The Contribution of Bank Lending to the Long-Term Stagnation in Japan

Joe Peek
University of Kentucky

ESRI Workshop on Japan’s Bubble, Deflation and Long-Term Stagnation

Columbia University
March 21-22, 2008
Objectives

• Investigate the consequences of increased bank lending to Japanese firms
• Compare the pre-bubble period to the post-bubble period
• To what extent could banks have helped to short-circuit the prolonged malaise by lending to viable, but temporarily distressed, firms?
• To what extent did banks contribute to the recovery of viable, but distressed, firms?
Potential Beneficial Effects

• Aid firms that are economically viable overcome a temporary liquidity crunch
• Provide resources to enable distressed firm to undertake operational restructuring to improve performance
• Macro: Operational restructuring will reallocate resources in the economy to more productive uses
Potential Adverse Effects

• Allow zombie firms to continue to operate
• Insulate potentially viable firms from market forces that would force painful, but needed, operational restructuring
• Macro: Misallocate credit, reduce competition, reduce productivity
Why Might Post-Bubble Period be Different?

• Widespread deterioration in firm health
• Widespread banking problems
• Ineffective bank supervision, providing perverse incentives to banks
• Development of corporate bond market
Corporate Affiliations

- Japan is a bank-centered economy
- Main bank relationships
  - Perceived national duty to aid borrowers
  - Protect reputation as main bank
- Keiretsu relationships
  - Risk-sharing or insurance relationships
- Cross-shareholding provides protection against hostile takeovers
Characteristics

• Main bank
  – Primary responsibility for monitoring firm
  – Provide corporate governance
  – Responsibility for rescuing troubled borrowers
  – Cross-shareholding relationships

• Keiretsu
  – Cross-shareholding relationships
  – Exchange information, e.g., President’s Clubs
  – Extensive business relationships
  – May exchange managers
  – Provide support to distressed group members
Benefits and Costs

• Benefits
  – Reduces information asymmetries
  – Reduces agency costs
  – Better information can lead to earlier signal of problems at firm, allowing earlier intervention

• Costs
  – Over-reliance on main bank can hurt firm if main bank health deteriorates, impeding ability of main bank to help firm
  – Can insulate distressed firms from market forces
Pre-Bubble Period Evidence

• Main bank affiliations provided benefits
  – Hoshi et al. (1991) distressed firms with corporate affiliations perform better after onset of distress than firms without strong corporate affiliations
  – Morck and Nakamura (1999): less downsizing by distressed firms if have strong corporate affiliations
Pre-Bubble Continued

• Questionable benefits
  – Weinstein and Yafeh (1998): potential “hold up” costs to firms; while credit availability increases, profitability or growth rate does not
  – Miwa and Ramseyer (2005): main banks do not, in fact, rescue distressed borrowers; closer main bank ties do not increase probability of increased main bank loans or of survival of distressed firm
Post-Bubble Evidence

• Mostly adverse effects, especially to the macroeconomy
  – Kang and Stultz (2000): firms more dependent on bank loans and with keiretsu affiliation had worse stock price performance immediately after bubble burst (1990-93), although performed better pre-bubble
  – Guo (2007): during 1993-99, greater reliance on main bank loans associated with weaker performance and longer duration of distress, and that performance even weaker the weaker the health of the main bank, although during 1978-92, greater reliance on main banks associated with better firm performance. However, keiretsu affiliations beneficial, even during post-bubble period.
Post-Bubble continued

• Reliance on bank loans
  – Peek and Rosengren (2005) and Arikawa and Miyajima (2006): even with deregulation of bond market, firms increased relative reliance on bank loans in last half of 1990s.
  – Hori and Osano (2002) and Arikawa and Miyajima (2006): firms with weaker prospects and greater likelihood of suffering financial distress relied more on main bank loans
Post-Bubble continued

• Why the increase in reliance on bank loans, especially among weakest firms?
  – Perverse incentives faced by banks
  – Severe nonperforming loans problems

• Results: Impeded creative destruction in form of needed restructuring of viable firms and the failure of zombies
Restructuring

• Pre-bubble: Kang and Shivdasani (1997): firms with greater main bank and large blockholder equity ownership are more likely to restructure; and improves subsequent performance

Research Plan

• Identify distressed firms
  – Interest coverage ratio < 1
  – Operating income <0
  – Quick ratio <1
  – Use “good” year followed by two consecutive “bad” years

• Identify firms in need of restructuring
• Identify operational restructuring activity
• Defining recovered firms
Important Issues

• Firm characteristics, including health, main bank relationship, keiretsu membership
  – Absolute health and within industry relative health
• Main bank characteristics, including health, exposure (debt and equity) to firm
• Macro environment