Japan – Past the Point of No Return

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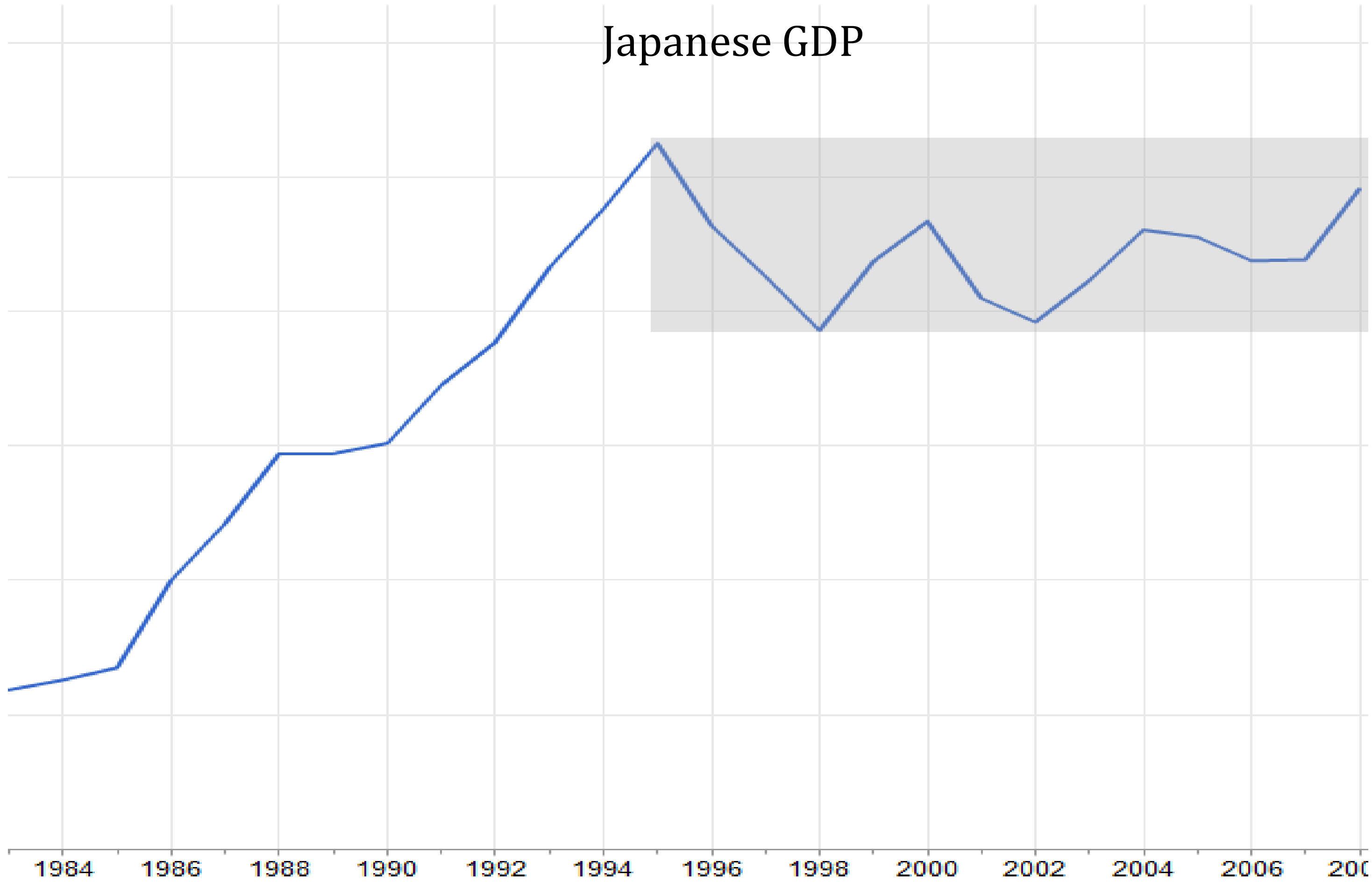
