Anil Kashyap

‘Zombie borrowers still a problem’

Anil Kashyap is Professor of Economics and Finance at the University of Chicago’s Graduate School of Business. His 2001 book, Corporate Financing and Governance in Japan: The Road to the Future (with Takeo Hoshi), won the Nikkei Prize for Excellent Books in Economic Science.

TOE: The common view is that Japan’s long problem of nonperforming loans (NPLs) is almost over, at least for the major banks. Do you agree?

Kashyap: I’m still skeptical. We still haven’t seen many of the really bad companies totally exit the market. Mitsubishi Motors (MMC) has probably been insolvent for some time, but it continues to operate. There are probably bad loans still buried in there. I don’t claim that any of the large banks are insolvent. But they still have much more exposure to the bad companies than many of the analysts suggest.

TOE: People talk about the “dirty thirty” of very large companies, but what about the problem loans at the small and medium enterprises (SMEs), who make up a much larger share of the economy?

Kashyap: It’s true that the regional firms and SMEs are still in bad shape. But the large bank exposure is more tied to the large companies. The fact that the recovery has stalled out and remains so dependent on exports is one clear signal that the domestic economy is still in bad shape. The manufacturing sector has always been healthier than the rest of the economy. But the protected parts of the economy—the service sectors and all the parts where foreign competition is not right on the doorstep—remain weak. The banks, even the large ones, are still exposed to that.

TOE: Even if you think the level of NPLs is higher than the government says, do you think the Financial Services Agency (FSA) is accurate when it reports NPLs are down by almost half at the big banks?

Kashyap: I think there has been some improvement, but not quite as much as most people believe.

There is a second problem. Even in the glory days in the late 1980s, the large Japanese banks were never particularly profitable. So, even if the large banks get rid of their NPLs, there is no Japanese bank earning a rate of return that is competitive with other globally active banks.

TOE: But there is a big difference between being inefficient and being in true crisis.

Kashyap: There is no full-blown crisis at this point, just kind of steady underperformance. And there’s no sign that we’re even close to returning to a normally operating financial system.

TOE: In a paper published in November, you said the banks needed another ¥20 trillion, or even ¥40 trillion ($200-400 billion) of public money to get back to a healthy level of capital. But now the banks are talking about returning the money that the government previously injected. The government and banks would probably define the end of a crisis as the banks reducing NPLs and staying solvent without another capital injection. Can they achieve this, even at the risk of underperformance?

Kashyap: I don’t know enough about the very largest banks to say. But many more of the regional lenders are going to have to close and that is going to involve payouts by the taxpayer. I don’t know if the number is still ¥20 trillion, but that estimate was for all the banks, not just the largest.

TOE: The banks say they have cut off their lending to many of the “zombie borrowers” and, indeed, that the zombies are slowly disappearing.

Kashyap: The economy has been doing pretty well for a year-and-half and that will naturally improve the zombie problem. But I don’t think we’re out of the woods yet. There are still a lot of zombies in the service sector.

The fact that MMC is still operating rather than being liquidated is going to put pressure on the rest of the auto sector.

TOE: How much have zombies hurt the economy?

Kashyap: It’s hard to quantify it, but the zombies definitely have a negative impact on the performance of non-zombie firms. In the sectors with more zombies, you see employment and investment is depressed, and productivity is lower.

Even the non-zombie firms in these sectors cut investment and employment. They’re forced to compete with zombies getting subsidies, such as below-market interest rates.

TOE: Has bank lending to troubled sectors like construction gone down?

Kashyap: Lending has probably peaked and gone down a bit in the past couple years. But compared to 15 years ago, the banks are more exposed, since they increased their lending to the zombie sectors in the 1990s.

TOE: According to your study (see top chart pg. 8), the percentage of zombie firms has risen to 15% of all firms by 2002, and to 25-30% in sectors like construction and real estate. Do you think the zombie share has gone down since 2002?

