

Japan's Rising Fiscal Pressure

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It's no secret that Japan faces considerable challenges in repairing its fiscal predicament. The starting point is awful, and demographic trends intensify the problem. While a crisis has yet to materialize, some of the fundamental underpinnings are beginning to fray.

Ugly Starting Point

Getting to grips with the underlying fiscal situation in Japan isn't the easiest of tasks. That's particularly been the case over the past year amid the arcane debate over supplementary budgets for post-quake reconstruction, special accounts and umpteen different classifications of bonds—not to mention the acrobatic maneuver to fit the budget numbers into self-imposed political straightjackets. But most people are pretty familiar with the message in **Display 1**. Japan's gross debt is now well over 200% of its gross domestic product (GDP), miles above that of other developed economies—including those at the center of the European sovereign-debt crisis.

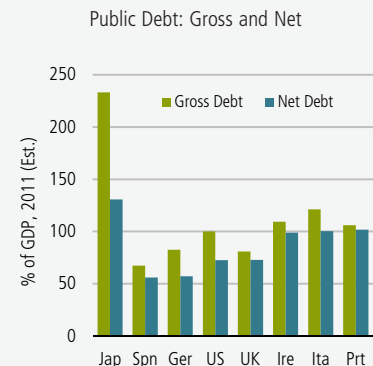
Some would argue that this overstates the problem. Indeed, there is a big gulf between net debt and gross debt—much bigger than in other countries. In part, this reflects a lack of consolidation of the numbers. A loan from one government entity to another, for example, is not netted out at the aggregate level, boosting

both financial assets and liabilities of the government and resulting in the higher gross debt measure. It also reflects the fact that the Japanese government holds significant financial assets. But even if we use net debt as the metric, Japan still stands out with debt to GDP something north of 120% (Display 1, again).

Daunting Challenge

So the starting point is clearly bad. But the challenge of wrestling this position back to some sort of sustainability looks even more daunting. **Display 2**, courtesy of the Japanese Cabinet Office, illustrates this quite well. While these figures are not 100% comparable with the figures in Display 1, the broad message is instructive. The Cabinet Office provides a couple of broad economic scenarios—labeled “prudent” and “growth” in the display. Importantly, both scenarios already incorporate policy change—a rise in the consumption tax from 5% to 10% by fiscal year 2015. In both, the improvement in the fiscal balance is short-lived and starts deteriorating in fiscal year 2016. This

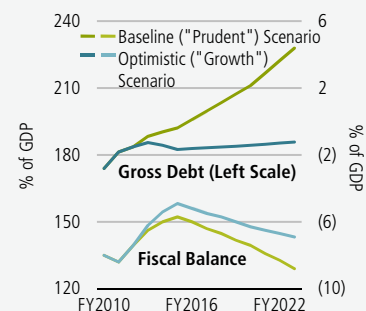
Display 1
Japan's Public Debt—A Standout



As of September 2011
Source: IMF Fiscal Monitor

Display 2
Fiscal Projections Underline the Challenge

Fiscal Projections:* Central and Local Government



As of August 2011
The “Prudent” scenario assumes nominal GDP growth in the 1¼%–2¼% range; a gradual increase in the consumption tax to 10% by FY2015; and measures to finance the recovery and reconstruction are in effect for five years. The “Growth” scenario assumes nominal GDP growth in the 3½%–4% range, and the same assumptions re consumption tax and reconstruction.
Source: Cabinet Office (Japan)

is true even in the optimistic scenario, where nominal GDP growth returns to 4% or so. This, in our view, is a testament to the power of the demographic headwinds facing Japan.

Why No Crisis?

If the problem is so clear and the challenge so great, why hasn't a crisis occurred to date? There are a number of candidates that are often trotted out as the reason. In brief:

1 Current account surplus

In aggregate, Japan's national saving exceeds investment, so the country is self-funding.

