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## Capital Exit: Japan and the Enron debacle

There is an interesting comparison between the policy response problem of Japan at the end of its **zero capital cost boom** of the 1980's and the comparable situation of the US in 2000/2001/2002. In Japan, there has been abundant denial and the near-absence of capital exit--or more precisely, capital exit only by exception. In the U.S., capital markets have imposed fairly prompt recognition of excess capacity, and, as a consequence, capital exit in many forms (including bankruptcies that come in swift profusion). A few shocks and the U.S. capital market appeared to recognize that those who live by access to easy and cheap capital can swiftly perish when that supply is denied. It begins with sharp write-downs of equity values, loss of credit standing and corporate debt downgrades. If access to capital then becomes insufficient for survival, then there is acquisition or merger with prior equity values sharply reduced. If that is insufficient, then comes bankruptcy.

Corporate reorganization under bankruptcy may allow a reduced form of the company to survive, or in the extreme cases, the remaining assets of the company are just sold off to the highest bidder. The company dies, but its physical capital may live on to be run by others. Unfortunately, in the nature of this process, some equity and debt holders will get out with small losses, but the rest who are looking backward rather than forward, will incur significant losses.

Enron provides a graphic example that no firm is too big to fail in a reasonably responsive capital market. Some will argue that recognition of Enron's financial fragility was too long delayed, but that may be an inherent characteristic of boom/bust cycles. Bubbles take much longer to inflate than to deflate and recognition is a necessary catalyst for the deflation of a bubble. The Enron case is complicated by accounting cover-ups, and perhaps by a predictable recognition failure by certain participants in the capital market who unduly benefit from underwriting fees. Failure could have occurred much earlier had all participants in the capital market a lower tolerance for risk. However, lowered risk tolerance is an attribute of a boom, so to say it should not have happened is not enough. That is to deny the phenomenon of the bubble itself. What we should recognize is that 'mean reversion' does not occur evenly. When risk tolerance begins to decay, it happens late in the cycle and then it happens swiftly. By definition, not everyone can get out "early." However 'unfair' to the shareholders, pension holders, large bank lenders, there is a kind of ruthless logic to capital excess when it is discovered, at least in the U.S. Capital exit is the purge that restores balance in the capital market. Inevitably, there are losers.

We have often commented that Japan lives on a different planet, and the recent example provided by the Daiei bailout proves it. In Japan, bankers invariably sustain large firms, long after the firms have passed the point of being able to repair their impaired capital structure under normal operations. In the extreme, this involves "loan forgiveness," but it rarely involves an immediate and radical downsizing of the firm and surprisingly, given scope of Japan's problems, bankruptcy is not frequent for large firms. Loan forgiveness merely makes official what has been long recognized: the firm can never pay back the amount of credit that it has been extended. This kind of logic allows a zombie existence for many, large firm, judged "too big to fail."

The reasons for this are many. First, one needs to notice that both borrower and lender have a similar interest: **non-recognition of the necessity for capital exit.** Neither borrower nor lender can admit that prior capital access has been too easy or that the underlying business model was faulty. For the economy, the problem is



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not the single firm, but the extension of the principal of non-recognition of capital inefficiency to the economy as a whole. Applied systematically, the Japanese capital market has been convulsed to maintain far too many, fundamentally unprofitable firms as a social ethic. Capitalism cannot work if all the rules of capital allocation are suspended. This is Japan's fate, but it is self-imposed by culture and enshrined by the political system. Making fundamental change in Japan is truly an epochal task.

I just read an interesting story today on the plight of Nissho Iwai and Marubeni---two of my former customers---who have horribly distorted balance sheets and very diminished profit possibilities. For years, when I exported meat to Japan, I marveled and then agonized over the crush of my profit margins by large Japanese Shosha's. They seemed to be able to do what I could do (after I showed them how, of course) for mills, while I required pennies. They had huge bank lines, massive debt to equity ratios and an unremitting willingness to sacrifice profits for volume. It was hard for me to keep sufficiently nimble and not lose my market position. Ultimately, I had to move on to other areas of endeavor since a ruthless willingness to sacrifice profits for volume will kill the returns to even the most nimble competitor.

It is generally not possible for an American business that must depend upon bank credit to continue to expand in spite of poor profits. Bank lenders are not comfortable with a strategy of 'making it up by volume.' In exceptional periods, such as a capital abundance boom, or its extreme version, zero cost capital, those restraints can vanish for a time. **Zero cost capital seems like a wonderful thing, but it is not. The absence of capital restraint can be a death sentence to a business.** The perfect proof of the dangers of zero cost capital is the recent bankruptcy announcement by Global Crossing.

