Japan Is Back in Favor Among Global Investors

The ivory gavel dropped with a bang, establishing yet another world auction record. The price of the wood block print *Foxfires*, from Hiroshige’s *Hundred Famous Views of Edo*, soared to £81,600 in the auction room of Sotheby’s in London in fall 2005. The winning bid was fully triple the house’s estimate. *Ohashi*, from the same series, commanded bids of up to £90,000 earlier in the day, close to twice the auction house’s projections.

After more than a decade, Japan is back. The Nikkei 225® closed the year 2005 above 16,000 for the first time since 1999, making the Tokyo market the best performer of any major developed economy for the year. Interest in Japanese culture is rebounding, driving up demand for antiques and other collectables. *Memoirs of a Geisha* opened in theatres across the United States. After dropping off in the

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early 1990s, the number of students registering to study Japanese at U.S. colleges is again on the rise. Japan appears to be on the verge of being trendy for the first time since the 1980s.

Some global investors are shaking their head in wonder. Many have long viewed Japan as the sick man of Asia. In a reversal of fortune rivaling the collapse of Soviet Russia, asset values in the world’s second-largest economy virtually imploded in the early 1990s. Businesspeople across the globe wrote it off as a disaster zone, and foreign investors deserted Tokyo in droves. In the mid-1990s, Frank Jennings, now portfolio manager of the $4 billion Global Opportunities Fund at Oppenheimer Funds, referred to the Japanese markets as “the ultimate capital destruction machine.” Some privately speculated that there would be “blood in the streets” as a result of what was regarded to be horrible mismanagement of the economy. The Nikkei 225* tumbled from almost 40,000 at the end of 1989 to a low of 7,607 in 2003, while commercial real estate in Tokyo lost about 70% of its value from its peak in the early 1990s.

What went wrong is not the focus of this book—I examine what some investors believe is finally going right. A debate continues to rage regarding why the Japanese economy slid into an apparently intractable recession, a debacle experienced by no other developed economy since World War II. While commentators in both the financial markets and academia agree that the tardiness of the government in addressing bad debts at Japanese banks delayed any rebound in share prices, views on the overall role that economic policy played in the downturn remain sharply divergent. Some analysts view the recession as typical of a business cycle downtrend and argue that fiscal and monetary policy was insufficiently stimulatory; others focus on perceived unique rigidities in the Japanese economy that prevented a reallocation of resources to more profitable industries. Happily for investors, they do not need to take sides in this ongoing discussion. Nonetheless, it is clearly to time to reassess what is going in the Japanese financial markets.

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The sheer magnitude of gut-wrenching and painful price declines in Tokyo has prompted sweeping comparisons with epochal events of the past. Alex Kerr wrote in *Dogs and Demons* that Japan lost more money than any nation in human history, surpassing even Rome's losses when it was sacked in 455 A.D. Perhaps, although no Vandals were seen helping themselves to finery in Ginza department stores following the collapse of the bubble economy. To be sure, fans of the eighteenth-century English historian Edward Gibbon and other such connoisseurs of decline find such parallels irresistible. But the legacy of Japan's so-called lost decade should not blind investors to the present.

“*This spectacle of the world, how is it fallen! How changed! How defaced! The path to victory is obliterated by vines, and the benches of the senators are concealed by a dunghill.*” Poggius’ words as he surveyed Roman ruins on the Capitoline Hill in the fifteenth century resonate strongly in Tokyo in the wake of the disastrous ’90s. Nonetheless, in the rubble of the Japanese economy, a new plant has taken root. An exceedingly rare species, it flourishes in times of uncertainty and change. It also grows only where hard work is rewarded and property rights are respected. The prospect of finding such a botanical specimen is prompting foreigners to flock to Tokyo. This highly coveted prize is the Japanese money tree.

Many foreign hedge fund managers and advisors, private equity turn-around specialists, property developers, and value investors now see the country as fertile ground to grow businesses and create value. Japan’s restructuring is perceived to be a once-in-a-lifetime opportunity, offering returns unavailable in other markets. This book focuses on where such foreigners are finding opportunities in Japan, how they are trying to make money, and the risks that still plague investors today.

