

JAPAN'S DEBT BOMB

Tick, Tick, BOOM?

In the late 1980s, Japan was set to buy the world, investing US\$650 billion abroad in American icons such as Rockefeller Center, Columbia Studios and Pebble Beach golf course. Since the early 1990s, however, annual growth has averaged just 1%, in what has been the deepest slump of any developed economy since the Great Depression.

東証1部	現在値	1324.49	円
日経店頭平均	現在値	124.75	円
ト(東京)	現在値	9845.15	ドル
ダウ	現在値	99082	万株
株式出来高	終値	1745.71	株
スタック指数	終値	12865	円
CME日経平均先物	1ヶ月	12620	円
日経先物1ヶ月	現在値	13000	円
日経平均コール1ヶ月	現在値	13000	円
日経平均プット1ヶ月	行使価格	13000	円
TOPIX先物1ヶ月	現在値		

By Rohit Gupta

The Nikkei 225 is currently hovering around a 20-year low, down almost 75% from a peak that saw it hit values of 38,900.

That was back in 1982, when Michael Jackson's *Thriller* ruled the pop charts and the musical *Cats* first opened on Broadway. For a brief moment, the Nikkei stood at almost 14 times the value of the Dow Jones Industrial Average, which it has recently fallen below for the first time since 1957.

Land prices have been in decline for 11 years in a row, having shed 80% of their worth since the late 1980s, when the theoretical value of the grounds at Tokyo's Imperial Palace exceeded the value of the State of California.

Now unemployment stands at 5.3%, just below a post-war peak of 5.6%, and interest rates are close to zero. Enormous fiscal injections by the government have turned a budget surplus amounting to 2% of GDP in 1990 into a deficit of 8%, with government debt standing at 140% of GDP – the US government's debt comes to 60% of its GDP. And a sovereign credit-risk rating of 'Aa3' with a negative outlook puts Japan on a par with Poland and South Africa.

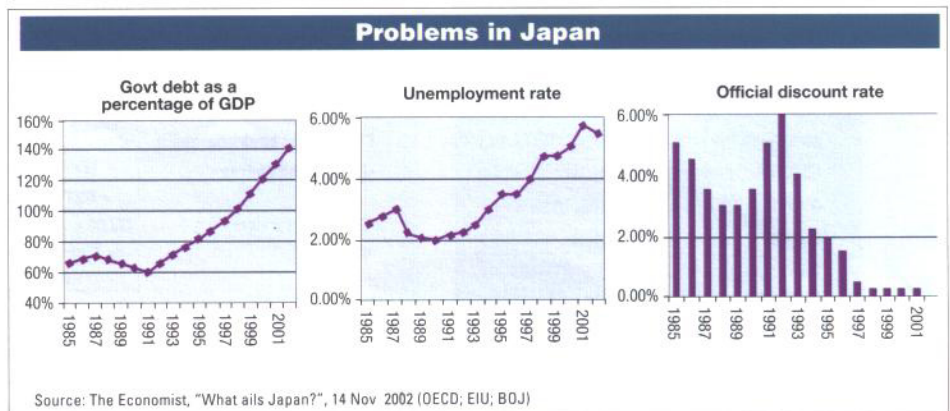
Now the country faces two dangers – deflation and an economic contraction. The vicious circle goes something like this. Prices are falling due to tepid consumption, so companies are producing less and selling what they do make at lower prices. That has caused them to cut back on staff and capacity, and people are now spending less because of the uncertainties of unemployment.

Added to that is the fact that companies with large inventories and losses are chalking up bad debts that are preventing banks from lending to new businesses, even the small or medium-sized enterprises that are doing quite well.

Some commentators like to point out

that Japan is so rich that it can buy its way out of financial collapse, because the debt overhang is effectively a case of Japan owing itself money. This is not, they repeat not, like Argentina, Russia or Thailand. And they are right in a sense – it could potentially be far worse (see **How overleveraged is Japan?**).

Japan has savings of US\$11 trillion, but the total on-and-off-balance-sheet claims (household, corporate and government) are estimated to be about US\$30 trillion, six times Japan's US\$5 trillion GDP. In the US, total private and public debt is US\$19 trillion, which is just twice the country's GDP, and in Japan the ratio is getting worse by the



How overleveraged is Japan? Just compare...

Japan's debts as a percentage of GDP		US debts as a percentage of GDP	
National debt	143	National debt	37
Off-balance-sheet claims on Japanese government	280	State and local governments	14
Bank loans (corporate and consumer)	132	Household debt	77
Non-bank-loan corporate debt	54	Business debt	70
TOTAL	609	TOTAL	198

Source: Forbes Global, 18 Feb 2002 (Goldman Sachs; Daiwa Securities)

month thanks to deflation running at 4% a year.

At the same time that Japan faces a debt bomb, it is also the world's largest creditor. It has US\$3 trillion in overseas assets, much of which is in US Treasury bills and bank loans to Europe. If Japanese banks get the jitters and start calling in overseas loans then an economic contraction would sweep the globe.

Japan's situation is not, some commentators repeat not, like Argentina, Russia or Thailand. And they are right in a sense – it could potentially be far worse.

