

WILL JAPAN DEFAULT?

Angst and Reality

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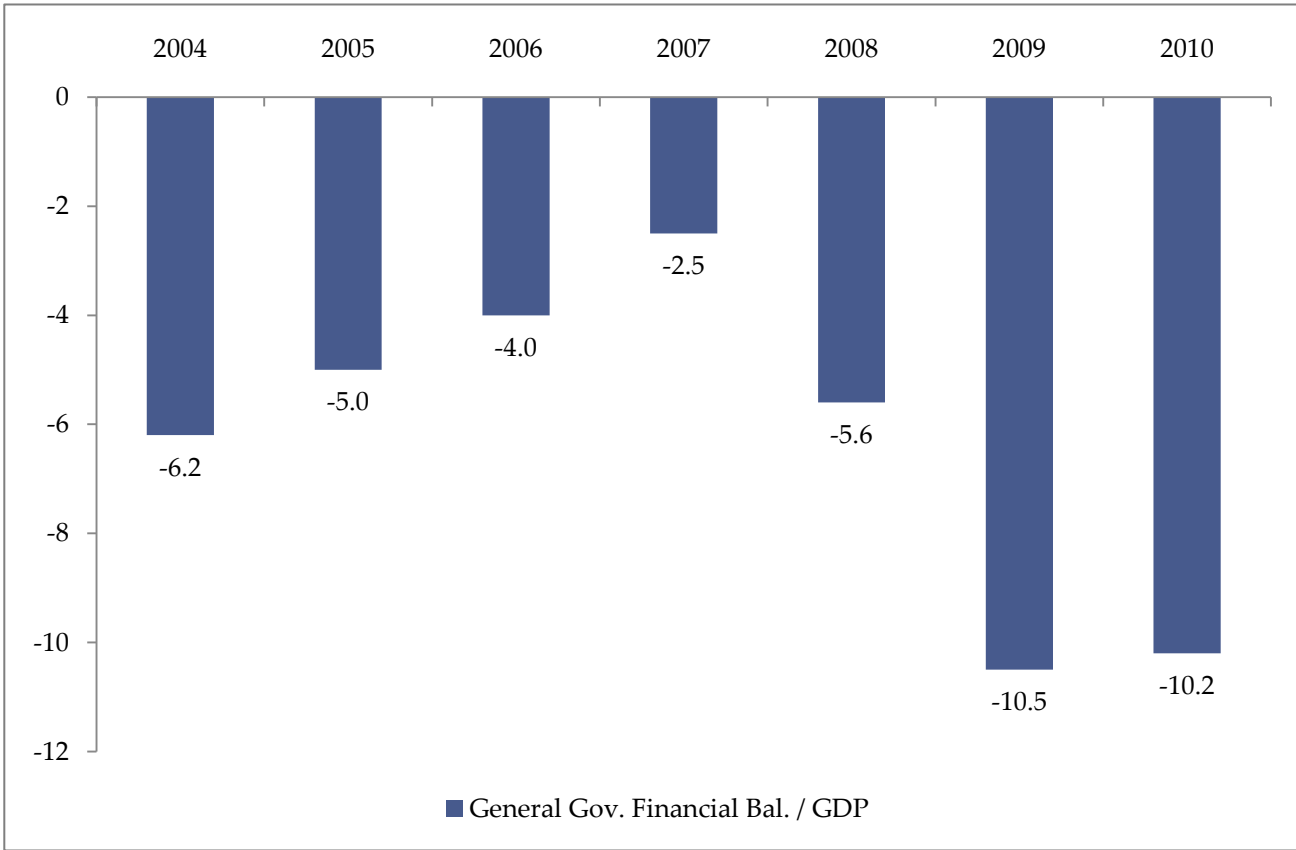


Dangerous Perceptions

- **Robert Samuelson, Washington Post, (November 2nd, 2009):**
 - “The mountainous debt reflects years of slow growth, many “stimulus” plans, an aging society and the impact of the global recession. By 2019, the debt-to-GDP ratio could hit 300 percent...”
- **Ambrose Evans-Pritchard, Daily Telegraph, (December 8th, 2009):**
 - “Economists are watching events in Japan with macabre interest. The country has blazed the path of extreme Keynesian fiscal stimulus over the last two decades—with poor results – making it a laboratory case for how much debt a mature economy can take on before it suffocates.”
- **Shuichi Obata, Senior Economist, Normura Securities, (January 27th, 2010):**
 - “There is no way Japan can keep bleeding deficits like this without drawing a roadmap to restore its fiscal health. Japan’s already a lit bomb, but no one knows the length of the fuse.”

