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The Urgency of Fiscal Reconstruction: Before Strain becomes Critical

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Japanese government bond prices remain high

Japan's public debt is approaching a level of 200% of GDP. This level stands out among the world's major nations. Looking at revenue and expenditure in terms of flow, we find expenditure exceeding 90 trillion yen against tax revenue of around 40 trillion yen. This situation is somehow maintained by massive issues of government bonds, but it is a fiscal situation that no one could consider sound or healthy.

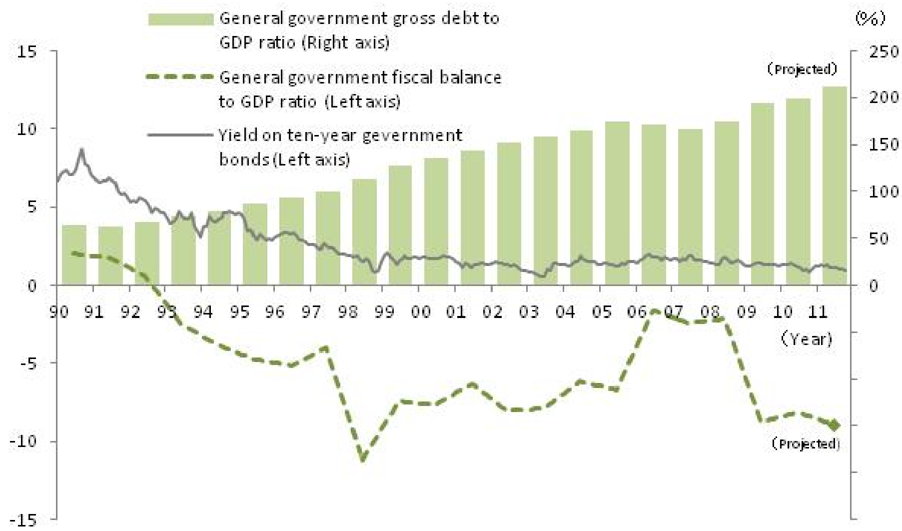
Even more serious is the increasing burden on the nation's finances represented by its low birth rate and aging population. As social security costs balloon, fiscal management will face a situation of increasing severity. We focus exclusively on the debt generated by the past deficit, but the really serious issue is the predicted future burgeoning of social security costs.

Despite the fact that the figures indicate a serious fiscal situation, prices of Japanese government bonds are the highest they have ever been. For bonds, the higher the price, the lower the yield. In the case of Japanese government bonds, the yield of even long-term 10-year bonds is at the historically low level of around 1%. As debt securities of a government with massive debts, the market underwrites Japanese government bonds at extremely low rates of interest. The low yields on government bonds have thus assisted the Japanese government in its fiscal management (Figure 1).

However, the high price of Japanese government bonds increases concerns over sovereign risk. The higher the price of underwritten bonds, and the greater the value of the bonds held, the greater the losses which will be suffered by financial institutions if prices decline. If the interest rates of government bonds increase, the burden of interest payments when new issues are made and when bonds are refunded will increase, making fiscal management more difficult for the government. It seems inherently impossible for a state of ultra-low interest rates – the lowest in history - to continue indefinitely.

Nevertheless, it appears that many people involved in finance believe that low interest rates will continue for the near future. The majority of Japanese government bonds are consumed by domestic savings. Given their need for ample stable assets, financial institutions such as banks which function as intermediaries have no choice under the present economic circumstances but to direct funds into government bonds. Selling pressure is not likely to arise in a situation in which an abundance of savings exists and these savings must be directed towards government bonds. Therefore, it is considered that interest rates will remain low for the near future. However, if one is persistent in asking whether it is safe to hold so many government bonds, uneasy looks start to appear. No one is certain that Japanese government bonds will maintain their current high prices.

Figure 1 The State of Japan's Finances and Yield on Govenrment Bonds
How long will bond yield remain low?



(Note) 2011 figures for general government fiscal balance and gross debt to GDP ratio are projected figures.
(Source) Compiled from OECD "Economic Outlook 89 Database" and Datastream.

High prices are supported by deflation

Many economists have warned of looming fiscal problems for more than ten years. They have stressed that if the present situation continues, government bond prices will collapse and the situation will become desperate. Certain politicians and participants in the finance industry respond to these concerns by pointing to high bond prices and claiming that economists are simply crying wolf. But this is a dangerous strategy. It encourages the view that the government bond situation will remain stable.

