Japan, Worse Than You Think

I was glad to read your Nov. 21 editorial, "Japan, Crisis and Nationalism," in which you join those of us who argue that the zombies are the key problem strangling the Japanese economy. But your rendition of the story mistakes cause and effect.

Japan is now best described as an economy where many bankrupt banks are continuing to lend to a number of bankrupt firms. The taxpayers are already the de-facto owners of the banks and the firms. The right analogy is that of state-owned banks lending to state-owned firms, with soft budget constraints. We all know how this impairs the ability of the rest of the private sector to flourish.

You miss the point when you say nationalization would cause a severe shock to the economy: A careful analysis of the condition of the banks shows that they already have essentially no private capital because there is no real shareholder investment left to be lost.

As Mitsuhiro Fukao has painstakingly shown in his recent study for the National Bureau of Economic Research, the stated levels of bank equity are mostly bogus tax credits and money from the last government bailout. Any real money attributable to private investors was nearly offset by the banks' embedded portfolio losses associated with cross-shareholdings. The only reason that most of the large banks' share prices were not zero was the hope that the government would provide yet another bailout. The recent plunge in bank share prices reflects a realization that more money may not come.

More importantly, the closing of the bankrupt borrowers would hardly be a confidence-destroying measure. It would displace a number of workers and temporarily depress incomes -- but that can be offset by unemployment payments. Indeed, the system already involves a large inefficient, unemployment protection scheme. Currently, money-losing firms pay their workers by drawing on loans that are backed by insured bank deposits. When the taxpayers are ultimately forced to pay off the deposit insurance they are essentially picking up the bill for paying these workers.

The advantage of making the direct unemployment transfers to the workers is that doing so eliminates the distortion that comes with allowing the zombie firms to continue. Namely, keeping the dead firms alive stops new businesses from getting started or successful ones from expanding. Shutting down the zombie firms would raise confidence and promote new business formation, given an adequate unemployment scheme. Likewise, continued life support for the zombies dooms any chance for sustained growth and recovery.

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