Japan

Japan has a very high level of government debt and continues to run large fiscal deficits. Despite this situation, when weakness hits global financial markets the Yen tends to appreciate and Japanese government bond yields tend to fall. The sovereign debt crisis is yet to blow through Japan.

Part of the justification for Japan being an apparent pillar of strength in the global financial world is the ability of the government to finance its large debt position and ongoing fiscal deficits from the savings of domestic investors. In addition, Japan's current account surplus position is a strength. While this may be the case, it is also worth noting that the "income" component of the current account seems to be making a greater contribution to the overall picture (measured over the past decade). This perhaps reflects the paucity of direct investment opportunities available in Japan. It also signals a less significant contribution from exports of goods and services that historically have been a cornerstone of the Japanese economy.

To put the Japan government debt and fiscal position in context (refer table below for more detail):

- Gross debt to GDP is around 227%. This compares to 142% in 2000;[1]
- Net debt to GDP is around 122%. This compares to 60% in 2000;
- Government debt with maturities of less than 1 year total nearly 50% of GDP (versus less than 30% in 2000);
- The government has not had a fiscal surplus in nearly 20 years and the budget deficit has recently increased to 7% of GDP; and
- Despite all of the forgoing, 10 year Japanese government bonds currently yield only 1.25%.

Domestic Japanese investors badly beaten by falling equity and property markets over the past 20 years see safety in their government's bonds. They provide a real yield of 2-3% (assuming deflation of 1-2% pa) and the sense of capital preservation. It is estimated that Japanese domestic investors (i.e. households) own at least 50% of Japanese government bonds (primarily through domestic financial institutions). This has worked nicely in the past as Japanese domestic investors have been happy to save and buy their government's debt – and the government has been happy to spend it. It also relies on the financial soundness of the Japanese banking / financial sector.

[1] The measures used here are from the IMF. By any measure Japan has an absolute and relatively high level of government debt.

<u>Japan - General Account Budget</u>

Trillions of Yen unless otherwise stated

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue	64	66	62	62	60	59	60	62	56	57	60	57	52	50	53	58	57	59	56	58	48
Expenditures	66	66	67	72	71	74	73	73	77	79	78	78	77	75	75	74	70	70	77	92	82
Deficit	**- 1**	**0**	**- 5**	**- 10**	**- 11**	**- 15**	**- 13**	**- 11**	**- 22**	**- 22**	**- 18**	**- 21**	**- 24**	**- 24**	**- 21**	**- 16**	**- 14**	**- 11**	**- 22**	**- 33**	**- 34**
Deficit % GDP	0	0	-1	-2	-2	-3	-3	-2	-4	-5	-3	-4	-5	-5	-4	-3	-3	-2	-4	-7	-7
GDP	445	467	479	483	488	495	505	516	505	498	503	498	491	490	498	502	507	516	505	474	475
Employment (millions)	62	64	64	65	65	65	65	66	65	65	64	64	63	63	63	64	64	64	64	63	62
Current account % GDP	1.5	2.0	3.0	3.0	2.7	2.1	1.4	2.3	3.1	2.6	2.6	2.1	2.9	3.2	3.7	3.6	3.9	4.8	3.2	2.8	2.8
Household savings %**	**13**	**15**	**15**	**14**	**13**	**13**	**10**	**10**	**11**	**10**	**9**	**5**	**5**	**4**	**4**	**4**	**4**	**3**	**3**	**3**	**na**
Gross debt*	**301**	**317**	**348**	**379**	**413**	**458**	**507**	**552**	**606**	**666**	**715**	**755**	**791**	**820**	**887**	**962**	**971**	**967**	**984**	**1,032**	**1,079**
Net debt*	**60**	**55**	**67**	**83**	**96**	**118**	**148**	**179**	**233**	**268**	**304**	**330**	**357**	**375**	**412**	**424**	**428**	**420**	**479**	**530**	**578**
Gross debt % GDP	**68**	**68**	**73**	**79**	**85**	**92**	**100**	**107**	**120**	**134**	**142**	**152**	**161**	**167**	**178**	**192**	**191**	**188**	**195**	**218**	**227**
Net debt % GDP	**13**	**12**	**14**	**17**	**20**	**24**	**29**	**35**	**46**	**54**	**60**	**66**	**73**	**77**	**83**	**85**	**84**	**81**	**95**	**112**	**122**

Source: Japan Ministry of Finance, IMF, OECD. * General Government. ** as % of disposal household income.

Going forward, Japan will experience significant demographic change. Japan has one of the oldest population age profiles of developed countries. This brings increasing healthcare and pension costs, leading to more government expenditure.[2] It also results in a smaller work force (total employment has declined over the last decade), which will need to be taxed at higher rates to maintain the status quo. Perhaps more importantly, it will also see Japanese domestic investors start to draw on their savings.

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[2] Social security costs make up around one-third of government budget expenditure. These costs have increased nearly 50% over the past decade.

The Japanese domestic household savings rate has been declining over the past decade – from 13% in 1990 to 9% in 2000 and to around 2-3% today.[3] We think it is reasonable to expect this trend to continue, with a negative savings rate in the very near term.

Given the above trends, invariably the government's source of capital will become less reliable. The potential consequences include greater reliance on foreign capital (we believe a 1.25% yield on a 10 year JGB will be insufficient to attract foreign capital) and tighter domestic demand / supply for Japanese savings. Alternatively, the government can increase tax rates or cut expenditure (such changes will need to be significant given that general account expenditure has exceeded revenue by around one-third on average over the past 5 years), although the impact of this on a fragile economy that has not grown for 20 years creates obvious risks.

In this environment we believe that the role of the Yen in global financial markets could change dramatically.

The next month or so could be an interesting time for Japan, as the government is set to present its plan of how it will stabilise / reduce its growing debt.

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[3] It is noted that corporate savings also contribute to the domestic savings pool in Japan and these have increased over the past 10 years – although this probably reflects the lack of opportunity for direct investment in Japan. Moreover, it strikes us as unusual to rely on the corporate sector as banker to their domestic government. Including corporate sector savings, the savings rate in Japan has still declined by nearly one-half over the past decade.

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