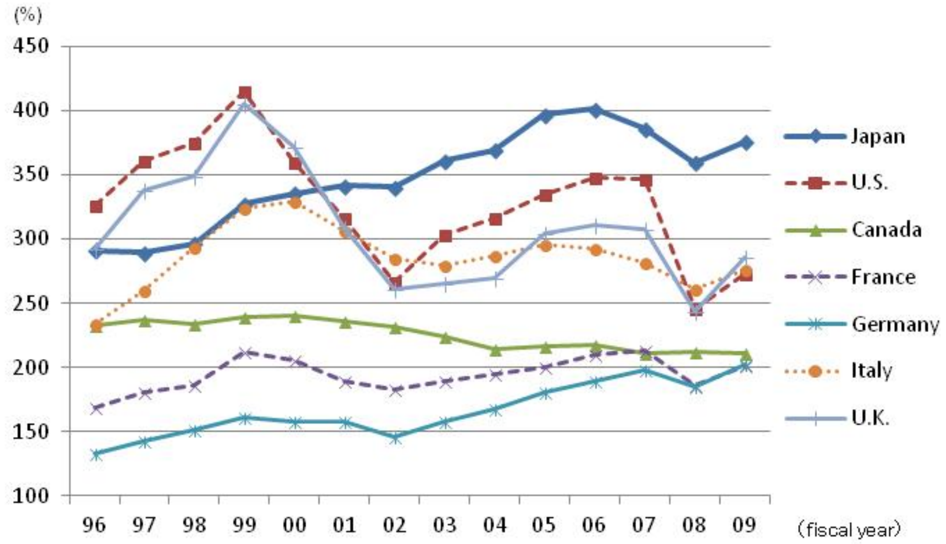
It is essential to consider this issue by asking why bond yields are so low despite the fact that the government’s outstanding debt is increasing, i.e. why bond prices are so high.

One reason that can be pointed to is powerful deflation. The Japanese economy has been in a state of deflation for more than ten years. Not only have prices displayed a declining tendency, but companies, households, and financial markets have all behaved in ways that reflect this fact. The household sector has devoted itself to saving. The curbing of unnecessary expenditure has been proportional to the strength of feelings of anxiety regarding the future.

As Figure 2 shows, while we can see the effect of fluctuations in stock prices and other factors, the ratio of net financial assets (excluding debt) to annual disposable income in the household sector has displayed an increasing tendency, and has recently increased approximately fourfold. Figures for other countries are not only lower, but have also not displayed the conspicuous increase we see in figures for Japan. The comparison demonstrates the defensive stance of the Japanese household sector. As a result of this defensive stance, internal demand stagnates, and at the same time the nation's massive savings flow to the financial markets.

Figure 2 Changes in the Ratio of Net Financial Assets to Annual Disposable Income in the Household Sector

Anxiety towards the future is curtailing consumption in Japan's household sector.



(Source) OECD "Economic Outlook 89 Database".

The corporate sector has adopted similar behavior. Following the collapse of the bubble, Japanese companies proceeded to adjust their balance sheets. They cut debt, curbed investment in facilities, and pushed ahead with restructuring. Companies found themselves with available funds on an unprecedented scale. Internal demand stagnated and accumulated corporate funds also flowed into the financial markets.

The accumulated funds that flowed into the money markets were directed towards large-scale purchases of government bonds. Amid a sequence of financial crises (the collapse of the bubble, the financial crisis of the late 1990s, the Lehman Brothers collapse), funds tended not to be directed towards investment in high-risk assets, and corporate demand for funds was weak against a background of deflation and economic stagnation. Financial market rules under the BIS framework also serve to encourage financial institutions to purchase government bonds as "safe assets."[*1]

As long as a state of deflation continues, interest rates should remain low. And as long as interest rates remain low, holding Japanese government bonds will not present an issue. In a deflationary state, the huge amounts of accumulated funds in the household and corporate sectors will continue to flow into financial markets, their use to purchase government bonds will continue, and the interest rates of those bonds will continue to remain low. This is how financial markets are thinking. But how long can this situation really last?

The strain building up in economic fault lines

In his book *Fault Lines: How Hidden Fractures still Threaten the World Economy*, Universitiy of Chicago professor Raghuram Rajan uses the analogy of fault lines to discuss strain in the economy. When strain and energy build up in fault lines, at some point that energy is released, resulting in an earthquake. In the same way, when strain builds up in economic fault lines, at some point it will result in a financial crisis, as for instance in the collapse of a bubble or of government bond prices.

