

The Third Try is the Charm

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

David Morris

David Morris works in credit underwriting and due diligence at United Airlines and is part of the financial analysis team that focuses on such issues as United's bankruptcy, its turnaround, and private equity. He has over seven years of experience in this as well as in identifying credit and portfolio risks and structuring and implementing solutions to box and manage these risks.

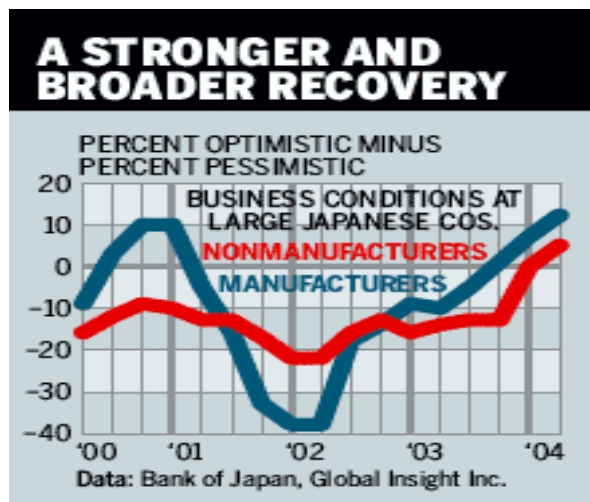
Prior to United Airlines, David was a member of the Risk Management Leadership Program at GE Capital and a VP with Bank One in its asset-based lending group. David got his MBA from University of Chicago Graduate School of Business in strategy and entrepreneurship and his BA in economics and Asian studies from Michigan State University.

After 10 years in the economic shadows following the collapse of its stock market, Japan's economy is once again showing signs of promise.

Some recent mileposts along Japan's economic highway:

- 1996: A 2.6% real GDP growth is crushed by the Asian financial crisis.
- 2000: A 1.1% real GDP growth is dashed as the tech bubble bursts and is further exacerbated by 9/11-driven fears that leave businesses and consumers sitting on their wallets.
- 2003: A 2.7% real GDP growth seems to signal the end of the current economic downturn.

After 10 years in the economic shadows following the collapse of its stock market, Japan's economy is once again showing signs of promise. Worries over the sustainability of the recent recovery are gradually fading. Obstacles remain but, based on Bank of Japan's latest quarterly survey of business sentiment as well as other recent reports, chances for a lasting upturn look the best they have in a long time.



Until now, large manufacturers have driven the recovery, with the economy averaging 3.6% growth over the past year. Now, the upturn is broadening from big exporting companies to small businesses, and domestic demand is beginning to gain some traction.

The BOJ's March Tankan survey, Japan's most comprehensive economic report on more than 10,000 businesses, registered its most buoyant results since 1997. The quarterly survey showed broad improvements in sentiment, not only among large manufacturers but among service industries and small and midsize companies as well. Firms are increasingly upbeat on future sales, profits, and capital spending, and they see con-

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tinuing improvement in financial conditions.

According to the BOJ figures published at the end of April, lending by regional banks rose by 0.1% in the first quarter of this year as compared with the prior year. This marks the fourth quarterly consecutive gain after more than four years of declines. By contrast, the amount of loans outstanding at all Japanese banks continued to slide, tumbling 5%.

A few analysts are saying the turnaround in regional lending could be an early indicator of a rebound among larger banks as well. They say Japan's banking industry finally could be seeing the light at the end of the tunnel following years of economic stagnation and disposal of mountains of bad debt left over from the late 1980's property bubble. In an encouraging sign, the number of Japanese corporate bankruptcies is declining, down 17% for the last fiscal year, according to private credit-research agency Teikoku Databank Ltd.

The current recovery, which began in the first quarter of last year, is Japan's most promising revival in more than a decade because it relies on private-sector demand rather than government stimulus. But for the country to truly pull out of a decade-old slump, analysts say Japan's banks have to stop hoarding cash to pay off bad loans and start investing again in productive economic activity.

Despite the yen's 13% gain over the past year, business optimism is still on the rise. Companies are showing more resilience in the face of the yen's strength than in the past, and even the government seems less worried, given its scaled-back efforts to weaken the yen. Moreover, a stronger U.S. jobs market, with over one million jobs created in the three months ended May 2004, suggests continued strength in U.S. demand for Japanese goods.

More importantly, the outlook for Japan's household spending, which rose for the second month in a row in February (5.2%), is improving. Consumer confidence is the highest in 2 1/2 years, buoyed by a steadier labor market and a 47% surge in stock prices in the year ended on March 31. Unemployment has declined from a record 5.5% a year ago to 5% in February. So far, increased overtime pay is the biggest plus for household income; regular pay and bonuses continue to lag.

Domestic demand remains shaky, which could prevent a sustained increase in consumer prices. Still, the emergence of selective price increases in certain sectors of the economy may signal that deflation's end is in sight.

Corporate capital investment in Japan is increasing steadily, while consumers, long used to saving due to worries about employment and retirement, are spending more freely. Big banks are also making progress in getting rid of their bad debts.

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Japan's consumer-price index has been falling for more than five years. But annual declines have narrowed in recent months, partly as a result of one-time factors, including increases in government taxes and charges last year.

