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The U.S. and Japan: the real similarities

As the "bust" in U.S. equity markets continues, particularly in the NASDAQ, there have been many articles written describing the similarities (and differences) between the U.S. recovery prospects and the actual performance of the Japanese economy. A major focus has been the asserted ineffectiveness of monetary policy, either as a result of the Bank of Japan not doing enough early in the Japanese bust or the claim that Japan suffers from a Liquidity Trap that disables monetary policy. That debate will continue for years as modern econometrics is applied to comparative economic history. Hopefully we shall all live long enough to get a definitive verdict. Oddly, however, little has been done on the 'real similarities,' particularly those that relate to the 'monitoring' aspects of the capital market and the longer-term implications for capital investment in a post-boom environment. One key to this analysis is to reflect upon the effects on the economy of a long period of cheap real capital. As Professor Berra said, "It ain't over 'til it's over!"

Cheap capital creates dubious firms and induces even credible firms to indulge in investment projects of dubious merit. That is not a surprise. The rationing effect of a high cost of capital is sharply diminished when we enter a period of 'low cost capital.' Second, during a Boom, other sources of credit, such as commercial banks flush with funds and wishing for borrowers, emerge with offers to prospects in areas previously unfamiliar to the lenders. Projects with minimal chances of economic success get funded, only to have their spent carcasses rot when the Boom turns into a Bust. Japan had its share as has the U.S. There is huge excess capacity all through the Telecom sector. There were all too many "dot.coms" who "got it" but failed anyway when the mirage of ever expanding markets evaporated leaving a drought of earnings.

The current fashion refers to such firms as those with 'poor business models.' Why were the business models that the firms put forth when they were raising capital judged to be suitable business models? It appears that capital markets were 'blinded,' by excessively cheap capital and plenty of access to such capital. If we want to know what is similar with the collapses in Japan and in the U.S., we should start with the capital market.

One feature of an excessive extension of credit flowing from a period of 'cheap capital,' was the curious inverse relationship that developed between credit extension and credit monitoring. "Let's put some perfume on this pig," says the commercial. In Japan, it was most noticeable in the real estate arena. The extension of real estate credit to dubious borrowers was often not accompanied by a careful monitoring of the realities of the real estate investment prospects. In effect, lenders focused on "balance sheets," attributing to the assets that served as collateral a stolidity that crashing markets later undermined. This was doubly the case in Japan where highly valued public equity was used as loan collateral. When the bust came, it took down the collateral values, but the real estate peak and subsequent crash came later. Asset based lending that ignores the pay back realities of cash flow is subject to that risk.

The U.S. was spared much of that excess in this episode probably because of its experience a decade earlier in the Savings and Loan debacle. But, there is no doubt that the U.S. is suffering from an overbuilt condition in office and other commercial real estate facilities. Focusing on 'balance sheets' and then dreaming up reasons why companies actually had non-monetary assets that were 'valuable' in a hot equity market was at the root of the dot.com equity boom. Similarly, lending to the Telcom industry focused on fiber in the ground when the payback on those assets was highly dependent upon a huge market re-arrangement, including access to the 'last mile.' The provisions of the Telecommunications act of 1996 and its modification in 1998, however, set up incentives that blocked that access, thus undermining the value of the supposed assets.

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Perhaps the most important similarity is the governance (or lack thereof) exercised by the capital market itself. In the U.S., we are coming to understand that substantial amounts of chicanery in accounting practices occurred. Assets were written up and liabilities were off loaded, dressing up the income statements of then prestigious companies. The most recent revelations suggest a connection between the investment banking wings of certain banks and access to new issues by executives of capital-raising companies. It might not be illegal by the then prevalent standards, but it is certainly suspicious. It appears as if substantial monetary incentives were created to do investment banking with certain firms. This is only the latest revelation. It adds to the hue and cry over executive compensation in the form of stock options.

From a capital markets perspective, the stock option issue is one of access to relevant information by all capital market participants. Unloading stock options, but delaying the release of that information, creates the appearance of an information asymmetry in the equity market. It may even connote trading on inside information that is now considered illegal. But, the securities divisions of investment banks were often 'in the know.' How could it be otherwise if they were offering collars or actually selling the shares for the entitled executives? In a boiling hot equity market, access to IPO shares was currency. If not outright bribery, this was certainly an effective enhancement of an investment bank's ability to raise capital? The American capital market's charms seem quite Japanese on this score!

Japan was replete with scandals that arose in the capital market. Buyers of IPO's that subsequently declined were "paid back" by security firms with other trades that compensated for the initial losses. There were examples of outright payments of stock to politicians who sat in judgment on economic matters. Balance sheets of very weakened companies were kept from public view by delayed accounting, by the refusal to write off bad assets, and by mergers or 'convoying' of weakened companies into allegedly stronger companies.

