

# **What Could Happen When The Japanese Economy Blows Up**

A presentation by

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to the

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# **An overview:**

## **What Could Happen When The Japanese Economy Blows Up**

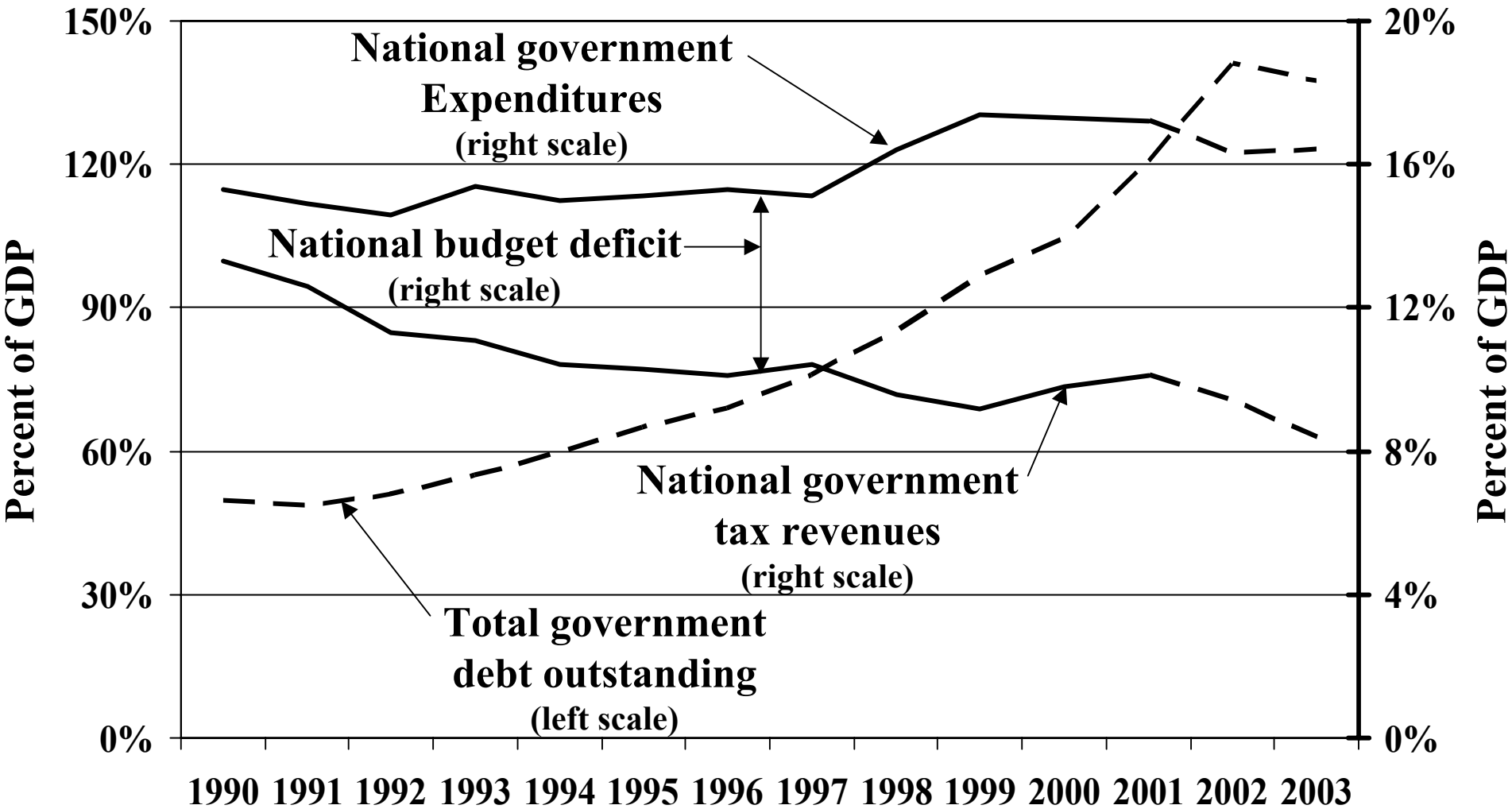
- Why Japan is facing an economic crisis
- Why Japan can't just muddle through its problems
- Why Japan can't inflate its way out of trouble
- What could trigger an economic crisis in Japan
- When the dominos start falling: Japan in crisis
- The impact of a financial crisis inside Japan
- The global fallout from a Japanese economic crisis
- What can be done to prevent the crisis from erupting
- Reforms Japan must launch once the crisis strikes
- The U.S. policy response to Japan's forthcoming crisis

# Why Japan is facing an economic crisis: The public-sector debt buildup

- Japan's public-sector debt is reaching unbearable levels – **Chart 1**
  - The plunge in tax revenues has been a larger contributor to the budget deficit than higher spending
- The government's contingent liabilities increasingly threaten to materially boost public debt
  - Bailing out banks and life insurers
  - Increased SME lending by quasi-government agencies
- Low nominal interest rates have masked the magnitude of the debt problem
- Japan's aging population magnifies the debt problem

