JAPAN'S RISE AND FALL... LET'S GO TO SCHOOL! *(Continued)*

Third - the consensus from economists is that Japan's biggest mistake during this economic ordeal was that it raised taxes (to pay off its exploding national debt) in 1997 by increasing its consumption tax from 3% to 5%. The evidence is in that this tax increase put another knife in the gut of Japan's attempt at economic recovery.

Lessons For The United States

Looking at Japan's story, it's clear there are a few simple fundamental lessons we can take from that nation's experience. The first regards Japan's rise. Japan rose not because its government was heavily involved in its economy. Japan rose because it stuck to the fundamentals: high levels of education and discipline for its young, high saving and investment rates, a business culture that pushed innovation and technological advances and a competitive free market playing field for its multi-national stars (Toyota, Honda, Sony etc). These are the things Japan did right. It's pretty basic stuff. We'd be the better for it if we kept this in mind.

What are some lessons from Japan's fall? The first is that while government must regulate where regulation is needed, outside of that it must stay out of the way of rational free market economic interplay between economic entities. Government must not implement policies that will create malevolent asset bubbles. Will our government digest this lesson and adjust its policies accordingly? – will our government acknowledge its complicity in creating our housing bubble through its support of Fannie Mae/Freddie Mac, the Community Reinvestment Act, FHA mortgage insurance, and an expansive Fed policy? The jury is still out on this one.

The second lesson is that government must have the guts to let failing businesses die so that these failing businesses' assets can re-deploy to companies that will better utilize these assets, and thus better leverage these assets' value for a nation's economy as a whole. Investors in failing entities must take losses and pay the price for their failed investment decisions. Otherwise the concept of moral hazard is injected into our economy, with obvious destructive consequences. Our government's bail-out of the banks, Chrysler, GM, AIG, Bear Stearns etc. tell us that at best, the jury is also still out on whether we will learn from Japan on this one.

The third lesson is that the positive economic effects of a fiscal stimulus are at best questionable. What's for sure in regards to a fiscal stimulus is that it will add to a nation's debt, and this additional debt must be repaid by others sometime in the future. What's also for sure is that any fiscal stimulus undertaken by a government should be implemented in a way that the money spent will not only stimulate the economy today, but will also represent an investment that will pay dividends out into the future. Japan ran up an enormous debt over the last 20 years, with virtually nothing to show for it, but which its future generations will be responsible for. It's clear that our debt is on a similar trend line as Japan's was and that much of the stimulus of 2009 went to wasteful projects, though to date we grade much higher than Japan on this one. Will we learn this lesson from Japan? I think, for the long-term, the jury is still out on this one also.

The last lesson we have room for is this one: When an economy is reeling, raising taxes will crush a recovery. This is what happened when Japan raised taxes in the middle of its recovery. Have we learned from this? The battle is still being waged, and thus it's my opinion that the jury is still out here too.

Japan is a ready-made case study that the United States can go to school on. Let's not waste this resource.

Jeff Jentgen
President
Fostrian Business Capital Corporation

SUMMER 2010

The Community Lender

from FOSTRIAN | Business Capital Corporation

Fostrian Business Capital is a commercial lender specializing in working capital loans to emerging companies through the factoring of their accounts receivable.

From Jeff:

As we continue to work through "The Great Recession" there is a wellspring of empirical economic history that we can (and should be) learning and drawing from. That wellspring is Japan…. and the economic ordeal Japan has faced over the last 20 years.

What I'd like to do in this issue of Fostrian's newsletter is draw a quick sketch of Japan's more recent economic history and try to extract some fundamental lessons for the U.S. from the Japanese story. I'll talk about Japan's collapse and the lessons we can draw from that. But I'll also go back and trace Japan's rise and point out some lessons we can learn from that period of time, also. One caveat: Because of the brevity of this newsletter I cannot give the Japan story the proper attention it deserves, and will necessarily leave out much of the story.

Changing direction, Fostrian has been working with various banks in helping these banks better position themselves with struggling credits. If you would like to learn more about this, please feel free to give me a call, or check out Fostrian's website under the section titled "For Banks".

I hope everybody is well, and let's get the most out of the balance of our summer!

JAPAN'S RISE AND FALL... LET'S GO TO SCHOOL!

The Japan Story
The skyrocketing emergence of Japan's economy in the post WWII period is one of the most remarkable stories in the history of nations' economies. A geographically small island nation, with minimal natural resources went from being a war torn nation to having the world's 2nd largest economy in just 30 years. Between 1960 and 1985 Japan's economy grew on a per-capita basis at a rate of 5% annually – 3 times that of the United States over the same period. In 1960, Japan's economy was 10% the size of the U.S. economy – by 1990 this figure had grown to 67%!

