-backed securities seemed to be that. And the eagerness to securitize those mortgages put a lot of pressure on an inadequately-regulated mortgage banking system to churn out the mortgages, turn them into securitized products, and then we had not kept our regulatory system in good order because it simply didn’t keep up with the innovation in financial products.

The thing that made this crisis really bad was not just the bursting of the underlying bubbles, we could have handled that, but it was the fact that we had erected a huge superstructure, over-leveraged, pumping out, of more and more exotic derivatives. And when that bubble broke, because the underlying assets U.S. housing prices were no longer as valuable, there was a very traumatic, huge crash which affected the real economy very seriously, as banks retrenched and no one could get credit.

In terms of the policy response, I think actually the policy-makers had learned many of the lessons of Japan. The Federal Reserve acted very aggressively, brought interest rates down. Certainly, the example of Japan operating at close to zero interest rates -- what do you do when you can't bring the interest rate down any further? -- was much talked about here. And we have done many of the same things that the Bank of Japan did, in terms of getting enormous amounts of liquidity out there, not just to the commercial banking system, but to all financial institutions, and beginning to do direct expansion of the money supply.

And in terms of rescuing the financial sector, the lesson of Japan that you have to get the troubled assets off the books of the banks, otherwise nothing will work, was learned, I think. And Secretary Paulson started there. His first effort became known as the "TARP," for "Troubled Asset Recovery Program." The problem was they couldn't figure out fast enough how to do this, how to value those troubled assets. So they turned to what I think they thought was second best -- but they needed to do something fast -- and that was direct injection of capital into the banks.

They had the same problem that the Japanese authorities had: it's hard to explain that to the public. Taxpayers don't like it. "Why are you giving money to these banks, who are the people that got us into trouble in the first place -- and not helping us out directly?" And our government didn't handle this very well, and we're still living with the consequences of that failure.

On the fiscal front, I think we have done better. And the stimulus got out quite quickly, and was quite substantial. But I think we should take to heart Minister Takenaka's cautions about you can overdo construction. The Japanese certainly did. But we, I think, start from a different place. We have neglected our public infrastructure for a long time. And not all of our stimulus is construction. Much of it is other things, in terms of modernizing our economy and getting broadband out there -- and particularly, upgrading our skills and education, where at the elementary and secondary level, we clearly fall behind Japan. We're very proud of our universities, and we do well there, but improving our education system for long-run productivity can be both a long-run investment and a stimulus.

But now we've come back to the troubled assets. And Secretary Geithner has put out a plan. I think to say that it is too small, as Mr. Okabe did, may be true. But it doesn't focus on the actual size. The Treasury has only put the original $700 billion into the banks, but don't forget the Federal Reserve. It is massively leveraging this Treasury contribution. Most of the new program announced recently, from a dollar point of view, comes from the Federal Reserve, not from the Treasury. And the other piece of it is trying to attract private capital and private expertise into the rescue of the banking system -- particularly in helping to value the assets. It may still be too small, but it's bigger than it looks.

But the reason it is constructed in this very complicated way comes back to the difficulty of explaining to taxpayers why they need to put up more money. It is the reluctance of our Treasury to say to Congress, "We need more." They're trying to use their limited funds as efficiently as they possibly can.

Finally, there is the question of consumption and saving going forward. Japan saves a lot. China has been saving enormous amounts. We have been saving too little. Somehow, as we get these systems back into working order, we've got to re-balance so that we save more, finance more of our domestic investment out of our own saving, and are not as dependent on the inflow of foreign capital.

Thank you.

DR. BOSWORTH: Thank you very much, Alice. The next speaker is Mr. Takita.

YOICHI TAKITA: Thank you very much. So I'd like to concentrate on the Japanese experience after the burst of the bubble. But three excellent speakers have already pointed out such things, and I'd like to have so how to identify the troubled assets and how to deal with it.

Anyway, happy families are alike. Every unhappy family is unhappy in its own way. You know. Whenever I talk about bubbles, I remember the famous quote from Anna Karenina, by Tolstoy.

The Japanese economy has struggled for 10 years since the burst of the bubble, and has finally emerged from purgatory. But the recovery is thanks to Professor Takenaka, after he became to the Minister for Financial Services. Because, you know, the Japanese Financial Services Agency, FSA, did strict test of bank assets, then pushed bankers to write off bad assets, then injected weak banks with new capital.

Frankly speaking, Geithner's plan reminds me of Takenaka's actions. Japanese banks' balance sheets are quite healthy compared with five years ago. I would like to stress that strict monitoring by the FSA helps Japanese banks very sound for the time being.

For example, I'd like to point out the sub-prime-related assets. For the time being, the outstanding, or the exposure, toward the sub-prime-related or the securitized products of the Japanese banks is far below the American and European counterparts. This is thanks to the lessons from the Japanese bubble.

But I'd like to point out more important things. It is that Japanese banks and Japanese authorities, for the time being, grasp the total picture of the securitized assets for the time being. For example, such exposure or the loss ratio forced each securitized product directly sub-prime related assets, for the CLOs or the CDOs or MBS, CMBS and leveraged loans.

It would be very surprising things to the American audience. Japanese FSA gathers such figures and discloses such figures every three months. It is very, very clear process to deal with such securitized assets or the sub-prime assets. Then I will show you the also very interesting things to you.

The recent figures of the such a securitized assets can be gotten from the last December. This figure shows that decrease from last September. That thing means that securitized (inaudible) is also very severe in Japan, but has already peaked out, or is very close to the peak. It also shows Japanese banks reacted very quickly to the securitization mess for the time being. They learned such lessons 10 years ago.

But, however, I don't mean to say there is no problem in Japan. Not at all. The situation may be reversed. Please remember, every unhappy family is unhappy in its own way.

At this time, the Japanese economy faces very tough conditions because of the sharp drop of its exports to the world. Japanese business escaped from their troubles by relying on external demand. In this point, I have a little bit different opinion from Mr. Takenaka. But, however, I'd like to talk about the recent things.

Japan was very happy to see the global economic boom. But, however, ironically speaking, such global economic boom was supported, not exclusively, but in large part, by the U.S. housing bubble. It is very, very ironical paradox.

Anyway, after the Lehman's failure, Japanese economy was shaken more than U.S. economy. It is also very paradoxical thing. Even Toyota Motors, they were in the red result. And the fourth quarter GDP of Japan fell by 2 percent, as Takenaka referred just now.

But, however, it's not Japan alone that was affected by the sub-prime issues. For example, during the same period -- meaning the fourth quarter of last year -- Thailand economy fell by 22 percent, you know. Korea -- not North Korea, but South Korea -- fell by 21 percent. And Singapore -- it's a very excellent small economy -- but it fell by 16 percent.