# Japan's Fiscal Outlook Is Worsening Rapidly

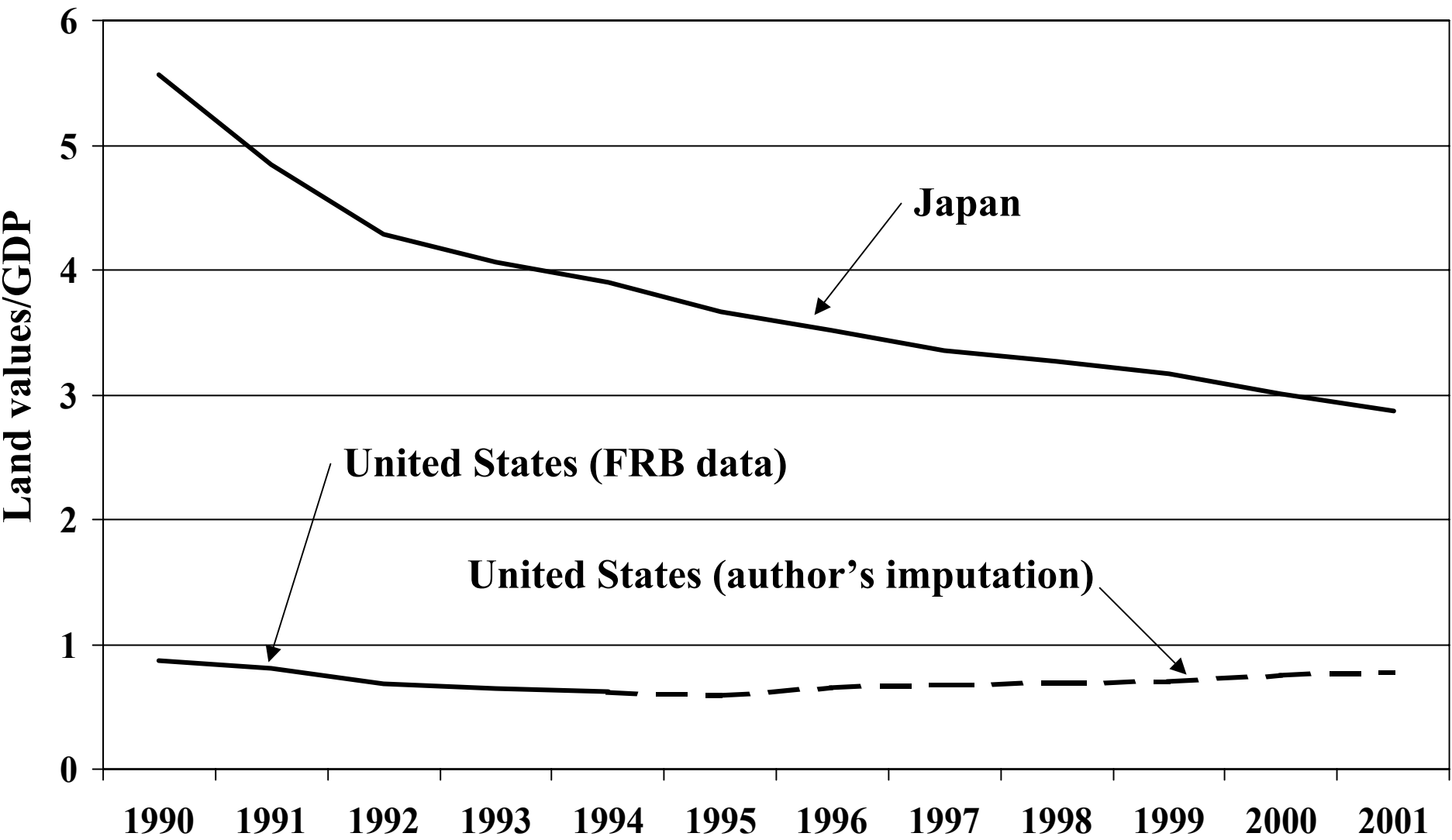
(Actual fiscal year data to 2001; government forecast for 2002 and 2003)



# Factors compounding the crisis risk

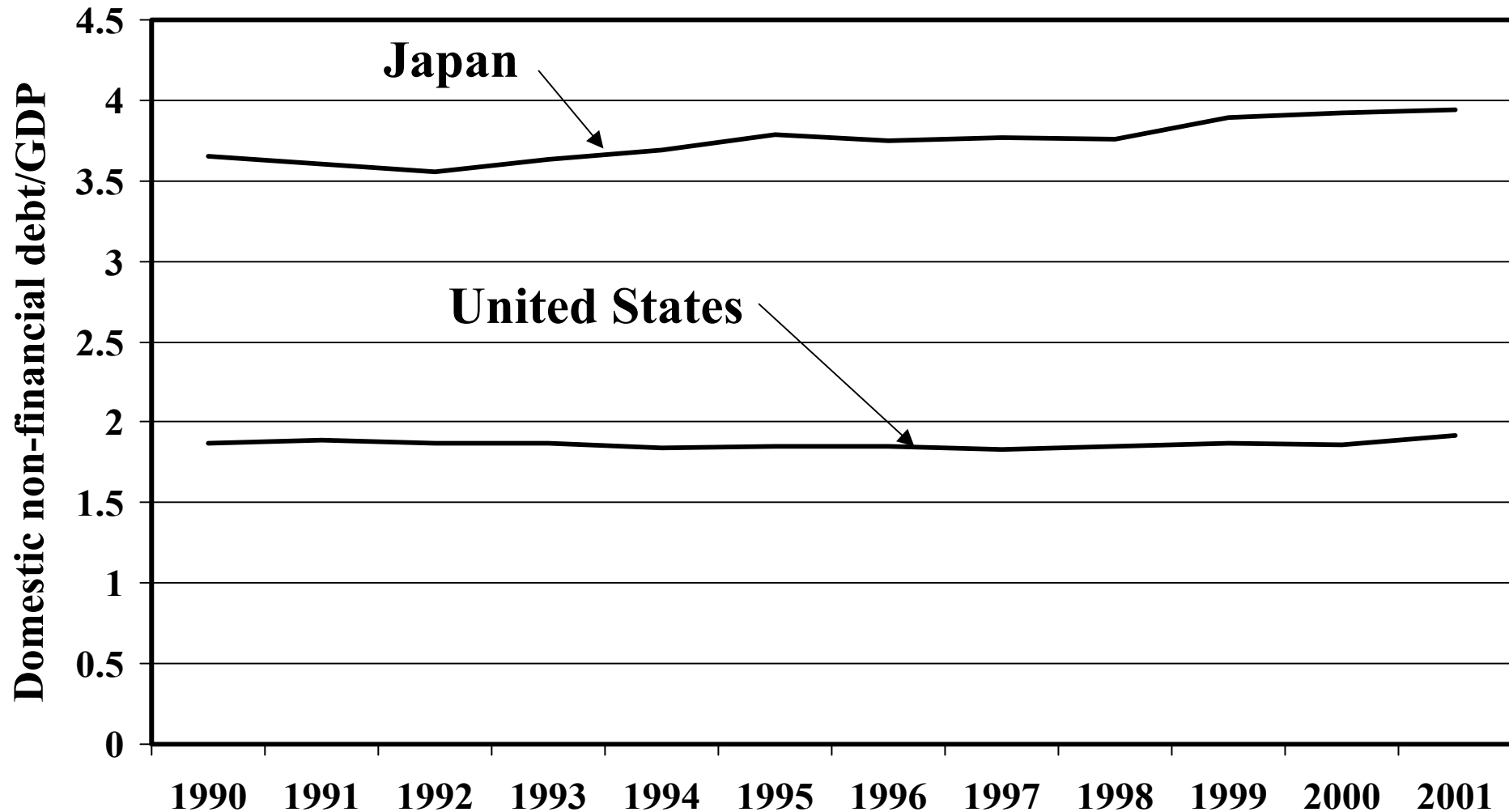
- Land values have much further to fall – **Chart 2**
  - Per capita land value today in Japan 3.5 times U.S. per capita value
- Rising domestic debt levels
  - Debt-to-GDP levels have reached unsustainable levels – **Chart 3**
  - It is completely irrelevant that Japan is the world's largest creditor nation – it is facing a **domestic** debt crisis – **Charts 4 and 5**
- Net worth is falling – **Charts 6, 7, 8, and 9**
- Substantial capital flight by households – **Chart 9** – and by corporations
- The Japanese stock market is still overvalued – **Chart 10**
- The Japanese economy is being hollowed out as production is shifted to China and Southeast Asia
- Political paralysis, the underlying cause of Japan's economic problems

