WHAT KIND OF "ZOMBIES" CONTRIBUTE TO THE COUNTRY'S ECONOMIC WOES?

CAN JAPAN RECOVER?

HOW IS JAPAN LIKE THE MOVIE *GROUNDHOG DAY*?

HOW CAN THE FORMER ECONOMIC POWERHOUSE BOUNCE BACK?

Chuck Clough, '66, and professor Anil Kashyap discuss Japan's economic pitfalls—and slow recovery.

Kashyap: Why do you think it took so long for Japan to start growing again?

Clough: The health of the banking system is key to the behavior of any economy. In the early 1990s, real estate loans made up 40 percent of the balance sheet of U.S. banks, and too many of those loans were unserviceable. The same thing happened in Japan, but on a much larger scale. In the 1980s, Japan's excessive bank lending financed tremendous real estate inflation, and many of those real estate loans became unserviceable. The difference is that, through the Resolution Trust Corporation, the U.S. cleared its banking system. That depressed U.S. growth for awhile, but bad loans were written off and insolvent banks closed. Japan took a different tack. It tried to avoid forcing bank write-offs in the hope that by keeping the zombie companies alive, they would avoid recession. The result: banks simply couldn't lend. Japan couldn't generate a new credit cycle to reignite growth, whether for corporate capital spending or consumer spending. The result was a generalized asset deflation, and the economy hovered on the brink of a depression for more than a decade.

In 1999, Japan's stock market rallied; the Nikkei rose to 20,000, and there was even a hint of economic recovery. Fortunately, the Bank of Japan finally took action, forcing banks to write off bad loans, or at least cease lending further to companies that had no hope of ever servicing their debt. The result was what we call "corporate restructuring"—closing down those corporate activities that drained cash. Because the easy credit was removed, the corporate recovery process started. As early as 2003, Japanese corporate balance sheets began to improve since cash assets were growing and some economic benefit from restructuring was beginning to show. Corporations were once again profitable. That didn't help either reported profits or its stock market throughout 1999–2004, because an asset deflation was plaguing the economy and it took longer to turn that around. But by early 2005, it was clear that a new credit cycle was beginning—the asset deflation began to stabilize, and in some areas, like high-grade commercial construction in Tokyo and Osaka, asset values began to improve. The end of deflation was the dynamic that indicated Japan was starting to turn around. In the meantime, Japan lost upward of 10 to 12 years of growth. There were many reasons for that long recession, but the most definitive one was Japan's refusal to restructure its banks after the magnitude of the difficult loan situation became visible. Ultimately, until its banking system was reformed, Japan's economy remained disabled.

Kashyap: I agree. In a recent paper with Ricardo Caballero and Takeo Hoshi ("Zombie Lending and Depressed Restructuring in Japan"), we argued that because the banks weren't restructured, they continued lending to firms we now call "zombies." By allowing the zombies to keep operating, the banks thwarted the growth of the healthy firms. That's why the failure to restructure was a problem. The open question is: How vibrant will the banking sector be, given that their loan spreads are still anemically low and not consistent with a long-run healthy and profitable banking system? Will the impending interest rate increases by the bank of Japan threaten recovery?

Clough: No. During the last recession, we saw astonishingly low interest rates all around the world. The overnight rate reached 1 percent in the United States. Japan's was zero for a long period of time. Interest rates were 3 percent in Europe, even in Italy. You would have to go back to the reign of Caesar Augustus to find 3 percent interest rates in Italy. In essence, low interest rates became a global phenomenon. Nevertheless, Japan did lead the way down. Zero percent interest rates are both positive and negative for the banking system. It obviously implies the cost of liabilities was negligible, but as you point out, Anil, there was no loan growth there either, so zero interest rates did not do the banks much good. I have noted that every time there was a hint the Bank of Japan was about to raise interest rates, Japanese stocks actually rallied. Therefore, I believe that the market's perception is that perhaps the extremely low interest rate structure in Japan has reached the point where it is not doing any more good, and it might actually be harming its economy because it does limit profitability in the financial sector, and that has to be unhealthy for any kind of long-run expansion. The advantage is that Japanese corporations and households are relatively—I underline relatively—debt free. A lot of debt either has been written off or liquidated over the past 15 years. For that reason the raw material for a very healthy credit expansion is there, but profit spreads for the banks have to be there as well.

The Japanese banking system has been restructured along two paths. The first has been that insolvent loans, for the most part, were liquidated; the second has been the consolidation of the banking system. Capacity has been taken out, leaving the remaining banks far healthier. We see capital asset ratios of 30 to 40 percent among regional banks in Japan. Now you have a different problem—a banking system that is overcapitalized—and I think that brings your point to the forefront: that it has to be a profitable banking system to be an effective banking system. Perhaps the move toward higher interest rates is a move in the right direction.