As demand strengthens, deflationary pressures are easing. The Tankan shows that prices companies pay and those they receive are firming up. However, prices paid, especially for materials, are gaining faster, threatening to squeeze profits. Much of the blame for rising material prices can be laid at China's feet: the latter's apparently insatiable appetite for wholesale building of its rapidly industrializing society serves as a double-edged sword. China is presently consuming about a third of Japan's economic output and, if it doesn't overheat, is expected to continue to drive exports.

What could send this Japanese recovery into a tailspin? There are five main risks to the present economy: China; the health of the financial system; public debt; demographics; and terrorism.

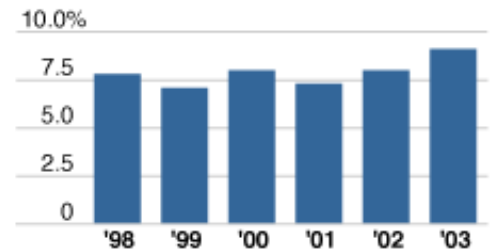
China

The main threat would be an economic train wreck in China, where an overheated economy would force Beijing to try and rein in lending and economic growth. All indications are that recent moves to slow the pace of growth and investment in China are having some effect. Recent economic data indicates that growth in industrial production slowed in May along with a slowing in the pace of the money supply. The risk is still great that limits to available credit could pressure financially weak companies and result in a hard landing. Given the Japanese recovery's reliance on Chinese demand, this outcome could have a disastrous impact and once again send the Japanese economy reeling.

GOOD NEIGHBORS

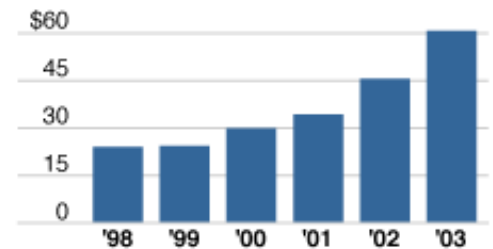
As China roars...

Year-to-year percentage change in China's GDP



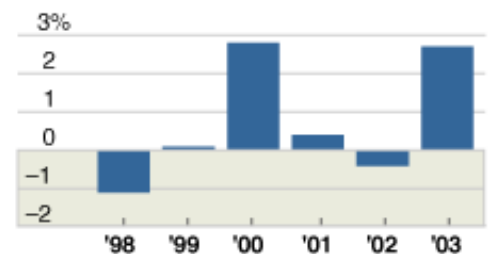
Japan's exports rise...

Japan's exports to China, in billions of dollars*



Improving its economy

Year-to-year percentage change in Japan's GDP



*Converted from yen at current rate

Sources: National Bureau of Statistics of China; Cabinet Office and Ministry of Finance, Government of Japan

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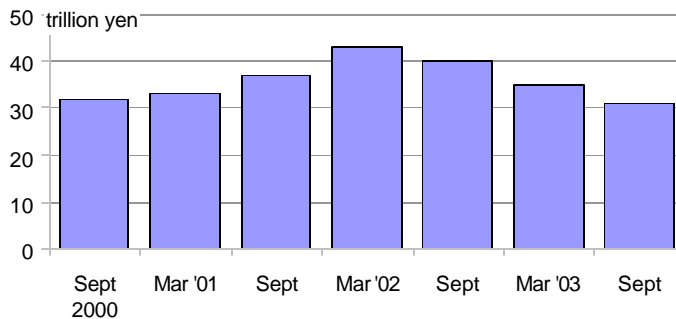
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Health of the Financial System

Japan's banks have been at the core of the nation's economic crisis and are just beginning to recover from ¥150 trillion of bad debt from the real estate bubble of the early 1990s. The number of nonperforming loans continues to shrink, down 10%, to \$300 billion, for the half year ended September 2003. Rebounding stock market and robust corporate profits have helped a great deal. However, an April 7th International Monetary Fund report points out that regional banks, which account for 44% of Japan's NPLs, continue to struggle.

Non-Performing Loans



Source: Financial Services Board

Public Debt

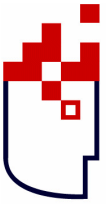
The government, sitting on public debt approaching 160% of GDP, has little room to maneuver should the economy falter. Fiscal stimulus is no longer a viable option and any up-tick in interest rates could negatively impact both highly leveraged companies and the government

Demographics

Demographics continue to pose a material threat to the long-run vitality of the Japanese economy. Japanese 65 and older constitute 18.5% of the population, a number expected to rise to 30% by 2030. This trend will further tax an already stretched national healthcare care system. In addition, aging populations do not work as hard or consume as much. This trend will be exacerbated by strong opposition to immigration.

Terrorism

Event risk is the wild card. A major oil shock or another 9/11 type terrorist attack could unravel much of the progress made in reforming and stabilizing the Japanese economy.



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So, what is the bottom line? Is the third try the charm? My bet is that China will manage to muddle through without a major meltdown as the U.S. economy starts humming in the run up to the Presidential election. The banks are on the right track and, with credit standards being harmonized with international standards and foreign buyout firms acquiring some distressed assets, this trend should continue. Demographics will continue to be a challenge but, if we can avoid a major event risk, I would venture to say we may now have a third horseman to help drive the economy.