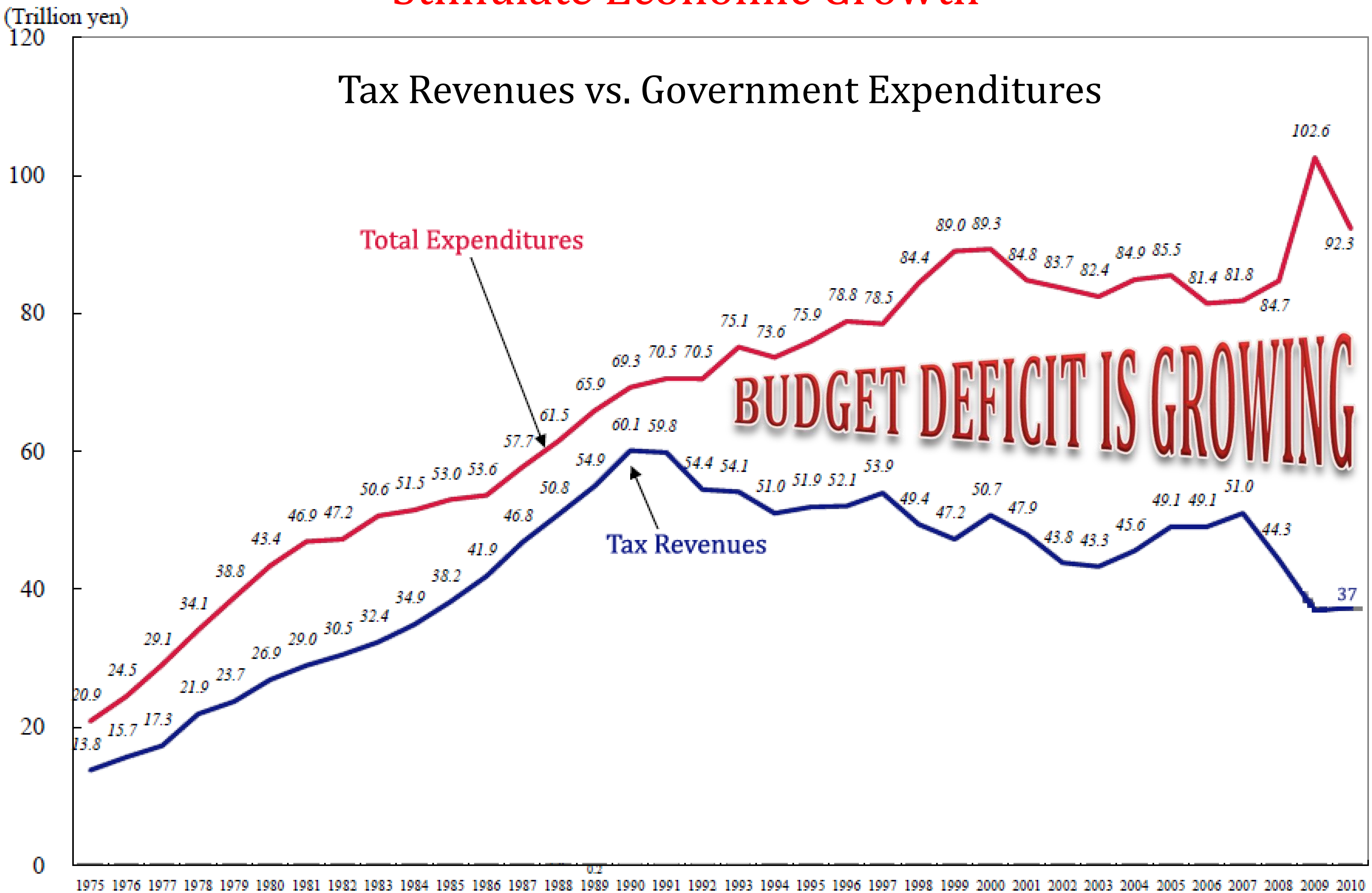
Japanese GDP Growth Comes to an End in the Early 1990s