The Case for Japan's Debt Armageddon

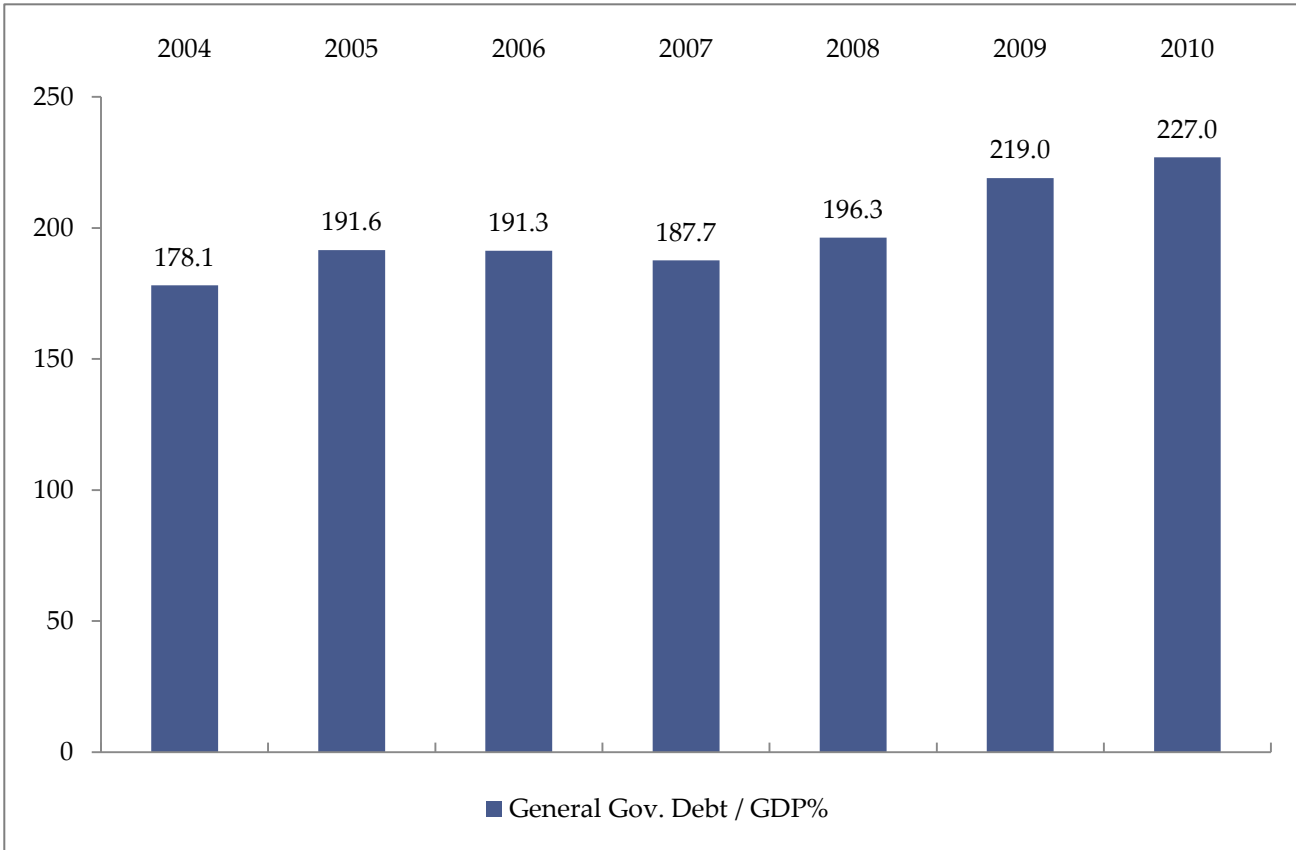
String of Fiscal Deficits (%)