Global Crossing laid thousands of miles of fiber optic cable around the world, only to find that even when capital is cheap---sooner or later the company could not pay the interest on the debt raised in such an abundant capital environment. **In fact, overly abundant capital probably often leads to poor business models. That is the dark side of the "zero cost capital" environment.** Too much capital access and insufficient profits can combine to cut down the tallest trees. It is the 'easy terms' in the capital market that allows the excesses to grow. That is the danger when money is too cheap. How does this end?

If there are revenues, then to achieve a realistic rate of return to capital, the capital assets must be re-priced. A firm can be sold for a 'value,' that effectively re-prices the assets, or the firm can go bankrupt. When the assets are 're-priced' through the bankruptcy process, the physical assets will remain, but their capital values will be slashed drastically, often wiping out the stakes of prior equity holders and sometimes reducing the value of the corporate debt to 'affordable' levels through massive 'haircuts.'

### Applications to Japan

Japan, in my view, suffers from two, long standing cultural/economic problems: It has an almost abject devotion to what I call the Fairness Doctrine. The Fairness Doctrine ("FD") says that above all, all elements in society must be treated fairly, (sometimes 'equally') irrespective of their respective, marginal contributions to output. The "poor" cannot be 'eaten' by the rich; the powerful cannot dine on the 'little people.' FD is enshrined by a rigorous application of democratic politics and a fear that a Market Economy can be too 'unjust' to its participants. This is the essence of the famous book by Eisuke Sakakibara, former Vice Minister of Finance for International Affairs.<sup>1</sup> Sakakibara, influenced by the glow of Japan's Bubble period in the 1980's, argued that Japan had found a 'third way' between unbridled capitalism and socialism. He saw a virtue in

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<sup>1</sup> Beyond Capitalism



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'stakeholder capitalism' that allowed the interest of all groups in society to have an effective voice in economic decisions. In our view, stakeholder capitalism is invariably a means to put-off hard decisions.

Easy capital access combined with FD delays the inevitable shrinking of excess capital and makes paying the piper an insuperable debt problem nearly impossible to resolve except by a social cataclysm. The "third way" requires that management must control the destiny of the corporation by gaining "stakeholder" concurrence on hard decisions. Yet, concurrence by lenders, customers, suppliers, employees, government, managers, and, lastly, the shareholders, means capital exit decisions are intolerably delayed, if not eliminated. It is a case of capital exit by exception or catastrophe.

Easy capital access often facilitates robbing the shareholder of any practical decision making power. Access to more capital keeps the same management that has made the error of too much investment, firmly entrenched by creating a capital moat around a set of poor capital allocation decisions. It makes the "old management" into a "stakeholder" that is vested in enlarging the excess capital problem. This inevitably delays capital exit when it does not block it entirely. Think of the Japanese Banking System with its permanent access to essentially zero cost borrowing? (The so-called 'zero interest rate policy') Do we really wonder why Japanese Banks don't change voluntarily? Eliminating shareholder governance has robbed the economy of a critical safety valve. Short of total insolvency, these banks will continue to operate much as they have.

Second, in the stakeholder view of social progress, Government should right any significant imbalances in the distribution of benefits that arise from the operation of the capitalistic system. Hence, there is a constant redistribution effort that in Japan takes the form of postal savings, road building, unequal application of tax laws, to name only a few. Many of these redistributive efforts interfere with the profit making capabilities of private firms. Too much capital is a problem, but redistribution that cuts off private profit possibilities makes escape even more difficult. Think what the Postal Savings system does to the profitability of private commercial banks? The remedy of capital exit has been cut off by a requirement for full stakeholder concurrence. It is as if one has an insurance policy only to find that the insurance company goes broke just when it is needed.

Under FD, there is no punishment for failure to execute a rational capital allocation process. Worse, there is a built-in incentive to grow through volume gains, rather than to grow through efficiency gains that could lead to higher profits per unit and higher rates of return to capital. Coupled, FD and easy access to unduly cheap capital create a propensity for capital inefficiency. When easy capital access is permitted for too long, Leviathan firms come to dot the landscape, and many are 'too big to fail.' "Too big to fail" means that cutting out the cancer will cause too much pain for a democratic society. The result is a Policy Stymie. That is what has happened in Japan while it waits for a miracle!