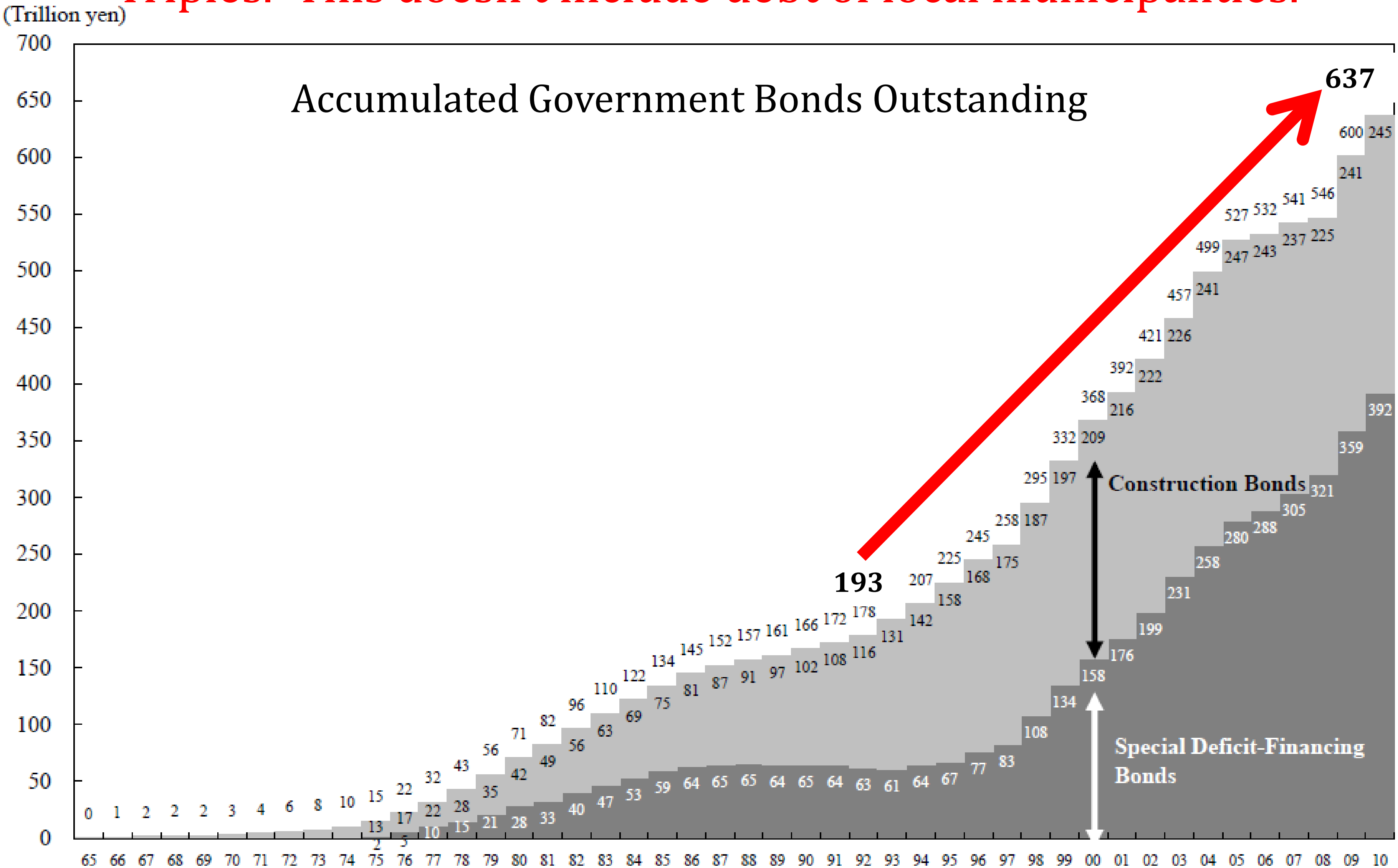
Source: [World Bank]