Consider what happened on a far smaller scale in 1997. Within three months of the collapse of Hokkaido Bank, which had assets of US\$80 billion, Japanese financial institutions pulled US\$118 billion out of the global economy, with most of it being withdrawn from Asia. That move turned Thailand's problem into a regional crisis and bankrupted South Korea, the world's tenth-largest economy.

London's Independent Strategy concluded recently that, "There is no record of any government ever being able to repay debts equal to several times the annual output of its country in real money. Japan will be no exception."

Catch 22

The Japanese economy cannot be put on a stable footing without fixing the banks,

but the banks cannot be fixed without re-inflating the economy. The problem facing Japan's banks is the same problem facing Japan's economy: companies simply cannot make a profit. There is no solution to the bad-debt problem without a solution to Japan's basic economic problems.

Banks eliminate bad debt year after year, but companies have been defaulting at a faster rate, leaving the country's financial institutions with more debt than before. Since 1992, Japanese banks have taken US\$660 billion of bad-debt losses but during that time the amount of bad debt remaining has increased from US\$103 billion to US\$340 billion. This has created the illusion that banks are doing nothing, but even if they were to wipe their books clean of bad debts overnight, they would continue to pile up at a rate of US\$50 billion to US\$75 billion a year.

The question is, what can anyone do about it? There is always a range of opinions about the direction of any major economy, but the divergent views over Japan are notable for being so polarised, even amongst mainstream economists and academics.

The more conventional view is that the economy is foundering because of a lack of domestic demand. People are not spending enough, so the government should step in and spend more to fill the gap. The prescribed cure – to borrow, tax or print the required amount of money – should stop deflation by making prices rise again.

Others argue, however, that Japan's economic structure is out of date, too reliant

Japanese property values have plummeted



on manufacturing and now artificially propped up by near-zero interest rates. Along with the slump in demand, Japan is thought to be suffering from overcapacity, particularly in the construction and retail sectors. Many such companies are never likely to be profitable yet banks prop them up so that they will not go bankrupt, which, unfortunately, means resources are tied to low-return industries.

Impediments

A sea of subsidies

The Japanese government continues to provide subsidies, guaranteed loans and tax incentives for tiny 'mom-and-pop' stores. These account for 55% of employment in Japan, compared to 19% in the US and 26% in France.

Barriers to entry

Food-processing tariffs are levied on the difference between the price of imported meat and vegetables and Japan's domestic produce.



The solution to this problem is to increase interest rates, making it difficult for inefficient companies to service their debts and, eventually, forcing foreclosure, releasing labour and distributing capital more effectively.

The third alternative is that today's woeful economic performance is not so much a reversal of fortune as a revelation of the hollowness of Japan's success in the 1980s. Even then, it is argued, Japan suffered from a 'dual economy', with a small group of world-beating exporters that everyone knew about obscuring a large group of laggards, hidden from the public's view.

Today, the illusion that made this possible in the first place lies shattered. Japan's leading car and electronics industries have already shifted most of their operations to lower-cost regions outside Japan. Left behind are the same old troubled, uncompetitive companies that cannot survive without the subsidies that Japan can no longer afford.

Feudal Japan?

Chu-sho kigyo, or Japan's small and medium-sized companies, make up more than 99% of Japanese industry. According to Ministry of Finance statistics there are roughly two million joint-stock corporations registered in Japan, three quarters of which are capitalised at under US\$70,000.

Keiretsu – a group of affiliated companies working towards each other's mutual success; the link between government and business.

The troubled retailer Daiei operates eight restaurants, seven hotels and a baseball team. The company is US\$17 billion in debt and survives on a lifeline from its banks.



Japan's small and medium-sized companies are finding it hard to secure bank loans

In the late 1980s, the theoretical value of the grounds at Tokyo's Imperial Palace exceeded the value of the State of California.

The rationale (and trap?)

In a more open society new entrants would enter the market and drive all these inefficient domestic players away. Yet the Japanese economy is far from open. In a misguided effort to protect jobs and maintain stability, the government subsidises inefficient players and blocks the entry of competitors. Bizarre as it may appear to outsiders, Japanese policies are driven by two rational objectives: to finance industry, and to ensure economic autonomy and political stability.

For a long time, this strategy worked. Four decades after the second world war left Japan in ruins, the country grew into one of the world's most formidable industrial machines, while the constant flow of subsidies to powerful political groups like farmers, shop owners and construction companies has brought 50 years of political peace.

There is no single solution to Japan's

ills. Neither a depreciating yen nor monetary expansion by the Bank of Japan will bring the country's economy back to life, and the same goes for fiscal reform, privatisation, deregulation, mass bankruptcy and the nationalisation of the banks. The government needs to do all of these things over a period of years, and the process will be painful.

Japan could, of course, continue to muddle through, with one or two years of further contractions accompanied by steady economic restructuring and, hopefully, a recovery in 2004. The country might, though, keep decaying until it reaches developing-nation status, much as Argentina has done since 1945. Worse still is the possibility of a collapse akin to that which befell Russia.

All is not lost. Analysis by the McKinsey Global Institute suggests that if the impediments to competition are removed then productivity could grow by as much as 4.7% a year for the next 10 years, which, assuming that Japan's workforce declines by 0.5% a year because of an ageing population, would equate to yearly growth in GDP *per capita* of a robust 4%. That would certainly be a welcome improvement. **Si**

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