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Japan's Mistaken Solutions

BY TADASHI NAKAMAE

Lessons on how not to respond to a financial crisis.

Looking for a country that has "survived" a financial meltdown? Well, some would say that country is Japan, which went through a banking crisis from the mid-1990s until the mid-2000s, and has been cited as an example that America and Europe, currently going through their own financial catastrophes, should emulate. Yet officials, such as U.S. Treasury Secretary Henry Paulson, as well as dozens of analysts, continue to waver over whether Japan is an example of how or how not to deal with a banking crisis.

The answer is simple. Japan's method of dealing with its banking crisis was a failure, and thus is a blueprint for how not to solve a financial crisis. The current mess that America and Europe face is similar in that their financial institutions, like Japan's, are seeing the value of their assets deteriorate rapidly. Shareholders' equity is disappearing, leading to a shortage of capital among financial institutions, obstructing their ability to make fresh loans.

The difference between what is happening now and what happened more a decade ago is that Japan's crisis was relatively simple. Banks had accumulated bad loans, which were backed by bad collateral, mainly in a real estate market that was collapsing in value. In contrast, the current banking crisis in America and Europe has been caused by bad investments in securitized products. Not only are these losing value, they pose a further problem in that their complicated structure and lack of transparency makes them almost impossible to value. Even top officials

The only way to overcome the current financial crisis is to nationalize the banks, remove their bad assets, and establish good banks with sound business models which can then be re-privatized.

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cannot put a number on how much money has been lost. No wonder Mr. Paulson was forced to pluck a number—$700 billion—out of thin air.

The flip side of the balance sheet also favored Japan, just as it is hurting the West today. Japan's banks could at least be fairly sure that they would not have funding difficulties, as they relied on household deposits in a country that likes to put its savings in banks. In America and Europe, however, troubled financial institutions have an additional problem in that they raised funds in the short-term money market, a source that is, and has been, quick to dry up. This means that the balance sheets of American investment banks such as Lehman Brothers and Bear Stearns and European commercial banks such as Deutsche Bank and UBS, to name but a few, are hugely leveraged.

As a result, the problems now facing America and Europe are far bigger that those of Japan a decade ago. And, given that Japan fell into an economic downturn that has lasted some eighteen years, using Japan's so-called solution to its banking crisis would be extremely dangerous for the global economy.

LESSONS FROM JAPAN

The West needs to do three things simultaneously. First, it needs to enable banks to obtain funds easily. Second, it needs to force banks to write down their assets, no matter how painful this may be. Third, it should recapitalize the banks so that they can make fresh loans. Doing these things one by one is not enough.

These three issues are so closely linked that it is foolish to assume that they can be taken care of separately. American officials have failed to see this, even though the markets have responded, temporarily, to each piecemeal attempt by the Federal Reserve and the government. The failure of America and Europe to take care of the third problem of recapitalizing their banks immediately makes any attempt to solve the first or second problems a waste of time. They have been unable to recapitalize banks because they are unable to gauge how much the financial system has lost and how much needs to be put back in. Worse, as the domino effect weakens the economy, the more money the financial system loses. Essentially, the governments are faced with a moving target.

This is exactly what happened in Japan in the 1990s. Japan's failure to deal with this problem shows that the best way to handle the current crisis is a complete nationalization of banks. This is by no means a "socialist" solution. Moreover, this involves the least moral hazard since shareholders, preferred or otherwise, and subordinated debt holders would not be protected at the expense of taxpayers. Nationalization gives depositors security, and prevents further runs on banks. It also enables the government to sever the bad assets and an equivalent amount of liabilities (in the form of short-term money market funds) from the banks' balance sheets. That leaves banks that are smaller, but are completely free of bad assets. Left with only good assets, these banks should have little difficulty securing fresh funds as re-privatized entities and would be able to lend easily again.

Given that Japan's zero interest rates were a direct result of its debt increasing faster than its GDP, the best way to raise interest rates would be to lower debt substantially.

There are several benefits to this solution for the bad assets as well. First, since these assets are now under state control, there is no need to rush to write them down. Second, since, say 90 percent of banks would be nationalized, so would their bad assets, most of which are in the form of derivatives.