We should say that such export-oriented Eastern Asian economies faced the same very tough conditions. It's not clear whether Mainland China fell into this same trend or not. I don't know.

But like other export-oriented Eastern Asian economies, Japan faced very tough conditions. This meant that since the burst of the bubble, Japan has not still succeeded in sparring its own domestic economy. It is a very important point that Takenaka has already pointed out.

But I'd like to add on the one more important point -- it is concerning about Japanese stock or equity market. I also have to mention the external investors have a large position in the Japanese stock market. The figures will be very marvelous figures. Roughly, 60 percent, or 70 percent, of total turnover in Japanese equity market is due to the foreign investors. Seventy percent is very, very large figures, as you know.

But, however, I'd like to the other important figure. Around 25 percent of the total listed stock of Japan are held by foreign investors. This is also very high figures. These facts show that Japanese equity market is highly internationalized. It's rather different from your image. Our U.S. friends used to advise me or other Japanese authorities to open the door. Surely, Japan has opened their door very widely. Such a share held by foreign investors very, very rapidly increased, and dramatically increased after the Takenaka became to be Minister of Finance Services. I think that such foreign investors provided very important risk capital to the Japanese market and to the Japanese economy.

In this context, I am not sympathetic to those persons who like to talk about conspiracy theory, you know. Because such persons like to say that such open-door policies sell the Japanese assets to other foreigners. Not at all. Such foreigners, foreign investors, provided such a very important, such risk money to the Japanese economy and companies. That's sure.

But, however, in this point I cannot help but saying some paradox. You know. Such investment provides very good momentum for the Japanese economy. But, however, after the sub-prime bubble burst, such investors are withdrawing such money from Japan to other mainland countries because they are keeping their cash position. In this point, Japanese market and Japanese economy just now facing very, very cold wind in Washington recent days, from such a widely opened doors and windows.

Then I should come to conclude my remarks for the time being.

Surely, Japan should deal with our own challenges by ourselves. And agenda is very clear: to move Japan from saving to investment. But it is only halfway here.

Japan damaged from the sub-prime crisis relatively small. But, however, Japan faces new challenges for the time being.

Thank you for your attention.

DR. BOSWORTH: Thank you very much for those remarks. And our last speaker this morning is Adam Posen, from the Institute for International Economics.

ADAM POSEN: Thank you, Barry. My apologies for the late arrival. I sincerely thank my colleagues at Nikkei and at Brookings for including me in this. This is obviously a topic of great concern.

The simplest way to tackle the topic -- as I think the other panelists have all said -- is do what Takenaka Sensei tells you to do and it'll be okay. That's essentially what worked in Japan. Unfortunately, we are unlikely, with the vetting process, to let Takenaka Sensei become head of the NEC. So we'll have to try to drag out a little more detail what should and should not be done.

I'm going to give a slightly different and perhaps a little more short-term spin on this. I don't know. But I think there are about seven major lessons to be taken -- some of which is based on research I represented in this room, now eight years ago, but which still hold up.

DR. BOSWORTH: Some holds up.

DR. POSEN: Oh, yeah – all – but depends how you spin it. But I guess the main points are as follows.

As much as a hero as Prime Minister Koizumi and Minister Takenaka were, Japan did not have to go through the '90s the way it did. And I think we have to start from that point. There are people -- Richard Koo, Martin Wolf -- well known to all of you -- who talk about "balance-sheet recessions," and who talk about the idea that you have such a huge loss of asset prices that -- in household and business balance sheets -- that you just cannot recover until that's worked through. And there was that counsel of despair at times in Japan and to a lesser degree there is that now.

And I just want to stress that I think what Takenaka and his colleagues did, and what the U.S. government is now doing, in essence, is right. Policy activism is the right response.

I firmly believe that Japan would have recovered in 1995 had there not been bad policies and neglect of the banking system. I firmly believe Japan could have still recovered in 1998, had there not been neglect of the banking system. And, therefore, it takes nothing away from the credit to the Koizumi team that they -- Japan did eventually recover in 2002 when the right things were done.

So I think that's the first point -- that the bias towards activities, while it does have its costs, while we have to think about it, is the right one. And that lesson, that bumper-sticker from Japan, is correct.

The second one, which is the big ticket right now, is the question of spending money on stimulus versus spending money on the banks. And I think Alice Rivlin, of course, is very wise and right to say we have this crazy public-private partnership, non-bank, bad-bank, pseudo-bank, aggregator-bank thing coming out of the Treasury because it's all about not going to Congress and getting money on-budget.

But if you take a broader -- and I feel the White House is putting the Obama Administration's pain on this. But if you take a broader historical perspective, that essentially -- as some of the other speakers today have mentioned -- is essentially what kept Japan from doing the right thing, in a sense, throughout the '90s.

The Japanese government did put money into cleaning up the Jusen to some degree. The Japanese government did put money, in '97 and '98, to dealing with some failed institutions. And this was very politically unpopular, and people said, "Well, we should be spending money on stimulus and jobs, and not on the banks." And then you get situations like we have.

And I think the important lesson of this, again, is not despair, but a certain amount of humility. That we all can remember Larry Summers and others running around -- and I was a junior member of this coalition -- running around, yelling at the Japanese officials in the late '90s, and backing people like Takenaka Heizo and Ito Takatoshi and others who wanted to do the right thing, and saying, you know, "Do it, do it, do it!" Well, it's harder when it's your own country, and you find out you can't just do it.

So that doesn't mean that the Geithner plan is wrong. As I've written, I think it may succeed, and if it does, it will succeed at a very high wealth transfer from taxpayers to certain financial firms. That may be the best deal that could be done right now. I would have hoped not, but I'm not in that position to make that call.

My concern -- and for this sophisticated audience under CNAPS, you know, will probably understand the reference -- my concern, and this is a place where I guess I differ a bit from Alice, is that we are not seeing Takenaka in 2002 right now, we are seeing Yanagisawa in 1998. That we are seeing someone who comes in, who has some good intent as a reformer, who is held to be a reformer, but who, in the end, for political reasons, wants to give away money to the banks with too little conditionality, and doesn't want to close any banks.

And we will see if that's the case. If that is the case -- again, if it is Japan in '98 and Yanagisawa, instead of Japan in 2002 and Takenaka -- more appropriately what will happen is 18 months, two years down the road we're just going to have to put more capital into the banks.

And, again, I don't want to belabor this, that is standard for this type of process. And that's why, for all the talk about lack of complexity in Sweden, the real accomplishment of the Swedes was they got it done. It's not about complexity, it's about politically getting it done.