Sources: Moody's / IMF

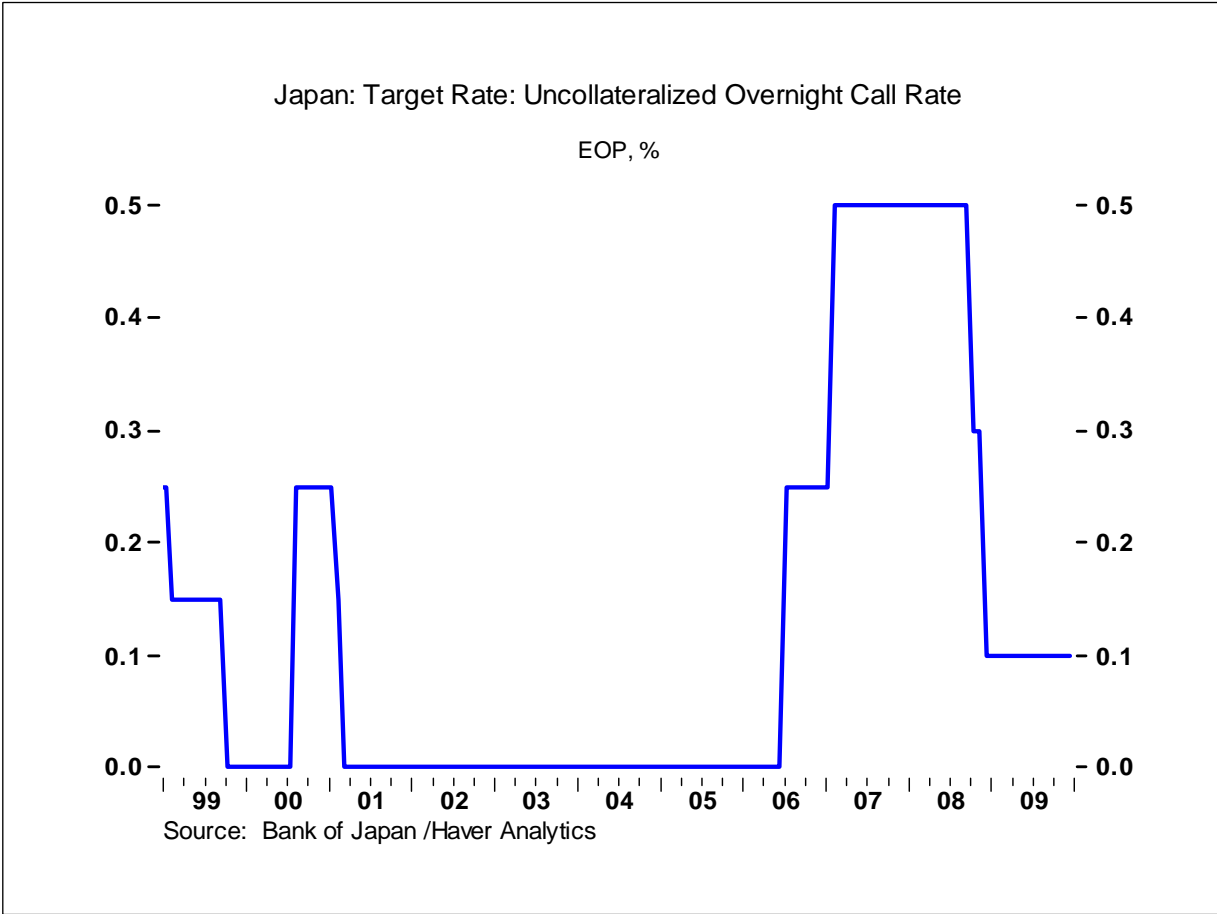
The Case for Japan's Debt Armageddon

Massive Build-up of Debt (%)

