

Japan's debt time bomb could detonate the global collapse

by William Engdahl

Late in November, Moody's Investors Service announced that it had downgraded the credit standing of the world's second-largest industrial nation, Japan. The decision by Moody's is highly unusual for a major Group of Seven industrial country, let alone one which is the world's largest net creditor and which holds the world's largest foreign currency reserves, some \$205 billion. Justifying its decision, the rating agency said that it acted "because of the uncertainties and heightened risks over the long term arising from economic and policy weaknesses that have led to significant deterioration in the Japanese government's fiscal position and in the financial system." If anything, Moody's understated the case.

More alarming, Moody's took account of recent major legislative action in Japan, including passage of a 60 trillion yen (\$500 billion) bank restructuring law and the largest economic stimulus package in Japanese history, in deciding, nonetheless, to downgrade the sovereign debt of Japan from Aaa, the highest possible, to the lower AA1 level.

Moody's action, which has been severely criticized in Japanese media as being unwarranted, amounts to a global warning bell for what could well be the next financial system crisis: a collapse of the Japanese bond market.

Opening the money spigot

The real reason for Moody's downgrade of Japan was not the situation at present, bad though it is. Rather, it reflects the explosion of further government debt obligations already in the pipeline. In recent weeks, the Obuchi government has passed a \$500 billion bill which allows the government to nationalize bankrupt or insolvent banks and reorganize them. In addition, the Diet (Parliament) passed a \$200 billion fiscal stimulus bill in November in a desperate effort to jump-start the Japanese economy, now in its worst depression since the late 1920s.

According to a study by Nomura Securities, since the collapse of Japan's asset bubble in stocks and real estate in 1991, the Japanese government has already spent \$714 billion on economic stimulus programs. The results to date, according to Moody's, have been that "fiscal stimulus has only worked for a very short period of time. What did they end up

with after five years? No growth and a huge increase in debt." Today, including certain huge unfunded state pension and other public liabilities, Japan's public debt level is at 111% of Gross Domestic Product, far more than \$3 trillion, for a country of 120 million people. The U.S. public debt totals just more than \$5.5 trillion for a nation of some 245 million, making Japan more heavily indebted, in per-capita terms, even than the United States.

Defenders of the Japanese government policy like to point to the fact that the Japanese bond market has been extremely strong, with the state able to sell its debt despite the meager 0.86% return it offers on 10-year Japanese Government Bonds (JGBs). By contrast, comparable U.S. Treasury debt offers an investor 5.5%. However, the apparent stability of Japan's bond markets gives no grounds for complacency.

According to informed Japanese estimates, more than 60% of Japan's government bonds issued are being bought by the government itself! The government is taking in its own wash. The Ministry of Finance Trust Fund Bureau, as well as the government's Postal Savings Bank, or KAMPO, have taken the lion's share of new government bonds. But that source of bailout for the government may be reaching its limits.

The Postal Savings Bank is the world's largest bank, with more than \$2 trillion in deposits. Because it is a government bank, many Japanese have put their savings there, for fear that the private banks could go under. The government in turn has, until now, been able to use its deposits to fund its own soaring debt. The problem is that KAMPO estimates that it will lose up to 45% of its \$2 trillion in deposits in the coming 12-24 months, when special 10-year high-interest deposit accounts, by law, are due to expire.

Because of this growing inability of KAMPO and the Finance Ministry to continue buying JGB debt, the ministry just announced that it will raise the monthly amount of bonds it sells to private investors from the current 1,400 billion yen, to 2,000 billion (\$16.6 billion) beginning in January. The news triggered near-panic in bond markets as fears grew that there would not be enough buyers for such a huge flood of new bonds, leading to sharp falls in JGB bond prices in the last two weeks of November.

But this is likely only the start of problems in the bond market of Japan. As well, Japanese insurance companies, a traditional buyer of JGB bonds, will be less able to buy the low-yield JGBs. They must desperately search for cash to meet policy obligations as Japan's economy weakens dramatically. Most Japanese life insurers have sold insurance policies or life annuities which guarantee policyholders returns of 4%. But, with the depressed stock market and the extremely low interest rates paid to hold government bonds, the insurers are able to earn only 2% on their investment. As well, Japanese are unwilling to buy life insurance in the depression, leading to a 4% fall in total insurance policies and revenue for the fiscal year ended Sept. 30. Some informed Japanese observers believe that the solvency crisis in Japan's \$10 trillion life insurance sector is the next financial bomb to explode, barring dramatic improvement in the economic situation. So far, no one in the government dares talk about what the cost of a public bailout of Japan's weak insurance sector could mean to bondholders.