# Japanese Land Values Have Much Further to Fall As Global Asset Values Converge

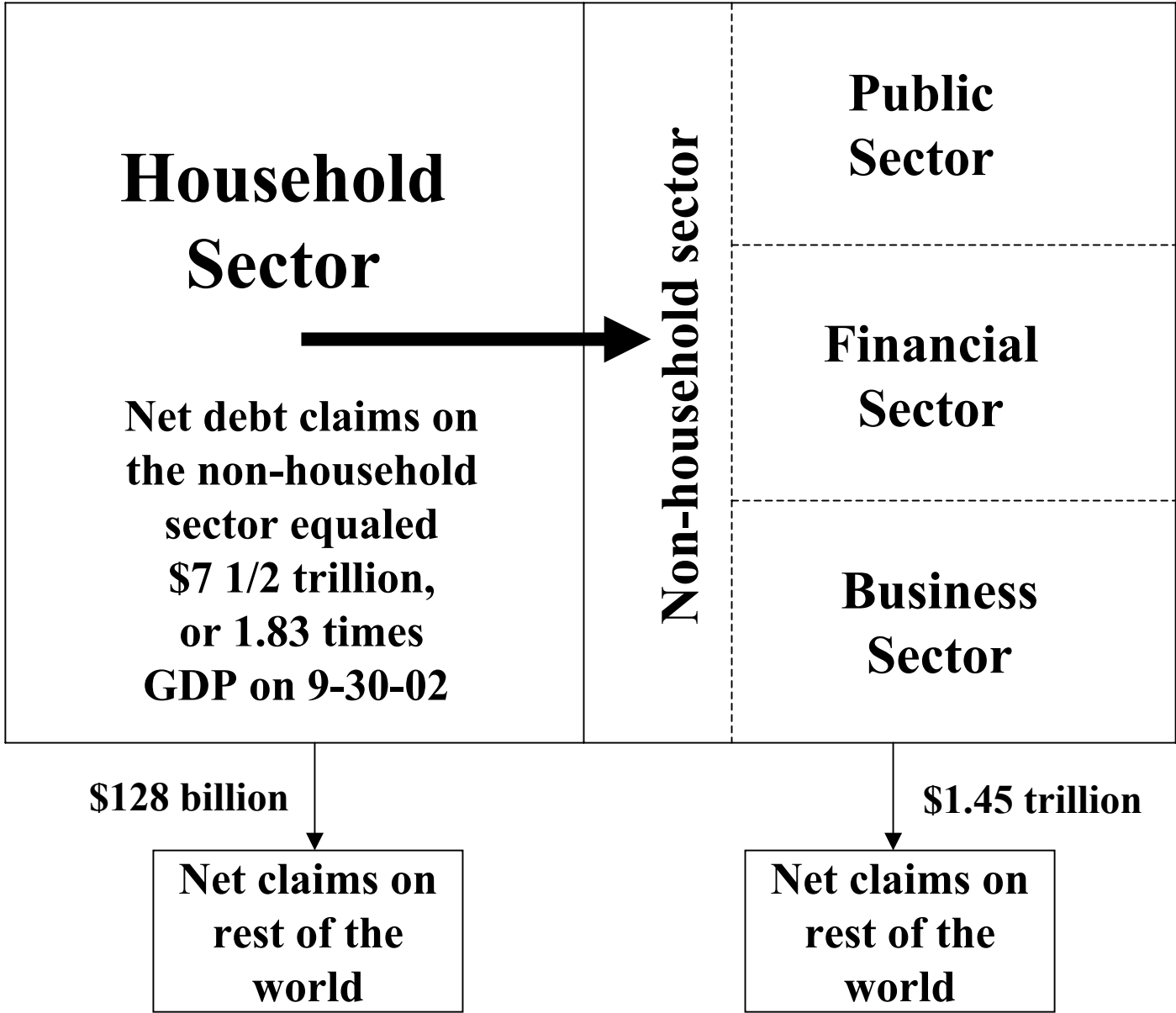


# Japan's Domestic Debt Burden is Much Greater than the U.S., and is Growing

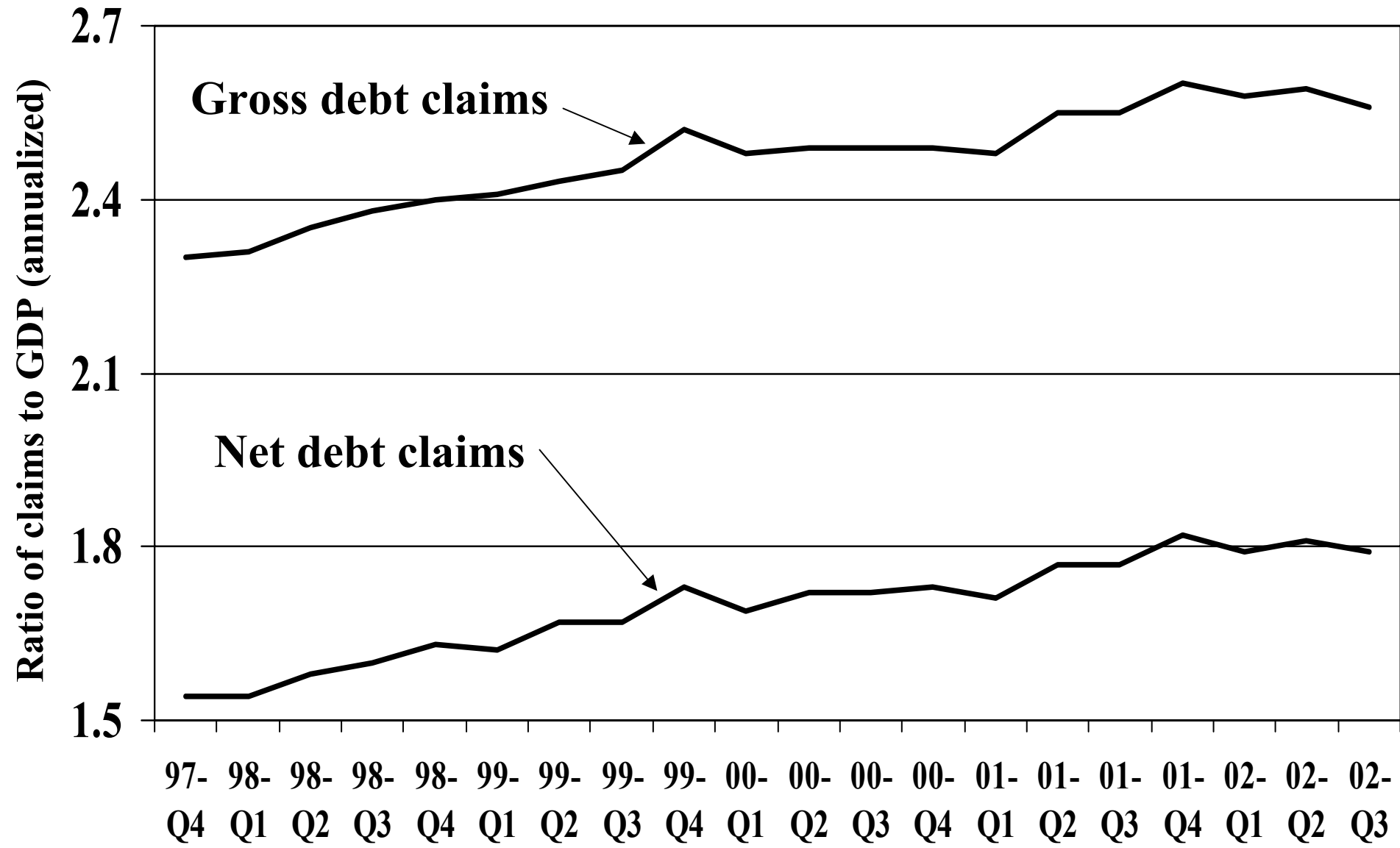
(Household, business, and government debt)