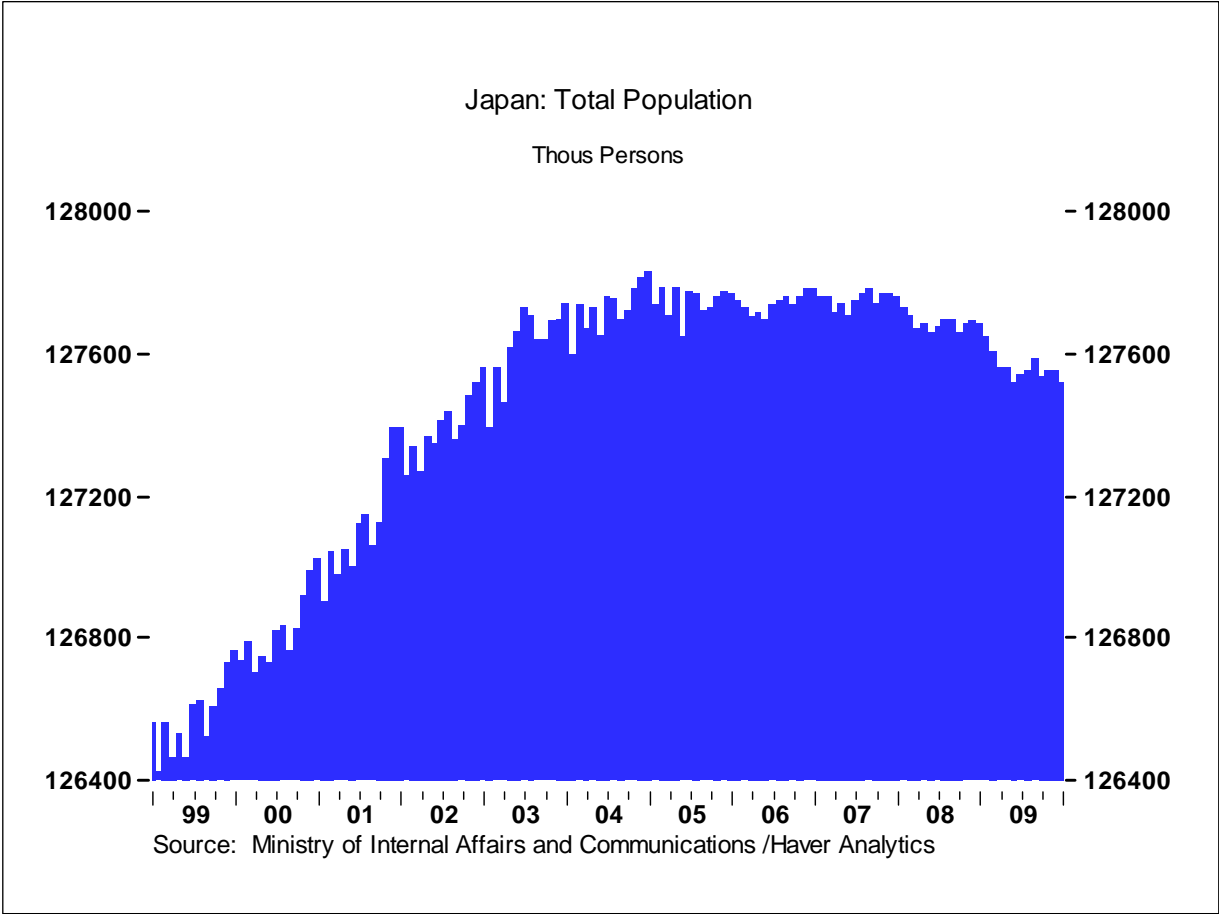


Sources: Moody's / IMF

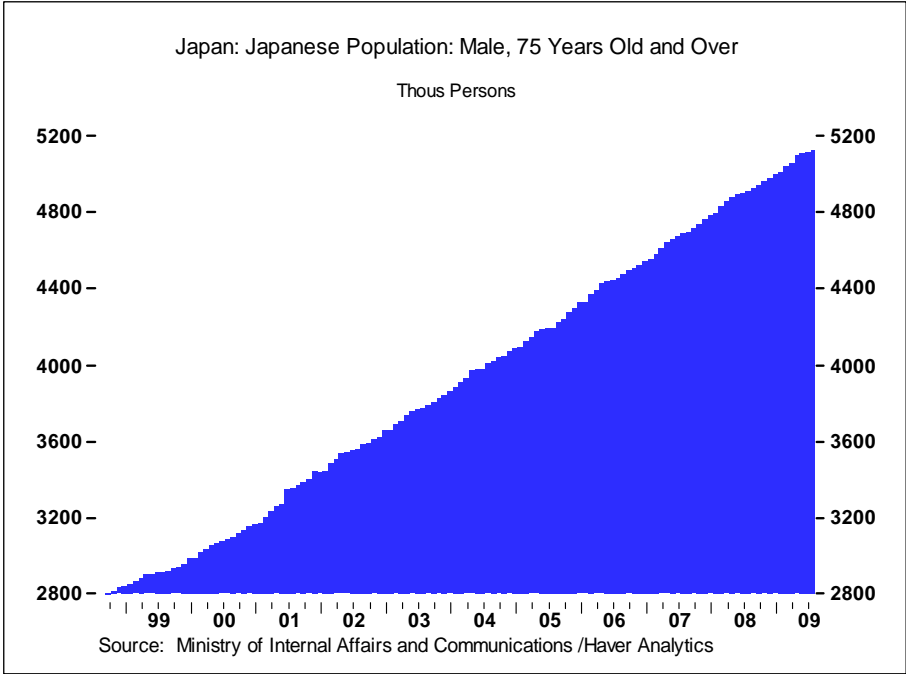