In the meantime, Japan's capital markets have evolved pretty well. There is a growing interest in the Japanese stock market on the part of non-Japanese investors, particularly private investors. There is a great deal of private capital moving into Japan, and if Japan's capital markets become a little more receptive of foreign capital, that would be a plus to the economy. For the moment the Japanese corporate sector is extremely liquid. Japanese corporate debt as a percentage of Japanese GDP back in 2001 was 140 to 150 percent; today, it's about 70 percent. Not only are corporations highly liquid, but households are as well, so there is a lot of dependency on the banking system right now. As we go down the road, access to a healthy banking system will be critical.

Kashyap: The only thing that scares me is that I don't think the Bank of Japan can explain exactly what it's doing and why it's so keen to raise interest rates. It's probably true that when they're zero it makes it harder for the banks to operate. Over the last 7 to 10 years, we saw a number of clear policy mistakes. Everyone pretty much agrees that the premature tightening in 2000 was a mistake, and they've had a number of these stumbles. I don't worry that 25 basis points or even 50 or 100 over the next 15 months by themselves would be a problem, but if the bank isn't clear as to what risks it thinks it's heading off, I think the chances of lapsing and doing something that's unwise down the road is a legitimate risk. I still think the deflation is more persistent than the people at the Bank of Japan seem to think, and I don't quite understand why, with inflation of half a percent, they cannot wait to be sure deflation is over. That said, I don't think in the immediate term that Bank of Japan's actions are going to trigger a collapse. If the "carry trade" no longer continues to be appealing, how will that change global capital flows?

Clough: I am a skeptic on that front. I may be wrong, but I question just how big the Yen carry trade was compared with other liquidity bubbles we have seen over time. There has not been the type of expansion of Japanese bank credit necessary to engineer a credit-based leveraged trade of the magnitude that the popular press seems to imply existed. Media reports seemed to come out of nowhere about the bubble that supposedly depended on Japanese low interest rates. No one had really heard or thought about it until a few months ago when the news media suddenly carried a number of stories covering the Yen carry trade. I question its importance. I can understand how it might exist, but it does not appear to be large enough to inflate as many asset classes as claimed. Perhaps you could inflate the Icelandic stock market by borrowing Yen, but I think that at about $30 billion in capitalization, it's a pretty small market. There has been lots of bank credit created in U.S. dollars and the Euro in recent years, but little in Yen. I am also skeptical that we have had the type of liquidity bubbles in the financial markets that we have had before. In the financial markets, we all expect to relive a recent experience, and that often dominates perceptions. After the October 1987 stock market crash, everybody anticipated a subsequent collapse. And since the demise of Long Term Capital Management, we have all been on guard for the next hedge fund blowup, or liquidity bubble to burst. Often, the capital markets have a different adventure in store for us, and are not so obliging as to offer us an event for which we are prepared. So, I question how big the Japanese-related liquidity bubble was.

Kashyap: I'm reassured to hear you've never seen any direct evidence of the magnitude of all of this. You hear it's going to be a big deal but it's very hard to assess. So in truth it's not actually something I've ever really understood or thought was necessarily going to trigger a galactic realignment of where money's flowing. I think it's got to be in the world's interest for Japan to be growing robustly, and if that means interest rates are going to be higher there, so be it. Keeping our eyes on fundamentals is probably much more important. How do the scheduled increases in taxes over the next few years affect your thinking about Japan?

Clough: Japan always has scheduled tax increases. That is just part of their political/intellectual infrastructure. It probably stems from the same double fear that infects most economic policymakers: nobody wants to relive the inflation experience of the 1970s, and everyone knows that was caused by loose monetary and fiscal policies. That clearly was the case in Japan. It is amazing that after 16 years of deflation, these concerns that budget deficits are harmful still dominate policy. My take is that we are dealing with a major credit cycle that has been in the liquidating phase for more than 16 years, and there is only some modest recovery on that front. We have seen modest recovery in employment prospects, and personal consumption expenditures are only beginning to grow. I have to assume that feels good to policymakers, and that it creates a constituency for a more balanced fiscal policy looking out. There have already been some encouraging events on the political front. Last fall, for example, the prime minister began the privatization of the post office, something that suggests trends are moving in the right direction. When the finance ministry threatens to raise a tax, I would downplay it unless they really did something extreme. I'm skeptical that we can go back to the same old Japan that we've been dealing with for the last 15 years. They are a very smart people, and they are very industrious people, and I think they now begin to see themselves as regaining their status as one of the most important economic powers on the planet. I doubt very much that they will do anything that could reverse that.


MG Maloney Black Star

"If the consumptive credit cycle continues to gather steam in Japan, there will be a great deal of opportunity."—Chuck Clough

Kashyap: They have a massive aging problem and a massive problem with fertility, so they have a huge problem managing the retirement and medical needs of the 50-year-olds now. Going into the 1990s, the ministry of finance thought it would be the golden decade. Think back to 1989; people were saying Japan would rule the world. The ministry of finance saw the demographic shifts coming and said, during these next 15 years of boom times we're going to build up massive surpluses that will take care of this generation as it ages. They did just the opposite—they ran up big deficits. There are still some people in the ministry of the finance who say, we've got to catch up. If I was going to highlight one policy mistake they could make, it would be to try to rebuild the fiscal position too rapidly. They've got to pay for what's happened over the past 10 or 15 years. One recovery was aborted when they jumped the consumption tax in 1997, and if they're too aggressive on that front I think they could trigger another slowdown. This is a legitimate risk. It's a problem that needs to be dealt with, but I just hope they're going to be responsible and do it over time. What Japanese sectors or firms do you find most attractive?

