

Japan debt crisis looms

An overhaul of the Japanese economy is long overdue, writes **Bert Ely**

Although Japan's massive banking problems are well known, they are exceeded by the even larger debt burden in the public and business sectors of the Japanese economy. In fact, bad loans to businesses are the principal cause of Japan's banking difficulties.

The face value of Japan's domestic debt now far exceeds the ability of borrowers to service that debt due largely to declining corporate profitability and the plunge in the value of Japan's tangible assets – its real estate as well as much of its infrastructure and productive capacity. The numerous attempts to resolve Japan's banking problems have failed to address the financial decline of bank borrowers.

Japan's domestic debt has been financed by the savings of its household sector. These savings largely take the form of bank deposits and other debt instruments which at least implicitly have been guaranteed by the Japanese government. Hence, the resolution of Japan's looming debt crisis almost certainly will require that the guaranteed liabilities of its financial institutions are locked into these institutions for a long time at a below-market rate of interest. In effect, the financial assets of Japanese households must lose substantial market value to reflect the reduced value of Japan's tangible assets.

The underlying cause of this debt crisis is the tremendous growth in recent years of Japanese government debt, relative to Japan's GDP, coupled with the increased leverage of Japan-

ese businesses. In effect, Japan has become highly leveraged domestically, which creates the potential for a domestic debt crisis even though its mercantilistic trade policies have made it the world's largest creditor nation.

From the end of 1993 to mid-1998, the public sector's net financial liabilities (government debt minus financial assets) rose from 40% of GDP to 64%. However, given the questionable value of many government financial assets, such as loans on housing and to small businesses, net liabilities may be much closer to the ratio of gross public debt to GDP of 107% at 30 June, 1998. By another measure, gross public debt on that date equalled 126% of GDP. The Maastricht debt limit for admission to euroland, by contrast, is 60%.

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Additionally, the Japanese government continues to run substantial budget deficits and has not yet recognised in its financial statements the substantial cost of bailing out Japan's banks, insurance companies, and other entities whose creditors the government will protect against loss. Wasteful government spending programmes which have failed to stimulate the economy merely add to budget deficits, as will future tax

reductions, at least in the short term. Therefore, Japan's public debt, as a percentage of GDP, will go much higher before it starts to decline. Further, this debt will become increasingly concentrated in the national government as local and prefectural governments lose creditworthiness and troubled private-sector firms increasingly turn to the government for fresh credit.

The financial deterioration in corporate Japan causes additional concern. Although the net financial liabilities of Japan's business sector have declined in recent years as a percent of GDP, stockholder equity in corporate Japan is eroding due to operating losses, lower asset values as real estate values continue to drop so as to converge with the rest of the world, and as excess production capacity becomes more evident. This decline threatens the survivability of many Japanese companies of all sizes. Recent reports of large corporations, such as Hitachi and Toshiba, showing losses for the first time in years or decades and the rising number of business bankruptcies evidence the net worth erosion occurring within corporate Japan.

The onset of Japan's debt crisis has been delayed by the willingness of the Japanese people to accept extremely low returns, specifically low interest rates, on their savings.

The Japanese government has deliberately perpetuated low rates and tolerated its weak financial system in order to postpone, because of Japanese aversion to job losses and plant closings, the increasingly painful yet necessary restructuring of its economy. This aversion is particularly true for agricultural regions and the construction industry where the Liberal Democratic Party (LDP), Japan's longtime ruling party, draws important political support. However, Japan cannot flout the physics of finance indefinitely. It is only a matter of time until Japan falls off of its financial high wire.

A combination of three events already under way will trigger Japan's financial crisis – capital flight, increased non-yen borrowing difficulties for Japan's banks, and cuts in the credit rating for Japanese government debt.

Until recently, Japanese savers

had few options for escaping Japan's low financial returns. However, reforms which took effect on 1 April, 1998, greatly increased the ability of Japanese citizens to hold non-yen financial assets, such as dollar deposits in foreign banks, stocks of foreign corporations, and foreign mutual funds. In effect, the Japanese government opened the door for capital flight from Japan. Although just a trickle so far—perhaps \$30-\$40 billion—Japanese capital flight could take off within the next two years as less risk averse Japanese citizens seek a higher return on their savings and protection against yen depreciation.