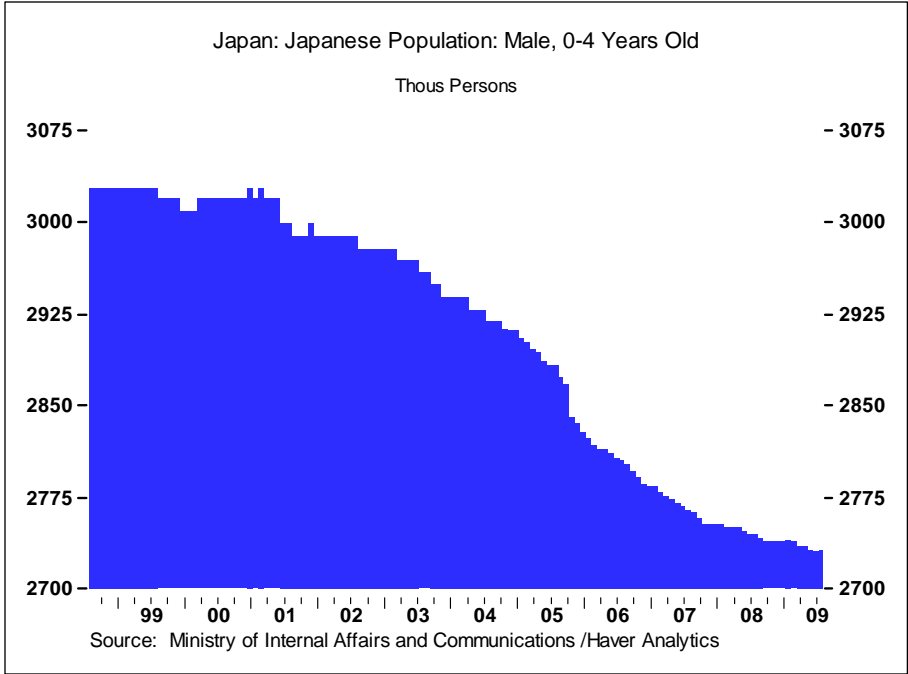
Low Rates / Low Costs / Vulnerable to Rate Hikes