This revaluation by the markets of the country’s prospects has been sudden and dramatic. Indeed, 3 short years ago, traders in Tokyo nervously eyed the nation’s fifth-largest banking group, which was teetering on the edge of bankruptcy.
By June 10, 2003, many foreigners viewed Japan as the Death Star of financial assets, blowing up funds and zapping the performance of any manager who had the temerity to overweight the country in global portfolios. The yield on Japanese 10-year government bonds fell that day to 0.46%, or effectively zero. People snapped up bonds that offered nothing but the assurance that they would get their original capital back in a decade. The Nikkei 225* had plummeted to a 20-year low of 7,607 a few weeks earlier.

Stock market participants were panicking, remembers Nick Ricciardi, a founder at Light Year Research (Japan) K.K. Unlike many brash, loud traders who appear to have the reflective capacity of race-car drivers rounding a curve in fourth gear, it is easy to picture Ricciardi enjoying a quiet chess match in the park. With dark eyes and an unruly head of brown hair, he lacks the hulking physique and stentorian voice often used to dominate discussions by the computer screens at derivatives desks. One should not be fooled, however. A grand master at market strategy in his 40s, he has little need to intimidate in debates, using instead sharp-edged logic and seamless mathematical reasoning.

Having headed the Asian Equity Derivatives business at Goldman Sachs until 1997, Ricciardi was originally banished to Tokyo by Robert Rubin when the former treasury secretary was still co-running the firm. Rubin interviewed him for a position managing Goldman's structured equity products business in Japan in 1990.

“I'm 24 years old, I am looking across at this senior guy, I can't believe I am even meeting him, and he is offering me this job,” he reminisces years later. The only catch was that the chairman was stipulating that Ricciardi could not return to the United States for years.

Suddenly Ricciardi realized the droll investment bank head was joking. He deadpanned, “Sure, I can stay there for 5 years; I never have to see my family again.”

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Following his years at Goldman, Ricciardi settled in Kyoto and started scouting firms overlooked by others. He scrutinized balance sheets and found amazing deals. “A couple of years ago, a great way to make money was to identify companies that had undervalued tangible assets,” Ricciardi notes, pointing to property, cash, and securities held by firms. Companies in aggregate on the First Section of the Tokyo Stock Exchange were priced below their book value, and many of these had a great deal of hidden assets.

“It was a relatively straightforward trade to identify those companies that were trading at the largest discounts.” Whole swaths of the Japanese market were made up of such bargains—companies trading below their net current asset value. This is a fire-sale price of a firm—what an investor could, in theory, take home from a firm’s safe and bank accounts after quickly shutting it down. To get this value, Riccardi subtracts total liabilities from the total amount of cash listed on a firm’s balance sheet. He then adds back cash equivalents, marketable securities, and tax-adjusted long-term shareholdings, and compares the result to the firm’s market capitalization.

“The situation was unparalleled in recent financial history in any real market. You probably had to go back the post-Depression 1930s in the States to find chunks of the market that were comparably undervalued,” Ricciardi points out.

The deep price declines in Japanese share prices prompted many institutional investors to give Japan another look. Much of corporate Japan was up for sale at bargain-basement prices. “I would say a year ago, many people would have argued Japan was the best-value market in the world,” remembers Jennings at Oppenheimer in early 2006.

Stocks selling below their net current asset value may well be bargain issues, observed the two pioneers of value investing, Benjamin Graham and David Dodd, in their classic Securities Analysis. One reason is that net current asset value “may be considered a conservative measure of liquidating value,” they wrote, but added that diversification of such stocks is desirable to ensure good performance.
Ricciardi saw even more Japanese companies trading below their net tangible asset value. This he defines as his calculation of net current assets (which subtracts total liabilities) plus conservative values for tangible assets, such as land, plant, equipment, and inventories. In isolated cases, there may be a good reason a company is trading at a deep discount relative to net tangible asset value. For example, if managers are corrupt and are not running the company in the interests of shareholders, a low stock price could be warranted. “But when you see it across thousands of companies, then it is highly unlikely that there are that many fraudulently run companies,” observes Ricciardi.

