Corporate Debt *Rejection*

The real reason global interest rates are so low.

BY RICHARD C. KOO

Low long-term rates in so many parts of the world—in spite of higher oil prices, larger budget deficits, higher short-term interest rates in the United States, and pick-up in economic activity in Japan—have baffled both policymakers and market participants. Although some monetary officials are claiming that low long-term rates represent the triumph of their monetary policy in taming inflationary expectations, the real reasons for low rates may not be so pretty.

The champion of low long-term rates has, of course, been Japan, which has seen long bond rates lower then the lowest rate observed in the United States during the Great Depression for very many years. Furthermore, low rates are persisting despite a significant pickup in economic activity since the spring of 2003, and despite an ever-larger government budget deficit.

This seemingly contradictory development, however, can be explained by the fact that, in Japan, corporate demand for funds has actually turned negative since 1998. In other words, today's corporate sector in Japan is actually a net supplier of funds to both the banking system and capital markets to the tune of ¥30 trillion per year or 6 percent of GDP. They have become suppliers of funds because so many companies are paying down debt. They are paying down debt because the nationwide collapse in asset prices starting in the early 1990s left them with huge debt overhang.

Even though their balance sheets may be under water, in most cases, their main line of business is still sound with healthy cash flow. The fact that Japan has maintained the largest trade surplus in the world throughout this period suggests that Japanese companies are still highly competitive, with good products that consumers around the world are willing to buy. The companies, therefore, are using their healthy cash flow from their main lines of business to pay down debt in order to repair their balance sheets.

Even though that is the right thing to do at the level of individual companies, when everybody does it all at the same time, the usual flow of funds in the economy is reversed, i.e., instead of going from household savings to corporate investment through the banks and

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Most companies will be financing investments from their internal cash flow. It is no wonder that bond markets in all these countries are pricing government bonds so highly: the government is the only borrower left.

capital markets, the companies are returning the money back to them. The households, on the other hand, have been saving money as before. With no borrowers left in the system, the entire banking system and capital market is flooded with cash. With so few borrowers left, the competition among the lenders is absolutely fierce, resulting in very low interest rates.

From the macroeconomic perspective, the sum of household savings and net corporate debt repayment, which is the money that is entering the banking system but is not coming out to re-enter the income stream due to the lack of borrowers, constitutes the deflationary gap of the economy. If this deflationary gap is left unattended, the economy will continue to contract by the amount of the gap until the private sector has become too poor to save any money or pay down debt. Such an outcome is usually called depression.

The extraordinary shift in corporate behavior in Japan is shown in the chart, put together from the flow of funds data indicating which sectors of the economy have been saving money (financial surplus), and which sectors have been borrowing and investing money (financial deficit). It is put together in such a way that when all sectors (household, corporate, government, overseas, and financial sectors) are added, they are supposed to add up to zero. In the interest of clarity, however, the financial sector, which should be neutral in the medium term, has been omitted.

In the ideal world, this chart would have the household sector at the very top, corporate sector at the very bottom, and all others in the middle at around zero, indicating that both the government budget and current account are in balance. The figure indicates, however that the corporate sector in Japan, which had borrowed and invested as much as 9 percent of GDP back in the early 1990s, has been in financial surplus since 1998. Today, it is in a surplus position to the tune of 6 percent of GDP or ¥30 trillion. This means the shift in corporate behavior subtracted nearly 15 (negative 9 to plus 6) percent from Japan's GDP compared with the early 1990s. It is no wonder that the Japanese economy has been doing so poorly.

Indeed, the only reason Japan did not collapse into a depression in spite of the above shift in corporate behavior is that the government has been borrowing and spending the excess savings in the private sector. And it has been doing that literally from the first day the deflationary gap surfaced back in the early 1990s. As the chart shows, the line for the government sector has the exact opposite slope to that of the corporate sector. It shows that the government, acting as the borrower of last resort, kept both the level of economic activity and money supply from shrinking in the face of massive nationwide effort by the companies to pay down debt.

Starting in 2003, a number of major companies finally came out of their debt repayment mode and started moving forward. Their turnaround not only provided jolts to all the other companies to finish paying down debt as fast as possible, but also the bulk of good corporate news that has been coming out of Japan recently.

In spite of this encouraging development, interest rates remain very low for two reasons. First, the majority of companies are still in the debt repayment mode, and two, those companies that finished repairing their balance sheets are not borrowing money. Indeed those companies that had to pay down debt under duress typically become highly averse to borrowing even after their balance sheets were repaired. These companies in what may be called "debt rejection syndrome" finance their investment activities almost entirely from their internal cash flow. The fact that Japanese companies are enjoying abundant cash flow after all that cost cutting and restructuring during the last decade means that they can go a long way before they will feel the need to borrow money. This is the reason why interest rates are remaining low in spite of a pick-up in economic activities.

