Japan

The fears about Japan's debt are overblown

Despite threats of fiscal disaster, the trade against government bonds is a 'widow-maker'

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One quadrillion yen. ¥1,000,000,000,000,000. Two hundred and thirty nine per cent of gross domestic product. Simply to state the epic size of Japan's public debt invokes a frisson of disaster foretold and virtuous warning duly given. A debt so large must surely end in financial catastrophe. Just look at Greece. Argument over. Do something and do it now, you deadbeats.

Debt paralyses economic debate in Japan, suppressing political differences over tax or spend, and hanging over all efforts to stimulate the economy. Yet despite two decades of warnings about fiscal Armageddon, a debt crisis never arrived. It never even came close, despite shocks on the

scale of Lehman Brothers and the Tohoku earthquake. Traders have a name for the bet against Japanese government bonds: "the widow-maker".

Financial morality tales usually end with a purifying crisis, to cleanse the vice of debt. But it is time to accept that such a crisis may never happen. So far, Japan has provided smoothly for the world's fastest-ageing population. It is the inchoate and incoherent fears of a debt disaster that have led to serious policy mistakes, such as the 2014 rise in consumption tax that choked off economic recovery.

There are only four ways a country can resolve a large public debt: growth, repayment, default or inflation. Growth is out. Whatever prime minister Shinzo Abe says, Japan cannot outgrow its liabilities while the population shrinks, no matter how many trade deals it signs or reforms it concludes. Large-scale immigration would change everything, but debt ratios should not decide so fundamental a social choice.

Repayment is almost as difficult. It would require a budget surplus over many years despite ever greater spending on healthcare, pensions and national defence. In turn, a surplus requires a corresponding deficit for consumers, companies or foreigners. Given the expectation of higher taxes and uncertain pension provision, Japanese households seem unlikely to run down their savings aggressively.

That makes the two crisis outcomes — default or inflation — seem inevitable. Default, however, makes no sense at all since almost all of Japan's debt is owned by the central bank and the domestic financial system. If it did not repay, the government would simply have to recapitalise them. It would be defaulting on itself.

Higher inflation — at or a bit above the 2 per cent inflation target Japan has missed for the past couple of decades — would help, not hurt, by gently eroding debt. Just possibly, in the transition to higher inflation, the Bank of Japan might lose control and let prices take off. But the government has little incentive to pursue an inflation tax. Japan is an asset-owning country full of price-conscious pensioners. There is no quicker route to political suicide than destroying their savings.

All four routes to resolving the public debt seem improbable. Nor is there any obvious reason, given that Japan is the world's biggest international creditor, why investor panic and flight from the yen should force it to choose among them.

That leaves a more plausible fifth option. Do not resolve the public debt. Live with it. This is surprisingly do-able.

In a forthcoming update to a prescient 2005 paper casting doubt on the likelihood of a debt crisis, Columbia University economist David Weinstein and co-author Mark Greenan find three reasons why Japan has avoided a bond panic: falling interest costs, ruthless control of spending on the elderly and a big rise in taxes.

The real interest rate Japan pays on its debt has fallen steadily. With short-term interest rates now negative, the country gets paid to borrow for short periods. The interest bill is even more manageable after factoring in revenues from Japan's foreign exchange reserves and other public financial assets. As a result, economic stimulus under Mr Abe has finally stabilised Japan's debt after years of relentless increase. It was 237 per cent of GDP in 2012. The International Monetary Fund forecasts 232 per cent of GDP for 2022.

Low interest rates mean the existing debt simply does not matter that much for fiscal sustainability. More importantly, and belying its reputation for wasteful public works, Japan has made a series of tough decisions on healthcare and pension spending. Real per capita outlays on the elderly have fallen. Tax revenues are up by six percentage points of GDP since 2000. "If this approach continues," write Mr Weinstein and Mr Greenan, "Japan may very well avoid either a financial crisis or a major inflationary episode."

Japan cannot afford to splurge. As the baby boom generation reaches old age, it will need to means test benefits and raise more revenue from wealth and consumption taxes. But Japan has shown it can do so. It is time, therefore, to drop the fears of imminent crisis and the demands for instant fiscal tightening. Mr Abe's policies have stabilised Japan's debt. It is imperative to keep them going until inflation is high enough to cut interest rates during a recession and the economy is strong enough to run a fiscal surplus during a boom.

A country with Japan's demographics will always be close to the edge. With discipline on spending, however, there is no reason to fall off it. The widow-maker has plenty more victims in it yet.

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