Even as strain builds up in fault lines, the surface of the earth remains stable until an earthquake occurs. Nevertheless, seismologists investigate fault lines and warn us of earthquakes. For years they pointed out the risk of major offshore earthquakes in the Tokai and Tonankai regions. Up to the present, no major earthquakes have occurred in these areas. But surely there are few who would claim that seismologists are therefore crying wolf.

Government debt presents us with some similarities. As long as the interest rates of government bonds remain low, no visible problem is presented by the fact that government debt has reached an enormous magnitude. There is no problem as long as the market continues to absorb bonds despite the fact that the government balance sheet continues in the red. As already indicated, if a deflationary state continues, an environment promoting problem-free consumption of government bonds will continue. However, the more that the government's outstanding debt swells as a result of this situation, the graver the implications of the existence of fault lines in the economy. In the case of earthquakes, if small earthquakes occur frequently while the level of strain in the fault lines is low, it is unlikely that a large earthquake which releases significant amounts of energy will occur. Similarly, if interest rates increase while the level of government debt is not particularly high, the problem will not be particularly serious.

Unfortunately, we are steadily progressing in a direction that will make the problem very severe. A budget in which tax revenues account for less than half of expenditure must be considered abnormal. Fiscal discipline is not being exercised at all, and if the situation is left as it is, matters can only become worse. The existence of abundant domestic savings, and the fact that those savings must be directed towards government bonds, has resulted in a weakening of fiscal discipline.

Figure 3 Government Debt to GDP Ratio in Past Cases of Financial Crisis/Collapse
The level of government debt leading to crisis or collapse varies from case to case.

Major cases	Gross debt to GDP ratio at time of occurrence
(1)Financial collapse in Japan	
End of WWII	204% (1944)
(2)Large scale financial collapses in emerging nations	
Russian crisis	73.1% (1998)
Argentine crisis	43.0% (1999)
(3)Financial crises in developed nations	
IMF crisis, Britain	51.8% (1976)
Swedish crisis	78.2% (1993)
Italian crisis	106.9% (1992)
European debt crisis	Greece: 131.6% (2009) Ireland: 102.4% (2010) Portugal: 103.1% (2010)
(Reference) Cases of success in reducing debt	
Post-WWII Britain	269.8% (1946)

(Note 1) "Financial crisis" refers to spirals in interest rates, precipitous declines in currency value, etc. against a background of deteriorating finances, and situations necessitating requests for assistance to the IMF or other organizations; "financial collapse" refers to situations in which a government defaults on its debt, there is a rapid increase in inflation, etc.
(Note 2) Post-WWII Britain was able to reduce an extremely high level of public debt due to factors including the ability to reduce military expenditure and postwar economic growth, inflation, etc.
(Source) Formulated based on NIRA (2011)

Assuming that the present situation continues, when will bond prices plunge? It is difficult to predict when turmoil will occur in the bond market, just as it is difficult to predict when an earthquake will occur. Greece is now facing immense difficulties, but Greek bonds were stably consumed until only several years ago. Looking at examples from history, while there are countries with debt to GDP ratios of 100% or below which experienced financial crises or debt defaults, we also find the case of postwar Britain, which restored fiscal soundness despite a debt to GDP ratio of close to 300% (Figure 3).

Factors promoting a decline in bond prices

A number of factors which might promote a decline in bond prices can be pointed to. One of these is the end of deflation. As will be clear from the discussion up to this point, if deflation ends and company funds begin to be directed more actively towards investments, the funds that support the purchase of government bonds will thin. Further, if the market predicts inflation, interest rates will reflect this fact and begin to increase. Japan's deflationary state will not lift so easily, but this is not to say that it will last forever.

Another factor to be considered is the fiscal problems occurring overseas. The financial crises in Europe are, for the moment, shifting funds towards the yen as a stable asset. This is a factor promoting a high yen, further increasing the price of government bonds. However, the developed nations are all facing the aging of their populations, and government financial management is facing increasing difficulties in both Europe and the U.S. These fiscal problems are common to developed nations, and there is no reason to assume that they will not manifest as sovereign risk and have repercussions in Japan.

The ongoing aging of Japanese society is another factor. We have indicated that Japan's household sector has abundant savings, but the sector's rate of saving is even now declining as the number of retired households increases with the aging of the population. If things continue without change, it will eventually become impossible for Japanese government bonds to be supported by domestic savings.