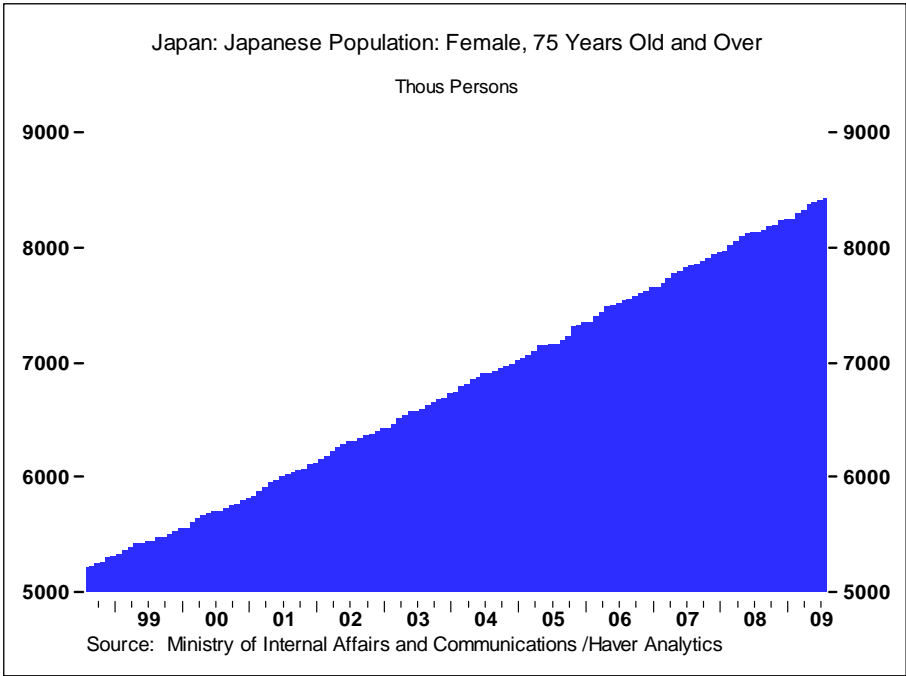
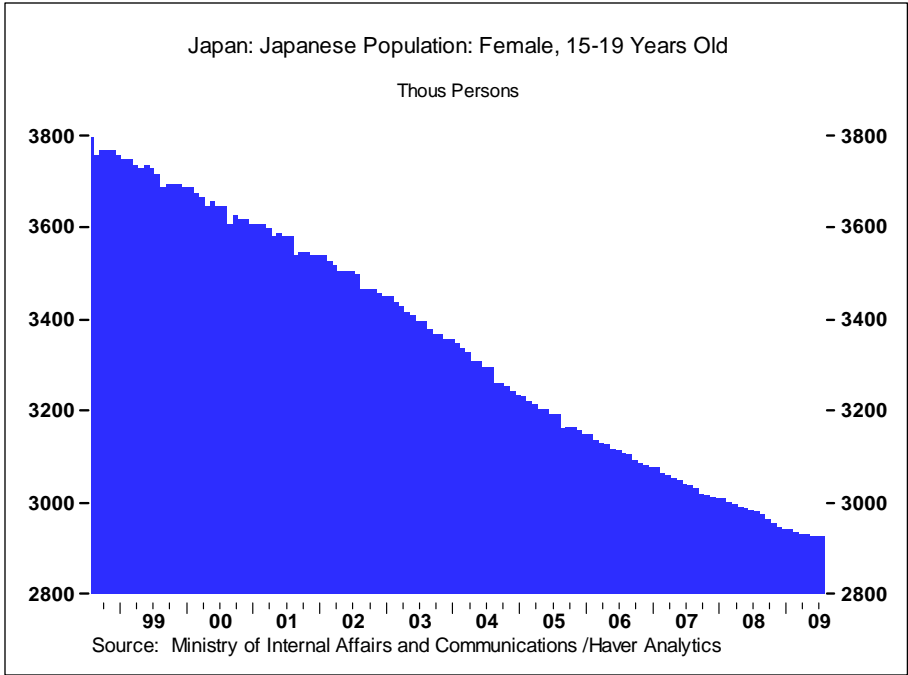
Bad Demographics



Bad Demographics



Bad Demographics



Other Complicating Factors

- Strong Yen hinders export expansion.
- Deflation makes debt more expensive.
- Any increase in interest rates magnifies debt burden.
- New government's policies are likely to allow more bankruptcies (good in long-term but adds to unemployment).

- Six finance ministers in 18 months.
- New Democratic Party is new and anti-business.
- New finance minister Naoto Kan described as a “high-spending populist and an advocate of radical stimulus measures.”
- Mr. Kan is also a “fierce critic of the Bank of Japan.”
- Gregg Gibbs, RBS: “Fiscal concerns dog most major economies, but Japan is the only one not discussing the need to start winding deficits back.”

What Keeps Japan Off the Default Path?

- Most of Japan's debt is owned domestically ("a broad and deep market for government debt."*)
- High national income and savings.
- A strong external payments position.
- Public confidence that the government will honor its obligations.

Is Japan Too Big to Fail?

- Still the world's 2nd largest economy.
- Key trade partner with most major OECD and BRIC economies.
- Home of some of the world's largest companies and banks.
- Any debt problems would be catastrophic to the global economy.
- There is a serious question as to whether international institutions could engineer a rescue (looking at over \$10 trillion in debt).

Japan's Economic Problems are a Slow Moving Avalanche

- A default should not be imminent, but ...
- ...The clock is ticking on the fiscal / debt front.
- Hatoyama government must demonstrate its awareness of the problem and formulate a credible plan.
- Globalization is increasing awareness of the problem unlike the past; this is shifting from a quantitative game to a confidence game.
- Ratings point to deterioration, but so do opinion polls.

- **Reinhart & Rogoff, This Time It Is Different:**
 - “One point that certainly jumps out from the analysis is that the fairly recent (2003-2008) quiet spell in which governments have generally honored their debt obligations is far from the norm.”
- Japan should not default in the short-term, but without remedial action the chances are increasing.
- The danger is a sudden / unexpected challenge of confidence that starts small but builds big.

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