The third point I would make, which comes directly out of this -- and this is something that was very actively demonstrated, repeatedly, in Japan, is: fiscal stimulus works, but only so far; that if you engage in fiscal stimulus, you do get a multiplier greater than one. And even if you engage in wasteful fiscal stimulus -- bridges in northern Hokkaido Island that get 10 cars a day or, as was reported in the Post the other day, we're going to do something about Mormon crickets, I think it was, in Utah?

Anyway, wasteful spending still has a positive multiplier. It may not be a good idea and, all else being equal, you might want to do things that have -- infrastructure investment, I think, is a good point there. But it does buy you time, it does buy you growth. It does prevent unemployment from rising more than it otherwise would.

The key point, though, is that it is not sustainable growth. And I mean that in two senses. First, as Japan demonstrated, you cannot move in an advanced economy 13 percent of your workforce into construction. It's not a good idea. Second, and more importantly, if you do not fix the banking system by the time your stimulus runs out, then private demand will not pick up when the stimulus runs out. That's what we saw in Japan in '97, that's what we saw in Japan in '99.

And so we have a clock ticking. And, again, I hope to be wrong, and see that the Treasury plan does resolve the banking problems in this country before the stimulus runs out in roughly 18 months. We will see. But if the banking problems are not in some substantial way resolved by then, we should expect another downturn in the U.S. at that point.

Fourth lesson -- monetary policy and deflation. One of the striking things -- and I'm not alone in noticing this by any means, but I still don't think it gets enough attention -- is how inertial, how sticky, deflation was in Japan. So once deflation started, it went down to negative-1 percent roughly annualized rate, depending on which index you look at, whatever. But the bottom line was it never accelerated. Even when the economy stayed bad, it didn't start going to minus-2, minus-4 -- which a straightforward model that has continued to predict pretty well on upside moves on inflation using output gap in Japan would have predicted.

And this had a couple implications. I mean, the first was, monetary policy did not remove inflation quickly in any easy way. It meant that inflation was actually less destructive than some of us worried it might be. It certainly didn't help matters, but you didn't see a lot of enormous drag and disruption, debt-deflation cycles in the economy that you might have worried about. And third, just simply, we don't understand it very well. I mean, that is not an outcome -- whatever type of standard macro model, if you use a right-leaning real business-cycle model, you don't have money and prices anyway, so you can't really model it. If you use a normal new-Keynesian model, you really can't get that result, either. It indicates we really don't understand what's going on.

Now, as a researcher, you say, "Oh, boy, maybe I can find out about that." But in terms of monetary policy, I think it indicates, again, a bit of humility. The Federal Reserve is right, as several of the previous speakers have said, to be throwing money at the problem. But I think we should stay away from very mechanistic monetarism that, "Oh, boy, they've printed a lot of money so at some point that has to turn into inflation." Or, "If we do this kind of quantitative easing, it will lead to this result."

There was a paper presented here several years ago by Bernanke, Reinhart and Sack that tried to make the case that the quantitative easing in Japan actually did work in that sense. I have very strong doubts about that paper. I mean, it just is a matter of intellectual debate.

I think what we're seeing -- which is indeed what we saw with the Bank of Japan in the '90s -- is monetary policy that is directed towards alleviating concerns in specific markets. So the way the BOJ moved into the commercial paper market, which has been emulated very successfully by the U.S. right now, removes the obstruction, at least temporarily, in that market. And that's helpful.

I think the market direct purchase of longer government bonds, as the Federal Reserve is moving into, as the Bank of England is already doing, as Bank of Japan did for awhile, I think that has some direct effects -- mostly through accommodating fiscal policy. But I don't think we should be viewing this as standard textbook, "We print a lot of money. It has this effect. Let's try to make a guess what the money multiplier is -- " -- because that's just not consonant with what we've seen.

The next three lessons are much shorter.

Fifth -- even if the government wants to do the right thing, keep pressuring them. This may sound self-justifying for my writing op-eds, but the fact remains. I think it was useful that the U.S. government and the IMF and the OECD and various other institutions did put pressure on the Japanese government to do the right thing during the late 1990s and into the Takenaka era. There were obviously always concerns about overplaying your hand, and the U.S. looking too dominant. But it says that today it is perfectly right and reasonable for the rest of the G-20, from the Chinese and the U.K. on down, to say to the U.S., "Get your house in order." And even if Tim Geithner whispers, sotto voce, off the record, "Well, I really am going to do it," you know, we heard that from Japanese officials in the '90s, and what's good for the goose is good for the gander.

Sixth, the fundamental and largest difference between Japan's case then, and U.S. now -- which we all, of course, recognize, but which should not be ignored -- is the difference in the global economy.

Japan, despite the Asian financial crisis of '97, '98, for most of its period of recession was able to export to a glowing world economy, had real depreciation of the currency without getting too much of a negative response from others. And others here have acknowledged this. And we've just had Mr. Takita and Takenaka talk about the need for domestic consumption.

Obviously, it's a much more fraught and difficult thing in the current context, when world trade is falling off a cliff, in terms of the figures the previous speaker just mentioned. And there is much more room for political fallout of what are correctly or incorrectly -- but largely correctly -- perceived as zero-sum moves in currency depreciations and begger-thy-neighbor. And we should be worried about that.

Final point -- the state of Japan's economy right now is quite poor, even though you've just had in Japan this very long recovery -- long-lived recovery, from late 2002 into, depending when you count it, late 2007, early 2008. And that happened even though the current FSA and the banks in Japan, I think, did -- as has been discussed -- essentially avoid many of the mistakes that their American, British and Continental European counterparts made.

And I think there's one key lesson to be taken from this as we talk about regulatory reform. Which is there's been a lot of loose talk, and some serious talk, which I think is unfounded, about the real problem in the U.S. banking system was, "We didn't have enough skin in the game. Securitization was bad. People didn't have enough at stake so they made bad decisions."

Well, actually, you look at Japan's banking system right now, and a major part of the problem in the Japanese economy isn't just the trade loss, it's that the major commercial banks still have cross-shareholdings with other industrial companies. And so when the economy turned down for even good companies in Japan, like Canon and Toyota and Fuji Xerox, and whatever, came down, that eroded the capital base of the Japanese banks, and that further accelerated the credit crunch -- even though they had done the right thing, largely, in terms of their loan book.

And the flip-side of that is we're all becoming increasingly aware of how many of these banks in the U.S. -- and I use the term "bank" very loosely -- that the stuff that was supposed to be off balance sheet actually wasn't off balance sheet in the end, and the people at Bear Stearns had 80 percent of their retirement savings in Bear Stearns stock. So I think another lesson from Japan that is relevant today is we cannot simply say, "Arm's length finance is bad. Relationship finance is good." It's a little more complicated than that.

