Japan's Debt Dilemma

Is Generational Conflict Avoidable?

BY NOAH SMITH

I had only one conversation with Gary Saxonhouse, an eminent American scholar of the Japanese economy, before his death in 2007. And I only got a chance him to ask one question: "What's Japan's biggest economic problem?"

"The debt, of course," he answered without hesitation. And it's hard to imagine that he would have changed his mind since then. Today, the Japanese government's debt is an eye-popping 238 percent of GDP.

That number would instinctively worry most people. By comparison, after years of running humungous budget deficits to offset sagging private demand during the Great Recession, the public debt of the United States is "just" 101 percent of GDP. But was Saxonhouse right? Is Japan's debt as crushing a burden as it seems?

UNHAPPY FAMILIES

Not all public debts, we should remember, are alike. Japan's debt, unlike that of, say, Greece or Argentina, is almost entirely domestically held. The mountain of liabilities thus represents the government's promises to various groups of Japanese people – individual bondholders, banks, corporations, pension funds and the Bank of Japan (Japan's equivalent of the Federal Reserve). If the debt carried no interest, the government could simply decide never to pay it back – rolling over each bond as it matured without harm to the economy.

But that simple it is not. First of all, the interest rate on the debt is not zero. Thus, even with Japan's low, low interest rates, servicing it means that more than 15 percent of government revenue must go toward interest payments. That revenue has to be extracted from the Japanese people through taxation, which distorts market incentives of all sorts and lowers GDP. Think of those interest obligations as a leaky pipe that circulates money from some Japanese to others, losing some into the ground along the way.

Second, managing such a large heap of debt incurs interest-rate risk. If rates ever rose sharply, required interest payments would eventually increase until they swamped the budget – the leaky pipe would burst. In order to prevent this from happening, the government must lean on the central bank to keep interest rates low in order to stay solvent – circumstances that economists call fiscal dominance. Standard economic theory says that could lead to out-of-control inflation, were the economic growth to accelerate.

Third, the debt mountain is still growing. If the debt-to-GDP ratio keeps rising without bounds, at some point the public could lose confidence in the government's ability to make future interest payments. If this fiscal limit were reached, interest rates would spike, leading to an immediate default. No one, by the way, has a clue to where the fiscal limit lies. It's only common sense that the higher the debt-to-GDP ratio goes, the greater the danger of bumping into the wall. But just how much greater is something that no one can really calculate. A major hedge fund manager, Kyle Bass, and others have loudly predicted a Japanese debt disaster for many years. So far they haven't been right, of course

So how bad would a sovereign default be? In the long run, it might not actually be so bad. After all, countries that default tend to experience a burst of growth after the pain of the first year. More specifically, sovereign default might lead to a cleansing of Japan's stable of unproductive companies that own much of the official paper – just what the country needs, perhaps.

Japan rose from the ashes of World War II; might it rise once again? Perhaps. But even with luck and skillful crisis management, the collateral damage would surely be great, and the risk that all would not end well would be high. No country of comparable economic output, wealth or geopolitical importance has ever defaulted in time of peace. Every Japanese bank, financial company, insurer and pension fund would become insolvent overnight.

The financial system would implode. Deprived of loans, a huge number of Japanese companies – among them, many that are productive and well managed, would be thrown into bankruptcy. Unemployment would skyrocket and gross investment would grind to a halt. The Japanese government would probably be forced to print money to pay unem-

NOAH SMITH teaches finance at Stony Brook University and is the creator of the blog *Noahpinion*. He worked in Japan from 2003 to 2006.

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ployment benefits and to keep floundering firms going. Japanese exporters would lose their international competitive position, and in this take-no-prisoners global economy would have a great deal of difficulty recovering it. The yen would collapse, and the country would have trouble paying for food and energy, most of which is imported. In short, debt default would lead to chaos.

Japan's political system is notoriously weak and an economic collapse would sweep away the regime that has been in place since 1945. What would replace it is anyone's guess, but historical experience and recent political rumblings suggest that it would be a deeply illiberal right-wing government. Just how China, Japan's wary global economic partner and rival, would react is anybody's guess.

NUCLEAR AND OTHER OPTIONS

If a clean-sweep default is implausible, what could be done to reduce the danger of default of any sort and to reduce the deepening distortions created by the government's ever-growing burden of interest payments? The fact that both the Japanese and foreigners continue to buy government bonds at historically low interest rates suggests that most believe pretty strongly there are ways to avoid to default. In fact, there are several things that could be done to manage the problem. But all of them involve some element of wealth redistribution, and so all of them would be difficult in political terms.

