Idiosyncratic Risk and the Creative Destruction in Japan

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The dramatic rise and fall of the Japanese equity market provides a unique opportunity to examine market-and firm-specific risks over different market conditions. The price behavior of Japanese equities in the 1990s is found to resemble that of U.S. equities during the Great Depression. Both show increasing market volatility and a prolonged large co-movement in equity prices. What is unique about the Japanese case is the surprising fall in firm-level volatility and turnover in Japanese stocks after its market crash in 1990. This large decrease in firm-level volatility may have impeded Japan's capital formation process as it has become more difficult over the past decade for both investors and managers to separate high quality from low quality firms. Using data on firm performance fundamentals and corporate bankruptcies, we show that the fall in firm-level volatility and turnover in Japanese stocks could be attributed to the sharp increase in earnings homogeneity among Japanese firms and the lack of corporate restructuring.

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