Although Japanese stocks in 2003 did not approach 1930s Depression-level prices in the United States, there were comparably undervalued parts of the market that Graham and Dodd “would be in heaven over if they were picking stocks today,” says Ricciardi. He points to Japan Maintenance Co., Ltd. (9787), and Toei Labo Tech Co., Ltd. (9732), as two companies that subsequently went through the roof. Japan Maintenance rose from a low of ¥250 in January 2001 to ¥3,040 by May 2006, a stunning elevenfold increase. Toei Labo Tech jumped from ¥122 in December 2002 to ¥688 in February 2006, a dramatic 463% gain.

“One of the big explanations for this undervalued situation was deflation,” points out Ricciardi. Wrenching price declines for years had led many investors to expect to lose money if they held on to assets in Japan. “To the extent that deflation is expected to persist permanently or for the foreseeable future, then you can get hurt buying companies below their net tangible asset value,” he warns. To illustrate his point, he uses the example of a company that owns $100 million of property and has a market capitalization of only $50 million. Under grinding deflation, the property holdings of the firm could ultimately lose 50% of their value. Under this scenario, the market could be pricing the firm correctly, assuming that investors had no ability to hedge.

June 2003 marked the height of such fears. Ricciardi attributes much of the rise in share prices since then to the end of deflationary
paranoia. About this time, the government agreed to bail out Resona Holdings, Inc., a major banking group. The government pumped about ¥2 trillion into the beleaguered institution, convincing many investors of its determination not to allow a full-fledged crisis in the banking sector, one that would have led to a credit crunch and, ultimately, a deflationary spiral. The outlook for banks was still far from rosy. The public was dismayed to learn in September that Resona Holdings was still hemorrhaging money at an alarming rate—it had lost more than ¥1 trillion during the previous 6 months. Indeed, it still took bravery to buy into Japanese stocks. Capital destruction was continuing. However, many foreigners decided it was safe to buy deeply discounted Japanese assets.

Investors heaving a sigh of relief at the government’s intervention, however, were only part of the story. Foreign shipments at Japanese firms began to pick up, supporting earnings. Exports climbed 12% year-on-year in 2004, their fastest rate of increase since the heady days preceding the Asian crisis in 1997. U.S. consumers packing shopping malls and Chinese factories running at full-throttle resulted in another 7% gain the following year. Fear receded in Tokyo, and, at some point, greed took over.

With the Nikkei ending 2005 over twice as high as it was during the grim days before the government’s announcement of the Resona Holdings bailout, Ricciardi is convinced the large move in the market due to tangible asset repricing has already occurred. A new strategy is needed to find value in Japan.

Some observers, convinced that the Japanese economy is finally back on track, argue that the stock market will be supported by across-the-board strong earnings growth for years to come. Such siren songs repeatedly seduced investors in the previous decade, but they often found share performance crashing on the rocks as Japan’s economy repeatedly stalled. “Ah, but this time it is different,” runs the argument. Jobs are being created, and wages are rising. Such income growth will fuel consumer demand, boost sales growth, and
support earnings, proclaim these bullish commentators. In 1997, jobs grew, and wages were also climbing at over twice the rate recorded in 2005. Nonetheless, the stock market imploded in the autumn, when exports collapsed during the Asian meltdown.

Is it really different this time? This is the question I put to Akira Furukawa, former Deputy Director General of the Economic Planning Agency’s (EPA’s) Economic Policy Bureau, in summer 2005. The EPA was folded into the Cabinet Office in 2001. The bespectacled scholar, whose hair is salted with gray, has the kindly presence of a gentlemanly diplomat. Furukawa enjoys an encyclopedic knowledge of economic trends and is one of the country’s leading experts on the business cycle. He has written numerous surveys of the Japanese economy published by the government, and regularly helped brief Cabinet members during his stint at the EPA. He retired from the government in 2000 and took a position with Ritsumeikan University, where he teaches courses in economic policy and statistics.

