# This Time It's *Different*

**BY RICHARD JERRAM**

*Japan is poised for growth because for once its financial system is healthier.*

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This time it's different.

Japanese policymaking has been repugnant to the eyes of many economists for much of the past two decades. Unfortunately, that tends to color our judgement and lead to the conclusion that Japan's economy can never properly recover or escape from the deflationary trap. It might offend my sense of justice to see politicians claiming credit for a recovery that their policies have impeded, but I try to make sure that does not make me blind to the cyclical and structural improvements now taking place.

Japan does not have a particularly unusual economic structure or set of problems, so much as a remarkable political ability to perpetuate the status quo. It has been the lack of response to economic distress over the past decade that has been unorthodox, not the nature of the problems.

Just because Japan has taken the wrong path out of the post-bubble distress does not mean that it will never arrive at a resolution. It has been an unnecessarily long and painful route, but finally an end is in sight. Perhaps uniquely among developed economies, Japan has elected to resolve a balance sheet problem through a lengthy accumulation of flows, rather than a one-off stock adjustment or a burst of inflation. The cost in terms of lost growth and damage to public finances has been substantial, with net debt-to-GDP rising from 18 percent of GDP in 1993 to 79 percent ten years later. Maybe we should blame the tolerant (misinformed?) electorate, but Japan is a democracy and it is more constructive to ask what happens next.

For the first time in a decade, the Japanese banking system is either solvent, or close to solvency. The background of regulatory forbearance means we cannot reliably expect to judge systemic health by looking at the balance sheets of the banks. However, we can come to this conclusion from two different angles.

First, the rational behavior of distressed banks is to lend more money to distressed companies, in order to avoid taking provisions against loans that have a high risk of default. Maintaining the pretense that bad loans are good loans helps to maintain the pretense that insolvent banks are solvent banks. Economists call this flow of good money after bad "evergreening" and in Japan it has become known more prosaically as "zombie life-support." When regulators are prepared to turn a blind eye and when interest rates are near zero, the banks are able to control the speed at which bad debts are recognized. As a result, bankruptcies have tended to rise with the economic cycle, when the banks' improving earnings allow them to deal with problem borrowers more aggressively. The goods news is that over the past two years, banks are increasingly behaving like solvent institutions, and I calculate that the flow of "evergreening" loans has fallen to about one-quarter of that seen in the late 1990s.

Second, looking at the ability of the corporate borrowers to service their loans, we calculate that banks are probably within a year of being adequately provisioned. In

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fact, the acceleration of the economic cycle since late 2003 might even be shortening this time frame. Neither approach is precise, but both show such a substantial improvement over the past couple of years that we can be confident that there has been a material improvement in the health of the banking system.

Of course, two years of economic recovery have helped the banks, as well as some institutions raising fresh capital. If the Chinese economy blows up tomorrow, then the source of 80 percent of export growth in 2003 could drag Japan back into recession, and drop the banks back into distress, but at the moment that does not look too likely.

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I hear various reasons why the current recovery is different, ranging from increased attention to shareholder value by corporate Japan; the idea that the trigger for recovery was not fiscal policy; that over-capacity has been reduced; and even that the recovery reflects the success of Prime Minister Koizumi's reformist agenda. Some are true and some might even be relevant.

However, the most significant reason the current upswing is different is because for the first time in over a decade it comes against a backdrop of a near-healthy banking system. The unknown factor is whether the banks are yet strong enough to become orthodox, risk-taking financial institutions, rather than the captive buyers of zero-risk weighted Japanese government bonds of the past decade. Major banks now have 14.4 percent of their assets in government debt, compared to 3.1 percent five years ago. Rather than taking credit risk by intermediating between private borrowers and private savers, savings are being channeled to the government, with the banks only taking duration risk.

Everything changes with a solvent banking system, but unfortunately, we don't know how long it will take. There is a common perception that Japanese bank management is irredeemably incompetent, whereas in reality the problem has been one of incentives. The management of a healthy bank has an incentive to develop future business and an ability to take credit risk and to invest in the systems that enable it to do so profitably. The management of a distressed bank typically has an incentive to conceal the extent of distress.

A solvent banking system, ready and able to take credit risk, would also remove a major source of deflationary pressure. And a swing in inflation expectations would drop real interest rates, which should boost corporate investment and purchases of consumer durables. It should also help the housing and real estate market, once there is the perception that the market has cleared and asset prices are firmer. Some recent signs of life in the housing market are a hint that we are not just near the end of the deflationary era, but perhaps at the start of a reflationary one.

We know that there is loan demand that is not being met, probably due to the weakness of the banks' balance sheets. Bank lending decisions in Japan still seem to be a binary process, with firms either having access to credit at the same price as everyone else, or not receiving a loan. This seems to be because lending is primarily based on collateral rather than an analysis of cash flow, so there is minimal lending from banks at premium rates. In contrast, there is plenty of activity from non-banks to small firms and individuals at rates in the 15–25 percent range. But we know there cannot be more demand for credit at a 15 percent interest rate than there is at a 5 percent rate. If healthy banks are able to invest in credit scoring systems to identify the potential borrowers, and start to take the credit risk in making slightly sub-prime loans, then the benefits to the economy should be substantial.

In fact, even if the banks are not yet prepared to take credit risk, there is an immediate benefit from being strong enough to stop the flow of new loans to distressed firms. The survival of "zombies" has depressed profit expectations and damaged new company formation and job growth in the sectors where they are prevalent. Most of the large problem borrowers have now been dealt with, so the "zombies" are no longer such a drag on dynamism or a source of deflationary pressure.

Over the past couple of years deflation has been ebbing, as the economy recovers and distressed borrowers are tackled. However, prices continue to fall and price expectations remain depressed. A solvent banking system should remove some of the deflationary pressures and contribute to a normalization of growth.

So the reason that "this time it's different" is that an increasingly healthy financial system brings the prospect of a domestic source of growth, independent from the world trade cycle. That would be a genuinely sustainable recovery. For that to happen we need to see an end to deflation and a normal approach to risk from financial institutions. This is not yet happening, but it is closer than at any time in the past decade.

Once deflation is over and the financial system is functioning, Japan could be looking at a growth surge for a few years, as the imbalances of the past decade correct. A smooth transition back to trend growth and inflation seems unlikely, especially as the Bank of Japan is under great pressure to tighten too little and too late. We could see a three-year period when nominal GDP expands perhaps 20–25 percent cumulatively before we head back to trend. But at least the challenge of calming an overshoot of growth and inflation is easier and better documented than fighting deflation. ◆