Thank you very much.

DR. BOSWORTH: Thank you very much, Adam. I think we now have an opportunity for a little bit of interaction with the audience. yes -- would you please identify yourself before you speak?

QUESTION: My name is Daisaku Kihara. I'm now the executive director, representing Japan in the IMF.

And as a person who was in the middle of the, I think, financial crisis in Japan between 1996 through 2003, I'd just like to make, I think, two comments. This is just, I think, factual.

And I'd just like to ask that I was a person who was referred in many journalism in Japan as natural enemy of, I think, Minister Takenaka, despite the fact that my younger brother is a very close friend of Mr. Takenaka, and they work together in recent times.

My point is, just factual -- we, or I think myself, I think, receive my old friends from Larry and Tim in 1997 and 1998, to address the issue of, I think, financial crisis in Japan. Until the time in August 1998, until the time when Larry actually bailed out long-term credit, ATCM. And that time the issue was not to, I think, get rid of the non-performing loans in Japan. But what Larry and Tim pressed us to do was the type of hard-landing approach which was actually applied in the case of U.S.A. to Lehman Brothers.

So it should be, I think recalled -- that what Larry asked us to do was hard landing.

And number two, it is a bit unfair to say that Mr. Yanagisawa was in charge in 1998. Actually, the so-called -- the failed capital injection to the Japanese banks across the board in the spring of 1998 was conducted under the, I think, Ministership of Mr. Miyazawa. And what Mr. Yanagisawa conducted was a so-called, I think, successful public injection, which was implemented in the spring of 1999.

And the major reason of the success was the very rigorous examination of the assets of all banks, actually preceded the actual injection of the public money. So all, I think, taxpayers in Japan was informed of the status of their assets. That's my, I think, two comments.

And one small question to, I think, Ms. Rivlin is: what's the reason of hesitating the rigorous examination of the bank assets -- assets of the major, I think, banks right now? Is it because of, I think, technical reason you mentioned? That is, it is so difficult to, I think, assess the real value of the, I think, securitized instruments? Or the fear, which is widely talked about in the market, that if it will be conducted rigorously, all 19 banks now under examination would become insolvent?

Thank you very much.

DR. BOSWORTH: Do you want to say something?

DR. RIVLIN: Well, the last question, about why we are taking so long to get on with it, and to get on with the valuation of the assets -- I'm not quite sure, actually. I think it has been partly the real difficulty of the problem, partly the fear of the answer. And that if we simply proceed too quickly and the values are very low, then we bring down some major institutions, and we don't want to deal with that.

I really don't know. I think we are getting on with it now. But you're absolutely right, it's taken a long time.

DR. POSEN: With respect to the Yanagisawa notion that you put out there, I was ignoring the early 2000 -- 1998 plan, because it was clearly a failure.

The Yanagisawa plan was a failure, as well, in the sense that, I fear, the Geithner plan will be -- that it was too much of a giveaway to the banks with too little conditionality, even though it was well-intended. And you can say it was successful, but if it had been successful, you wouldn't have had to have Minister Takenaka come in four years later and really write down the value of the assets.

Moreover, as Mr. Takita just mentioned, there were always publications of non-performing loans. And there's a very interesting, you can do a comparison -- and we talked about this at the IMF the other day, actually -- of what the IMF and the private-sector people thought were the non-performing loans, versus what the government said they were.

And in ‘98, ‘99, 2000 there was a very large gap. It was only after the measures taken in 2002 that the market assessments and the IMF assessments matched the official government assessments.

So, no, I was not mistaken in calling the Yanagisawa plan a failure.

DR. BOSWORTH: Whose adjustments changed?

DR. POSEN: Eventually, the non-performing loans officially declared by the government went up after the inspections in 2002. And very shortly after that, the IMF and market participants’ assessments converged very fast down to where the government’s were.

QUESTION: I’m Don Sherk, with Johns Hopkins University.

I was particularly interested to note that none of the three Japanese speakers referred to the yen exchange rate. Are we to conclude that the Japanese government does not see the exchange rate as a policy variable?

MR. OKABE: (Interpretation; original remarks in Japanese) Well, with regard to exchange rate, the Japanese government is not guiding the exchange rate, the down, or the other way around. I don’t think the Japanese government has that kind of intention.

And I think that it’s pretty clear by the fact that the yen is moving between 90 and 100. So from that, I think it is very clear there is no government guidance on that. And given this, the worldwide, global financial crisis, I do not believe that the Japanese government try to bring down the yen.

And also it is quite clear from the fact that Japanese Finance Ministry hasn’t intervened in the exchange market in the last few years. And I believe that the appreciation of the yen at moderate speed is favorable to the Japanese economy, because that would create the environment where it is easier to implement structural reform.

Of course, if the yen were to become low at this time -- I mean, high at this time, it would be difficult. However, if you look at the long-term trend, I think that the appreciation of yen at the gradual pace would be desirable for Japanese economy.

DR. BOSWORTH: I might add to that, I think, as well, that exchange-rate policy has now become perceived around the world as just another form of trade protectionism. If the governments -- if the large governments, anyway -- intervene, like the United States, or Japan, or China, to influence their exchange rate, what’s the difference between that and a tariff? On imports it has very much the same effect. I think the Japanese government was to be applauded that when the yen was appreciating at a fairly rapid rate earlier this year they didn't do anything.

I think his analysis turns out to be right, as well, that it's largely transitory. It probably had to do with the yen-carry trade. Once that's over, I think the yen returns to a more typical historical value. So I think the U.S. regards that as a very positive development, internationally.

Yes?

DR. RIVLIN: Yes -- and if it's not transitory, if it's just -- if it is a result of permanent forces, then the intervention is not likely to be very effective.

DR. BOSWORTH: That's also another -- we could also question whether it ever works anymore. Right.

Do we have another question? Yes.

QUESTION: Thank you. Mike Billington, from Executive Intelligence Review. I'd like to ask Mr. Arai what was the relationship between -- excuse me, Mr. Takahashi and Franklin Roosevelt and the Roosevelt Administration, both personally and in terms of their cooperation or coordination?

And secondly, if I may, Dr. Rivlin, and others if you wish, as you know Mr. LaRouche has long called for a return to the Roosevelt approach to this crisis to put the banking system under bankruptcy and receivership, and to essentially write-off the derivative bubble, and then putting funds into the banking system that can go into reconstruction and physical economy.

And recently, James Galbraith has come out with a very strong call for that policy. And also the head of the Kansas City Fed, Mr. Hoenig, has called for a return to the RFC, and putting the banks under receivership before you pump the money in.