Ritsumeikan was initially founded by Prince Kiminachi Saionji on the site of the Kyoto Imperial Palace. Saionji was the last of a group of elite elderly statesmen, known as genro, who held tremendous sway over Japanese politics until the beginning of World War II. The current university adopted this name in 1913 and has campuses throughout the Kyoto area, including one across the street from the Ryoanji Temple, known throughout the world for its elegant rock garden. The economics department is located 15 minutes from nearby Otsu City, an ancient capital of Japan that predates the sixth-century Nara Period.

Furukawa’s office overlooks the imposing gray mass of Mt. Hiei and glittering Lake Biwa in nearby Shiga Prefecture. Mt. Hiei, home to the Enryakuji Monastery, was the site of one of the bloodiest massacres in Japanese history. The Japanese credit Oda Nobunaga, along with Toyotomi Hideyoshi and Tokugawa Ieyasu, with unifying their country after the destruction of the Ashikaga shoguns. He had a
complete lack of regard for tradition. In 1571, Nobunaga and his
troops surrounded the mountain, whose 800-year-old Buddhist cen-
ter opposed him, and he gave the order to kill every inhabitant and
burn every building.

“Nobunaga was a reformist,” observes Furukawa when asked
about the warlord’s role in Japanese history, over dinner in a French
restaurant in Marunouchi OAZO, one of the high-rise office build-
ings recently built near Tokyo Station. On further reflection, he adds,
“Perhaps he was a destroyer.”

Nobunaga is a favorite historical figure of Prime Minister
Junichiro Koizumi. Referring to the current ambitious prime minis-
ter, Furukawa notes, “Koizumi is also a reformist, but he lacks
Nobunaga’s power.” Nonetheless, he argues that progress has been
made under previous administrations, and the outlook for the econ-
omy is brighter than it has been in more than a decade.

Furukawa wrote a segment of the Economic Survey of Japan
(1996-1997) that attracted much attention—a simple, common-sense
explanation of the stagnation the economy had experienced since the
collapse of the bubble in the early 1990s. At the time, his analysis was
a useful tool in interpreting the outlook for monetary policy.

In the wake of the stock market and real estate market collapses,
the Bank of Japan (BoJ) aggressively slashed rates, ultimately cutting
them next to zero in February 1999. Central bankers in Tokyo then
were clearly uncomfortable; since interest rates had hit rock bottom,
monetary policy options in the event of further economic shocks were
limited to controversial quantitative easing measures. Such measures,
which essentially involved flooding the banking system with excess
funds, were feared by some to be excessively inflationary; others
doubted the effectiveness of such measures because banks at the
time were trying to shrink their balance sheets. Many investors
sensed that the BoJ was on a hair trigger, eager to raise rates at the
earliest opportunity. Indeed, in summer 2000, the central bank
started draining excess liquidity in the overnight call market, putting
upward pressure on rates, a move that turned out to be premature as the economy slowed abruptly in the winter. The BoJ reversed course in March 2001.

With the central bank clearly eager to tighten, investors needed to know what conditions the central bank considered necessary for a lifting of the zero-interest-rate policy. The central bank gave some clues regarding what it was looking for. For example, the BoJ repeatedly mentioned in its economic reports that accommodative monetary policy was necessary until the economy entered a sustainable recovery. However, it was unclear what the central bank meant by this vague phrase.

Furukawa's elegant, simple model explained what a sustainable recovery would entail for Japan in the wake of the chronic asset deflation that the country has experienced since 1990. He noted that the basic mechanism engine for growth—production increases—was usually triggered by either rising demand for Japanese exports abroad or boosted public works spending. In a healthy economy, production increases jumped started two virtuous cycles. First, among Japanese households, rising production usually sparked additional hiring by industrial firms, thus supporting income growth. The rising demand for workers resulted in wage increases and bonus gains, also supporting rising incomes. Such income gains boosted consumer spending, further increasing demand for consumer goods, and production increased further.