It is not always the case that size implies inefficiency, as companies such as Toyota illustrate. Sometimes big companies can be efficient, in spite of abundant capital excess, but the key to efficiency is discipline over the revenue and profit side of any present value calculation. The firm has to ask how profitable the investment is likely to be in a not-so-free-capital-access environment. One limitation is the competitive strength of new firms that can easily enter a market. If there is constant threat of new entry and an absence of legal measures to block entry, there can be some modest and continuing discipline to capital use even in Japan. This may explain the difficulties Japan has had in transitioning to markets that are totally entry free. The threats are too large and open entry challenges the easy capital access approach.



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Thinking of the Marubeni/Nissho Iwai story, it is easy to see how abundant capital access often leads to capital inefficiency under the guise that new lines of business will cover up lines that should be closed. This is another form of the Volume over Profits story. Volume should be construed in a broad sense. With abundant capital access, firms are often induced to enter fields outside of their core competencies. Sometimes, they are not even sure in which fields they have core competency, and capital access leads them to enter fields where they are not clearly competent, without sufficient planning or a viable business strategy. The Shosha's provide an excellent example. Originally, their primary functions were to be information processors and financiers in their own right. Those functions are now more efficiently supplied by 'markets' rather than by individual firms and the Shosha's have become dysfunctional. But, to close them would mean considerable unemployment. With the absence of shareholder governance and with a Main Bank attached to each Shosha, they are locked in a death spiral. For too long, the diet has been too much capital supplied too easily.

FD insures that the Main Bank cannot say "no" to its traditional borrowers and the result is borrowers wind up 'owning' lenders. As the old saw puts it, 'Borrow \$100 and the Bank owns you. Borrow \$100,000,000 and you own the Bank.' With management immune from the pressures of shareholder dissent, the over-lending and over-borrowing are predictable results.

This argument can be extended throughout the structure of Japanese business firms. The size distribution of firms in Japan shows a bi-modal distribution of firms: a few large ones and many small firms. In a more rigorous capital market, many of these inefficient, small firms would not survive, but the mores of Japanese business society, often require the protection of both supplier and customer networks under the dictum of 'long-standing relationships.' Ultimately, this ethos is supported by a political society that underwrites the absence of economic failure, except under the direst of circumstance when the constant roll-over of loans and interest must mean even more non-performing loans. 'One man, one vote' is a potent antidote to a rigorous albeit heartless capital model. Democratic politics guarantees endless methods to offset rigorous capital exit policies---loan guarantees for failing "middle business;" loan rollover by banks that prevent the needed death of zombie companies, and, ultimately, the bailout by the government of impoverished financial firms.

In this scenario, the lenders themselves become zombie companies. If lenders become "too big to fail," massive taxpayer bailouts of financial companies engorged with bad debts must be the result. In the meanwhile, the political order will try various life-support schemes to insure the continued existence of businesses that would not continue if the capital market were to function on a rational allocation basis.

In the U.S., there is always a running battle to keep the FD from undoing what our capital market would otherwise impose. Generally, the criterion is "systemic risk," that is a failure by a giant company that would impose a likely cascade of defaults that could be otherwise avoided. It is always a hard call to assume that rigorous if ruthless capital rationing will reduce the incidence of issues of systemic risk. Generally, the U.S. has kept the FD sufficiently contained to allow good economic growth---but it is an endless battle. If we look around the world, we see many countries losing that battle. Germany, France, and other members of the EU allow far too much encroachment of a vigorous capital market that would otherwise tend to police itself.

In France, a nationalistic attachment to the French 'cultural exception' is used to provide restrictions on market adjustment processes. A poignant example is the large subsidies to French film-makers. This is also capital misallocation, but it is a minor offense in the panoply of legislative measures that democratic politics can conjure up to create "fairness." When Jean Messier, CEO of Vivendi told the French that the future of media was in America, they got very upset. First, because he defied the notion that France was a cultural exception, and, second, because the facts made it hard to argue that he was not right! I suspect that a Japanese businessman who criticized the doctrine of fairness or insisted that shareholders should dominate corporate decision-making would be pilloried in a similar fashion. Maybe it will come to that as firms such as Toyota move more of their plants out of Japan and cease bowing to the perpetual concerns that politicians voice about



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employment in Japan. Toyota has no choice if it wishes to stay competitive internationally. To survive, it must constantly lower its costs. This must invariably mean moving its plants to centers of market demand or building components where costs can be sharply reduced.

Fairness is the refuge of politicians who know the ultimate lifeblood of continued electoral success in a democratic system: **appeal to the marginal voter whose interests can 'swing' the election.** Give the swing voter extra tidbits and let the rest of the voters, apathetic as they are, simply vote the way they always have voted. This puts the power in the hands of those with strong espousals for societal concerns that may be marginal or at worst counter-productive.