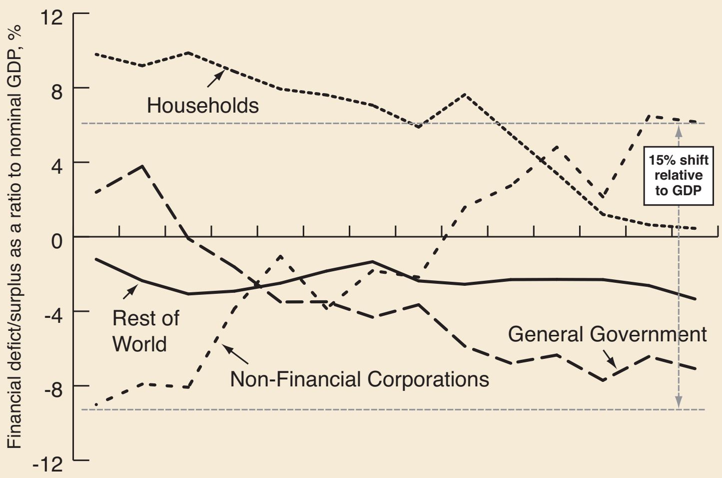
The Japanese story is repeated to a remarkable degree in both Germany and the United States following the collapse of the global information technology bubble in 2000. Corporate sectors in both countries are in financial surplus as well, a highly unusual phenomenon.

In Germany, the bursting of the telecommunication bubble hit businesses and households badly. German companies, which are usually known for their caution, apparently dropped their guards during the bubble days as they increased their fund procurement sharply from 1997 to 2000. When the prices of telecommunication shares collapsed in 2000, they suddenly realized they were overextended and began running in the opposite direction, i.e., strengthening their balance sheets. By 2002, the German corporate sector was in financial surplus, a shift of nearly 6 percent of GDP in only two years.

As though this were not bad enough, German households sharply increased their saving rate during the same period. In other words, the German economy was hit from both the corporate and household sectors. It is no wonder the German economy has been doing so poorly in recent years. They are in a balance sheet recession just like Japan.

Furthermore, a serious credit crunch developed in Germany centering on major banks, bringing nightmares to so many companies that relied on those banks for financing. Even though many of these companies were subsequently saved by government and regional financial institutions, the bitter experience they went through made them highly susceptible to debt rejection syndrome.

Japanese Companies Have Been Repairing Balance Sheets Since the Bursting of the Land-Price Bubble



Source: Bank of Japan, Cabinet Office.

In the United States, the story has a slightly longer historical twist. The U.S. corporate sector was actually in financial surplus in the 1991–93 period. This was the infamous credit crunch brought about by both the bursting of the commercial real estate bubble of the late 1980s and the backlash from the bank supervisors following the savings and loan fiasco that surfaced in 1989. In other words, as far as the corporate sector was concerned, this was largely an involuntary debt repayment forced upon them by the troubled banking sector.

This experience of forced debt repayment, however, apparently had tremendous impact on the psyche of U.S. corporate executives as they refused to increase borrowing for years afterwards. Even though the U.S. economy was doing extremely well during the 1994–2000 period, corporate debt rejection syndrome persisted as companies stayed away from procuring funds throughout the period. Even during the height of the information technology bubble, funds procured by the U.S. corporate sector amounted to less than 1 percent of GDP, in sharp contrast to their behavior before the 1991–93 credit crunch.

The bursting of the information technology bubble in 2000 promptly pushed the U.S. corporate sector back into financial surplus as it rushed to repair its overextended balance sheets. Thanks to its earlier caution, the damage sustained as a result of the bursting of the information technology bubble was probably much smaller than that of the German companies. On the other hand, the corporate accounting scandals that followed and the policy response—the Sarbanes-Oxley Act—are making U.S. corporate executives unusually cautious. Indeed, it is said that in corporate boardrooms today, so much time is spent talking about corporate governance issues that there is no time left to talk about making money.

What the above means is that as companies in the United States, Japan, and Germany are all paying down debt, corporate aversion to borrowing is found in all three. With the usual demand for funds from business largely non-existent, it is not surprising that the level of interest rates has been depressed in all three countries. In this environment of very low interest rates, credit spreads also fall as fund managers seek higher-yielding corporate bonds in order to add additional yield to their low-yield bond portfolios.