Government Cuts Taxes and Increases Expenditures to Stimulate Economic Growth



Source: Japan Ministry of Finance

Gross Government Debt Used to Fill in the Budget Gap. Debt Triples. This doesn't include debt of local municipalities.



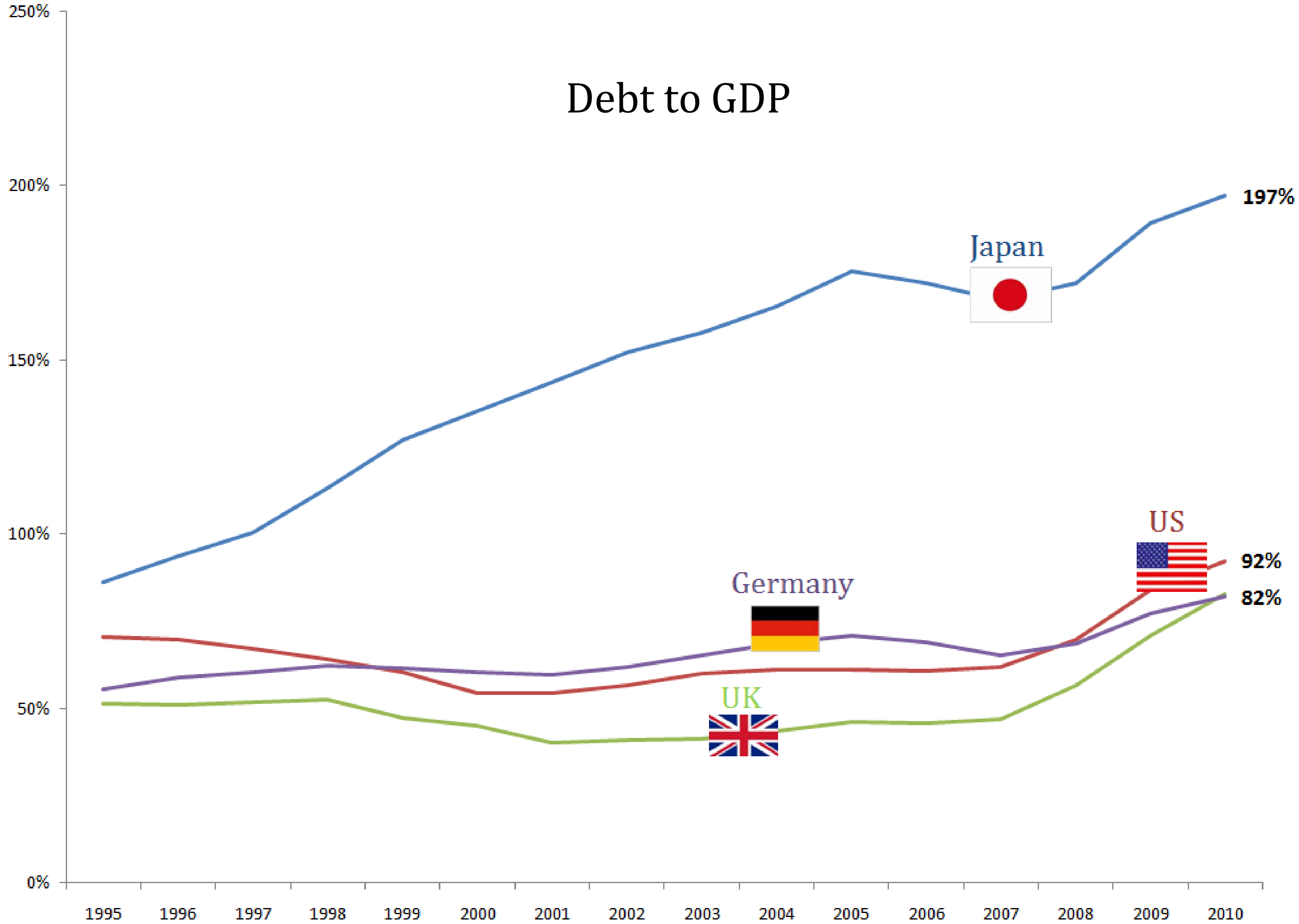
Source: Japan Ministry of Finance

Here is the official explanation by the Japan Ministry of Finance of what took place from the early 1990s to 2000; the same story continues till today.

It all sounds like this: Economy doesn't grow: 1) cut taxes 2) increase government spending 3) raise debt