The success of all modern societies depends upon adaptability and the capital exit is critical to adaptation. Without constant pressure that can force capital exit in failing firms and industries, an economy cannot adapt to high rates of technical change. Lack of adaptability will undermine per capita income growth since high rates of technical change are what powers growth in per capita income.

Americans are rightly horrified by many aspects of the Enron case. Enron is seen as a vile example of unfairness, of the inhumane characteristic of capitalism and the ability of a few to delude the many, profiting in the process. Outside of the blatant attempts by the executives and by the auditors to mislead the capital market, the Enron case may be a kind of triumph of capitalism. Imagine what would have happened in Japan? The faulty capital structure would have grown even larger. Banks would not have withdrawn credits. They would have increased them. If the fundamental failure (outside of fraudulent accounting or securities fraud) was a bad business model, it could have gone on for much longer. Instead, the American capital market put out its judgment: A Dead Company Should Die. And the possible issue of systemic risk to the energy markets of the U.S. was answered clearly when the bankruptcy caused scarcely a ripple in market prices or product availability.

If there is a criticism, it was that the market reacted too slowly. It should have been able to see Enron's faulted business model much earlier and begin restraining credit growth. Had it done so earlier, it is possible that Enron would have taken a different course while saving itself in the process. In my opinion, Enron's collapse came too late; held up too long by self-serving accountants and perhaps by underwriters who failed to look more deeply into the business of their client. Enron went bankrupt and its real and human assets will migrate to other firms that can use them profitably.

The reallocation of capital caused by its exit will benefit the natural gas industry, financial markets that created energy derivatives of all kinds and countless other markets in which Enron participated. Bankruptcy is just an extreme form of capital exit. Most firms do not get there because the capital market cuts off their access to capital long before they grow too unwieldy and too unprofitable. If we did not have our K-Mart's, Enron's (and in an earlier age, Penn Central's), we would get insufficient capital exit and we would become an economy constrained to low growth by excess capacity and insufficient profits.

When restrictions on normal market processes of capital exit occur in a State that also permits an overweening commitment to Fairness at the sacrifice of a commitment to efficiency, and when the democratic process rewards legislators who are 'single issue' candidates, there are big troubles ahead.

Japan is now in very serious trouble, despite its revered 'creditor status.' The financial sector is now in such pitiful shape that it is virtually inevitable the Japanese Government will be forced to bail out a number of



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Japanese financial companies. Both the currency market and the Japanese government bond market are seeing the strain. The currency market seems to be both the recipient of market doubt and 'open mouth operations' by the Ministry of Finance. The MOF wants further depreciation of the yen in the hope that currency depreciation will give some lift to the export sector. That may revive some business, but it risks a run from the currency itself, both by foreigners and domestic savers who could come to appreciate dollar assets far more. Paradoxically, Enron has probably helped Japan by slowing down that recognition.

The recent escalation in JGB yields coupled to the deterioration of the Yen may be not be a final warning that "Mrs. Watanabe" is finally losing her patience with "fairness" and its ultimate social cost---but this is certainly a possible interpretation. If the Japanese saver deserts the Yen, the last moat protecting Japan's financial system will have been crossed. *Après le deluge* conjures up a very ugly picture. When the Enron scandal disappears from day-to-day view, Japan's Mess will be on full view in the world capital market. The task of capital exit in Japan has now gotten so large as to consume any purported 'reformer.' Koizumi has just lost one of his last assets---his high poll ratings. This cannot be taken lightly by bond and currency markets.

### **Is this the last act of the Japanese collapse?**

Is the Tanaka case a marker entitled, "Warning! End of the Road just ahead?" Perhaps there is a parallel to the 'recognition' problem in capital markets? Enron was already badly wounded when the disclosure of the write-off of previous years profits was finally published---only the markets did not know it. In the U.S., we will likely get an adjustment to risk behavior, but it should not be a catastrophe. Weak firms or those whose accounting is suspect will be punished. If the U.S. Congress does not go too far overboard in its zeal for 'fairness,' U.S. capital markets will perform a re-rating of risk and economic growth will continue.

In Japan, the outcome will be far different. Too much of the capital exit route has been blocked by FD and the cancer of excess capital has grown exceedingly large. Japan's politics is far too democratic to force a change under the current party structures. Unless and until Mrs. Watanabe not only runs from the Yen, but also runs away from past voting patterns, there are too few incentives for capital exit and for systemic change in Japan. In our view, poor conditions for capital exit and adherence to FD paint a bleak picture for Japan in the future. It is not a question of 'if.' It is a question of 'when.'



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