There is also another factor that causes concern. This is political risk. The market supports government bonds at low rates of interest because there is an expectation that fiscal soundness will eventually be restored. The tax burden on Japan's citizens is still low. If taxes are increased and the social security system is reformed, Japan's finances will become sound over the long term. Given this, there is no need to worry even if government debt increases in the short-term. This is how the markets think. However, considering the government's confusion with regard to fiscal management, there is a possibility that a pessimistic view, questioning the ability of Japan's politicians to restore fiscal soundness, may gain ground. If this happens, there is no guarantee that bond prices will remain high.

"If we're all in it together, there is nothing to fear." This phrase exactly captures the herd mentality of assets markets. The idea that there is nothing to worry about because most financial institutions are purchasing government bonds is an example of this herd mentality.

However, one mistake can shift herd mentality in the opposite direction. No financial institution could very well remain alone in retaining its government bond holdings when other institutions around it were selling theirs. Political trends exert an influence on herd mentality of this type.

Fiscal soundness will be restored by increasing taxes and reforming the social security system

Partisans of direct economic stimulus claim that tax increases are out of the question at present, in the wake of the tsunami disaster and against the background of fears of a global recession. But this argument is not new. Arguments of this type have been used to postpone tax increases for almost twenty years. If these arguments continue to be made, tax increases will be deferred indefinitely. However, the longer that the government puts off the work of fiscal reconstruction, the greater the difficulty of achieving a soft landing. Today's Greece presents us with a model case. The Greek government worked extremely hard to increase taxes and cut expenditure, but this was drastic medicine that had a powerful impact on the lives of Greek citizens. When the economy worsened, tax revenues declined further. In a vicious cycle, this prompted further measures to achieve fiscal soundness. The backlash against the government among citizens increased in strength.

Viewed from outside, the actions of the Greek public seem unreasonable. The nation's financial difficulties emerged from a reliance on lavish government expenditure in a "civil servant's paradise." It is odd, then, to complain that fiscal reconstruction is making life difficult. Slovakia, with average incomes of around one-third of Greece, instituted stringent measures to realize fiscal soundness in order to become a member of the EU. The Slovakian public must be wondering why they are required to bail out the selfish Greeks.

But this is the essence of fiscal reconstruction. Finances become problematic because the tax burden on the public is too low, or expenditure is too high. Low taxes and generous government spending are desirable to the public, but if such a situation goes too far, it can only be considered populist politics. As populist politics become further entrenched, the difficulty of achieving a soft landing in the painful process of fiscal reconstruction increases. If it had not entered the eurozone, Greece would presumably have suffered the hard landing of a financial collapse. But entry into the eurozone is no guarantee that this will not happen in the future.

Is Japan a victim of populist politics? I will refrain from comment on this issue, as I am not a specialist in political science. I will simply point out that a situation in which the government continues to amass debt without increasing taxes and without reforming the social security system presents aspects that must be pointed to as populist politics. Fiscal reconstruction does not happen by magic. Some of Japan's politicians believe that inflation should be stimulated on purpose. Clearly, it is possible to make active use of monetary policy in order to overcome deflation. However, even if we assume that an inflationary policy is able to significantly reduce Japan's massive public debt, such a policy would have a tremendous impact on the economy. This, precisely, would be a hard landing.

In order to achieve a soft landing in the process of fiscal reconstruction, there is no choice other than increasing taxes and reforming the social security system. Here again, the longer that these reforms are postponed, the greater the difficulty of achieving a soft landing.

Fiscal reconstruction takes time. However, it is important to clarify the direction for long-term fiscal reconstruction at the earliest possible stage and to adopt a stance that indicates seriousness with regard to the steady implementation of the necessary measures. Demonstrating to the market that Japan's finances are sustainable over the long term is the best method of avoiding a collapse in bond prices.

This paper has discussed Japan's public debt problem using the analogy of a fault line. In the case of actual fault lines, it is not possible to release strain by digging down from the surface. If there is a possibility that an earthquake might occur, the only choice we have is to accept that fact and attempt to minimize the damage. But fault lines in the economy are different. The strain of public debt can be released by means of policy responses. It is imperative that we release that strain before it becomes too great to control.

Note

*1 The BIS regulations are regulations concerning debt-to-capital requirements for banks formulated by the Bank for International Settlements in order to ensure financial soundness among banks. The regulations demand that banks maintain their debt-to-capital ratio, determined using equity capital as the numerator and the magnitude of risk as the denominator, at a fixed level. For the risk weighting applied when calculating the assets making up the denominator, government bonds of the bank's country of origin count as 0%.

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