So I'd like to know what you think about the chance that this is on the table, and what you think about it yourself.

MR. ARAI: (Interpretation; original remarks in Japanese) Well, I haven't read the biography of Minister Takahashi in detail, so I really do not know. And I am not in the position to give you a correct answer.

However, what I understand is that at that time, there were some staff at the Bank of Japan who cooperated with Minister Takahashi. And the fact -- Minister Takahashi's decision to take the Keynesian policy, or the Keynesian approach, I think was supported by those people who serve as very good advisors to him.

And in 1931, 1932, when Mr. Takahashi became Finance Minister, the Keynesian policy was not considered as a leading theory, and it was not that popular. So I really do not know whether there was any commonality between the policy taken by Minister Takahashi and the policies taken by President Roosevelt. I do not know. I just do not have that knowledge.

But I know that at that time the Keynesian approach was not considered very popular, and I think that Mr. Takenaka is more knowledgeable about this subject.

But what I wanted to say was even though there existed a huge supply-demand gap, if the government was willing to take bold policy very quickly, it's possible to eliminate such a huge gap. And Minister Takahashi's policy serves for the model for that. And looking back the history of the policy taken by Minister Takahashi, it happened to be the Keynesian approach.

MR. TAKITA: I'd like to point out one very, very quick comment on Mr. Arai.

First of all, of course, you know that Franklin Roosevelt came to the U.S. President in 1933. That's why Mr. Takahashi has developed his own policy by his own ideas, it's first point. And who was very important person in the Bank of Japan, who advised to Mr. Takahashi. His name is Eigo Fukai, Fukai Eigo. He is a very excellent economist, and he became to the Governor of the Bank of Japan before World War II.

And Eigo Fukai learned the Keynesian policy very well, and his books about currency policy is very, very useful even now, is second point.

And third very, very short comment is Mr. Takahashi himself read the book of Keynes -- according to essays of Mr. Takahashi -- he wrote about Keynes, himself. But Mr. Takahashi said a little comment: "I am not so sympathetic with Keynesian theory." It's very, very short episode. Thank you.

DR. BOSWORTH: Okay -- Alice, maybe you can take the second question that he had?

DR. RIVLIN: The second question -- why aren't we being more Rooseveltian in the present situation? And following the prescriptions of Professor Jamie Galbraith?

Well, first, I think the situation is very, very different. Roosevelt had no choices on the banks. We didn't have deposit insurance. The banks were failing all over the place. Closing the banks and sort of starting over was about the only option that he had. And that's not true at the moment.

Actually, I think there are two differences.

One is that our government is much bigger now, and the automatic stabilizers work. The government was quite small when Roosevelt came in, compared to the size of the economy. So they had to do more. And even if you look at what they did, as a percent of GDP it wasn't all that big.

But, second, there is much more concern now -- and I think there should be -- about the implications of the long-run deficits and debt. Because we are now in a situation in which, even if we hadn't had this crisis, and even if we were just going along at a reasonable growth rate, we have a looming set of huge imbalances in the Federal budget, in the sense that -- partly because of demographics, partly because of the way we run our health care system -- we will have very large deficits of several orders of magnitude larger than we're used to in the future if we don't change course.

And I think throwing caution to the winds, which Jamie Galbraith would do -- he doesn't care about the deficit at all -- at the moment would be a pretty dangerous thing to do.

DR. BOSWORTH: Mr. Okabe, you wanted to comment?

MR. OKABE: (Interpretation; original remarks in Japanese) There's been a lot of discussion today about fiscal stimulus measures, fiscal mobilization, and it's true that Japan's fiscal stimulus during the lost decade wasn't very effective. It was centered on public investment.

But I think that a reason is that it was only Japan that was engaged in fiscal stimulus. And since the economy was this open, demand just leaked out.

But now we're facing a global depression, and so the U.S., Japan, Europe, China and emerging markets are all trying to coordinate -- which I think is significant. And so the role of fiscal stimulus now, I think, should be looked at not in a way that because of Japan's failures ends up underestimating fiscal stimulus.

Of course, it has to be done in an efficient manner. And as Mr. Arai pointed out, there has to be an exit strategy. But I do think that it is important.

QUESTION: I'm Chuck Podolak from Johns Hopkins University. I'm curious to hear from the panel opinions on some comparisons between the Japanese non-performing loans and the American toxic assets. It seems that we've been able to draw some significant technical lessons in the monetary arena. I'm wondering if it's prudent to draw similar technical lessons in the financial arena, or if there's enough difference in the structure of those, of the bad assets, in the two scenarios?

DR. POSEN: I think it's an interesting question, and I would put up a couple things.

I mean, at first brush, the assets were less complicated, and they were less toxic. They were just "distressed," for the most part, in Japan. What do we mean by "toxic?" That not only is the price going down a lot, not only do not many people want them, but it's almost impossible to put a price on them, and it's difficult to disentangle its relationship to other securities.

And to that degree -- while there were some exceptions in Japan, there were always kinds of stories about real estate loans where yakuza had certain ties and, you know, all kinds of little things -- basically, Japan, like the U.S. in the savings and loan crisis, could go with a real RTC model and do it.

So the question is, what's different now?

I don't want to pretend that all the distressed assets on the banks and other financial companies' books are fitting that definition of toxic. Some of them are just distressed, and the banks don't want to sell them as cheaply as people want to buy them. You know, that's life.

But I do think there is a subset of assets in the U.S. case -- some of which having to do with derivatives, more of which having to do with securitization -- that genuinely are toxic in the sense that I defined it. And to me -- and others on the panel may have a very different view on this, but to me this is an argument for more government intervention rather than less.

In the Japanese case, in the U.S. in the '80s, you could do some relatively simple things to get the market going.

For large sections of these toxic assets in the U.S., you basically need somebody who holds a majority or a super-majority of the asset classes to start putting things back together and unwinding what's going on. And it seems to me that the only way you're going to get that is the government purchasing. And that, to me, is one of the other problems with the public-private partnership.

Now, this doesn't foreclose -- and maybe the Obama Administration intends this -- that essentially they will sell to the public-private partnership whatever is good, or marketable. The U.S. government will be left with the lemons. But, in a sense, that's okay. And then you restructure them and sell them.

But I think that that would be the key difference. That, if anything, I think there's a stronger argument for the government buying, temporarily, a very large position in these assets in order to restructure.

DR. RIVLIN: Well, I think the analysis is right.

The argument that the Treasury makes for getting the private sector in is not just that they want the capital, but that they want the expertise on exactly these issues. And I don't know how to evaluate that.

DR. BOSWORTH: Adam identified one thing: the difficulties of trying to price these assets.