But the winning streak would not last. In response to the yen undergoing an appreciation against the dollar in 1985, Japan compensated with aggressive monetary and fiscal policies that would, by 1990, create one of largest asset bubbles the world has ever seen. In 1990, in answer to this bubble, Japan aggressively increased interest rates, which would contribute to the bursting of this asset bubble, and start one of the most precipitous declines in asset values (land, real estate and stocks) in history. Banks' collateral values were crushed and the result was that bank lending froze. Deflation would take hold and affect Japan's economy like a cancer. In 1989, debt/GDP stood at 70% – by 2010 it would have exploded to 225%. The Nikkei stock index would decline by 80% between December of 1989 and April of 2003. By 2001 land prices were down 70%; by 2004, home prices were down 90% with commercial real estate down 99%. 99%! All told $20trillion in stock and real estate wealth vaporized during this downturn. And it's not over yet. Japan is still fighting through this.

Why Japan Rose
In the 1980s, at the time Japan was riding high, the conventional wisdom was that Japan's extraordinary success was due to Japan's high level of government - business cooperation, where government would coddle and protect certain industries, and orchestrate certain economic interplay between entities that would normally be left to the free market. In the 1980s it was also conventional wisdom that Japan's keiretsus were an integral element of Japan's success. Keiretsus are Japanese business groups/networks of businesses that own stakes in one another and historically have shown nepotism in their mutual business dealings. These keiretsus would often times have a bank as their flagship member; the flagship bank would show a high degree of favoritism to its fellow keiretsu members when making lending decisions. The bank would act with this same degree of favoritism when working out problem loans to these fellow keiretsu members. A company could be a loser but would still be subsidized and propped up by loans from its keiretsu bank partner.

In hindsight, it's clear that these government/keiretsu/business relationships were not the primary reason for Japan's amazing growth between 1960 and 1990. In fact, it has become clear that these cozy relationships actually hindered and at times were destructive to Japan's economy, and that Japan's growth occurred DESPITE these cozy relationships.

Why did Japan grow at such a rapid rate between 1960 and 1990? Answer: Because Japan got the basics right.

Historically, Japan has put a strong emphasis on educating its people. Japan is the world's second highest spender on education (second to the United States)… and emphasizes discipline in its schools. The result is Japan has the world's highest literacy rate and a highly skilled workforce.

A second reason for Japan's success: Japan's has always been a saving/investing economy – much more so than the United States. This high saving/investment rate contributed strongly to Japan's post WWII economic success.

Third - Japan's government and overall economic culture has put a high premium on the value of innovation and technological advancement.

Lastly, while many of Japan's smaller businesses were coddled by cozy relationships with government and keiretsu partners, some of Japan's larger, more renowned companies (Sony, Toyota, Honda etc.) chose to compete in the international free market. These companies were the better for the competition, succeeded wildly and thus became pillars of Japan's 1960-1990 success.

Why Japan Fell (and kept on falling)
Through overly aggressive fiscal and monetary policies starting in 1985, in response to the appreciation of the yen vis-à-vis the dollar, Japan's government was complicit in bringing on its massive asset bubble. It then was complicit in that it acted abruptly and popped this bubble by severely contracting its monetary policy – implementing a large (1.25%) interest rate hike in 1990.

It's been 20 years and Japan is still not out of the woods. The consensus is that the reason for this is because its government has repeatedly implemented bad policy that has too often compounded Japan's economic problems instead of solving them. Some examples:

First - Japan implemented several fiscal "stimulus" deficit spending programs that were based on wasteful government spending – spending for spending's sake (bridges to nowhere, paying to dig a hole and then refill the hole etc) …where Japan should have been spending on programs that would constitute Japan investing into its future… or better yet cutting taxes and letting its tax payers decide where the stimulus moneys should be spent. The consensus is that these stimulus programs did little to lift the Japanese economy, but DID contribute to Japan's debt/GDP ratio increasing from 70% in 1989 to today's ominous ratio of 225%.

Secondly - Japan bailed out its banks with the condition put on the bailed out banks that they must lend to dying ("zombie") companies – companies that were inefficient and needed to be liquidated. Instead of allowing these zombie companies to die, and have their assets liquidated and redeployed to entities that would make better use of these assets, the Japanese government propped these zombie companies up. These zombie companies' continued subsidized existence would compete with and thus suffocate Japan's efficient/winning businesses - businesses that were well managed, received no subsidies (government directed loans) and whom Japan depended on to pull its economy out of depression. In effect, Japan guillotined many of its successful businesses by propping up its losers. This defies natural law and all rational economic precepts. After the first decade of Japan's depression, many of these government directed bank loans to zombie companies went bad and would overtake depressed asset values as the most virulent cancer holding back Japan's recovery.

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