- Early 1990s: "Japan experienced a serious economic downturn. … Government initiated various economic measures, including a series of large-scale public work programs …. these measures required further issuance of bonds…."
- 1994: "A major tax reduction amounting to … 1.3% of GDP was carried out, with the gap financed by the issuance of special deficit-financing bonds."
- 1995: "A major tax cut amounting to ¥5.5 trillion was carried out… Furthermore… the Government decided to initiate the largest ever economic stimulus package… As a result … government bond issues … reached … 28.0% of total government expenditures."
- 1996: "A major tax cut on the same scale as that in 1994 and 1995 was continuously carried out. … the amount of government bonds issued was … 28.8% of total government expenditures."
- 1997: "the Government decided not to continue the temporary tax cut, and instead raised the consumption tax rate from 3% to 5%. … However, due to the severe economic downturn … decided to carry out a temporary tax cut … government bond issues reached ¥18.5 trillion, or 23.5% of total government expenditures."
- 1998: "**Fiscal Structural Reform Act** … given the still stagnant economic situation, the Government announced two more economic packages, one in April … ¥16 trillion, and … in November… of over ¥27 trillion… bonds issued totaled a record high of ¥34.0 trillion, and the ratio of bond issues to total expenditures reached an all-time high of 40.3%."
- 1999: "Budget was compiled with priority on promoting economic recovery … the amount of government bonds to be issued was … 6.3% of GDP… 37.9% of total government expenditures… Government took measures to deal with the continuous economic slump…. announced **Emergency Employment Measures** … in light of weak private demand and a severe employment situation, the Government decided to use contingencies for public works amounting to ¥500 billion…
- … Government announced **Policy Measures for Economic Rebirth** … This package totaled over ¥17 trillion… government bond issues reached a record high 43.4% of total government expenditures … amount of bonds to be issued soared up to ¥38.6 trillion.
- 2000: "… providing utmost assurance to the Government's economic management in putting the economy back onto the track to a full-scale recovery… budget continued to be stimulative… bond issuances reaching ¥32.6 trillion, or 38.6% of total expenditures … a policy package for **New Economic Development towards the Rebirth of Japan** was issued… As a result, government bond issuances for the year increased to be ¥33.0 trillion, or 36.9% of total expenditures… [Source: Japan Ministry of Finance. Emphasis added and text truncated for brevity.]

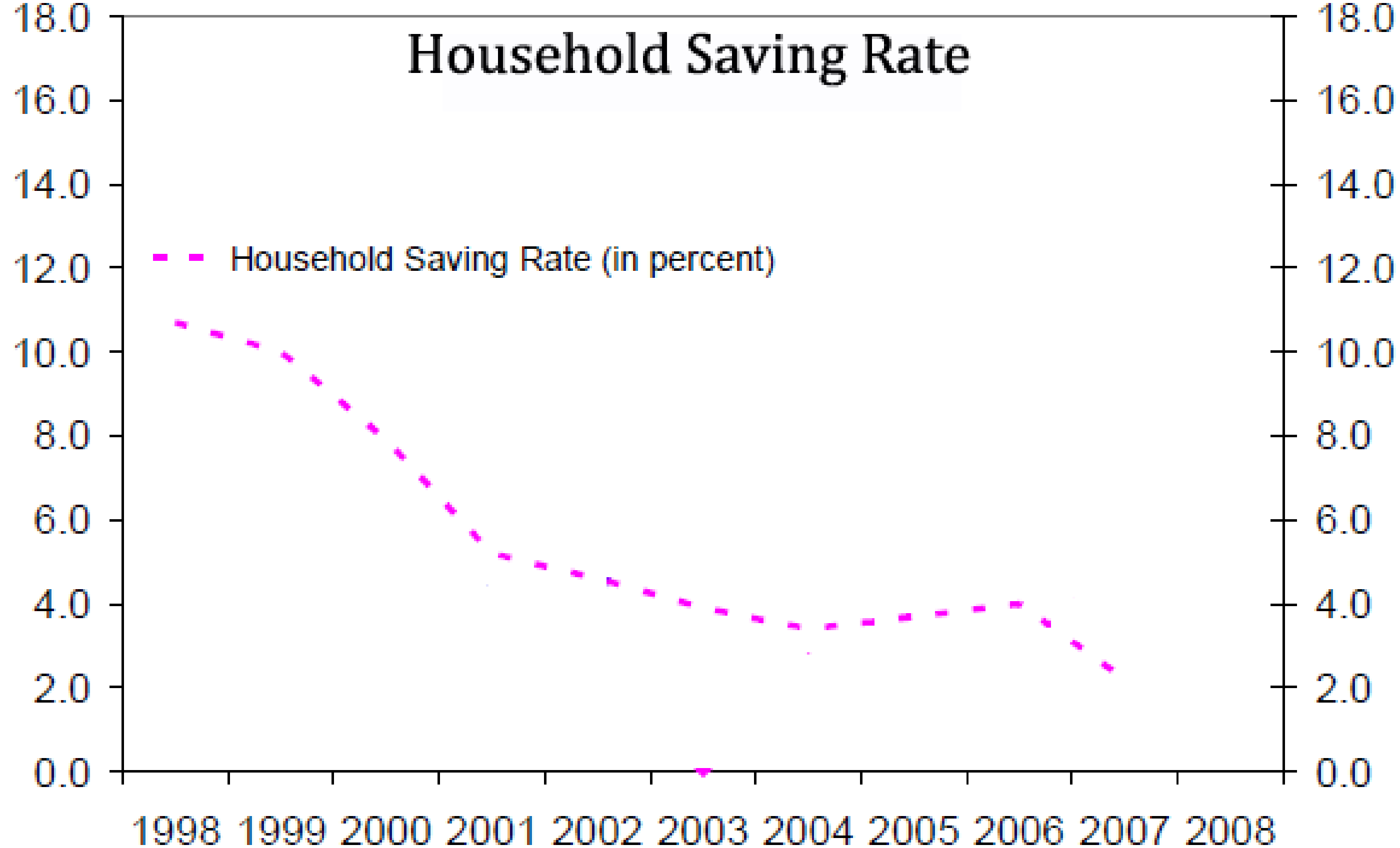
Japanese Debt to GDP by Far THE Highest in the Developed World *