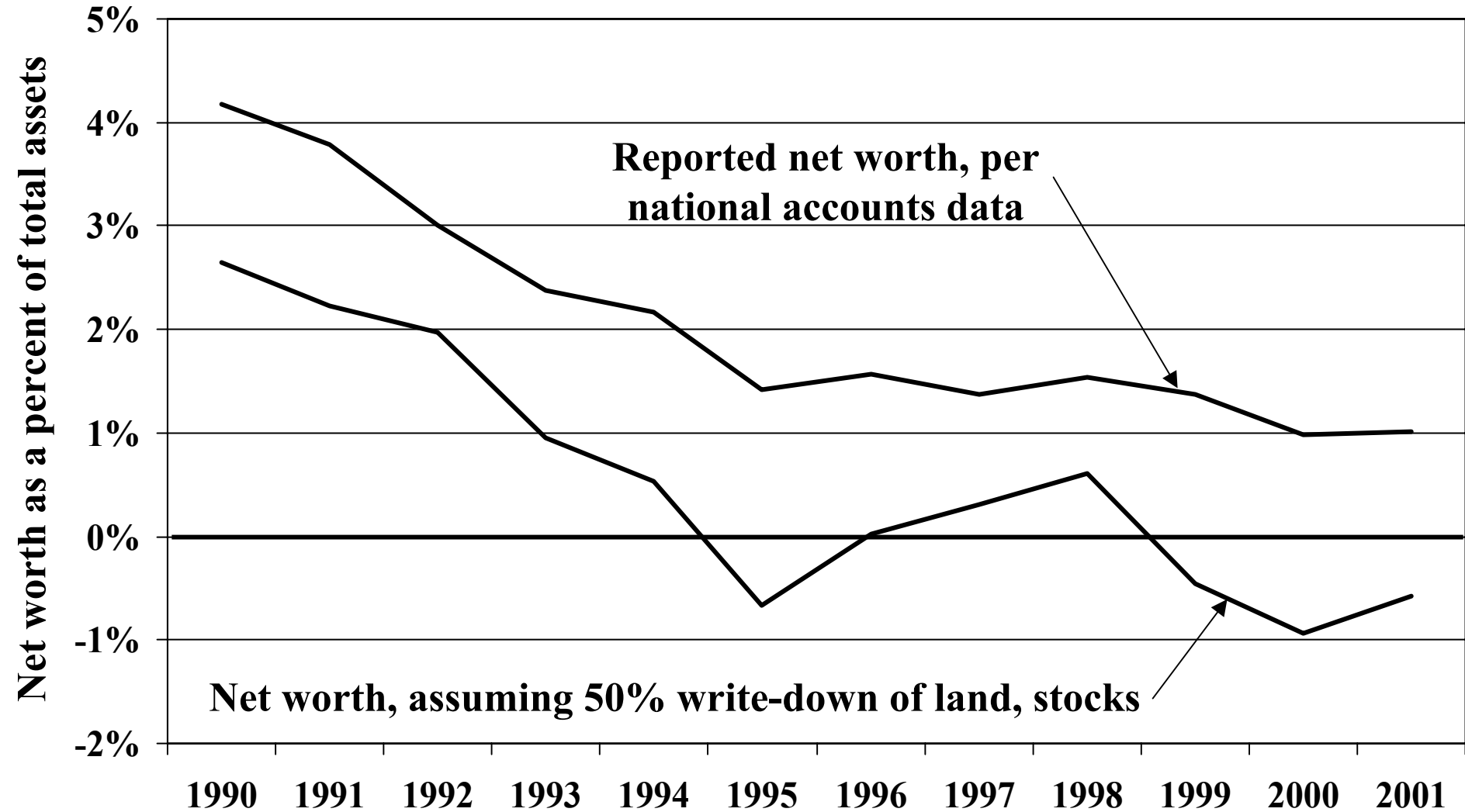
# The Japanese Debt Conundrum



# Japanese Household Debt Claims (Gross and Net) on Japan's Non-household Sector were Rising Relative to GDP

