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Many people in the financial world – not all of them kooks – have managed to convince themselves that Japan is hurtling towards some kind of fiscal doomsday. And that no matter what the Hatoyama government does or doesn't do, it's already too late. That Japan will be defaulting on its pension obligations. Or defaulting on its debt. Or will find itself unable to halt a string of bank failures that will bring the financial system to its knees. Or some combination thereof.

Robert Samuleson picked up on this scuttlebutt in a November 1 article in the *Washington Post*. He warned Americans that they are at risk of following Japan into an abyss of debt that will increasingly “constrict governments' economic maneuvering room.” He refers to a JP Morgan Chase study of Japan's fiscal situation and seems to have relied on it for much of what he had to say about Japan. Jim O'Neill, head of global economic research at Goldman Sachs, has for months been predicting that Japan's fiscal woes would translate into a weaker yen. I myself was talking recently to a hedge fund manager who was speaking of Japan's hitting a “debt wall.”

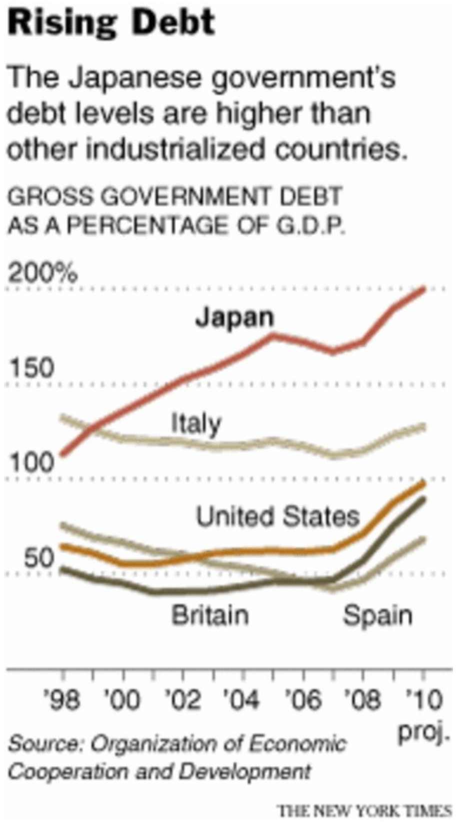
Topping off the hysteria about Japan was a piece in Britain's *Daily Telegraph* on November 1 by Ambrose Evans-Pritchard.

Sprinkling his piece with quotes from people such as the former IMF Chief Economist Simon Johnson (“a real risk that Japan could end up in major default”) and various finance gurus (“the sums are gargantuan,” “ the situation is irrecoverable,” “incredibly dangerous,” “shocking,” “horrible,” “the risk of a downward spiral”), Evans-Pritchard works himself up into a fever pitch of indignation, accusing the Japanese government of “sitting frozen like a rabbit in the headlamps” and concludes with the obligatory warning for the rest of us about our profligate, debt-addicted ways.

Now when Evans-Pritchard begins writing that the Japan Post Bank is “balking” at taking on additional Japanese government debt, one begins to doubt his grasp of Japanese political reality. The notion that the Post Office has an investment policy independent of that of the government is pretty hard to swallow – particularly when it is headed today by Saito Jiro, former MOF *jimu jikan* (administrative vice minister – the pinnacle of the traditional bureaucratic hierarchy). And many of us can remember that much of the financial world worked itself up into a comparable state of of frenzy about Japan back in the mid 1990s. Back then, the idea was that it was Japan's banks that were going to collapse and take the world down with them rather than its bond market. But it was the same general fear that Evans-Pritchard expresses in his piece -- that Japan's leaders simply don't understand how bad things are; that they are risking not only their own well-being but everyone else's unless they can be waked up and set on the right course.

Now just because the little boy cried of a wolf once before when the creature in question turned out to be more of a miserably wet dog than a genuine menace doesn't mean that a real wolf might not be moving in for the kill today. To be sure, even back in 1997, all the hysteria – particularly the pressure from the Clinton White House – provided the government of the late Hashimoto Ryutaro with the political cover to get the bank bail-out package through the Diet. So perhaps another bout of hysteria could have its uses again. And while Evans-Pritchard may need some tutoring on the way Japanese institutions work, many of the facts that so frighten him are not in dispute.

The debt numbers are indeed growing and Japan's debt as a percentage of GDP is among the highest in the developed world – more than twice as high as the US.



Rising Debt projections. OECD

Deflation is worsening. Thus the Japanese economy is burdened with relatively high real interest rates that monetary policy cannot fix since it is not, in practical terms, possible to cut interest rates below zero. The population is aging. For a generation now, the Japanese government has squandered the country's savings on white elephants: seawalls, dams, bridges and roads to nowhere, airports in sight of each other – monstrosities that not only produce no revenue but actually eat into it since many have to be subsidized to continue to operate. Savings rates have dropped like proverbial stones and are now actually lower than those in the United States.

So why am I not yet ready to join the doomsayers? To start with, using impeccable neo-liberal logic, if the "market" believed things were really that bad, investors would be fleeing the yen while the prices of Japanese government bonds ("JGB's") would be tumbling (i.e., yields would be rising). I am no adherent of efficient markets reasoning (in a nutshell, according to that reasoning, prices can't be wrong – they tell us everything we can possibly know at any particular moment about the future), but given that most of the doomsayers generally subscribe to orthodox free market economics, they have some explaining to do. An investor who genuinely believes the Japanese government is going to default on its debt or that Japan will find itself in some intractable economic squeeze is not going to wait until these things actually happen to sell holdings of JGBs or short the yen. Indeed, an investor who is completely convinced these events are inevitable can make out like a bandit by placing large bets against the yen and JGBs. That's the whole point behind the efficient markets hypothesis – that if enough investors believe the yen and the JGBs are headed for steep falls, then they will by their very actions bring these on. And if they haven't, well then, there is somebody somewhere who has convinced himself of a very different scenario. Who is right? We don't know, but the efficient markets hypothesis will tell you that for the moment, more investors believe the yen and the JGB are sound than otherwise.