* Second to Zimbabwe if you count developing countries

Source: Japan Ministry of Finance

90% of Debt Financed Internally through Very High Household Savings Rate … But Savings Rate is on Decline



Source: BoJ and cabinet office.
1/ Fiscal year basis.

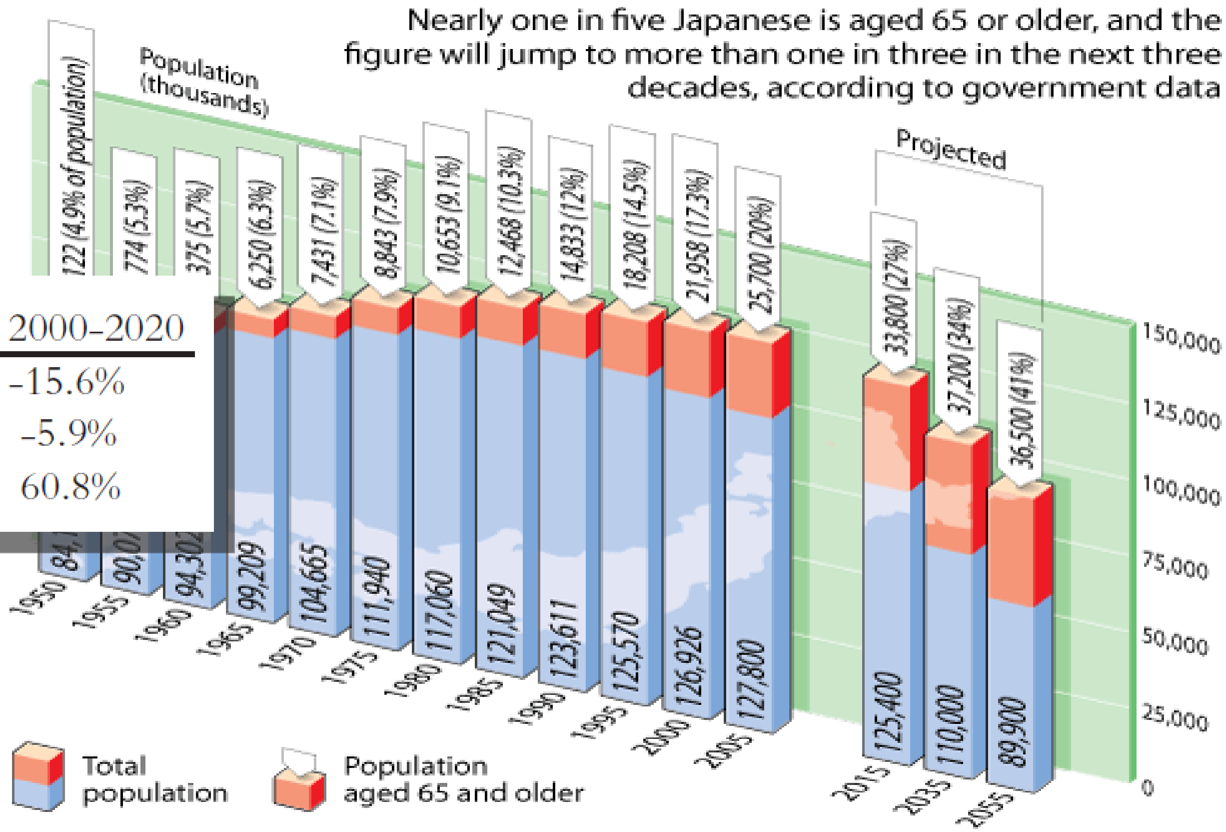
Here is why…

Japan Has the Oldest Population in the World –
Bad for Savings. Japanese Savings Rate is Approaching Zero.