In the corporate sector, production led to a second self-sustaining dynamism through increasing profits. In addition to hiring more workers, firms invested in plant and equipment as returns on real assets rose. Such demand for machinery triggered more production, thus restarting the cycle again. If the Japanese economy was functioning normally, an export-led recovery, or one triggered by public works spending, was possible because of the boosted spending by both households and corporations in the wake of rising production levels.
However, Furukawa went further and noted why a sustainable recovery was not materializing. Several wrenches were being thrown into the growth mechanism. Payrolls were bloated in the 1990s. Managers aged and swelled the executive ranks, resulting in firms top-heavy with white-collar workers. Personnel costs as a percentage of sales climbed to a record high by 1999. Even when production levels rose, firms refused to hire more workers, as they attempted to rein in spending on salaries. As a result, many households witnessed neither wage gains nor new job offers even when factories revved up production activities. In addition, worries about the economy kept the savings rate relatively high. Meanwhile, corporate-sector profit gains were meager even when production levels rose because of the intense deflation in the economy. Falling prices limited nominal sales gains even when real output levels climbed. Depressed profits meant firms had little to spend on additional investments in plant and equipment, and no further boost to production was experienced. Firms were also shifting production to lower-cost centers overseas.

The decade-long banking crisis also weighed heavily on the corporate sector. Furukawa noted in 1997 that banks were adjusting their balance sheets in response to damage sustained during the collapse of the stock and real estate bubbles earlier in the decade. Financial institutions scaled back lending dramatically twice since the early 1990s, according to BoJ surveys. When concerns about a series of bank collapses in 1997 resulted in major banks facing a rising cost of capital, the so-called Japan premium, banks suddenly became much more tight-fisted. Later, when banks faced a deadline to achieve capital adequacy ratio goals dictated by the government in 2001, funds for some corporations dried up again.

Furukawa’s analysis suggested that when external stimuli to the Japanese economy—the previously noted export increases and public works spending—ran their course, the economy would sink back into recession. Indeed, this happened repeatedly. Large-scale downturns were twice triggered by collapses in foreign demand—once in 1997,
in the wake of the Asian crisis, and a second time in 2001, when the NASDAQ shock triggered a slowdown in U.S. demand. Without export growth, there was no trigger for economic activity—public works spending has been a drag on growth since 1999. Despite optimistic forecasts to the contrary, domestic demand proved neither sustainable nor resilient, and the economy grew only 0.1% in 2002.

Bolstered by strong demand from China, Japanese production is once again rising. The capacity utilization rate of manufacturers, after bottoming out at an abysmal 64.9% in December 2001, had risen to 79% by January 2006. Although the economy overall is far from overheating, in industries most directly linked to the Chinese market, such as steel, the recovery has been even more dramatic; JFE Steel Corp. usage rates have jumped from 83% to more than 100% on the back of strong shipments to China. The most closely watched measure of cyclical activity in Japan, the sentiment of business managers’ index in the BoJ Short-term Economic Survey of Enterprises in Japan, more commonly known as the Tankan, bottomed out in the winter of 2001–2002. The GDP report has also strengthened in recent years, with real output rising 1.8% in 2003, 2.3% in 2004, and 2.7% in 2005.

Importantly, the return on real assets in Japan has started to tick up as well. Rising returns suggest that business operations are becoming more profitable and thus could fuel investment. Returns on real assets have declined for decades in Japan, reflecting not only the maturing of the Japanese economy, but also the rigidity of its markets. If managers do not reallocate resources in response to changes in demand over time, returns drop as sales dry up. Over-regulation, particularly in the services sector, has often prevented companies from taking advantage of new opportunities in the past. In the 1970s, return on real assets was about 18%. In the 1980s, returns remained a respectable 16%. During the deflationary decade of the 1990s, returns halved to only 8%. Although returns have fallen further in the last 5 years, they appear to have bottomed out in 2002 when they hit a
near-record low of 5.3%. They have since climbed back to more than 7.6% in 2005. The growth rates of the 1970s and 1980s are likely never to be repeated, but the declining trend, which has been accompanied by severe asset deflation and economic stagnation, must be broken.

Are the twin engines for sustainable growth in Japan—the virtuous cycles in the corporate and household sectors outlined by Furukawa—still misfiring? Clearly, the first emergence in more than a decade of a sustainable, private demand-driven recovery in the world’s second-largest economy is not an event that global asset allocators can afford to miss.