Since many of these banks would have been counterparties in such deals, a lot of these derivatives could be cancelled out. Third, the government can use its status to secure funding so that it can continue to rollover the funding for these bad assets until they can be sorted out. Fourth, the so-called "good" banks with clean balance sheets would be able to establish business models that are profitable, making them appealing to investors, so that they can be reprivatized quickly. These proceeds would finance the eventual write-down of the bad assets, hopefully leaving the government—and taxpayer—with a net profit, or at least, with minimal losses. Unlike other measures such as Mr. Paulson's $700 billion "solution," this measure would not increase government debt—a huge advantage.

HOW NOT TO WEAKEN YOUR ECONOMY DURING A FINANCIAL CRISIS

Japan showed the world how easy it was to weaken an economy by pursuing mistaken solutions to a financial crisis. Take debt as an example. Debt is the counterpart to the funding necessary to help companies, consumers, governments, and ultimately economies prosper and grow. In 1979 Japan's debt was equal to 277 percent of its GDP. At the peak of Japan's bubble economy, debt was 458 percent of GDP. After the bubble burst, the growth of Japan's debt-to-GDP ratio slowed but accelerated again in 1996 when the banking crisis emerged. By 2005 debt was equal to as much as 541 percent of GDP. The sharp increase in debt between 1979 and 1989 created Japan's real estate bubble and a related stock market bubble as companies borrowed to buy increasingly expensive pieces of land. After these bubbles burst, the growth of the debt-to- GDP ratio slowed and real estate prices tumbled. Afterwards, banks and borrowers were trapped in a vicious cycle. Borrowers, hit badly by the collapsing property market, saw their creditworthiness fall, making it hard for them to raise fresh funds. Similarly banks saw their capital, hitherto buffered by large unrealized gains on their stock portfolios, shrink. Worse, their non-performing loans increased, weakening their balance sheets further, leaving them unable to take on extra risk by making fresh loans. The private sector functioned as it should in a market economy.

Unfortunately, the government and the central bank decided to step in. As debt stopped increasing, asset deflation accelerated, Again, this is perfectly natural. Yet a panicked government intervened by itself borrowing money in order to increase wasteful public spending in an attempt to prop up the economy. Meanwhile, the Bank of Japan lowered interest rates in hopes of stimulating the economy, and eventually, having run out of room to cut interest rates further, it started pumping money into the economy through huge purchases of government bonds. The central bank's balance sheet expanded from 9 percent of GDP in 1994 to 29 percent in 2004, an unprecedented level. None of this helped Japan's economy recover. The private financial sector's debt-to-GDP ratio increased from 57 percent in 1979 to 144 percent in 1989. After the bubble burst it remained flat, illustrating that most of Japan's post-bubble debt was created by the government. Government debt, 60 percent of GDP in 1990, tripled to 180 percent by 2007. In contrast, non-financial companies saw their debt fall from 150 percent of GDP in 1995 to 91 percent in 2007. Household debt, which had peaked in 1999 at 71 percent of GDP, fell to 63 percent in 2007, as households too tightened their purse-strings.

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The government and the central bank's intervention caused by panicked decision-making backfired in two ways. First, take the efficiency of money. The higher the debt-to-GDP ratio, the lower the contribution one unit of debt makes in supporting economic activity. During the bubble years, the falling returns on debt can be attributed to the private sector's borrowing and investment frenzy.

Post-bubble, however, the decline was exacerbated by the government's and central bank's misguided policies to keep increasing debt. For every ¥1 trillion of fresh debt, ¥360 billion worth of GDP was created in 1979. This fell to ¥218 billion in 1989 and dropped further to ¥188 billion in 2007. Most of the decrease on the return on debt took place during the bubble years. Given this, decreasing the private-sector debt should have been a top priority as soon as the bubble burst in the early 1990s.

Left to itself this is what happened in the private sector. Unfortunately, the government and central bank, blinded by panic, increased debt, ensuring that returns on debt would fall further at the expense of the economy's long-term growth potential.

The decline in debt efficiency is clearly reflected in long-term interest rates. Japan's ten-year government bond yield fell from 8.9 percent in 1980 to around 1 percent today. Furthermore nominal GDP growth came down from 9.3 percent in 1980 to nearly zero throughout the past decade.

Low debt efficiency was a big reason why Japan was able to maintain its strategy of zero interest rates for over a decade. This itself has led to bad repercussions for the overall economy. It enables weak and inefficient companies to stay alive, since their cost of capital was effectively zero. This reduced the overall efficiency of Japanese industries and economic productivity. Japan's zero interest rate policy completely wiped out household interest income. In the early 1990s, households were earning roughly ¥35 trillion on their savings, more than 12 percent of current household consumption. That this occurred during a period when unemployment was rising and wages were falling helped to depress substantially domestic consumption. If Japan is looking for a consumption-led recovery (which has yet to happen), interest rates need to be raised, since wages will not recover until the economy is back on its feet.