Each of these transactions prevents capital markets from clearing at realistic values. In effect, the transactions 'hide' proper valuation. In some cases, this was even permitted by Japanese regulators who looked first at the huge potential for financial panic or a banking crisis and then used the potential for panic to justify keeping the information sufficiently opaque. It still goes on as can be seen in the dubious standards applied by Japanese banking regulators as to the classification of non-performing loans.

Yet the financial crisis in Japan has not passed, precisely for the reason that the market doesn't 'clear.' Bad assets remain, often unsold, and almost always insufficiently marked down. "Zombie companies" continue to have their loans rolled over and in some cases are able to float bonds when they are virtually dead in the water.[1] That is not a surprise when the entire Japanese banking system is prevented from "clearing" by Japanese regulators---for fear that it will cause a panic. The result is that the crisis has stretched into a decade-long period of extremely weak economic growth. A real fear is that it could last another decade!

Is there a similarity in the U.S? The incredible stream of merger activity by WorldCom has a 'convoy' kind of quality. It appears now that WorldCom ceased to be profitable many years ago, long before its equity price collapse. Yet, the mergers continued in part because the earnings on the books were the result of accounting slights of hand. Capital markets permitted the mergers because the accounting information that would have destroyed this strategy was unavailable…either by design or by capital market oversight. The current vogue is to blame it all on the accounting profession for being much too compliant, much too much given over to 'serving the client.' That answer is far too simple and it suggests a solution likely to be inadequate but very politically correct. The solution is to regulate the accounting industry.

[1] See Phred Dvorak's "Walking Wounded" Wall Street Journal, August 28, 2002

A closer inspection suggests that capital market participants, along its entire food chain, bears responsibility. Someone needs to ask whether capital market participants are not subject to a manufacturer's warranty on all the securities that are offered into the capital market? How else can the buyers of public securities have some recourse to obscured or deliberately falsified accounting statements?

Japanese investment responded to cheap real capital in a fashion totally at one with economic theory. When the cost of capital is sharply reduced and the availability of funding (either through equity and/or bond issuance and/or bank loans often given on 'soft terms,') creates a virtual condition of "zero cost capital" private domestic investment soars. It happened in Japan and it happened here as well.

The residue of that kind of experience is an excess capital stock with the excesses concentrated particularly in the areas in the economy that are found to be the weakest. When the tide goes out is when you find the beached fish and boats. An economy that suffers a slow down in aggregate demand after a long period of capacity expansion is bound to suffer a relatively long period during which the capital stock is 'worked-off."[2] What is worse, capital excess is precisely in the areas whose real demands have flopped. In Japan, it is the commercial banks. They are like stranded whales---and they bear a striking similarity to the Telcoms and their associated supplier networks in the U.S.

One possible way out of the dilemma posed by excessive capital stocks in weakened industries is massive capital exit. In Telcoms, it means merger of firms and devaluation of the existing capital stock until even with lessened revenues, an appropriate rate of return on capital can be achieved. In the U.S., this will mean running afoul of the existing regulatory network because nearly all solutions must encompass the "last mile," and mergers must then be equivalent to creating either monopoly or oligopolies. Will it happen? Probably, but very slowly. It also will require leveraged financing.

In Japan, the problem of constricting the over banked financial system is essentially political. Which bank will be the acquirer and which the acquired? Inherent in the NPL classification controversy is the political question of survival. It is not surprising that with a Government that totters on from defeat to defeat, no leadership has developed in the regulatory agencies that rule in the financial sector.

Capital market booms, followed by busts leave a residue. Japan and the U.S. have some real similarities. They both got access to "zero cost capital," and they both suffered indigestion from building excess capacity. Their capital markets, while quite different, have also produced some remarkably similar behavioral patterns. Obfuscation and scandal occurred in both. They also have similar residues of excess capacity, which need treatment. In the U.S. the Telcom industry needs to be restructured, along with its communication cousin, the cable industry. In Japan, the banking sector (and probably its cousins in the insurance industry) needs radical treatment if Japan is to regain any growth momentum. In both countries, sadly, these are industries that have large political constituencies and they have powerful political friends. The cure demands hard political decisions, a currency always in short supply.

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[2] Efforts by monetary authorities to stimulate aggregate demand following a long period of capacity expansion have been questioned by many economists. In fact, this was a core issue in the debate between Hayek and Keynes in the 1930's during which Keynes argued that a Central Bank could be sufficiently aggressive to ward off the problem. Hayek disagreed that monetary policy could do much to counteract the problem in the short run. Although Keynes was judged to have won the debate, Keynes then followed with the General Theory that put Fiscal Policy measures back in the saddle.

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