Today 1 in 4 Japanese is over 65 years old

Age group	1980-2000	2000-2020
25-44	-7.3%	-15.6%
45-64	42.1%	-5.9%
65 +	107.9%	60.8%

(Source: Woodrow Wilson Center)



Source: Reuters

As people get older their incomes start to decline, their expenses (health care) rise, their savings rate drops. Their demand for bonds will drop as well – Japanese will become net sellers of bonds.

Population is on Indefinite Decline – Horrible for the Economy and Savings

- One of the lowest birth rates in the world. Pay is based on seniority. Elders make too much money, young too little. Young don't want to start families. (Source: Woodrow Wilson Center)

- Need to have 2.1 births per woman to maintain population size. 2009 birth rate: 1.21

- There is no immigration to soften very low birth rates (Japan is a closed society).

Fertility Rate is on Decline

Year	Total fertility rate	Rank
2003	1.38	202
2004	1.39	200
2005	1.39	198
2006	1.4	197
2007	1.23	212
2008	1.22	213
2009	1.21	216

Source: CIA World Book

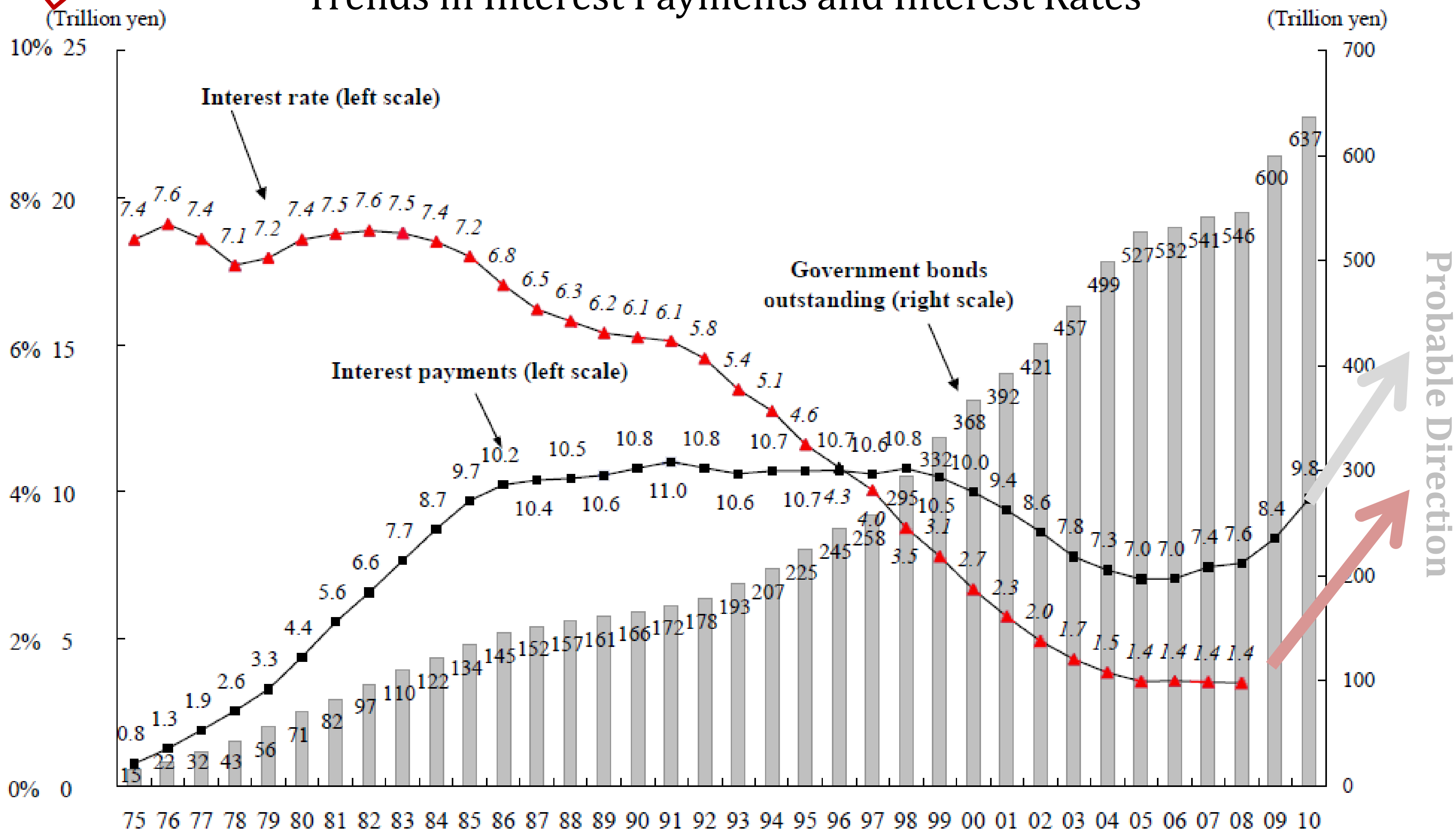
One of the least fertile countries

Declining and aging population doesn't bode well for economic growth. Economic growth is paramount for the economy, whose debt obligations are increasing and interest expense soon will be rising (you'll see).

PAST

Debt Ballooning. Interest Rate Declining. Interest Expense Stays Flat. Cost of Debt Is Manageable.

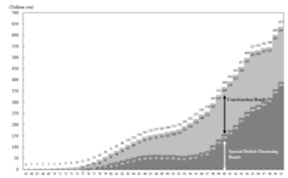
Trends in Interest Payments and Interest Rates

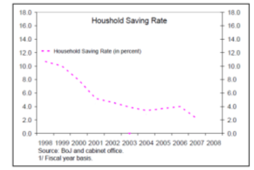


Source: Japan Ministry of Finance

FUTURE

High Supply of Debt + Low Demand for Debt





Higher Interest Rates

1.4% → ????

Even Greater Budget Deficit

Tax Increases

Printing Money

Further Slows Economy

Torpedoes Yen

Higher Interest Rates

Vicious cycle

Japan is in a death trap: it cannot lower interest rates; they are already scratching zero. Higher interest rates will cripple the economy.

Additional thoughts:

- Current interest expense at 1.4% interest rate is 9.8 trillion yen; current expenditure of Education & Science, Public Works, and National Defense ministries is about 5 trillion yen each (source: Japan Ministry of Finance). If interest rates double (i.e. rise to 2.8%) interest costs increase by 9.8 trillion – Education & Science and National Defense both lose funding.

- Today, interest expense is 26.4% of tax revenues (using 2010 estimates). If rates double, interest-rate expense will be 52.8% of tax revenues.