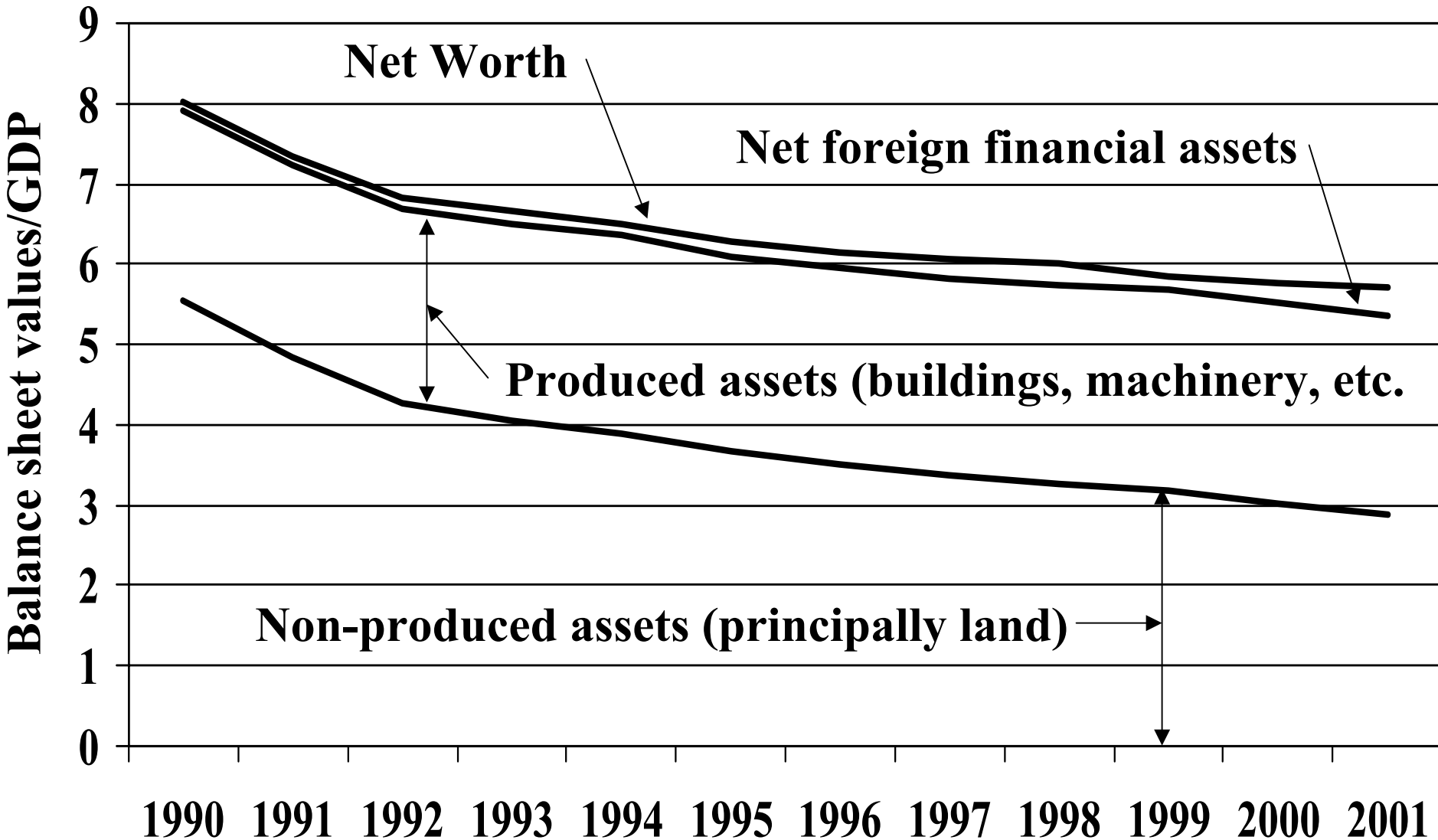


# The Net Worth of Japan's Financial Sector is Steadily Declining

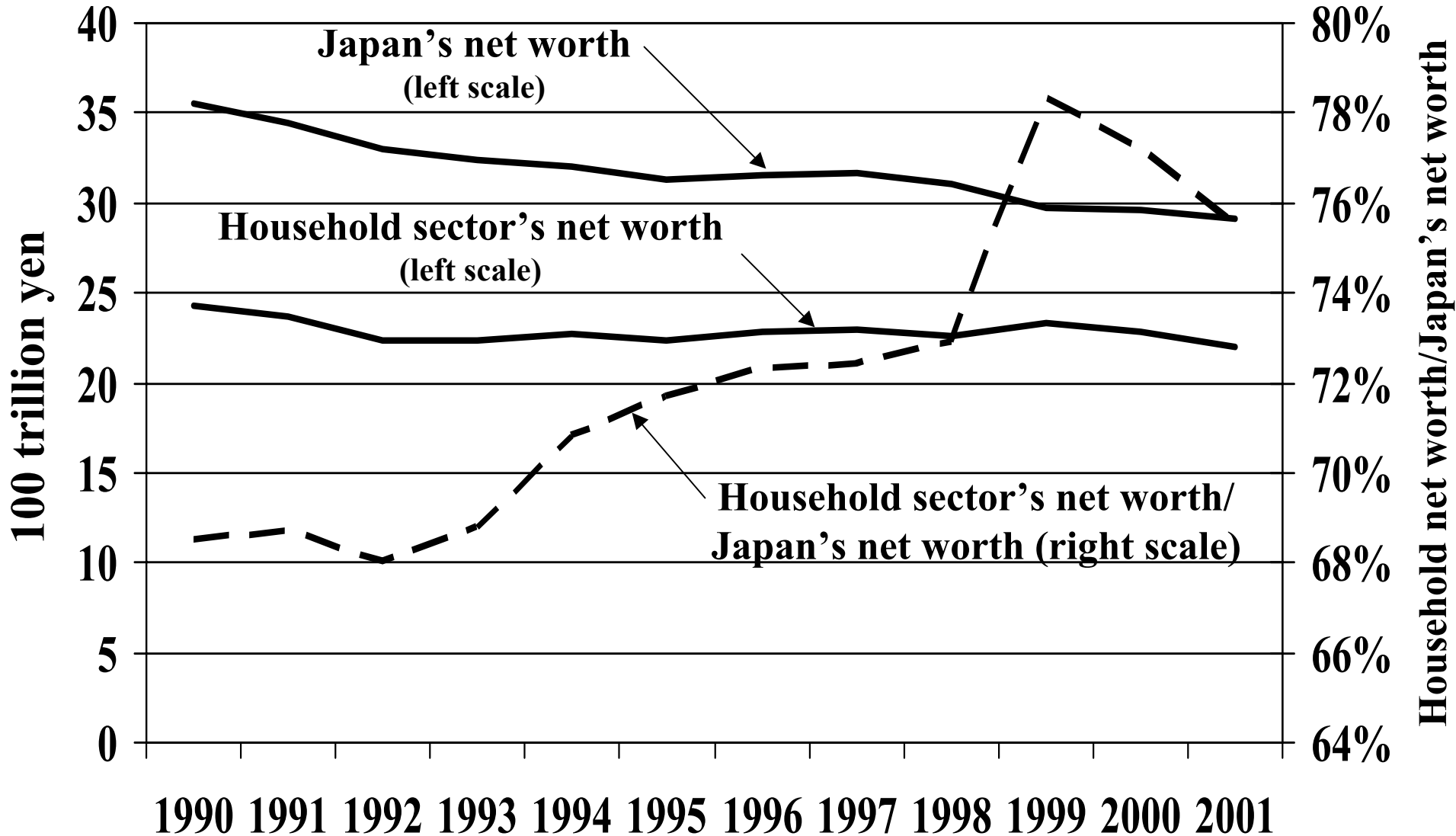


# The Decline in Japan's Net Worth

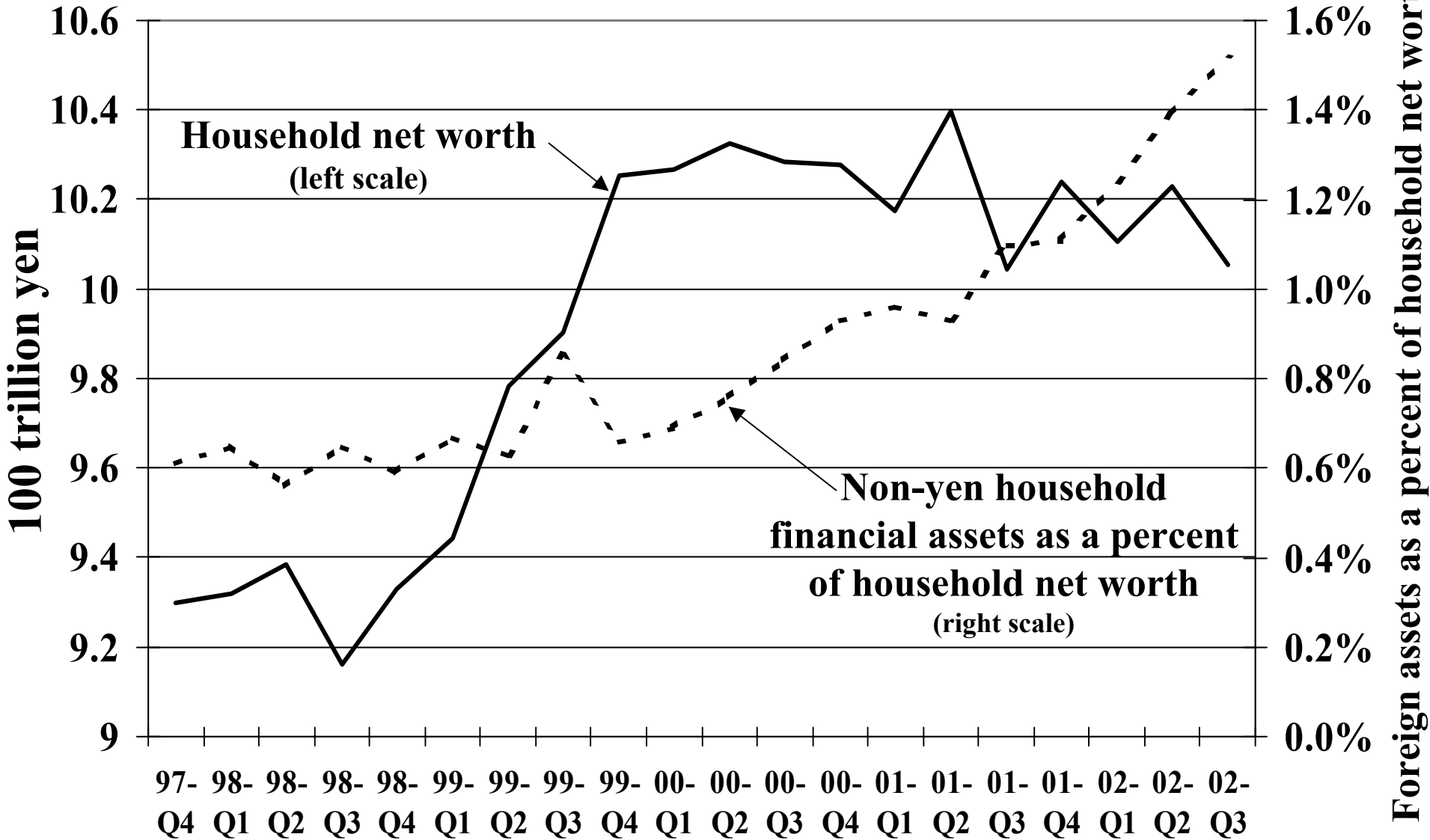