Given that Japan's zero interest rates were a direct result of its debt increasing faster than its GDP, the best way to raise interest rates would be to lower debt substantially. First, the Bank of Japan needs to shrink its balance sheet by ending its monthly purchases of government bonds (currently running around ¥1.2 trillion a month). Second, the Bank of

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Japan must get rid of the government bonds it has already amassed. This should prompt a rise in long-term bond yields, followed by a general increase in interest rates. This, in turn, is likely to act as a catalyst of change in the domestic economy. We estimate that interest rates should rise until some 20 percent of small- and medium-sized companies fail. The remaining 80 percent, which were healthier to begin with, would then be able to increase their efficiency and become more profitable.

This is important because debt in the small- and medium-sized business sector has not fallen since Japan's economic bubble burst. True, the overall numbers indicate that non-financial industry debt has fallen. Most of this, however, was accomplished by large companies, not small ones.

So what happens to the employees of the 20 percent of small- and medium-sized companies that need to fail? Retraining programs, a common feature amongst developed countries, need to be put in place so that these workers can move into jobs in newly emerging industries such as agriculture and various services industries. Many of these new industries will be supported by demand from households, which will at this point, be enjoying—and spending—hefty returns on their savings thanks to higher interest rates.

So far the West has emulated Japan by seeking to protect the value of assets at the expense of burgeoning debt. Japan shows why this is likely to have disastrous consequences for their economies in the long run.

Right now, America and Europe appear to be in such dire straits that by contrast Japan appears fairly healthy. Not true. Japan is still fragile due to its inability to resolve its post-bubble economic problems, and the consequent financial crisis has left it extremely vulnerable to new shocks.

As mentioned above, Japan's small- and medium-sized businesses have huge amounts of debt left on their balance sheets. As the economy deteriorates, the weaker firms face looming bankruptcy, even if interest rates remain low. Similarly, banks, which continue to hold large amounts of stocks, are starting to see unrealized losses on these portfolios rise as stock markets plunge. For example, at Tokyo Mitsubishi UFJ Financial Group, the largest bank, shareholders' equity, which was ¥10.6 trillion at the end of June 2007, fell to ¥9.3 trillion by the end of June 2008. At Mizuho Financial Group, the second largest bank, shareholders' equity fell from ¥6.5 trillion to ¥5.3 trillion in the same period. These numbers are likely to have shrunk further in recent months as stock markets have plummeted. Japan's regional banks, prominent lenders to small- and medium-sized businesses, are in an even worse state. A credit crunch, similar to that five years ago, is reemerging as banks, wary of taking on fresh risks, stop lending and worse, are demanding that their weaker clients repay the principal on their loans.

Across the Pacific Ocean, America appears to be following in Japan's footsteps. Yet America faces additional challenges. During the Reagan years, the so-called highpoint of America's market economy, household spending—consumption plus housing investment—as a ratio to GDP increased from 66 percent in 1981 to 76 percent in 2005. This number is now falling, and we expect it to reach 70 percent within the next five years. Ideally, this decline will be offset by producing sectors, such as manufacturing, agriculture, mining, and exportable services. These industries would hopefully increase their capital expenditure and net exports. Between 1981 and 2005, when household spending was driving the economy, this had fallen from 13 percent to 4.5 percent of GDP. Preferably, capital expenditure and net exports will now pick up the slack and rise to perhaps 10 percent. In other words, America's economic engine would shift from consumption to production.

To achieve this, the return on capital needs to be higher. However, if American officialdom panics, as it has been doing of late, this will not happen because like Japan, it would be pouring public funds into the financial system, raising public debt and lowering capital efficiency. The inevitable outcome of such a policy will be the need to keep spending public funds, this time to prop up the economy rather than the financial system. This will usher in another era of big government and an economy with extremely low productivity. On what will the American government spend money? There are three possibilities: investment in public works, welfare spending, and increased military spending. While the first two options are to an extent necessary, what America really needs to do to raise its capital efficiency entails less government spending. America should start by completely, rather than partially, nationalizing its failed and failing banks, which should actually cost it less than a random injection of funds. ◆