Furthermore, if the U.S. experience between 1994 and 2000 period is any guide, the corporate debt rejection syndrome could last for a long time. That means interest rates will also remain low for an extended period of time. More precisely, interest rates are likely to remain significantly lower than those suggested by the respective countries' GDP growth rates. This is because most companies will be financing investments from their internal cash flow. It is no wonder that bond markets in all these countries, which are facing corporate debt rejection syndrome first-hand every day, are pricing government bonds so highly: the government is the only borrower left.

After the Great Depression, the last and possibly the greatest balance sheet recession in history, American households and companies became so averse to borrowing that it took three full decades for U.S. short- and long-term interest rates to return to the 1920s average, which turned out to be 4.1 percent for both. In other words, it took until 1959 for both short- and long-term rates to return to 4.1 percent. When one considers that during this period there was a massive increase in fiscal spending during the New Deal era of the 1930s, an astronomical increase in fiscal spending during World War II, and the mobilization for the

Korean War, it is remarkable how low interest rates remained. Even though there was an "accord" between the Federal Reserve and the U.S. Treasury to keep rates low, the low rates were sustained most likely because there were so few borrowers left in the private sector.

In this rapidly changing world of 21st century, it is highly unlikely that it will take thirty years for interest rates to normalize. Furthermore, countries such China have almost insatiable appetite for capital. On the other hand, it can be argued that had it not been for World War II, the Great Depression and the subsequent debt rejection syndrome could have lasted even longer than thirty years. Also, China is a current account surplus country, i.e., it is actually exporting capital!

Balance sheet recession and its aftermath, the debt rejection syndrome, do not happen very often—only after a nationwide asset price bubble, which is a rare phenomenon in itself. But when they happen, the usual assumption in economics, that companies are maximizing profits, is violated. This is because in a balance sheet recession, many if not most companies are minimizing debt. But when everybody moves to minimize debt, the invisible hand of Adam Smith works to push the economy toward a contractionary equilibrium, otherwise known as depression.

Furthermore, when companies are minimizing debt, monetary policy becomes largely ineffective. Even though central banks typically bring interest rates down in response to a recession, they cannot increase the money supply because nobody is borrowing money to take the liquidity provided by the central bank out of the banking system.

In this environment, the government cannot tell the companies *not* to pay down debt. However, if the government did nothing, the economy would continue to contract until the private sector was too poor to save any money. In order to avoid such an outcome, the government must do the opposite of the private sector—it must borrow the household savings and corporate debt repayment and put them back into the income stream by spending them. In other words, fiscal spending becomes absolutely essential in fighting a balance sheet recession.

From this perspective, Japanese Prime Minister Koizumi's decision to scuttle his election pledge to limit the issuance of Japanese government bonds to ¥30 trillion per year in 2003 was a step in the right direction. Indeed, this decision allowed fiscal policy to play the role of automatic stabilizer for the first time in three years and contributed in no small way to the recovery of the Japanese economy in 2003.

For the United States, the massive expansion in fiscal stimulus under President Bush as the government budget went from a surplus equivalent to 2 percent of GDP to a deficit equivalent to 4 percent of GDP in just three years helped maintain the level of economic activity in no small way.

For Germany, the fact that the ECOFIN suspended in late 2003 the limits on budget deficits contained in the Maastricht Treaty is a very positive development. It would have been even better had the ECOFIN specified the balance sheet recession as the key reason for the suspension, so as to ensure that eurozone will not lose its fiscal discipline during ordinary (i.e., non-balance sheet driven) recessions.

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Looking further down the road, the fact that the debt rejection syndrome in the three largest economies of the world may continue for some time suggests that it may be wise to think of the need for a global borrower of last resort. To the extent that corporate debt minimization is linked to corporate profit maximization, we need both the lender of last resort as well as the borrower of last resort. Thanks to the efforts of Keynes, White, and others, we already have the lender of last resort in the form of the International Monetary Fund. But there is no borrower of last resort, and this omission may cost the world economy dearly if the corporate concerns over balance sheets got much worse than where they are now.

The above also means premature efforts to reduce budget deficits when the economy is in a balance sheet recession are extremely dangerous, as U.S. President Herbert Hoover in the 1930s and Japanese Prime Minister Ryutaro Hashimoto in 1997 found out. Indeed, the biggest risk to the world economy today may be the well-intended effort on the part of "responsible" academics, policymakers, and journalists to reduce budget deficits when the private sector is still in a balance sheet repair mode.

Low long-term interest rates in the three largest economies in spite of ever increasing budget deficits and higher oil prices are a stern reminder that the corporate sectors of those economies have not regained full health. Even though a small government relying on monetary policy is best when the private sector is healthy and forward looking, a proactive government with a credible fiscal policy is absolutely essential when the private sector is sick and in need of balance sheet repair. ◆