(Calendar-year-end balance sheet data versus calendar-year GDP)



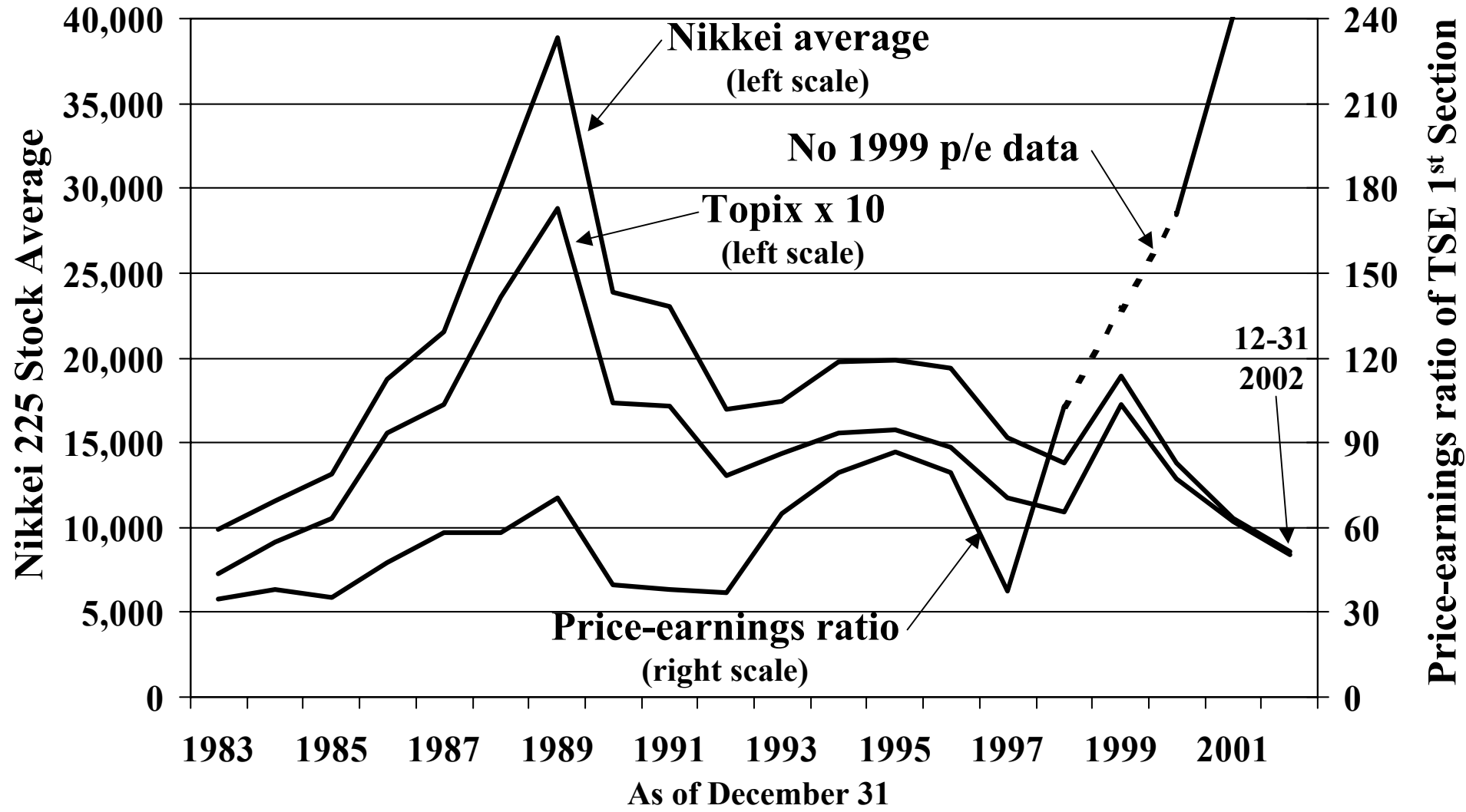
# The Decline in Japan's Net Worth, Viewed in Yen Terms