But historically, if you took the savings and loan crisis, we didn't have to price the assets. We shut down the institutions, and we took the assets out. It didn't matter what they were worth. We only left, for reorganization of the institution, assets that everyone would agree were good. So we avoided the pricing problem by closing the institution first -- actually, as did Roosevelt's administration at the very beginning of their term.

The difficulty with trying -- the U.S. has now is we're trying to leave these institutions open, and at the same time remove the assets. That may be impossible to do. And I would worry a lot that there's just a severe incentive hazard in these sort of arrangements -- the asymmetric risk on the loss side. That's a big problem for American taxpayers to accept.

And Mr. Takenaka, at the very beginning of his presentation, stressed the problem that Japan had once the public turned against the government and its efforts to try to resolve the crisis.

I would worry that in this way -- although you hear in the United States all the time, "We've learned the lesson from Japan and we're not going to repeat Japan -- " -- it seems to me, so far, in the first two years, we're going exactly down the same path as Japan. It's very hard to deviate from that, I think.

But -- does anyone from the Japan side have anything they'd like to add.

MR. TAKITA: Thank you. I think that the typical balance-sheet problem, it's very similar to the Japanese case. I think that complex and simplicity is a relative thing.

I'd like to say the balance-sheet matters are left side and right side. All of you know that. Balance sheet has a left side, asset side, right side is liability and capital side. My friends said to me that on the left side there is nothing right. On the left hand, there is nothing – sorry -- on the right hand, there is nothing left. Means left side assets cannot be believed by the market participate. On the other hand, right-hand means capital is not left at all.

The story is very similar when Mr. Takenaka come to the Minister. And this is a business of the government, is crucially important. And such a turnaround could be promoted, this business action. And I hope that Tim Geithner could choose such a tough but important way for the time being, if not U.S. faces a very, very tough, could be lost-decade condition in the near future.

It's my short comment.

DR. BOSWORTH: What a note of optimism. I think this is an opportunity, then, to break a second. Give the panel a chance to get off the stage. But the next presentation is that of Doug Elliott, from Brookings.

DR. BUSH: I'd like to thank the panelists for provoking a very rich discussion, and to Barry, for chairing.

We've had what you might call a "Washington View" and a "Tokyo View." Now we're going to have a "New York View," with Doug Elliott, who was an investment banker for over 20 years, and so knows whereof he speaks.

DOUGLAS ELLIOTT: All right. Well, thank you. It's a truly humbling experience to follow such a distinguished panel -- Minister Takenaka, and the other panelists here. Luckily, I have a near-total immunity to humility, as a New Yorker, a former investment banker, and a think-tanker. So I will proceed to say things anyway.

They have, however, caused me to eliminate the very first part of my talk, which was going to make some observations about comparisons between the lost decade and now. It's been done so well that I dare not go to that.

But what I do think might be interesting for you -- hopefully useful -- is to talk about the policy prescriptions that are being pushed by various people here, using the lost decade of Japan as an object lesson in what can go wrong if you don't do these prescriptions.

I won't talk about the macroeconomic side, where we do seem to have taken a number of lessons from Japan. I won't talk about that because I'm not an economist and know nothing about it.

I am a financial institutions expert. That was what I worked with as an investment banker. I was a financial institutions investment banker -- principally with J.P. Morgan. I also spent three years, starting about six years ago, just as a pure public service thing, as a volunteer -- I set up a small think-tank to look at the federal government's financial institutions, it's lending and insurance activities, feeling that those were important already, even at that point, and ill understood.

So, as you'll see from the rest of my talk, I'm trying to look at all of this through the perspective of financial institutions, so I'll be looking at the banking crisis, as it were.

There have been two principal policy prescriptions that -- in the pure banking part of this -- that have been proposed, pointing to the lost decade as sort of the bad example, the thing to avoid. One of those is nationalization, basically taking over the entirety of the banks, cleaning them up, and then disposing of them again as quickly as can reasonably be done. The other proposal is to nationalize the bad assets -- basically set up a "bad bank" and have that take over the toxic assets and dispose of them. You could, of course, combine the nationalization of the whole bank with creation of a bad bank. So there are variations there. And then I'll come back at the end of my talk, if I have some time, to talk about what the Administration is doing, which is neither of these two.

Now, as I ago through this, you'll see I have some serious reservations about both of these proposals. I don't know enough to know whether they follow from a strict reading of the Japanese situation. But just looking at them on their own, I have a few concerns -- though there are certainly policy arguments for them, as well.

I'll start with nationalization. I think it's useful to begin there by looking at the economic backdrop and how that plays out with the nationalization arguments. So what I've looked at is I've only seen three comprehensive analyses. And if any of you know of more, I'd love to find more. But three comprehensive analyses that have looked at the likely credit losses in the U.S., by category, and done a truly serious analysis. The three I'm aware of are the IMF's excellent analyses. The first one was September/October, and then they updated it in January. There's a Goldman Sachs analysis which is a little lighter on the loan side, but is a very good analysis of the mortgage side and housing, in general. And then Dr. Nouriel Roubini, at NYU, has built on the IMF analysis and taken a more pessimistic view, but using the same general framework as the IMF analysis.

Now, I will say there's probably been only about one good thing for us from all the securitization activity, which is: we have managed to export about half of the toxic assets to the rest of the world. So when one of the panelists talked about their estimates of U.S. credit losses as high as 4 trillion dollars, that, in fact, is accurate. That's a rounding of Dr. Roubini's estimates of 3.8 trillion dollars. That is for credit losses of all kinds related to U.S. credit instruments -- loans, securitizations, et cetera.

About half of that, however -- actually, a bit more than half -- is held by people who are foreigners for the most part or, in some cases, outside of our banking and investment banking system. So when we look at the banking crisis, even the most pessimistic number, Dr. Roubini's, is for 1.8 trillion dollars. The IMF and Goldman put it at 900 billion -- I believe, the IMF number -- and an even trillion dollars is the Goldman number.

These are big numbers. I'm not going to argue differently than that. But the good thing about them is we're talking about big numbers within the context of a very large system.

And some of these losses haven't occurred yet. They're projected to occur over the course of the next year or two as the recession worsens, and then there are knock-on effects from the worsening of that recession. So it means that we have some time to generate some additional earnings, plus what we already have.

So I should probably just make a general request for forgiveness. This is a whole set of topics that I could go on for several hours. I won't. But I'm necessarily going to condense an awful lot of this. I have various papers -- you can look at the Brookings website -- and there's a lot of other good work that's been done, as well.