Furukawa notes that some data suggests that a few hurdles to growth have been lowered. After years of wrestling with bloated payrolls, many firms are finally hiring again as they pump up production. The BoJ surveys of labor market conditions have been improving since the second quarter of 2002. The effective-job-offers-to-applicants ratio hit its highest level in more than 10 years in 2005 and has finally reached 1, which means there is a job for every applicant in the market (although not necessarily the right one, in the eyes of the unemployed). Ongoing retrenchment may have finally brought employee numbers in line with production levels. In recent years, companies have shed full-time workers and hired part-timers, to trim expensive benefits and increase control over their labor costs. In 2002, for example, when the number of full-time employees fell by 2.5% YoY, the number of part-time workers jumped more than 6%. This trend appears to be abating. In 2005, firms began to hire full-time workers again, which the International Monetary Fund contends supports consumption. Total cash earnings of workers had fallen since 2001, but these stabilized in 2005—a lukewarm endorsement of improvement, to be sure, but Furukawa sees evidence that the long process of restructuring the Japanese workforce is coming to an end.
In addition to improving conditions in the labor market, households save less. Savings rates have declined in recent years. The renewed drop apparently stemmed from a collapse in income during the downturn in 2002. However, now Furukawa and other economists look for demographic trends to push savings rates lower. As Japanese society ages, a greater proportion of the population will enter retirement. Retirees tend to dissave. In any case, the savings rate is unlikely to climb higher.

In the corporate sector, the rebound in exports has bolstered profits and led to further investment in plant and equipment. Rising capacity utilization rates and increasing returns on investment point to renewed demand for such spending. Banks also have become more eager to make loans; recent surveys show a continued decline in firms complaining about frugal lenders. The central bank stopped citing balance sheet restructuring in the banking sector as a risk for the first time in recent memory in its biannual Outlook of Economic Activity and Prices of October 2004. Banks achieved the government’s goal of halving the amount of nonperforming loans on the sector’s balance sheets by the end of fiscal 2004. The fallout of the banking crisis on the real economy (at least, in the opinion of the central bank) has come to an end.

Such developments are promising, to be sure, but deflation remains chronic among many goods makers and service providers. Falling prices weigh heavily on nominal sales growth and suggest that cost-cutting pressures will remain intense. Large retail store sales are falling and widely expected to remain weak. Still, the outlook for the economy is better than the markets have enjoyed in years, Furukawa concludes.

In Japan’s worst train disaster in 4 decades, two West JR train cars smashed into a condominium building edged on a curve after five carriages derailed, killing 107 people in Amagaseki, Hyogo Prefecture, on April 25, 2005. Transport Minister Kazuo Kitagawa later said
that the cause was undoubtedly speeding, which could have been avoided if a new automatic train stop (ATS) system had been installed.

Masaru Kaneko, an economics professor at Keio University, noted in an Asahi Shimbun newspaper column the following June that industry watchers had observed that investment in ATS systems had been low, even though profits had risen at JR West since FY 1999. The lightening of the train cars, a cost-reduction measure, also contributed to the number of fatalities. Kaneko is an outspoken critic of the Koizumi administration and has written many books, including works on public finances and globalization. In his book Chouki Teitai (translated as Long-Term Economic Stagnation), published in 2002, he outlined problems his country faces in achieving sustainable growth.

Many TV viewers instantly recognize this avuncular scholar. With long, grayish hair parted in the middle and a down-to-earth, affable demeanor unlike the cold aloofness cultivated by many intellectuals, he often finds a receptive audience for his pointed jabs at the Koizumi administration. I met him in his office, which was lined with floor-to-ceiling bookcases stuffed with economic texts.

West JR spun off when Japan National Railways was privatized and divided in 1987. Throughout the 1990s, Kaneko was critical of policymakers promoting deregulation and privatization while the country was grappling with entrenched deflation. He observes that Japanese policymakers often argue that such policies introduced by U.S. President Ronald Reagan and U.K. Prime Minister Margaret Thatcher are necessary to tackle Japan's economic stagnation. However, Kaneko also notes that in those countries, deregulation and privatization measures were introduced to fight inflation in the wake of the second oil shock. In Japan's case, deflation, not inflation, is the problem. Such initiatives can only lead to higher unemployment and a further downward pressure on prices, he warns.
Kaneko observes problems with the adoption of what he calls “market fundamentalist” policies being promoted by the current and previous administrations. He dates the move to deregulation and “American standards” to the defeat of the Liberal Democratic Party in 1994. By measures forced through the Diet to align Japanese bank requirements with global standards for reserves, banks and their corporate customers were forced to dump shares to raise capital. This led to stock price declines, further worsening the condition of the banking sector. Instead of a rational restructuring of the corporate sector, small and medium-size companies were starved of capital—and still are.