Kashyap: There is a lag in the data, but my guess is that by the end of 2004, it would be down a few points. I’d be very surprised if it’s below 10%.

TOE: Most people expected that reducing the NPLs and closing down the zombies would entail a lot of social dislocation, including large job losses. Why haven’t we seen that?

Kashyap: One reason that the dislocation has not been so sharp is because the adjustment has not been as big as some say it is.

TOE: You’ve been critical of the pending takeover of UFJ bank by Tokyo-Mitsubishi. Why?

Kashyap: It’s hard to see what UFJ will do for Tokyo-Mitsubishi. It’s not as if UFJ has a bunch of core competencies that create revenue synergies. In fact, the lesson from most banking mergers is that revenue synergies are much harder to accomplish than savings.
on costs. The key to this merger is cost savings. But we didn’t hear that. Instead, we heard a weak rationalization: that the new merged bank can be the dominant consumer lender in Western Japan. They’re creating the largest bank in the world and their strategic vision is to do more consumer lending in Western Japan? That doesn’t add up.

In fact, the UFJ record on cost cutting is pretty dismal. UFJ has been adding employees for the last two years even though its operating performance has been pretty dreadful.

UFJ likes to publicize the decline of full-time employees on the banks within the UFJ group. But employees in the non-bank subsidiaries have been rising, especially part-timers. So, total employment is up.

The original Tokyo-Mitsubishi merger brought together two banks that had very little overlap and had a clear strategic fit. It was a rare case of true revenue synergies. That’s because the Bank of Tokyo didn’t have strong domestic operations.

The most skeptical, cynical interpretation is that this was a defensive action taken by Tokyo-Mitsubishi’s management. They were worried that Citibank or someone might have taken them over. So, they bought something that made themselves too big to be acquired.

TOE: Suppose the banks get rid of their NPLs. Then, say some analysts, they can start expanding their loans again. But other analysts say that, despite having cut back on loans by 20%, the banks need to shrink their loan base further and shift into higher-margin products.

Kashyap: We don’t know yet if bank loans need to shrink further because we don’t know how many bad loans remain. The smaller banks we haven’t seen the kind of FSA inspections we saw for the largest customers of the largest banks.

As long as the zombies are still around, the healthy companies don’t want to borrow since they don’t want to compete against the zombies. Once you kill the zombies, then healthy firms will want to expand and loan demand will recover.

TOE: However, plain vanilla loans are low-profit products. Don’t the banks need to move into higher-profit, fee-based services.

Kashyap: So far, Japanese banks have had little success in new products compared to global banks in other countries (see bottom chart). They’ve not documented that there is any area among these new higher-margin product where they can excel.

Ideally, there should have been some more acquisitions by foreign banks that have expertise, so that there could have been a technology transfer. The chances of that happening for any large banks are basically nil.

As a result, it’s doubtful the Japanese banks will do well in these new products. So, the question is: can they cut costs enough so that they can sustain their operations relying mainly on these less profitable lines of business like ordinary loans? They can only do that if they become very, very efficient. That’s something that they’re not even close to.

TOE: People keep saying that there needs to be a balance between the banking system and capital markets. Is that happening?

Kashyap: There is slow evolution in that direction. It makes no sense for Japan’s well-developed international firms, or even the next tier of firms, to depend on the banks. It’s cheaper to raise money in the capital markets. If some of the ailing banks had been pushed out of the system, that would have made it easier for the remaining banks to compete. It would also be a clear signal that you weren’t going to keep using the banks to provide subsidized credit. No one gets a subsidy in the bond market. As long as there is still the hope of getting subsidized credit from the banks, that will be a drag on development of the capital markets. But eventually, Japan will look like the other major industrial economies. The capital markets will play a greater role. The banks will be less prominent.

TOE: Can the banks themselves play a big role in the capital markets through investment banking subsidiaries?

Kashyap: If the banks had a long track record that demonstrated competency in that area, I’d say yes. But that’s not the case.