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 magni- tude of the difficult loan situation became visible. Ultimately, until its banking system was reformed, Japan’s economy remained disabled.

Kathy: 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 restruc- tured, 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 Caes- ar 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. Zero percent interest rates decrease the cost of liabilities negligi- ble, but as you point out, Arul, 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 threatened to raise interest rates, Japanese stocks began to improve. The end of deflation was the dynamic that became visible. Ultimately, 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 overcapi- talized—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 mov- ing 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.

Clough: 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 years, Japan has seen 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 defla- tion is more persistent than the people at the Bank of Japan seem to think, and I don’t quite understand why, with infla- tion 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?

Kathy: I am a skeptic on that front. I may be wrong, but I ques- tion 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 sup- posedly 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 under- stand how it might exist, but it does not appear to be large enough to inflate as many asset classes as claimed. Perhaps you’re right.

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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 relieve the inflation experience of the 1970s, and everyone knows that was caused by loose monetary and fiscal policies. That clearly was the case in the 1980s. I am a skeptic on that front. I may be wrong, but I ques- tion 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 sup- posedly 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’re right.

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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 30-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?

Clough: For many years, the export sector was the only engine of economic expansion. But if we are right, and Japan is established 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. One is consumer discretionary spending, 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 companies could make such a huge impact on 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 steadied 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.

Chuck Clough founded the Boston-based Clough Capital Partners in 2000. The firm manages three mutual funds and a hedge fund with $2.5 billion in assets under management. Previously he spent more than a decade as chief investment strategist at Merrill Lynch, where he was responsible for directing the global investment strategy research effort. To learn more, visit cloughglobal.com.

Anil Kashyap is Edward Eagle Brown Professor of Economics and Finance. His research interests include banking, corporate finance, monetary systems, and business cycles. To learn more, visit ChicagoGSB.edu/magazine/facultylinks.

Feature Japan

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