A Japanese Debt Crisis?!?

And the possibility of global contagion?

A veteran Washington journalist surveys the scene.

BY JOHN M. BERRY

While everyone has been watching Europe struggle to ward off sovereign debt defaults that could sink the euro, and the United States narrowly avoid a debt default last summer because of sheer political intransigence, Japan has quietly sunk ever deeper in its own bottomless morass of debt.

There have been no dramatic warnings of imminent default, and yields on ten-year Japanese government bonds—known as JGBs—at about 1 percent are the lowest in the world save Switzerland. Nevertheless, the International Monetary Fund expects Japan's overall fiscal deficit this year to be more than 10 percent of gross national product and its gross debt to reach a stunning 241 percent of GDP. That's roughly twice the gross debt level of Italy, the most indebted country in Europe.

Even with rock-bottom interest rates, Japan is spending half of its tax revenue on debt service. Its deficit is expected to be so large in the fiscal year that began April 1 that it will have to borrow more than it collects in taxes.

So why aren't the alarm bells ringing loudly in its bond market? Several reasons. First, decades of high saving rates allowed the Japanese government to easily finance internally the large annual government budget deficits incurred in the effort to keep the banking system and a stagnating economy afloat. Only a very small share of JGBs are held outside the country while the bulk of the outstanding debt is owned by

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Japanese banks, pension plans, insurance companies, and the huge postal savings system. Meanwhile, money from decades of large trade surpluses have enabled the Japanese to acquire trillions of dollars worth of assets abroad that have just begun to be cashed in.

Unfortunately, a perfect storm of bad policy, bad luck, inescapable demographics, and debt dynamics have set the stage for a debt crisis. The only question is how soon it will occur. Some analysts, such as Robin Koepke and Emre Tiftik of the Institute of International Finance, an organization of major banks around the world, do not expect any impact, such as a rise in JGB yields, for several years.

But Carl B. Weinberg, chief economist at High Frequency Economics in Valhalla, New York, believes the reckoning will come much sooner.

The Japanese economy "is headed for a catastrophic collapse as the delayed effect as decades of reckless public sector spending bump into the funding limitations for an aging population," Weinberg told his clients last month in his *Weekly Notes on the Global Economy.* "Competition in export markets from elsewhere in Asia and the continuing challenges sparked by last spring's earthquake, tsunami, and atomic accident are just footnotes to a bigger process."

With a public sector debt of more than 200 percent—defined somewhat differently than the IMF measure—and an average coupon on that debt of 1.4 percent, "interest payments alone consume 2.8 percent of nominal GDP," Weinberg said. "Nominal GDP growth has not bested 2.8 percent for a whole year since 1991. Debt service alone will boost the ratio of national debt-to-GDP forever unless GDP growth can be jump-started."

Added Weinberg, "Any GDP growth at all will be minimal because of a shrinking population."

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The labor force has been getting smaller since 2000 because Japan's baby boomers are retiring and their replacement age cohorts are smaller. In the process, Weinberg said, retirees switch from being savers to dissavers. In the early 1980s, only about 10 percent of Japanese were 65 or older and the household saving rate a robust 17 percent. Since then, aging has pushed the over-65 group to nearly 25 percent of the population and the saving rate is down to around 4 percent.

According to Weinberg, the big pools of savings have begun to shrink, pools held by "the same institutions that have historically been the main buyers of most of Japan's public sector debt… With net cash outflows, they will have to stop buying JGBs, and possibly even start selling them."

It was against this background that last year's earthquake and tsunami struck, badly damaging several power-generating nuclear reactors. That damage coupled with a new fear of radiation has caused the government to shut down all but one of country's fifty-four reactors, which in turn has forced a switch to use of more costly imported oil and liquefied natural gas for fuel for power generation. Now forecasters say trade deficits will be offsetting income received from those foreign assets, reducing current account surpluses.