- As Japan starts looking for new (external) investors for its bonds, it will be competing with much higher global interest rates and better sovereign credit profiles. This will lead to a higher cost of debt.

- Population is aging and shrinking, taxes will be going up, interest rates rising – this crashes the budget deficit, and a sovereign debt downgrade will follow – further increasing cost of borrowing – putting additional pressure on Japanese interest rates. Somewhere in between, government starts printing money – this torpedoes currency.

- As a consequence interest rates will rise globally. Japan is the largest holder of the US debt. Normally, yen should substantially depreciate against the dollar, but Japan is the second largest holder of US Treasuries ($760 billion). Japan will have to liquidate at least part of dollar reserves; this should mitigate some of the yen depreciation.

- Though the US doesn't appear to be in terrific shape, comparatively, today, in many respects the US is in much better shape than Japan: Debt to GDP is lower, population is younger, combination of higher birth rates and immigration results in population growth. We have much higher consumer debt, and until recently we had a negative savings rate. However, corporations are much more robust than Japanese; unlike Japanese, they are not managed to maximize employment but for the interest of shareholders.

- If the US doesn't learn from lessons of Japan we'll be in a similar situation in ten or fifteen years. Note however that cultural issues (e.g., not dealing with problems in order to save face) exacerbated Japanese problems.

The lesson we should learn: Continuous stimulus predicated on tax cutting and increased government spending, financed by borrowing (which future generations will have to repay) is not a viable solution to deal with economic slowdown. Eventually, increased debt levels and higher interest rates drive government deficit up, which in turn brings a combination of higher taxes, inflation, and a decline in the dollar.

We should let the economy naturally fix itself. It may be painful in the short term, but it's a necessary, natural process. An economy that has only expansions and no recessions is like heaven without hell.

P.S. I've addressed a similar subject in the article "Chinese Quest in Shortcut to Greatness."

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