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First of all, it should be noted that China’s current rapid economic expansion reminds us of Japan’s fast growth during the 1960s. There are certain similarities. Among others, Japan’s decade of the 1960s can be characterized by about 10% GDP growth rate, the heavy and chemical industries playing the central role, and energy demand, particularly petroleum consumption, growing at a double digit rate. The natural environment was severely damaged during the decade.

However, there are important differences. China’s growth began from an even lower level compared with Japan. Everything in China is much bigger in scale and is happening much faster.

Japan, even after the extremely rapid economic growth during the 1960s, was able to maintain a somewhat lower but healthy growth during the 1970s and the first half of 1980s. I believe that there are a couple of reasons why Japan was able to do so:

In the early 1970s, the first energy crisis corrected some of the excesses of the 1960s. The world realized that there are finite limits to global resources that can be exploited and developed in the short period of time. During the 1960s the world’s demand for petroleum increased at about 3-4% per year. It meant that the world needed to add every year a productive capacity equivalent to that of Kuwait, 2 million barrels per day. Building such a large capacity every year was getting to be physically difficult. The world had to look for ways and means to save and improve the efficiency of energy use.

Japan also launched serious efforts to protect the environment. The government mandated the use of lead free gasoline for automobiles and de-sulfured fuel oil or natural gas. Furthermore, the industrial structure has also begun to shift away from the heavy and chemical industries.

As a result, Japan achieved measurable improvements in air quality and the unit of energy input per GDP output unit. Japan has achieved the best ratio.

The Root of Japan’s Problems in the 90s

I believe that the root of the “Japan Problem” began to surface from the early 1980s when Japanese business management was widely regarded as the model. The United States began to suffer from the effects of inflation and lost competitiveness in the world market. Seeing these unexpected but favorable developments, Japan’s corporate managers

became much impressed with themselves and began to say “we now have very little to learn from the United States.”

To make the matter worse, the 1986 Plaza Accord caused a sudden and very large revaluation of the Japanese Yen/US dollar exchange rate from 240 yen to 180 Yen per dollar. The Japanese government decided to provide the market with almost an unlimited supply of low interest rate credit. This in turn caused not only individuals but also many companies to put the money in company stocks and real estate properties at home and overseas. The Nikkei 225 which hovered around 8000 Yen in 1985 climbed to 39,000 Yen by the end of 1990. The property market in most major cities went through the roof.

The Need for Changes for Japanese Politics and Business

The bursting of the bubble and its aftermath are very well known, and I will not dwell on them. Rather I wish to discuss what and how we must change ourselves in order to make Japan again a strong and competitive economy in the next several years before it is too late.

- 1) Japanese corporate management lacks true global orientation. Only a handful of companies have non-Japanese individuals as members of the board. Sony seems to be the only large Japanese company who has a non-Japanese as its chief executive officer, but that was a result of its attempt to turn around the continuing bad performance under the previous management.
- 2) A government deliberative council on education spent an inordinate amount of time discussing whether or not grade schools should teach English as a second language and has finally decided against it. In sharp contrast with such a decision, in China they now teach English from the first grade. Most Japanese in leadership positions either in politics/government or business do not have the ability to communicate directly in English with their counterparts in other countries.
- 3) Japanese banks' overseas presence is rather insignificant as they tend to work with only Japanese corporate customers operating abroad rather than becoming an integral part of the local economy. For their overseas operations, Japanese banks must change the management structure to place locally hired qualified individuals in key positions.
- 4) Lastly, I believe that we must invite qualified non-Japanese into Japanese corporate management. The fact that practically every Japanese company management consists of only Japanese individuals, causes management to hold on to traditional approaches and reject non-traditional or unconventional approaches as heresies. When the world is changing very fast and many innovative concepts and approaches are being introduced, such an attitude of isolation could become a deterrent to Japan's progress.

Chinese Government Has Bailed Out State Owned Banks

Now turning to China, Chinese banks were faced with bad asset problems similar to those of Japanese banks during the 1990s. We know that the Japanese banking industry took nearly 10 years to clean up the balance sheet problems and restore capital ratios to acceptable levels. The Chinese government transferred much of the NPLs from state

owned banks into newly created asset management companies and then injected large amounts of US dollars from government foreign exchange funds to shore up the banks' impaired capital base.

During the past three years or so, large Chinese banks, particularly some of the state owned banks have begun to pursue the strategy of developing a strong credit culture and risk management skills and will be working hard to prevent the recurrence of irregularities within their institutions. At the same time, in order to improve their profitability, they are developing capabilities to offer fee generating products and services other than deposits and loans.

Needless to say, the future success of these large Chinese banks importantly depends on several critical factors. It depends on whether the Chinese economy can continue to grow at high rates as in the past. If the economy stops growing at high rates, the loan assets which otherwise would remain normal could turn into bad assets.

I believe that the Chinese government and the People's Bank of China will be capable of avoiding the occurrence of bubble related banking problems. Furthermore, a sudden and very large RMB revaluation as we saw for the Japanese yen in 1986 will not happen. The Chinese government will let the RMB only gradually adjust its exchange rate in a measured way.

Thirdly, all of the Chinese banks must create a sound credit culture and strive to develop skills to analyze and evaluate customers' credit worthiness and apply proper pricing for each obligor category. They must add risk premium differentials to their base loan interest rate appropriate for each risk category of borrowers.

As important as credit management, they must develop a management process that enables their internal decision makers to know on a real time basis what transactions are being conducted between the banks and their customers on what products and services. So long as many of the transactions at local branch levels are recorded manually, errors and frauds can take place without being detected on a real time basis. Good internal control can be achieved only if they have a well developed machine based management process.

How China Construction Bank Has Been Managed

I was an independent director of China Construction Bank from September, 2004 until June of this year (2007) and was involved in four of the five Board committees. From the limited but invaluable experiences in the past couple of years I would like to make the following observations:

Firstly, as you know, the size of all of the state-owned banks is very large and they need not be larger. CCB has a 500 billion dollar balance sheet, 300,000 employees, and 14,000 branches and makes about US \$5 billion net income per year. The NPL ratio was 3.2% as of the end of June, 2007. The most critical question is whether or not the bank will be

able to contain NPL problems in the future in terms of both amounts and ratios. To this end, the bank must be firm in rejecting problematic loans not only to private businesses but also to state owned enterprises even when the borrowers have strong political backing.

As far as the corporate governance is concerned, I have been very much impressed with the openness of CCB management when we discussed credit risk and compliance issues. CCB's board meeting generally lasts for two full days including the meetings of the Board committees which generally meet prior to the board meetings. As an independent director, I was a member of four Board Committees out of the five and serve as chairman of the Nomination and Compensation Committee. During the three years, I attended more than 30 board meetings as well as a similar number of committee meetings, probably spending as much as three hundred to four hundred hours on CCB matters.

Future of Chinese Banks

Another critical question that I would like to touch on is where these state owned banks are headed in the future. We know that some foreign strategic investors have acquired substantial equity positions and these banks have had initial public offerings. Seeing these developments, one wonders whether or not the state-owned banks are moving towards privatization and what will be a future role of the government as the major equity holder in these banks? My own view is that privatization which replaces government ownership with public shareholders is unlikely to happen. The purpose of inviting foreign strategic investors was primarily to acquire knowledge and skills from them to build a well managed and profitable bank that can compete in the global market.

I believe that there is a very good chance that some of the large Chinese banks will become globally competitive and profitable institutions in the decade of 2010s.

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