So just to kind of cut to the chase on the economic backdrop, what it comes down to is if the IMF or Goldman estimates are right -- and they're based largely on something close to the consensus economic estimates -- the trillion-dollar loss that's occurring there will be offset pretty closely by capital that's already been injected -- there's roughly half a trillion dollars that has already gone back into the banking system -- plus at least another half-trillion dollars of earnings at the banks. Because, remember, once you've taken out all of the loan losses, which is a big part of what banks charge their interest rate for -- once you take that out, the banks are very profitable. The system as a whole generates 200, 300 billion dollars a year when you exclude loan losses.

So, given that these losses started a little over a year ago and are going to continue through, perhaps, another year, there is a real hope that the system will be recapitalized by the actions that have already been taken, and the remainder of the TARP money that's left, plus earnings that have been generated.

On the other hand, if Dr. Roubini is right, there's another 800 billion dollar of losses we have to cover from somewhere. That could theoretically still be handled in the same general manner the Administration has, but it would be much tougher -- and politically, I would think, probably impossible.

So, when you look at nationalization as kind of a system-wide phenomenon, rather than taking a couple isolated large banks -- I mean, if you can perhaps the word "isolated" is not the right one here. But that is, rather than picking off a couple of the weakest, if you're talking about a wider set of nationalizations, for that purpose, if you believe the more pessimistic underlying economic views of Dr. Roubini and others who are in that realm, we probably will be forced to do wide nationalizations. I'm not an economist. I have no way of judging.

If, however, the consensus is right or close to right, the approaches that are being taken by the Administration on recapitalization and on toxic assets probably will be sufficient to bring the system through.

Now, from my point of view, I think that's very good news. Because the nationalization has a number of negatives. It, in my opinion, should be a last resort. Now, I'm not excluding that we might find ourselves at that last resort for one or two of the largest banks. I'm hoping not, but I certainly can't rule it out.

So, why is it I think that we should wait until we know we have to do it, rather than doing it preemptively?

First of all, the strongest arguments I've heard for nationalization -- and, by the way, I should add that not only am I not an economist, at least two of the people who advocate this have won the Nobel Prize in economics. So I do have to address this with a certain level of humility. But I think that they're playing down certain problems that I see as quite severe.

One reason that I believe they're playing it down is that they have talked about the nationalization as a kind of temporary receivership. They've tried to invent nicer terms for it than "nationalization," because we all know nationalization runs against the grain in America. One of the cuter terms was "a pre-privatization."

(Laughter)

So the idea is just, you take this over, you clean it up, and you bang it out again pretty fast. I think this is totally infeasible in the present environment for institutions of this size. I want to stress that, because that's a key premise for the other things I'm concerned about. If we could really take this over, clean it up, and put it back out very fast, many of the things I'm worried about wouldn't be issues.

Now, why is it that I'm so sure this will take awhile?

Well, let's look at one object lesson from history. The last major bank we took over was in 1984. It was called Continental Illinois. It was the sixth or seventh largest bank in the country at that point -- depending on how you measured. It had been growing fairly rapidly -- which, by the way, is usually a scary thing with a bank. Rapid growth often is a sign that they're doing things they really shouldn't be.

We took over Continental Illinois in 1984. We owned significant chunks of it for seven years. This was not an easy thing for us to get rid of. It took several years before we got any of it out there. And this, I might add, was in a major bull market. You may recall the great bull market started in 1982. There weren't that many other troubled financial institutions at the time. And it was 1/50th of the size of Citigroup. It did not have significant investment banking operations because of Glass-Stiegel, and it did not have significant foreign operations.

So you had a relatively simple bank. They had screwed up in fairly ordinary ways. And it still took a long time to exit from that.

Whereas we're looking at an environment in which it's hard to envision who is going to come and write a very large check for all, or a big chunk, of Citigroup right now. It's one of the problems we're finding with AIG. AIG has a number of superb insurance operations. The thought all along was they would be easy to sell. But it's really hard to get a good price for a financial institution these days, and so it's a prolonged process.

All right. The second problem is what I would just call a "contagion effect." It's hard to draw the line so that -- I'll just use some specific names because the press does. The ones that people have focused most on are Citigroup and Bank of America. It's a little bit hard to draw the line, so you nationalize one or both of those, and everybody knows you're not going to go further. Because whatever your rationale is for taking over them is going to look scary to people who look at the third weakest bank, whoever you want to nominate for that honor. So it's not impossible to deal with this, but there is a concern that the first couple large nationalizations -- it's like eating the potato chips where you just keep eating the potato chips -- that it's hard to stop.

Another issue is, once you take over the banks, you own them. And you own them in the middle of the most severe recession we've had in many years. It's difficult to know what additional losses will occur that haven't yet shown up, especially as the recession is still getting worse.

Now, one way to minimize that -- or at least, the initial hit -- is to spread the pain to the debt-holders, as well. And that is something that a number of people propose. There are good arguments for it. I tend, personally, to lean against it, though I'm not dogmatic about it.

The reason I lean against it seems to be the reason that none of the major developed countries I'm aware of have gone to that approach when they've had major banking crises, which is, as the banking system gets better again, you're going to want people to supply capital in the form of debt. And if you've just caused massive losses, it's going to be much harder to bring them in, and the interest rate you pay is much higher.

Now, that's a strong pragmatic argument. You could certainly argue the other way. But it's certainly not cost-free to just go in and pass the pain to the debt-holders.

A fourth point, which I think is ill understood, is even a Citigroup, for all its problems, has what we tend to call "franchise value." Chairman Bernanke has been talking about this.

What it's saying is, even a bank that's managed to get itself in a lot of trouble has good parts. And if you were, for example, to remove the things that have caused the most pain -- the toxic assets, and maybe some units that were never very good -- there's enough there to have real value. But as soon as you go in and you take it over, you cause massive uncertainty, upheaval. A lot of customers will leave, many of your best employees will leave over time -- especially if you put in significant compensation restrictions. There's enough upheaval, you endanger that franchise value.

Speaking of compensation limitations, there's a fear of political interference. Now, political interference is when you don't like it. Of course, it may also be, "aiding public policy" by actions that will help the banks, as well, if you do like it. But there's certainly a concern that there will be a series of things that are done that have political benefits but will hurt the bank. And I guess I'll jump to one of my later points.

One of my fears, simply put, is if we do own a Citigroup for seven or 10 years, it will be in the same position that Fannie Mae and Freddie Mac were in. It will be an institution with two missions: make money -- because we'd like to sell it eventually -- and it will -- all these signals that there are these public policy purposes it needs to serve, whether that's increasing its mortgage lending whether it's not loaning as much to foreigners. I don't know if any of you were as alarmed as I was, but Congressman Dennis Kucinich chaired a subcommittee hearing at which he was shocked and appalled to discover that our large international banks are lending money to foreigners. So Dubai came up. I forget who the other party was. But you can just imagine the whole series of things that would be -- constraints that would be placed on the banks.