2 Concentrated holdings

A small number of large domestic institutions—banks, insurers, public pension funds and the Bank of Japan (BoJ)—dominate the Japanese government bond (JGB) market. Foreign participation is very low, at about 5%.

3 Conservative investor base

Asset allocation of the Japanese investor base is very conservative, with a high degree of home bias. Domestic bank deposits and insurance products etc. continue to dominate asset allocation.

4 Central bank support

There appears, at least on the surface, to be negligible front-end risk, with the BoJ likely to continue holding policy rates at zero and remaining a big buyer of JGBs.

5 Limited impact of credit rating agencies

Downgrades by Moody's since 1998 and by S&P since 2001 have had no discernible impact on the JGB market, where the 10-year yield has been bobbing around 1% for the past few years.

6 No penalty for political complacency

A broad perception has been that policymakers have time on their side and that there is plenty of scope to act at

some point eventually, for instance, by raising the consumption tax.

"True, but..."

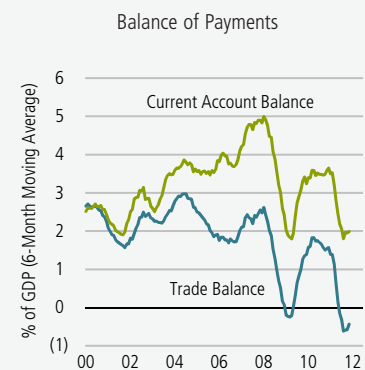
Arguably, however, each of these "C's" has a "yes, but..." attached to it. Let's take the first one, the current account surplus.

Display 3 makes it clear that there is a trend change under way. Since about 2004, the trade surplus—which had been the mainstay of the current account surplus—has been trending lower and is now firmly in deficit territory. This is partly temporary, reflecting the impact of the Great East Japan Earthquake and its tsunami, but there is arguably a structural element in it as well. While Japan may not print a trade deficit every month, it is now more likely to be in the red, undermining the perception of impenetrable external accounts.

Looking at this another way, a trend decline in the household saving rate from 20% in the early 1980s to 2% now (and zero at the end of 2008)—a reflection of the aging population—has come hand in hand with this erosion in the current account surplus. And this demographic issue is beginning to impact the second candidate on the list. The aging population implies greater pension payouts. As a result, in order to fund these payments, the biggest public sector pension fund, GPIF, has become a net seller of JGBs. In fiscal year 2010, for example, it sold six trillion yen of its securities holdings in order to fund pension payouts. The bulk of that amount, close to 4.5 trillion yen, was in JGBs.

The fact that these current account and flow-of-funds fundamentals have started to change was one of the reasons why the Japanese rating agency, R&I, downgraded Japan from AAA to AA+ last December. While past rating actions by Moody's and S&P have tended to be dismissed in the market, a relative insider doing this is considered a bigger deal. Suffice it to say, candidate 5 is being eroded too.

Display 3
Current Account Balance Deteriorates as Trade Deficits Persist



As of November 2011
Source: Thomson Datastream and AllianceBernstein

Another factor that R&I cited in its downgrade was the political environment, specifically whether the government would be able to take concrete steps towards reform—which relates to candidate 6. The ball has started rolling on that front with the ruling Democratic Party of Japan (DPJ) approving an increase in the consumption tax rate. But there are big question marks over the current administration's ability to push the necessary bills through the diet, particularly: in an environment where there is not broad-based popular support; where the DPJ does not enjoy a majority in the upper house; and where support is fractured even within the DPJ. In any case, as the scenarios illustrated in Display 2 make clear, more policy change besides a five percentage point rise in the consumption tax will be required.

Now, does this mean that a crisis is imminent? Perhaps not. But as a significant tail risk that requires monitoring, this has to be fairly high on the list. There is certainly a greater willingness to countenance this scenario. The six "C's" listed above, along the direction of the yen, will be crucial to watch over the coming year. ■

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