# Japanese Household Sector's Financial Net Worth Has Been Declining Almost 3 Years



# The Japanese stock market is still overvalued despite its plunge



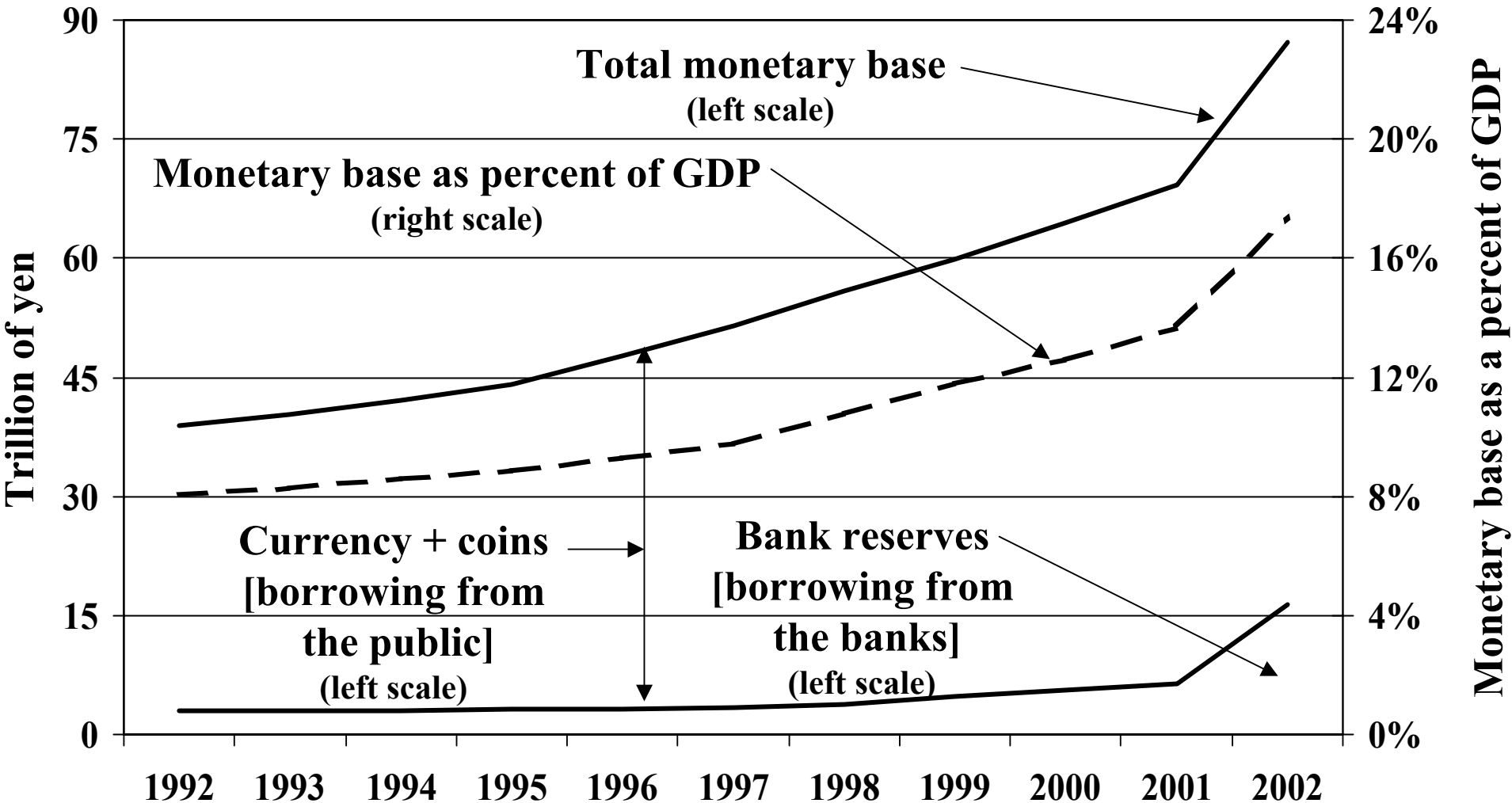
# Why Japan Can't Just Muddle Through Its Economic Problems

- Japan's domestic indebtedness continues to grow relative to its GDP – **Chart 3**
  - Japan's fiscal outlook is worsening rapidly – **Chart 1**
- Industrial restructuring is not happening fast enough to avert a crisis
- Japan is playing Russian roulette with its economy – sooner or later it will hit a loaded chamber
- Imposing capital controls to arrest capital flight would backfire by driving down the yen
- Japan is not addressing its longer term problems, specifically its aging population and a low birth rate