On a more positive note—one of the very few—the Bank of Japan in February announced an expanded program of quantitative easing—buying ¥10 trillion worth of JGBs—to spur economic growth and end persistent deflation. That is along the lines of what the Federal Reserve has done in the United

Dubious Advice?

Yoshihiko Noda

Prime Minister Yoshihiko Noda, who acknowledges the threat posed by the soaring debt, has proposed increasing the country's very low consumption tax from 5 percent to 10 percent in two steps by 2015. The legislation is contentious even among members of his ruling Democratic Party of Japan, and Noda was forced to agree not to push for a larger increase. Some of the bill's opponents fear the tax increase would reduce household spending and further weaken growth prospects.

—J. Berry

The IMF team completes Japan's 2011 Article IV consultation discussions. Japanese authorities weren't happy. As the report put it, "they were skeptical about the staff's tail risk analysis showing how a JGB shock could affect global financial markets through banks' balance sheets." From left to right: Shogo Ishii, Anoop Singh, John Lipsky, Mahmood Pradhan, and Ken Kang.

States and the Bank of England in Britain. The Bank of Japan also set a new inflation goal of 1 percent.

The initial market reaction was positive. The Nikkei 225 stock index jumped and the value of the Japanese yen, which had been bolstered by repatriation of some of those foreign assets and become a serious drag on exports, dropped. But within two months half those changes had dissipated and the Bank of Japan was resisting government pleas to do more.

"Carefully managed, this policy could spur both Japan's economy and the corresponding world output that would result from a robust Japan," John H. Makin, a resident scholar at the American Enterprise Institute, wrote in an AEI policy brief in March. "The weaker yen means that Japan's exports may reverse their recent sharp drop, thereby improving the outlook for Japan's traded goods sector, while a boost to equity prices would help household balance sheets and may spur increased consumption, helping Japan's domestic companies."

However, the levels of both the Nikkei index and the yen have moved back only to about where they were a year ago, and some economists who have also welcomed the Bank of Japan action are skeptical about how much impact it will have on the economy and particularly on deflation. For instance, the latest IIF forecast predicted price declines would continue at least for the next couple of years. Recent IMF research also found little impact from earlier Bank of Japan quantitative easing on either inflation or inflation expectations.

Continued mild deflation would, of course, be a particular problem for the Japanese debt/GDP ratio. For stabilizing the ratio, more rapid gains in nominal GDP, not real growth alone, are the key. Since early 2009 there has been only one quarter in which the year-over-year change in the Tokyo area consumer price index was positive. If real growth comes close to the 1.5 percent to 2 percent pace commonly predicted for 2012 but prices continue to fall at a 1 percent rate, nominal GDP would rise only 1 percent or less. The forecasts are even a tad weaker for 2013, and absent a huge shift in fiscal policy the debt/GDP ratio would keep shooting up.

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The reality, according to senior IMF officials, is that merely doubling the low tax rate would not be enough to stabilize the debt/GDP ratio. At a press briefing in January, Anoop Singh, director of the IMF's Asia and Pacific Department, said officials have had debates with Japanese authorities over the need "to raise the consumption tax gradually, not immediately—say to 15 percent beyond 2015," and that other spending reforms are needed as well to bring down the debt ratio.

Actually, it's not clear that even a combination of measures would do the trick given where the debt ratio is likely to be a few years from now. The latest IMF *Fiscal Monitor* report puts the gross debt ratio at 247 percent next year. In all the data on debt and financial crises gathered by Carmen M. Reinhart and Kenneth S. Rogoff for their seminal work, *This Time Is Different, Eight Centuries of Financial Folly,* there is no comparable number. "Our data set for the book has the UK hitting 215 percent of GDP in 1945 at the end of World War II" when output obviously was below trend, Rogoff said.