"By allowing the zombies to keep operating, the banks thwarted the growth of the healthy firms."—Anil Kashyap

Clough: For many years, the export sector was the only engine of economic expansion. But if we are right, and Japan is establishing a sounder financial sector, the opportunities would emerge primarily among domestic stocks. In our funds, we have invested in three areas, none of which are the exporters. We have invested in companies whose profits are leveraged to a domestic economic expansion. We own regional banks, with capital to asset ratios as high as 20 to 30 percent, and with the reemergence of consumer and real estate borrowing, there are growth opportunities there. We own food companies, retail companies, retail distribution companies, domestic capital spending, and capital goods companies. The strategy is to stay as close to the consumer in Japan as you can. Japan's consumption cycle might become even more visible later this year and in early 2007 if U.S. consumption slows. If so, the export companies will be negatively affected, but if domestic employment incomes and spending are beginning to improve, a lot of local companies will benefit.

Kashyap: What would you say to someone who looked at the Japanese economy and thought for the past decade it was kind of like the movie *Groundhog Day,* meaning everything keeps repeating itself for the same old reasons? Why should someone who has tuned out Japan be paying closer attention? What makes you more excited about Japan than China or other Asian opportunities?

Clough: We have money in both Japan and the rest of Asia, so it isn't an either/or situation. There are different kinds of opportunities. Contrast Japan with the United States. We have had a tremendous consumer expansion, and that has shown in two ways. Consumer balance sheets here have become highly leveraged; to put numbers on it, since 2001, while Japanese corporations have de-levered and Japanese consumers have become less credit exposed, domestic household debt here in the United States has increased 65 percent. A lot of that is related to the real estate cycle. The U.S. is probably at the top of a consumer spending cycle, and consumer balance sheets in the U.S. are so levered as interest rates go up, the capability to spend is somewhat diminished. We view Japan as being on the opposite side of the credit cycle. While the U.S. could see a much more sluggish consumer spending environment, Japan might be in a more dynamic one.

The second trend has to do with what corporation profitability might look like going out. In the U.S. services sector, the largest component of our economy, capacity is overbuilt. For example, the corporation Home Depot, which a decade ago was one of the great U.S. growth companies, announced a plan to restructure the company. I never thought in my lifetime I would hear the word restructuring and Home Depot in the same sentence. But there are too many Home Depot stores in existence today as well as many competitor stores. There is such a large capital stock that even some of the great growth companies of the last 20 years are beginning to say they have to change their business model. They can't just continue to put out more capacity since returns on investment in those parts of our economy are peaking. Japan is at the opposite end of that cycle. There is a great deal of opportunity. Downtown real estate in places like Tokyo and Kyoto is beginning to improve in value. They went from deflation to experiencing some pretty tight capacity characteristics. So while return on assets might be peaking here, they might be turning up there.

As to capital markets, the interest in Japan probably started with a company called Steel Partners, which was established by a few private U.S. investors. They started to do something in Japan that had never been done before: international investor buyouts of Japanese equity. Instead of being rejected, the strategy is actually growing over time to the point now that even Japanese management is beginning to see the value of restructuring equity assets. In Japan, equity is cheap, especially with interest rates as low as they are. Japanese equities represent only 9 percent of global equity, and yet it is still the world's second-largest economy, so there seems to be a lot of room for an upgrade of the Japanese equity market. Again, I make a clear distinction between companies that are focused on exports that might have less opportunity. And, if the consumptive credit cycle continues to gather steam in Japan, there will be a great deal of opportunity.

Kashyap: I hope so.

Clough: In our business, since assets are priced every day, we tend to focus on the most recent data point. Over the last 15 to 18 months, there has been steady improvement in Japan. For Japan to have a quarter with 4 to 5 percent GDP growth is pretty good.

Japan is also part of the Asian recovery story, and only one other nation refused to modernize its financial system after the 1997 Asian currency collapse. The prime minister of Malaysia then, in response to the crisis, lashed out at the global community, and slapped on capital controls. For a while, it looked like a successful policy because capital could not leave Malaysia, and Malaysia sidestepped the liquidity crisis that engulfed most of Asia. But as time passed, most people realized it was the wrong policy, because there never was any pressure to restructure and modernize its banking system or to establish a legitimate capital market. Korea was the first to recover; others followed, but Malaysia was left behind. The right thing to do was to write off bad loans as quickly as possible, and reestablish some legitimacy to your financial sector. Japan and Malaysia, the two nations that decided to try to muddle through, ended up suffering. It is a superficial analysis, but it seems to be the Asian story in a nutshell.

As a result, there might be some opportunity today in Malaysia as well. It is a strong commodities-based economy that sits next to China. ■

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