# Why Japan Can't Inflate Its Way out of Trouble

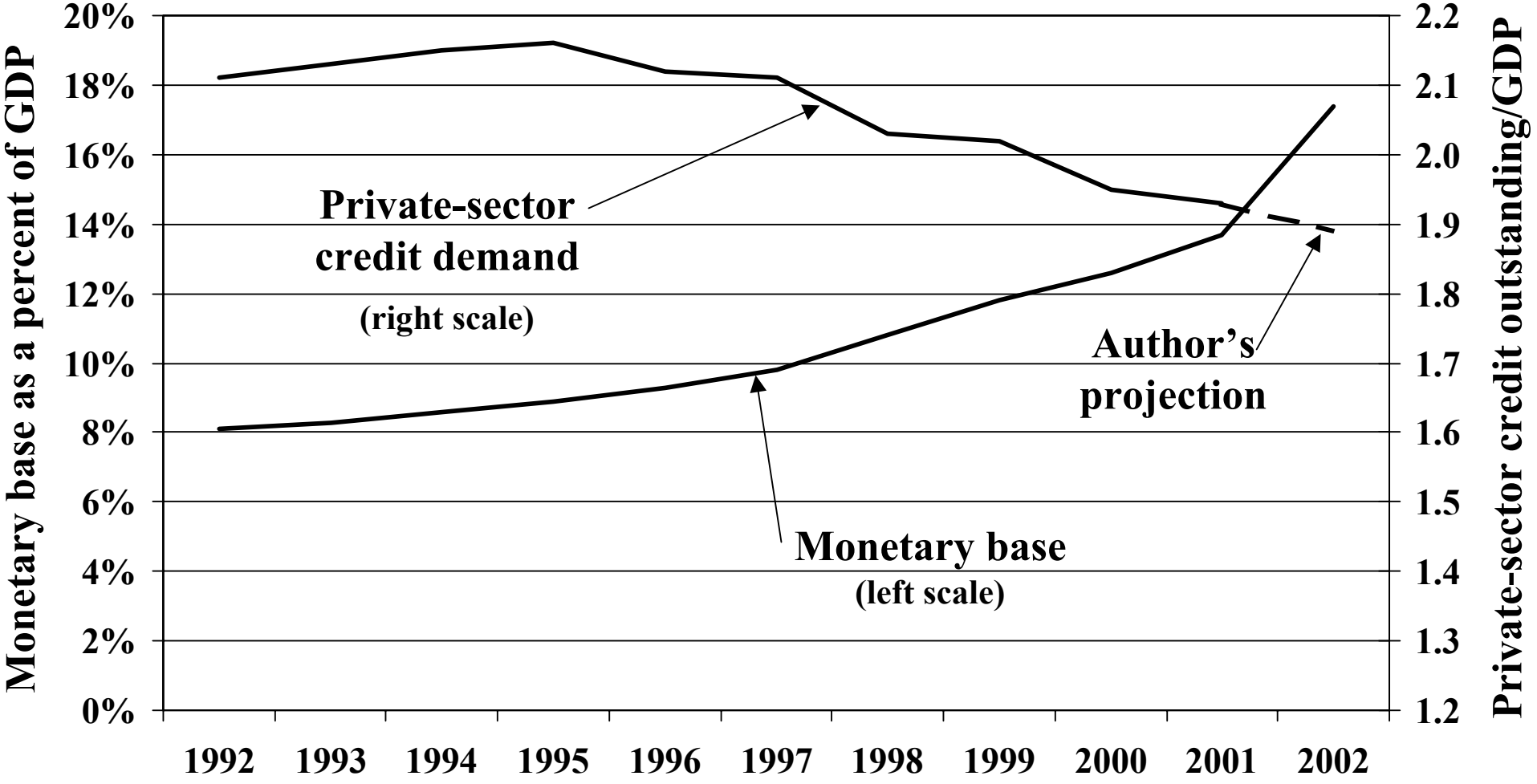
- As a practical matter, inducing inflation in Japan is difficult
  - Interest rates can't go much lower— they are almost at zero now
  - Increasing the money supply will not create inflation in an economy with an extensive banking system
    - The growing monetary base merely represents increased government borrowing from the public (currency) and the banks (reserves) – **Ch. 11**
    - Private-sector credit demand is declining despite a growing base – **Ch. 12**
    - The printing press can't trigger an inflation without drastically impairing Japan's financial system – the Japanese now hold currency voluntarily
- Inflation would shift wealth from the household sector to the non-household sector, triggering a flight from the yen
  - However, a resolution of Japan's economic crisis will have the same wealth-shifting effect

# Increasing the Monetary Base Has Not Stimulated Japan's Economy



# Private-sector Credit Demand has Declined Despite a Growing Monetary Base

(Private sector = non-financial corporations, households, and non-profits)



# What could trigger an economic crisis in Japan

- Accelerated efforts to clean up Japan's banking problems, which would trigger higher unemployment
- Domestic political turmoil, particularly within the LDP
- Accelerated capital flight
  - Japan could quickly become a net debtor nation
- Economic turmoil elsewhere in East Asia
  - Military threats or action on the Korean peninsula
  - Increased civil disturbances in China
  - Hong Kong breaks its peg to the U.S. dollar
- Oil prices shoot up to a high level, and stay there

# When the dominos start falling:

## Japan in financial crisis

**Banks call loans/reduce business credit**

**Businesses downsize/shut down operations**

**Employees laid off**

**GDP declines**

**Tax collections decline**

**Safety net spending rises**

**Government deficit increases**

**Government debt/GDP ratio rises**

**Household debt claims/GDP rises**

**Nominal interest rates rise**

**Market value of JGBs plunges**

**Yen drops relative to dollar**

**Japanese citizens flee yen**

**Yen drops further relative to dollar**

**Other Asian currencies fall, too**

This is happening to some extent

This occurs once a full-fledged crisis is underway

# **The impact of a financial crisis inside Japan**

- High and sustained unemployment – double digits
- Significant population relocation with Japan
  - New jobs will not be where many job losses will occur
- Political realignment, hopefully for the good
- Debt haircuts on creditors, principally householders
- Accelerated emigration, particularly among better educated younger people
- Tremendous reallocation of capital investments to
  - Growth industries
  - The urban infrastructure

# The global fallout from a Japanese economic crisis

- Currency realignment in East Asia
  - Yen will end up lower against the dollar, Euro
  - Chinese yuan RMB will increase in value against the yen
  - Korean won???
  - Hong Kong dollar will devalue against U.S. dollar
- Trade and investment flows within East Asia will be disrupted
  - Japanese exports would suddenly be more competitive, creating major problems with its trading partners
- Political turmoil within East Asia
  - This turmoil could lead to domestic disruptions in China and intensify military strains on the Korean peninsula

**What can be done to prevent  
the crisis from erupting**

**Nothing!**

**And nothing should be attempted to prevent it**

# Reforms Japan must launch once the crisis strikes

- Impose haircuts on public and private debt obligations to reduce the nominal amount of debt outstanding
- Get the government out of the credit-granting business
  - Fully reprivatize all failed banks
  - Privatize the Postal Savings System
- Implement stronger bankruptcy and foreclosure laws and administration
- Initiate a broad-scale deregulation of business, labor force
  - Entrepreneurs, not bureaucrats, must identify growth industries
- Sharply reduce trade barriers
- Eliminate impediments to more efficient land use
- Political reforms
  - End malapportionment – one person, one vote
  - End proportional representation in the Diet

# **The U.S. policy response to Japan's forthcoming economic crisis**

- The U.S. must accept the necessity of the crisis
  - Japan must go through an economic purging process
- The U.S. must accept the inevitable economic turmoil that will result from the crisis, as currencies and trade and investment flows realign themselves
  - Stock, commodities markets will experience volatility
- No effort should be made to support the yen
  - The IMF should not lend to Japan
- The U.S. should focus primarily on maintaining political and military calm in East Asia

# Data Sources

- **Chart 1** --
- **Chart 2** --
- **Chart 3** --
- **Chart 4** --
- **Chart 5** --
- **Chart 6** – To be completed
- **Chart 7** --
- **Chart 8** --
- **Chart 9** --
- **Chart 10** –
- **Chart 11** –
- **Chart 12**

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