He also points to ongoing stagnation of consumption. The seniority-based system in many corporations leads to an upward-sloping curve in wages when plotted against worker age. However, rising pressure on firms to boost profits is leading to an increasing number of older, better-paid workers getting let go, he notes. This flattens the lifetime earnings curve and lowers income at households. Kaneko is skeptical that a recovery can be sustained in the event of slowing overseas demand.

Even as Japan remains dependent on exports for growth, Kaneko warns that the global economic system is becoming increasingly unstable and is characterized by sharp cyclical swings and financial bubbles. He argues that Japanese market-fundamentalist policymakers are not coordinating domestic policies with overseas risks. He cites the Economic Package and other policy initiatives announced in spring 2001 as insufficiently responsive to the NASDAQ downturn the previous year, which, as a result, led to further deterioration of the banking system. Looking ahead, he worries that the global economy is increasingly dependent on asset inflation in the United States because the United States needs to attract overseas capital to finance its huge fiscal and trade imbalances. However, he doubts the sustainability of such capital and trade flows, and argues that adjustment will proceed during a protracted period of “slow panic.”
He also points to a bubble in the Chinese economy, one that requires policy coordination among China and its trading partners. In particular, growth of the Chinese Western and Northeastern regions needs to be promoted to offset the impact of tightening credit in China’s urban areas, he argues. Against the backdrop of anti-Japanese demonstrations in Shanghai and other cities in spring 2005, the Japanese government is unable to play a constructive role in encouraging a more balanced Chinese regional policy. This raises the specter of a hard landing, rather than a soft landing, for East Asia.

Interestingly, Kaneko sees parallels in Japan’s current deflationary period and the policy mistakes in the period leading up to and during the Great Depression. In the early 1920s, following the decline in demand at the end of World War I, the BoJ extended aid to threatened banks. The banking system weakened further after the Great Kanto Earthquake of 1923. The central bank responded to this disaster by extending emergency loans to banks through rediscounted commercial bills. Eventually, the central bank reached its financing limits, and the bankruptcy of Watanabe Bank in 1927 plunged the financial system into crisis, fueling a sharp increase in bad debt.

Kaneko notes that the 1990s were also marked by a decline in demand early in the decade, this time because of the collapse of the bubble economy. The last decade also witnessed bank runs and a major earthquake in Kobe in 1995. Kaneko observes that there was a run-up in U.S. share prices during both the 1920s and 1990s.

In July 1929, Prime Minister Gi’ichi Tanaka was forced to resign when he was unable to punish army officers involved with the assassination of a Chinese warlord in Manchuria. The opposition administration of Osachi Hamaguchi thus took the reins of power as the global economy sank into depression. Hamaguchi appointed Junnosuke Inoue, who previously served as head of the central bank, as finance minister.
The policies of the Hamaguchi government resemble those of the Koizumi administration in three important ways, Kaneko maintains. First, corporate restructuring was encouraged because of a surfeit of bad debt. Second, a contractionary fiscal stance was urged. Finally, the Hamaguchi government insisted on a return to global standards in Japanese finance, which consisted of shifting Japan to the gold standard. During the current slowdown, the government forced banks to meet the capital requirements of the Basel Accords. Although the central bank has become more sophisticated in providing liquidity to the banking system in recent years, fundamental policy errors are being repeated, he observes.

Kaneko suggests that an over-reliance on the market mechanism could raise havoc in the Japanese financial system. A too-narrow focus on shrinking bad debt balances (because many banks labor under them) could raise doubts about the survival of both banks and their client firms. Meanwhile, if companies lose their trust in banks and each other, overall trading on credit will contract as well.

