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Japan's Sovereign Crisis
: The choice that the people have taken

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Global financial crisis, which triggered huge losses of financial institutions and developed into recessions in real world economy, is now changing into a sovereign crisis in many advanced nations. In August 2011, the credit rating of the US Treasury bonds was downgraded by the Standard and Poor's from the most excellent level of AAA to AA+, and the market attention is now being focused on the French sovereign bonds as a next candidate for rating cut.

The rating of Japanese Government bonds was downgraded in January 2011 by the S&P from AA to AA-, which was followed by a similar cut by the Moody's in August from Aa2 to Aa3. However, market reactions were only nominal. Maybe this is partly because the holding of Japanese government bonds by foreign investors is small (5%) as compared with that of the US Treasuries (25%) and also because the default risk is almost non-existing in Japan since the sovereign power over the bonds (money sovereignty) is completely (on a one to one base) backed by the sovereign power over the budget (fiscal sovereignty). Yet, it is also true that an increasing number of people have concerns about the extraordinarily high level of government debt outstanding that exceeds 200% of the GDP.

National burden ratios should have been raised in line with the aging of population

Various explanations can be made about the backgrounds for the huge accumulation of the government debts. Misled and inappropriate economic policies taken in the past decade failed to raise the productivity of the Japanese economy, thus resulting only in the swelling of the government debts. Widening gaps between expenditures and revenues have been embedded in the budgetary process because of the slow growth and deflation, for whatever the reasons for the latter. International comparisons of the macro-economic indicators, however, reveal the fact that the level of tax and social security contributions was kept absolutely low in Japan in financing the mounting expenditures for social security in the face of aging society.

As the population ages, a larger redistribution of the income is needed. Retired people continue to consume even though they do not earn the income flow. In particular, the expenditures for such consumption as medical and elder care services will increase as they grow older. Who will pay for them? There will be no other way than to pay from the social savings including the saving of the person himself that receives these services. Looking around the world, a correlation is seen that the countries with higher ratio of the aged population have higher national burden ratio, indicating that many societies accept higher tax rates and social contributions in line with the progress of aging. Until 1989, Japan also followed the same trend but thereafter, the national burden ratio did not rise despite the accelerated aging, and Japan tended to go on funding through government borrowing.

It was Japanese that has chosen the way to rely on debts.

It is not without reason that Japan has chosen since 1990s the approach to rely on the government bonds, rather than to raise taxes and social security premiums. Firstly, Japan has experienced a much speedier aging process than many other industrialized nations. To address squarely the problems of this speedy aging, it was critically needed to raise the rates very frequently, yet strong resistance of the people was expected for the raise. Secondly and unfortunately enough, this period overlapped the protracted economic stagnation that followed the burst of the babbles. Therefore, the funding by the government bonds was chosen as an easier way with less strong sense of burden felt by the public than raising taxes and social security premium rates.

Perhaps it was not because the government had a proactive intention to choose the easier approach but because it was carried away to do so after all. Mass media criticized the increase of the budget deficits but they did not try to address the roots of the problem and suggest any alternatives to be taken. For many years, politicians were warned at every election that they would “lose the election if they even hinted a possibility of raising taxes. ” Therefore, the present budget situation was nothing but a choice that the Japanese people made by themselves.

What are the problems?

Although the largest holders of the government bonds are banks and other financial institutions such as postal savings and insurance companies, the ultimate holders are the households since their deposits and insurance premiums are the source for buying the bonds. Through the intermediation of their money into the government bonds, the Japanese people are actually financing their social security cost within a range of their income without relying on the foreign funds. Isn’t it acceptable if the social security cost is financed within the capacity of national economy? What are the problems?

① Postponement of the burden

Firstly, as it is often pointed out, the sense of burden will be weakened at the present point as financing the costs through government bonds enables the burden to be carried away to the future generations. A simple macroeconomic compilation of the national burden ratio, after tolerating some margins of error, suggests that the government needs to collect the money by taxes and social insurance premiums equivalent of 50-60% of national income if the burden is to be born at an appropriate level compatible with the ratio of Japanese aging population. This means that the ratio has to be raised by at least 10% from the present level, equivalent to about ¥50 trillion. If this amount is to be raised by consumption tax only, the tax rate should be raised by 20% or so. Since the VAT rates are around 20% in many European countries, higher level of consumption tax than 20% should be reasonable in Japan where the population is aging more rapidly than in Europe.