In order for Japanese citizens to buy non-yen assets, they must withdraw yen from Japanese financial institutions and then sell those yen for their currency of choice. To maintain the value of the yen, the Japanese government and Japanese financial institutions must then sell non-yen assets in order to buy the yen being sold by individuals. These transactions have the net effect of shifting the ownership and control of Japan's financial claims on the rest of the world from Financial Japan, Inc. (the government and the country's financial institutions) to individual Japanese. This flight from the yen could become a flood, which would quickly drain Financial Japan, Inc. of its foreign reserves, thereby more starkly revealing its insolvency.

That drain will greatly exacerbate the growing inability of Japanese banks to borrow in the interbank loan market to finance their non-yen assets. Increasingly, Japanese banks are forced to sell yen to foreign banks for dollars which the foreign banks then use to buy supposedly riskless Japanese government debt. The tremendous demand for this debt has driven some short-term rates into negative territory, an unheard of event. These rates signal, though, the tremendous non-yen liquidity problem facing Japanese banks, a problem which will worsen greatly if flight from the yen increases.

Capital flight will accelerate as Japan's credit rating deteriorates due to the government's escalating debt. Moody's and Fitch IBCA have stripped Japan of its AAA status; the other rating agencies will soon follow as Japan begins a long ratings decline,

possibly to junk bond status. To stem capital flight, Japan's government will be forced to let its interest rates rise to world levels to restore the attractiveness of holding yen. Higher interest rates, however, will drive Japan towards its inevitable financial crisis, for the following reasons.

Higher interest rates on Japan's enormous public debt will ratchet up the government's annual budget deficit, forcing it to issue debt at a faster rate. If Japan tries to prevent rates from rising, the yen will plunge. Imposing controls to restrict capital flight will have limited effect at this point.

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Higher rates will depress the market value of existing debt which carries lower rates, thereby worsening the insolvency outlook for Japanese financial institutions. Additionally, because they hold substantial low-yielding assets, these institutions will be hard-pressed to pay a market rate of interest to Japanese savers. These institutions will therefore face severe liquidity pressures as savers flee to higher yielding assets. Liquidity advances to cash-stricken institutions from the Bank of Japan or directly from the Japanese government will merely be a down payment on the losses the government will incur in protecting the creditors of these institutions.

Interest rates will rise for bank borrowers, which will accelerate the bankruptcy rate among Japanese businesses. The resulting rise in unemployment will further depress Japan's GDP, pushing its debt/GDP ratio even higher. However, the asset redistribution and corporate reorganisations forced by these bankruptcies will accelerate the painful yet massive restructuring which Japan's economy must undergo in order to start growing again.

The combination of higher interest rates and corporate liquidations will depress asset prices further, accelerating the downward economic spiral. However, Japanese asset prices will converge with prices in other countries.

A wave of corporate insolvencies will finally break the vicious circle which has permitted the LDP and the government bureaucracy it protects to run the economy as a form of state-directed capitalism. Japan will then start to become a true market economy.

Inflation will not solve Japan's problems because of the massive amount of debt already outstanding and a shift to market-determined interest rates which fully reflect inflation expectations. Ideally, then, debt owed by Japanese businesses and financial institutions to Japan's households should be given a haircut, as often occurs in corporate bankruptcies. However, because the face value of financial institution debt has been or soon will be guaranteed by the government, another bankruptcy technique must be utilised—the existing indebtedness of insolvent financial institutions must be locked into these institutions on a long-term basis at below-market interest rates.

Depositors, insureds, and other debtholders must be free to sell these locked-in assets in a secondary market at whatever discount from face value they will accept. The wide interest spreads financial institutions will enjoy as a result of this locked-in financing will give them the wherewithal to substantially mark down the loans they have made to insolvent companies. These mark downs will help to restore economic vitality to those businesses which are slowly imploding under their debt burdens.

Japan faces tremendous economic turmoil as it undergoes a long overdue restructuring of its economy. This turmoil undoubtedly will spread to other countries, notably in east Asia, and potentially to the world economy. However, Japan's financial and economic deterioration has reached the point where this crisis is unavoidable. □

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