In a speech in March, Carlo Cottarelli, director of the IMF's Fiscal Affairs Department, described some of the profound impacts of a high debt/GDP ratio found in recent research by IMF economists. For instance, debt service costs tend to crowd out private investment and reduce productivity growth. "The difference in potential growth between having a debt ratio of 120 percent of GDP and a debt ratio of 60 percent of GDP is about one percentage point… Italy and Japan, two high debt-low growth countries, are good examples of this kind of effects," Cottarelli said.

Indeed, that is one more reason Weinberg is so pessimistic about Japan's economic future. GDP plunged about 9 percent over four quarters spanning 2008 and 2009 and had not recovered before last year's natural and atomic disasters. "GDP remains 3.6 percent lower than its pre-2008 peak and no higher than it was six years ago," he said. With the crowding out related to the surge in the debt ratio, capital spending is nearly a third lower than at its peak. By Weinberg's estimate, the combination of a shrinking labor force and lower business investment means potential GDP growth in Japan is now negative.

Last July, an IMF mission to Japan concluded the annual economic and policy analysis—the so-called Article IV assessment—all member countries undergo. With measured language, its report said, "The capacity of the market to absorb debt will gradually decline as private savings fall due to population aging. If Japanese government bond yields were to rise rapidly, Japanese banks including Japan Post, which hold almost 40 percent of outstanding JGBs, could experience sizeable losses and may change the composition of their asset portfolios. In addition, increases in JGB yields as a result of delays in fiscal reform may lead to higher interest rates elsewhere, especially in some economies where government debt is already high."

Japanese authorities weren't happy with that last bit of analysis. As the report put it, "they were skeptical about the staff's tail risk analysis showing how a JGB shock could affect global financial markets through banks' balance sheets, as the share of foreign assets held by Japanese banks was around 10–20 percent. In general, they cautioned against relying too heavily on models of financial contagion and strict interpretation of the results." (In financial terms a "tail risk" is an event that is very unlikely to occur but typically could be very costly if it did.)

However, models about financial contagion are based only on past experience and Japan's unique situation is beyond all past experience. Its debt ratio is higher than anywhere else, all but a small portion of its debt is in domestic hands, and that debt constitutes a very large share of the assets of major Japanese financial institutions. If rising rates were to lower the value of their JGBs and threaten the institutions' solvency, the government would be in a very poor position to prop them up as it did in the 1990s.

Each month that a major fiscal consolidation, as it's euphemistically called, is postponed, the risk of some sort of financial crisis rises.

One reason the country is so deeply in debt is that in 1992 falling real estate prices triggered a calamitous banking crisis and economic stagnation. Eventually seven banks were nationalized, sixty-one institutions closed, and twenty-eight others merged, according to Reinhart and Rogoff. Loss estimates ranged up to 18 percent of GDP and a massive program of public works spending was begun to stimulate the economy. All that spending caused the gross debt/GDP ratio to soar from about 65 percent in 1991 to around 190 percent in 2005. Today, with that ratio about 50 percentage points higher, the government may no longer have the wherewithal to mount such a bailout of the banking system.

To achieve debt sustainability, the IMF analysis last July said it would take a 10-percentage-point increase in the consumption tax over the next five years—rather than the 5 percentage point increase Prime Minister Noda has proposed over the next three—and spending cuts equal to 5 percent of GDP. It also assumed these changes would take place in the context of growth and inflation both averaging 1 percent a year, so that nominal GDP is rising 2 percent annually.

As of now, the tax increases look unlikely at best, and so does 2 percent nominal GDP growth. The medium-term economic projections in the analysis also showed the debt/GDP ratio reaching 247 percent in 2015. Six months later, in January, the IMF *Fiscal Monitor* said that number was likely to be hit next year, not three years from now. Each month that a major fiscal consolidation, as it's euphemistically called, is postponed, the risk of some sort of financial crisis rises. The first concrete sign will come when JGB yields start rising in a noticeable way. When that begins to happen, as the IMF report warned, it could affect far more of the world that just Japan. ◆

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