Yen to US$ exchange rate

The obvious rejoinder is that maybe some investors indeed plan to dump their yen and JGB holdings, but in the meantime, believe they can make money from the idiots out there who don't see how bad things are – and that they can get out in time. Buy the yen today at 90 to the dollar, wait until it crashes to 140, and pocket the 50 yen difference. In efficient markets land, this isn't supposed to happen, but any one who looks at the real world history of financial crises – the "Manias, Panics, and Crashes" of the late Charles Kindleberger's legendary book – knows that this kind of thing goes on everywhere; that everyone thinks he is smarter than the next guy and can get out in time – until he can't. This explanation would make sense if we were in the midst of euphoria about Japan; real killings in the financial markets are, after all made by people who bet against the herd and are then proved right. But the herd today – if articles like Evans-Pritchard's are any indication – believes Japan is headed over the proverbial cliff. It's pretty hard these days to find any bullish writing on the prospects for the Japanese economy.

Well, then, maybe the markets are being manipulated. Putting aside the efficient markets theologians who maintain that is impossible, who might be doing it? There is only one candidate: the Japanese government itself. Unfortunately for this theory, the new government in Tokyo has been quite explicit that it does not intend for the time being to intervene in order to *suppress* the value of the yen. In other words, market forces are making the yen *stronger*, not weaker. Meanwhile, the JGB market has indeed long been "manipulated" if you want to call it that – most JGBs end up in the portfolios of deposit taking institutions in Japan that tend to march to the orders (more precisely, the hints and nods) of the bureaucrats in the Finance Ministry, the Bank of Japan, and the Financial Services Agency. There is a school of thought – I count myself among its members – that the day may come when the authorities will indeed lose control of the JGB market and when they do, JGB prices will fall (in finance-speak, yields will rise). But we're not there yet – if we were, to say it one more time, JGB prices would already be falling.

More broadly, there are several things to keep in mind about all the doomsaying.

1. Japan continues to enjoy the luxury of financing its government debt from its own savings in its own currency – and, at least for the moment, pays practically no interest on it. This means that comparisons with countries such as the US that must borrow from foreigners (not to mention developing world countries that have to borrow from foreigners in a foreign currency at substantial interest rates) are not terribly relevant.
2. A stronger yen is, to be sure, hard on exporters. But it also changes the terms of trade in Japan's favor. Of course this is a tautology, but it is worth pointing out that other things being equal, standards of living rise in Japan when Japanese people can buy foreign commodities (foodstuffs/ petroleum) for fewer yen.
3. A rise in interest rates is not necessarily a bad thing. One reason the demographic crunch in Japan understandably frightens people is that it is essentially impossible today to purchase future yen cash flows with today's yen – interest rates are far too low. A rise in interest rates would finally permit savers to do that, as they used to before next-to-nothing interest rates were introduced some 15 years ago. Since then, Japanese savers have been unable to find any kind of investment that promises to return reliable streams of cash flow in the future – one reason now that so many of them are finding that their savings are inadequate to finance retirement. A "normal" interest rate environment of 4-6% annual coupons on JGBs would, to be sure, be a frightening prospect for many Japanese corporations. But it would be a relief to any wage earner who hung on to his or her job and needed to save for retirement.
4. The DPJ government wants to restructure the Japanese economy. While success is by no means assured, a super-strong yen accompanied by rising interest rates may actually help them do it by, among other things, making it politically possible to shut down inefficient producers and reduce white-elephant spending. Yes, many will lose their jobs when inefficient producers go bankrupt or the government stops building useless roads and dams. But a cushion of a strong yen makes it much easier for the government to introduce welfare spending sufficient to prevent economic devastation for people who are temporarily out of work. One reason, for example, that the Scandinavian economies are so relatively strong is that they combine very strong social welfare spending with flexible labor markets, meaning that job loss does not have to spell economic devastation. And it bears remembering that the restructuring of the American economy that led to US dominance in emerging IT sectors in the 1990s had its roots in the high-interest rate, high-dollar environment of the pre-Plaza Accord 1980s. Furthermore, as a glance at places like Shanghai or the eastern seaboard of Thailand can affirm, Japanese business is now irrevocably committed to waves of foreign direct investment – a strategy for which a super strong yen is a very powerful tool.

Of course Japan faces formidable problems, but the world has been underestimating the place for 150 years now and really shows no sign of learning from this history. Yes, many of Japan's savings have been wasted, yes, the birth strike by Japanese women is both understandable and worrisome, yes, we're in for some rough years particularly for an economy that has long relied on exports as its primary engine of growth. Those exports are unlikely to recover any time soon. But the levels of human capital here and the immense creativity of the population are still enviable. To be sure, the country has been poorly served by its leaders, but perhaps even that is changing. Everett Dirksen's quip at the 1968 Republican Convention about the United States could perhaps serve equally well for Japan -- "We're not sick, we're just mismanaged!"

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Recommended citation: R. Taggart Murphy, "Is Japan Headed for a Fiscal Doomsday?" The Asia-Pacific Journal, 46-4-09, November 16, 2009.

Here is Richard Katz's take on the issues from *The Asian Wall Street Journal*.