As a solution to what Kaneko calls “Koizumi deflation,” Kaneko argues that banks must undertake strict audits, and bad debts should be offset with government funds. Meanwhile, Kaneko advocates that the national pension system be changed from an insurance style to a tax-payment style. As labor market mobility increases, Kaneko advocates a standardization of corporate pension and health insurance plans to provide a safety net for workers.

Decentralization of authority to the regions is also critical, he urges. Some tax revenue collection should be transferred from the central to the prefectural local governments, to encourage self-sufficiency as well as provide security to local residents. The Koizumi administration should also undertake small-scale public works and welfare projects to underpin sustainable economic growth in the countryside, Kaneko argues. Finally, to insulate Japan from what he sees as excessive dependency on increasingly volatile U.S. markets,
the Koizumi administration should foster a framework for cooperation among East Asian nations in trade and monetary affairs. Kaneko is not alone among Japanese scholars in criticizing the direction of government policy; Takamitsu Sawa, director of the Institute of Economic Research at prestigious Kyoto University, noted critically in a recent newspaper editorial that the Japanese government supports neoclassical economics and conservatism. Such policies contravene modern Western philosophies and even bushido, the way of the samurai, he caustically observed.

Despite Koizumi’s landslide victory in September 2005—ostensibly a referendum on the privatization of Japan Post —support for market opening, deregulation, and globalization, while increasing, is not as deeply rooted in East Asia as in the United States or even Europe. Kaneko raises concerns about the need for a safety net for Japanese households as the government attempts to restructure the economy. Others worry that on a pan-Asian basis, economic integration has limited institutional underpinnings. Eisuke Sakakibara, known as “Mr. Yen” in his days at the Ministry of Finance for his perceived ability to manipulate the exchange markets, observes that “the origins of integration in Europe were institutional in nature, and the regional institutions that were created have become a driving force for the deepening of that integration.” On the other hand, the former Vice Minister for International Affairs notes, “East Asia’s efforts to formalize regional cooperation into a workable arrangement for the promotion of trade, investment, and security in the region have been varied but not very successful.”

The bureaucracy in Kasumigaseki has been deeply suspicious regarding the reliability of markets to allocate resources fairly since the early 1950s. John Dower’s study of the occupation period in his Pulitzer prize–winning book Embracing Defeat underscores the traumatic experience many families faced securing food following the end of the war. When Americans think of free markets, they take a
functioning legal system for granted. What some Japanese senior
bureaucrats may have in mind are the lawless black markets that
thrived under the train tracks of Ueno in the later 1940s. As a new
generation emerges to replace the old guard in the ministries and
the Diet, running turf battles over liberalization efforts are likely to
continue.

Strong overseas growth, especially in China and the United
States, has resulted in a recovery in the Japanese economy in recent
years. Twice in the past 10 years, overseas downturns have resulted in
Japanese slowdowns, and there is no compelling evidence that Japan
is strong enough to go it alone if exports plunge again. However, just
because top-line growth in Japan remains heavily dependent on over-
seas demand obviously does not mean there are no opportunities for
foreign investors. Foreign investors looking for exposure to the rap-
idly growing Chinese economy can invest in Japanese firms operating
in the country, benefiting from the legal safeguards and deep liquid-
ity of Tokyo markets, which are unavailable when buying directly into
firms listed in Shanghai. Meanwhile, as market liberalization and
deregulation proceeds, albeit at a halting and sometimes disappoint-
ing pace, investors can also look for arbitrage opportunities as ineffi-
ciencies in the economy are eliminated.

The most exciting opportunities in Japan, however, may well be
invisible. In the future, astute value investors, both foreign and
Japanese, will likely shift their attention from discounted tangible
assets to intangible ones. Assets such as patents, licenses, and corpo-
rate brands, also sometimes referred to as invisible assets, are likely to
account for an increasing amount of corporate value in the twenty-
first century. Because intangibles are extremely hard to evaluate,
investors have rarely explicitly focused on them when deciding
whether to buy companies in the past. On the other hand, companies
have been hesitant to share information on their holdings of such
intellectual property, carefully guarding such knowledge as a vital
secret. Such days may be ending. Indeed, the age of intellectual prop-
erty wars has already dawned.
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