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The most obvious would be to raise taxes – indeed, tax hikes have figured in Japanese government plans for decades. But the tax approach would not be for the fainthearted. A number of economists have tackled the question of how much Japan would have to raise taxes in order to put its debt-to-GDP level on a stable long-term path. Two economists, Gary Hansen and Selahattin Imrohoroglu, took a crack at the calculation in 2013, and the results were not encouraging. They concluded that the tax take would have to be somewhere between 40 and 60 percent of GDP– rates almost unimaginable in a functioning market economy.

A 2011 paper by three other economists, Takero Doi, Takeo Hoshi and Tatsuyoshi Okimoto, came up with a figure of between 40 and 47 percent of GDP – near the lower end of Hansen and Imrohoroglu's numbers. But their estimate is already outdated, since the debt has been increasing steadily in the interim.

Note also that these estimates are almost certainly on the optimistic side, since they abstract from Keynesian demand-side effects. An ill-timed hike in Japan's broad-based consumption tax last year was widely blamed for pushing GDP growth back into negative territory, leading the government to postpone a planned hike this year. And even if a government were brave enough (and foolish enough) to try to tax its way out of deficits in a period of slow to no growth, it's self-evident that taxes would have to be raised even more than the economists calculate from supply-side effects alone.

But forget the demand side for a moment. Tax collection at the rates implied by the Hansen-Imrohoroglu analysis would be unprecedented outside wartime. The highest-tax countries in the world today, Sweden and

Denmark, garnish less than 45 percent of their GDP in taxes – and use the revenue to provide benefits appreciated by taxpayers. Japan currently takes in about 28 percent of GDP, so taming the debt would require an increase in taxes of between 12 and 32 percentage points that would do nothing to improve the lot of Japanese families. The aforementioned 2014 consumption-tax hike, which raised the tax from 5 percent to 8 percent, prompted popular outrage – and had in fact been delayed for many years due to its unpopularity.

So raising taxes would at best be only part of the solution to the debt problem. What about cutting spending?

I still remember cheering in the early 2000s as Japanese Prime Minister Junichiro Koizumi took an axe to the wasteful public works outlays that had been responsible for much of the run-up in debt during the 1990s. That splurge of "investment" was probably motivated less by economics and more by the patronage system that the political scientist Ethan Scheiner calls "clientelism." The flood of government money paved over riverbeds and turned parks into parking lots. And I've personally driven over one of Japan's fabled "bridges to nowhere," built to make work for favored constituents. But the outlays failed to provide much of a lasting boost to the economy. When Koizumi finally cut off the tap, a huge source of national waste was eliminated.

This did not, however, plug the gaping budget hole, because demographic factors kicked in. Even as public-works spending was cut back, Japan's population peaked and went into decline. Meanwhile, the Baby Boom generation began to retire, leaving ever-fewer workers to support each retiree. That reality is reflected in the ongoing increase in the government's pension and health care obligations – spending that cannot easily be cut without impoverishing a large number of aging citizens. In any case, such cuts are not in the cards because older people in Japan (like older people in the United States) vote in large numbers and (unlike many of their American counterparts) are not easily distracted from bread-and-butter issues.

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Of course, the best option would be for Japan to grow out of its debt. And here, there's a glimmer of hope. Japan's productivity essentially stopped rising in 1990, even in its vaunted manufacturing industries. Since then, only small gains have been recorded. This productivity stagnation can be seen in the erosion of Japan's export competitiveness, in declining wages, and in the failure of Japan's GDP per capita to catch up to anywhere near that of the United States. Indeed, calculated in terms of purchasing power, Japan's GDP per capita is less than that of Taiwan or Ireland

and only a smidge greater than that of Israel.

Ironically, that offers grounds for optimism, since it means productivity has room to rise. Many of the structural reforms that Prime Minister Shinzo Abe is now either enacting or pushing for would unleash the power of neoliberalism – flexible labor markets, free trade and shareholder capitalism – on the stodgy, moribund Japanese corporate culture. That will surely disrupt Japanese society, but should ultimately give Japan a burst of growth in income and tax revenue that, other things being equal, would both shrink the numerator and boost the denominator of the debt-to-GDP ratio.

Other things are not equal, unfortunately. More income per person is of limited help when it comes to closing the deficit if you have fewer and fewer people. And here we come back to Japan's relentless population decline. Although the country's total fertility rate – the number of children an average woman is likely to bear – has ticked up in recent years, it still stands at only 1.4, far below the replacement level of 2.1. That means Japan's native-born population will continue to fall for decades, even if fertility magically recovered.

What about immigration? Not likely, because Japan, unlike the United States or Canada, defines itself ethnically. And even if the barriers to immigration could be lifted, a surge large enough to reverse the population decline and bail out the government's debt problem would likely cause a backlash that would make the United States' anti-immigration movement look tame.