If the people daily recognize the burden in the form of consumption tax, it is expected that the efficiency of expenditures is strictly checked by the taxpayers. By funding the cost through bonds, however, it is feared that this checking function has been significantly weakened and the future generations should bear the burden that results from this. As long as the larger portion of the bonds is sold within the country, the burden will not come up to the surface. However, the future prospects of the demography and household’s financial assets are foretelling a possibility of an increasing dependence on foreign funds, which in turn will lead to a rise of interest rates, a plunge of external value of yen denominated assets, and ultimately higher inflation.

②Cause for instability of financial system

Secondly, unlike taxes and social security premiums, the government bonds constitute liabilities that incur the interest burdens within the national economy. If the rising interest begins to pose excessive pressure on the economy, activities of the private sectors will be crowded out, and the whole economy will be deprived of its dynamic power. Even though the ultimate buyers of the government debts are households, largest direct holders are banks. The current European hardships clearly show how risky is the situation that the risks of falling price of national debts are concentrated on the banking system.

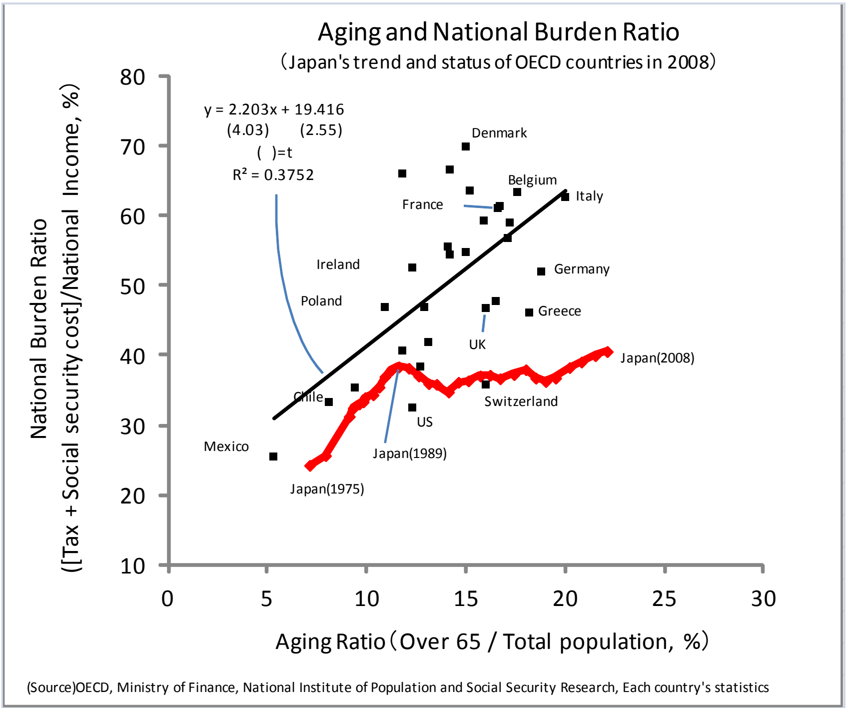
③ Uncertainty for the future is one of the causes of economic stagnation

Thirdly, excessive dependence on the national debts will intensify the concerns among the people that the social security system such as pensions, medical care and nursing care of elders may be threatened to break down. Social security system is a basis for social trust of the people, and therefore if the system faces a risk of being eroded, it will create a great uncertainty among the people. Consumers will refrain from consuming, and it will be natural that they become cautious even about having children. As a result, this will trigger a negative chain of accelerating the slowing of economic growth.

④ **Risks of decelerating investment needed for growth**

Fourthly, there is a risk that the expenditures will not be distributed to the areas needed for a long term economic development. In other words, if the budget reduction is too pushed on fulfilling the target at any rate without proper understanding of the essence of the problems, there is a serious risk of deeply cutting the budget to be directed to the growth areas. Taking education expense for instance, the expenditures for education in the budget, especially those for higher education beyond senior high school, quite pale among the OECD countries. It is not an exaggeration to say that the human intellectuals are the only resource for creation of added value in Japan which has no other special resources. It goes without saying that simple discussion of budget reduction steps without addressing the real causes of the budget deficits would threaten the basis for long-term growth, even though continued efforts are needed to pursue the efficiency of the expenditures by eliminating the unnecessary outlays.

It seems that recently influence of the third and fourth factors has grown too large to ignore. We should not allow these factors to cast a negative shadow over the future of Japan by discouraging the consumption and investment incentives, and devitalizing the energy of future Japan.



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