Making matters worse, Japan is about to be hit with a demographic explosion of retirees at a time when the economy is in depression and the birth rate is among the lowest of the major Organization for Economic Cooperation and Development countries. Simply put, the state is legally obligated to pay unprecedented levels of public pensions at just the time, about 2002-2003, that its spending to try to reverse the economic and banking debacle will also demand the highest outlay from the government.

Worse than Brazil?

On Nov. 25, the Japanese government announced that because of the sharp decline in corporate tax revenues, Japan would face an estimated \$83 billion tax revenue shortfall in the budget for the fiscal year ending March 31, the lowest revenue level since 1987. This will create a national budget deficit which will hit 9.8% of Japanese GDP, significantly larger even than that of the troubled Brazilian economy.

But the sad state of national government finances only tells part of the story: Japanese municipal governments are on the verge of bankruptcy. Tax revenue shortfalls for Japanese municipalities this fiscal year are estimated to be at least 3 trillion yen (\$24.5 billion), more than double the worst year on record. By law, Japanese cities are prevented from paying out annually more than 20% of their budget in debt service costs. Some 31 prefectures have hit the "warning" level of 15%, and six are already at the 20% limit.

In addition, local governments floated tens of billions in municipal bonds after the collapse of the bubble economy in 1991. By next March 31, the total of municipal debt outstanding in the form of municipal bonds will hit 160 trillion yen (\$1.3 trillion), an increase of 130% since 1991. As much as 50% of national government public works programs calculate an equal share in local government spending. With cities on the edge of bankruptcy, clearly the optimistic projections of

the Obuchi government for its stimulus are in grave doubt. Instead of helping stimulate their local economies, Japanese local governments are being forced to impose harsh new austerity. Some cities have begun to levy special fees or taxes for parents of children in high school, over and above normal local taxes, to raise funds. The effect is worsening depression of the overall Japanese economy. Japan is in a vicious, self-feeding deflationary spiral at this point.

Nomura Securities estimates that for the present fiscal year and the next, the central government will have to raise 52 trillion yen (\$436 billion) by issuing new bonds. With its own government agencies unable to continue the present buying levels of some 60% of new bonds, and private banks and insurance companies beginning to worry about a fall in bond prices, the fear is that it would take little added pressure to trigger a panic sell-off by bondholders.

Were the Japanese bond market to crash in coming months under these combined stresses, the shock would devastate the fragile global financial architecture. Soaring interest rates in Japan would cripple any possibility of economic recovery at its most delicate phase. As well, under Japan's new financial "Big Bang" deregulation rules, Japanese private investors can now easily take their savings and invest them outside Japan. Were capital flight to snowball under conditions of worsening Japanese bond and stock markets, it could mean a renewed collapse of the yen, and could put enormous pressure on Japan's huge holdings of U.S. Treasury bonds and bills.

Japan's troubled banks at this point would be one of the worst hit in any collapse in the Japan bond market. According to a recent study by Goldman Sachs, almost 30% of the total assets of Japanese banks today are held in the form of Japanese Government Bonds. With the value of their permanent stock holdings vanishing to negative worth with the Nikkei at 14,000, were their huge bond holdings to collapse further in price, a chain-reaction of Japan bank insolvencies could rapidly overshadow the present problems of Japanese banks.

Informed private estimates by McKinsey-Japan, a consulting firm, place the total bad loans held by Japanese banks at some \$2 trillion, well above the official figure of \$660 billion. This includes significant bad loans on the books of KAMPO and other government banks. At least \$1.2 trillion of that total is reportedly held by the private banks, the result of eight years of inability to forge the far-reaching internal consensus needed to radically reorganize the entire structure of Japan, Inc. Had the government stepped in in 1991 and closed bankrupt banks, wiping the slate clean, and recapitalized healthy banks to lend to the real economy, Japan today would likely be the engine of a global industrial boom, rather than the albatross around the global neck. The coming few months will pose the most awesome challenge to date for the embattled Japanese political system. A New Bretton Woods system is very much still on the agenda.