WHATEVER IT TAKES

So if Japan is not going to be able to tax, reduce spending, or grow its way out of the debt trap, that leaves one option. It's time to talk about debt monetization – about using monetary policy to pay off debt.

The simplest and most well-tested form of debt monetization is the one Japan is already using: fiscal dominance. The Bank of Japan's vow to do whatever it takes to raise inflation from nil into the 2 percent range effectively means buying up financial assets wherever it can find them and pushing down interest rates on all sorts of debt to historic lows.

This strategy works well when paired with another technique: financial repression – the policy of leaning on banks and funds to buy government bonds no matter how low the interest rate goes. (Of course, this policy has the drawback of reducing bank funds available for loans to productive enterprises.) But in Japan, there are signs that the government's ability to bully banks and companies into buying its bonds is ebbing. Nor can Japanese households pick up the slack. The once-vaunted savings rate of the Japanese household has now fallen below that of the United States, thanks in large part to the ballooning numbers of retirees.

Who does that leave to buy the Japanese government's bonds? The Bank of Japan. The more dramatic version of debt monetization – the nuclear option, if you will – is to have the bank buy bonds directly from the government as it issues them. Japan's government actually did this from 1931 to 1936, as a strategy for combating the Great Depression. It worked then and it might work now.

In fact, if you are willing to go to the nuclear option of true debt monetization, you could also pay down the existing stock of debt. For starters, the Bank of Japan could cancel the debt that the government already owes it. This is the approach recommended by Adair Turner, former head of Britain's Financial Services Agency. Second, much of the Japanese government's debt is held by pension

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funds that are run by the federal government. This debt could be swapped for cash created by the central bank, allowing the government to write down huge quantities of debt.

The numbers involved are staggering. Analyses by Columbia economist David Weinstein, and a Jobu University economist Hidetomi Tanaka suggest that anywhere from two-thirds to five-sixths of Japan's government debt is held by various government-owned pension funds and corporations, or by the Bank of Japan. Monetizing that debt would vaporize Japan's debt problem.

There is, however, a great danger here: it might also vaporize Japan's currency. If the government gives itself permission to get rid of any amount of debt by monetizing it, it would have potent incentives to borrow and then shed the burden by converting the debt to cash. Realizing that, people and companies would likely become unwilling to hold yen because its value would be vulnerable to the indiscipline of the government. That way lies hyperinflation.

Of course, no one knows how much debt would have to be monetized to trigger hyperinflation, just as no one knows how high the debt-to-GDP ratio can go before bond buyers rebel. Either way, Japan is navigating uncharted waters.

So to recap: Japan could raise taxes to punishing levels or slash benefits to older people. It could continue to create money at a rapid clip to hold down interest rates. Or it could go a step further and create enough money to pay down much of the stock of Japan's debt and to finance government deficits directly. The path of least resistance, it seems, is to opt for some combination of these methods.

But notice something interesting about the menu of options for taming the debt monster. The only one that doesn't amount to a disguised tax on Japan's aging is the tax hike.

Remember, Japan's debt represents money that the Japanese government owes to Japanese people. The people who are owed that money are the older generations – mostly the Baby Boomers who enjoyed the fruits of Japan's long period of growth from the 1960s through the 1980s. These people had secure, well-paying jobs, along with a strong inclination to save for rainy days. And they stashed much of their wealth, either directly or indirectly, in government bonds.

The Japanese government now faces a choice. It could make good on its commitments to that generation by exacting tribute from younger generations through taxes – and harming the economy in the process. Or it could confiscate some of the wealth of that older generation through debt monetization, risking out-of-control inflation.

Remember, too, that Japan's Baby Boomers outnumber the young and can be counted on to vote for their own interests. To put it another way, Japan is effectively a gerontocracy. Hence, there will be massive pressure on the government to hike taxes to stabilize the debt. But that would impose a new burden on Japan's young, who already face declining wages. They are responding by failing to get married or to have children, thus perpetuating Japan's demographic decline. In short, young Japanese people are carrying the older generation on their backs, and it is breaking them.

The option of monetization, by contrast, would not only erode the debt mountain but also brighten the economic situation of the beleaguered younger generation. Yes, the approach would generate inflation, but some inflation would be good for Japan right now. Hyperinflation is, of course, a risk, but this risk could be managed, for example, by increasing bank-reserve requirements if inflation seems to be spiraling up. Meanwhile, cuts in government pension benefits – another confiscation of the wealth of the old to relieve the burdens of the young – could help close the budget deficit.

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Japan is dealing with problems no country has ever encountered before. It faces an epochal choice: to take the sure path of continued stagnation and keep its promise to the Baby Boom generation or to launch a bold and risky experiment of debt monetization that would relieve the burden on the young. We are reaching the point where Japan has run out of room for procrastination.