Japan's debt crisis hangs over global economy

Nick Beams
14 July 2000

With a meeting of the leaders of the G7 major industrial economies to be convened in Okinawa later this month, international attention is focusing on the state of the Japanese economy and the implications of mounting government debts for the health of the world economy as a whole.

In the run-up to the G-7 conference, to be held on July 21-23, the meeting of the Bank of Japan (BoJ) to be held next Monday will attract considerable attention. The key issue to be decided is whether the central bank will end its zero interest rate program and begin to lift rates.

The zero rate regime was introduced in February 1999 in the immediate aftermath of the Asian economic crisis and the emergence of major bankruptcies in Japan. But over recent months the BoJ governor, Masura Hayami, has warned that “the time is near” when he would like to begin tightening monetary policy.

The Japanese government of Prime Minister Mori, however, opposes a return to a more normal interest rate regime at this stage. It maintains that interest rates should only be lifted when there are signs that the economy has definitely pulled out of the stagnation it has experienced since 1992 and there are clear signs of self-sustaining growth.

BoJ officials argue that since the emergency which led to the zero interest rate regime is over there is no longer any need for an emergency policy. Moreover, they maintain, the low interest rate policy means that companies with access to cheap funds have no incentive to carry out urgently needed restructuring.

Given the usual demands emanating from Washington for tight monetary policies and cuts in government spending, it is at first sight surprising to find that the Clinton administration has come down against a higher interest rate regime and is insisting that the Japanese government maintain its policy of stimulating the economy through large-scale spending packages.

Speaking on the eve of last weekend's meeting of G7 finance ministers held in Fukuoka in southern Japan, part of the lead-up to the Okinawa summit, US treasury secretary Lawrence Summers insisted that it was “an absolute critical priority for Japan” to sustain economic growth and that the government should use all measures at its disposal to ensure self-sustaining economic recovery. While Summers did not directly comment on BoJ interest rate policy, his remarks indicated that US wants the zero interest policy to remain in place.

The Italian finance ministry director general Mario Draghi was a little more direct, saying the G7 would be “perplexed” if the BoJ lifted interest rates and threatened economic growth.

The unusual stance taken by the finance ministers reflects their concern that unless the Japanese economy starts to grow on a consistent basis, it could drag down the world economy as a whole, particularly under conditions where financial authorities are working to cut back economic expansion in the US.

While the regime of low-interest rates and continued government stimulus packages is keeping Japanese growth rates marginally positive, at least in the short term, there is no indication that they are creating the conditions for long-term self-sustaining expansion. Despite the results of the latest Tankan business survey, which indicated a certain revival in confidence in the corporate sector, statistics on consumer spending—widely regarded as a key indicator—pointed to a decline in Japanese household spending of 1.9 percent in May compared to the same month last year.

Even more significant are figures on the escalation of government debt, which show that the program of fiscal stimulus is reaching its limits and could be creating the conditions for a deeper economic crisis.

Figures published last month show that central government debt surged by 13 percent in the financial year to the end of March, reaching a record high of $4,731 billion. This means that central government debt is now around 100 percent of gross domestic product and nearly 130 percent of GDP if other public debt is included.

International credit rating agencies are voicing their concerns. Last month Japan's finance minister Kiichi Miyazawa appealed to the US agency Moody's not to downgrade Japan's credit rating and to “think” before doing “something which it might regret.”

Moody's began a review of the Japanese economy last February warning that it might have to downgrade the government's credit rating unless it produced a credible policy to show that it was tackling the debt problem. While such reviews usually last around four months, Moody's have indicated that it could take six months in this case.

However the Fitch international rating agency has decided not to wait, downgrading Japan's rating from AAA to AA+ at the end of last month because of concerns over the state of public finances.

"Japan's fiscal deficit, excluding social security, has risen to around 10 percent of gross domestic product as a result of successive fiscal stimulus packages and underlying falls in the tax burden," the agency said. Fitch estimated the gross public debt at around 125 percent of GDP, easily the highest level among the leading capitalist nations in the Organisation for Economic Cooperation and Development.

The spiraling debt has become the subject of political conflict within Japan. Earlier this month, Yukio Hatoyama, the leader of the Democratic Party of Japan (the main opposition group) warned that it could race out of control unless the government cut back its spending. "Japan's central and local government debt will reach Y645,000bn ($6,000bn) this year—the country is standing on the edge of a cliff in terms of its public finances," he said.

The fragile state of the Japanese financial system was also the subject of a commentary in the July 7 edition of the US magazine *Business Week* under the title "The Tsunami Threatening Japan".

"Flash forward to 2005," the comment began. "Japan's government debt is clocking in at nearly 200 percent of gross domestic product, and servicing that load is soaking up 70 percent of tax revenues. The bond market is in a tailspin, and long-term rates are surging. There's talk of capital controls. Japan is under pressure from the Group of Eight to opt for an International Monetary Fund-style round of draconian budget cuts and an auction of state-owned assets."

This scenario, the commentary continued, is fantasy—at least for now—but the "idea of IMF intervention isn't far-fetched, if Japan's debt levels continue to spiral." Close scrutiny of the real state of Japan's finances would reveal some "frightening truths" including the biggest: that "Japan is closer to a tipping point, where it could slide into financial crisis, than anyone wants to admit. If that happened, the global turmoil would be huge."

Seven years of government pump-priming, bailouts and a declining tax base have pushed Japan from a 3 percent budget surplus in 1993 to a 10 percent deficit today.

The commentary cited remarks by Goldman Sachs Asia vice-chairman Kenneth Courtis who has warned that unless the situation changes rapidly, Tokyo could be hit by another financial crisis in a year or so. And according to Massachusetts Institute of Technology Japan expert David Asher, Japan faces a "financial Mt Fuji" which will dwarf the crises in Mexico and East Asia.

Much of the discussion in the international media tends to view the worsening economic situation in Japan as the outcome of national policies and national historical developments, in isolation from the rest of the world economy. In fact the Japanese crisis is intimately bound up with tendencies in the global financial system stretching back to the stockmarket collapse in October 1987.

When Wall Street crashed, the immediate response of central bankers and finance ministers around the world, in particularly the newly installed chairman of the US Federal Reserve Board Alan Greenspan, was that they were not going to make the same mistake as their predecessors in 1929. Consequently, they pursued a policy of credit expansion in order to boost stock markets and avert an immediate recession.

This policy had the most far-reaching consequences in Japan. The growth in international liquidity saw the creation of a giant financial bubble. The Tokyo stock market escalated to unprecedented heights (at its peak the Nikkei Index reached over 39,000 compared to its level of around 17,000 today) while real estate prices were so high it was calculated that the land under the Imperial Palace was worth more than all of California.

When the bubble eventually collapsed in the early 1990s Japanese banks and corporations were left with billions of dollars of worthless assets on their books, leading to cutbacks in investment and stagnation throughout the economy.

In response to Keynesian-style stimulus measures, the economy did show some signs of recovery by 1996 prompting the government to introduce a consumption tax in April 1997 in order to restore its fiscal position. But within months of the introduction of the new tax—a very unpopular measure in Japan—the region was hit by the Asian crisis, leading to major bankruptcies in Japan, coupled with a decline in consumer confidence and spending.

Now the debt crisis, which had its origins in the financial storms at the end of the 1980s, threatens to feed back into the global financial system. On the one hand, while the major capitalist powers are demanding that Japan stimulate its economy in order to prevent a global slowdown or even a recession, on the other, the continuation of these policies could create even bigger problems than those they are trying to avoid.