I'd also say that I fear that they would become somewhat more like the Federal banking institutions, simply because the same constraints and mode of thinking that shaped the Federal financial institutions would likely apply as long as the Federal government owned all or most of, again, say Citigroup.

Now, I don't mean that these financial institutions are doing a bad job. But I've studied them closely, and one of the things you quickly realize is they do not underwrite. They do not attempt, very seriously, to determine who's a good borrower and who's a bad borrower. It's simply not very easy for them to do that, and the political constraints on it are very strong. Well, we need our private banks to make that very judgment. The idea is they take money from savers, and they figure out the best allocation within the economy for those funds.

So those things all worry me about nationalization. Now, that said, there certainly are smart people who differ with me. And I, myself, do fear we might, at some point, have to go for Citigroup. We already own a big chunk of it, as is. But I'm hoping we won't have to.

The other policy I mentioned that's often justified referring to Japan is the idea of a bad bank. And here we're talking about the variation of a bad bank where the government sets up an institution which takes over the toxic assets.

Well, if you haven't nationalized the entire bank, what you need to do at that point is pay for the toxic assets. And as Adam Posen has already referred to, it's really hard to know what these are worth. And this isn't that some people are just trying to avoid admitting reality -- although I'm sure some are -- it's also that you've got two issues that nobody knows the right answer to.

One is the value of these securities depends on what our future mortgage-foreclosure rate is and what the recovery rates are. And we're going through an essentially unprecedented period of housing turmoil. So nobody can tell you what the answer is there.

And the second is, there are strong arguments about what is the right return for an investor? These are multi-year instruments, so the amount you demand to expect to earn each year makes a big difference on how you value it. And the private investors want to buy these things at a price that they think will give them a 20 percent annual return. The banks, not unreasonably, are saying: "This is not a high-tech stock. These are mortgages. They went bad. But we understand mortgages better than that. If we earn 12 percent a year, these will be some of our better assets. So we're valuing them more on that rate."

I don't know what the right answers are. But you can really make arguments that some of these assets are worth anywhere from 30 cents on the dollar to 60 cents on the dollar. We know there's been a lot of value lost, but we don't know whether it's minus-40 cents or minus-70 cents.

So trying to set up a bank that's owned by the government that buys the assets, finding the right price for that is very hard. And if the government overpays, it's taxpayer money that's being lost. If the government tries to underpay, either the transactions won't happen, or the banks will be forced into it, but you've unnecessarily exacerbated their capital problems. So pricing is the big difficulty with it.

In addition to that, I have some concerns, again looking at the Federal financial institutions. Which again, I just want to stress, I'm actually fond of them in many ways. But looking at how they operate points out some worries.

One is, you would have to ramp up a very large organization to take over the toxic assets and manage them. Because you do want them to be managed. You don't want to just sock them away and see what money comes in. And then you'd have to ramp it down at the other end. You'd need an exit strategy.

In doing that, you would take the assets away from the organizations that have finally figured them out, the banks who have lost a lot of money and have put a lot of resources into understanding them, and you've moved them to a new organization. Now, the new organization would doubtless subcontract much of this. But, again, you'd have spent considerable time getting the organization set up, and then getting the contract set up.

Also, the profit motive is a very strong motive to motivate people to try to figure out how to manage these toxic assets to make the most money. If it's in government hands, there's a worry that other concerns would become paramount, or at least would constrain the attempt to get the most value out of that.

So -- that's my view of those two things. Again, perhaps there are valid lessons from the Japanese experience, but I think trying them in the U.S. has significant disadvantages.

So I will go just very briefly over what is the government actually doing.

As we've already talked about, the government is extensively recapitalizing the financial institutions, and intends to put somewhat more money in, as well. There's this public-private partnership. I'm skeptical about it, but I'm hoping to be proved wrong.

The concern I have with this partnership to buy the toxic assets is that the banks want to sell it for something close to 60 cents on the dollar. The investors want to buy it at something close to 30 cents on the dollar. We're providing significant economic value through cheap money and guarantees, but we can't bridge a 30-point difference. So if my fears are right, this plan will just fizzle and not go very far.

We also have a plan for mitigating the problems of mortgage foreclosures. And, of course, as I think one of the panelists alluded to, most of the lending that has vanished isn't lending that was done by the banks and retained by the banks. It was lending that was done by the banks and then put into securities and sold onto other investors. Securitization has virtually vanished, and the Fed is making a major effort, with help from Treasury, to restart the securitization market.

I could go into these all at a lot more length, but I won't, in terms of that. So why don't I just keep the remaining few minutes for any questions people might have.

DR. BUSH: Thank you very much. I think we have time for a couple of questions before we have to close. There's one.

QUESTION: I have like one comment and, I think, one question. Comment is I know that the Goldman's study is still very, I think, optimistic, compared with actually the figure you mentioned at the last stage of your speech. Because basically what they are projecting is something like between 5 percent or, I think, 15 percent write-off rate for the loans, and between 15 percent to, I think, 30 percent write-off rate for, I think, securities. And that's my comment.

And my question is, in late 1990s I also received advice from Larry or Tim, and among them there was the idea of the either loss-sharing or, I think, profit-sharing. So, for example, in the case of, I think, those, I think, securities, that don't have any market, that can be moved to the new bad bank with the specific provision of future profit-sharing.

I would like to ask for your comment. Thank you.

MR. ELLIOTT: Sure. I think what you're referring to is actually a variation of something that is my favorite solution. And I should probably have said earlier that we are in a deep hole. Every solution here is bad. So anything -- even my favorite solution -- is ugly. It's just I think it's less ugly than the others.

So, in terms of what you're talking about, I actually favor keeping the toxic assets on the books of the banks -- to the extent they want to keep them. I mean, they're free to sell them -- but having the Federal government provide a guarantee of a floor value, not at the current valuation but somewhat below. They've done this for Citigroup and for Bank of America already.

Because what I think the markets are reacting to is not the possibility that the banks will lose some additional money, they're reacting to the possibility they'll lose a whole lot more money on these assets. Since it's so hard to come up with the price, I think a guarantee would be easier. You still have an implicit pricing issue. You would charge a different level for the guarantee, depending on what you think the starting value is. But it's not as tough a problem.

So that may not be exactly what you were referring to, but I think it's at least close.

DR. BUSH: One more question? No? No takers? In that case, thank you all for coming, again. Thanks to the panelists, thanks to Nikkei. And best wishes for the rest of the day. The meeting is adjourned.

(Applause)