

Japanese economy plagued by deflation and debt

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The most recent economic statistics appear to show Japan is shaking off the worst effects of the global economic crisis, with employment, exports and GDP all showing positive growth. But these headline figures say nothing about the economic issues most critical for Japan, namely, chronic deflation and public debt. It is the resolution of those problems—or attempts to resolve them—that foreshadow a far-reaching assault on the living standards of the working class.

Statistics from Japan's Cabinet Office indicate price-adjusted GDP growth during the October–December 2009 quarter of 0.9 percent, equating to an annualised growth rate of 3.8 percent. The official unemployment rate fell in January for the first time in a year, down 0.3 percent to 4.9 percent. Meanwhile, the value of Japanese exports rose 41 percent in the 12 months to January, the biggest annual rise in 30 years.

Analysts generally reacted positively. “The message is that the cyclical recovery is quite powerful,” according to Richard Jerram, chief economist at Macquarie Securities in Tokyo. Akiyoshi Takumori from Sumitomo Mitsui Asset Management Co told *Bloomberg*: “These figures confirm the economy is recovering, led by solid overseas demand. Although the level is still low, the recovery will fuel production and make companies more comfortable with increasing investment.”

Cabinet Office parliamentary secretary, Keisuke Tsumura, was more careful, declaring that “concerns about a double-dip recession have receded slightly”. Finance Minister Naoto Kan told the media that the final 2009 GDP figures demonstrated that “broader trends in the economy have taken a step forward”. Agence France Presse quoted high level officials as saying that despite the appearance of “green shoots” in February, the economy remained in a “tight spot”.

The Japanese government is in fact acutely aware that despite the new GDP and export figures, deep-seated economic problems remain. Firstly, the latest statistics are obviously calculated from a very low base. The Japanese economy shrank by 5.2 percent across 2009. The new figures only look lively by comparison.

Secondly, last-quarter's record-making export figures are in part the result of the adrenalin shot delivered by global emergency budgetary measures, including bailouts. “Fiscal stimulus programs that boosted auto exports in 2009 have now expired in China, the US and EU economies. The boost from inventory adjustment abroad is also beginning to wane,” according to Nikhilesh Bhattacharya, an economist with Moody's. “This should result in slower growth in exports, which would be reflective of the weak growth now being seen in advanced economies across the globe.”

Moreover, a closer look at the GDP numbers points to deeper problems. Japan's annualised 3.8 percent growth rate is not only a *projected* GDP figure, but is a projection calculated using a *price deflator*, that is, a number that represents the adjustment of the raw GDP figure for price changes. A positive deflator represents an adjustment for inflation. A negative deflator means that prices have been falling.

In the fourth quarter of 2009, when Japanese productivity growth turned positive for the first time since the onset of recession, the price deflator *fell* 2.8 percent, the most rapid deflation on record. In other words, the headline GDP figure is largely explained by price falls. This trend towards speedy deflation is reflected in other statistics. Prices in February 2010 were 1.2 percent lower than they had been a year earlier, equating to the largest fall in Japan's core price index for 17 years.

Persistent deflation has been the primary direct cause of low growth and rising unemployment since the bursting of Japan's share market and property bubbles in the early 1990s. The latest bout of deflation continues a long-established state of affairs. Nevertheless, recent price declines are significant because they occur despite the application of massive government stimulus in 2009, and the Bank of Japan's “all-stops” monetary policy, that is, zero interest rates coupled with massive injections of liquidity.

The return of aggressive deflation signals to the Japanese

ruling class that it is impotent to address debt levels. Not only do price falls mean stagnant growth and declining tax revenues (revenues collapsed in 2009) but deflation signals the need for more stimulus down the track. However, the economy is already overloaded with huge debts—the product of previous failed stimulus packages.

This bleak picture is reflected in market attitudes. The explosion in global public debt over 18 months and the threat of sovereign default across the eurozone have focused bond markets on the question of what level of debt is safe. The markets are increasingly taking the view that Japan's debt, which will rise to an estimated 250 percent of GDP by 2014, is at the outer limits. In January, the ratings agency Standard & Poors changed its outlook on Japan's AA rating from stable to negative. In February, Moody's expressed concern about Japan's debt levels and warned that it would downgrade Japan's rating from Aa3 to Aa2 unless the government made significant cuts to its budget bottom line.

The debate now taking place among leading economists is over how, if at all, the Japanese ruling class can avoid a further alarming deterioration of the debt situation.

According to Harvard economist Kenneth Rogoff, “although hardly in crisis (yet), Japan's fiscal situation [public debt is 200 percent of GDP] grows more alarming by the day. Until now, the government has been able to finance its vast debts locally, despite paying paltry interest rates even on longer-term borrowings. Remarkably, Japanese savers soak up some 95 percent of their government's debt... [But] as the population ages and shrinks, more people will retire and start selling those government bonds that they are now lapping up.” Rogoff concludes by warning that “at some point, Japan will face its own Greek tragedy as the market charges sharply higher interest rates.”

Not all Japan observers are fearful. According to London's *Financial Times*, Japan's debt crisis is “mythical”. The paper's Peter Tasker writes that “there is no magic debt-to-GDP ratio that leads inexorably to a crisis. The eurozone's sinners got into trouble with far lower ratios—sub-50 percent in Spain's case—than Japan. What matters is the financeability of any given level of debt, which in turn depends on the availability of savings and the preferences of the savers.”

But these more sanguine assessments are not based on a long-term view. The high relative rate of Japanese savings was an important contributor to the country's impressive growth rates up until the early 1990s. The same savings rate has been the chief source of the debt that government has taken on since 1990 to combat the effects of deflation. But the Japanese savings rate, 15 percent of GDP in 1990, is today little more

than 2 percent (the US rate is about 4 percent).

Moreover, the rapid aging of Japan's population means that more money is being removed from pension funds than is being invested. In 2009, Japan's \$US1.5 trillion state pension fund (the world's largest) became a net seller of government bonds. In other words, Japan's cheap pool of domestic savings is evaporating. The Japanese government—which now devotes 20 percent of budget to debt servicing costs—will be forced to go with increasing frequency to a volatile and already debt-soaked global bond market.

Even those steps can only be temporary. According to Akito Fukunaga, a Tokyo-based fixed income strategist with Credit Suisse, “Japan will keep on selling more bonds this year and the next, but that won't work in three or five years. If you ask me what Japan can resort to after that, the answer is not much.” Indeed, the only options left to the Japanese ruling class are measures that risk social dislocation on an unprecedented scale—either massive cuts to the Japanese public sector or the orchestration of a dramatic reflation via, say, intervention into currency markets. Each option involves the Japanese working class footing the bill for current and future debts.

Prime Minister Yukio Hatoyama's Democrat government, which was elected last August, has already begun to impose new burdens on working people. Earlier this month it announced it was discussing plans to create a new “two-tier” pension system funded by increases in consumption tax (currently at 5 percent). The lower tier will be a minimum guaranteed provision, but with rising unemployment, increasing numbers of workers will end up on this minimum scheme. Although large-scale public sector cuts are off the agenda at least until after critical upper house elections in July, the stage is set for further dramatic reductions to living standards.



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