

WHY JAPAN WILL AVERT A FISCAL MELTDOWN

The severity of the challenge facing Japan should not be underestimated. But it is not about to follow Greece and Ireland into the emergency debt ward.



REUTERS/BEAWIHARTA

BY ALAN WHEATLEY,
GLOBAL ECONOMICS CORRESPONDENT
TOKYO, MARCH 17

IN THESE DARK HOURS, Japan would do well to heed former White House Chief of Staff Rahm Emanuel's memorable maxim that you never want a serious crisis to go to

waste.

As the nation struggles to avert a nuclear catastrophe on the heels of a deadly earthquake and tsunami, it takes a huge leap of faith to foresee any positives emerging from the triple disaster for a stagnant, rapidly ageing and heavily indebted economy.

Yet a number of experts say the disaster might -- just might -- shake Japan out of its collective economic and political torpor of the past two decades and provide a new sense of purpose for a nation that has seemingly lost its way.

They also say that widespread fear of a Japanese fiscal death spiral is mostly

BLOG

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overblown.

Masaru Hamasaki, a senior strategist at Toyota Asset Management in Tokyo, said the severity of the challenge facing Japan should not be underestimated.

The numbers killed in last Friday's quake centred on Sendai in northeastern Japan will far exceed the 6,400 toll from the 1995 temblor in Kobe.

Many more people have been affected directly and indirectly, for instance by power cuts and the risk of radioactive fallout from the crippled Fukushima Daiichi nuclear power plant. The usually bustling streets of Tokyo were eerily empty this week.

And the economy is even less vigorous than in 1995, smack in the middle of Japan's so-called Lost Decade.

"But out of this crisis affecting a large part of the population, a sense of 'public morality' is already building up," Hamasaki said. "If the country's leaders can harness this spirit in the long term, then I'm sure Japan will move in a positive direction."

This civic duty, an impulse of shared responsibility, is likely to count for more than any spreadsheet in trying to assess the impact on Japan's bond markets of financing the still unknowable bill of rebuilding after the quake, the strongest on record here.

Some pundits fear that adding substantially to a gross debt burden that is already more than twice Japan's national output will be the straw that breaks the bond market's back.

"The debt will rise significantly. Until now, the country could finance its obligations at relatively low rates. If additional debts come on top now, there will be questions about solvency," Peter Bofinger, a member of Germany's "wisemen" council of economic advisers, said in an interview with the German daily Sueddeutsche Zeitung published on Monday.

Economics Minister Kaoru Yosano has acknowledged that, unless it changes its ways, Japan faces a fiscal dead end.

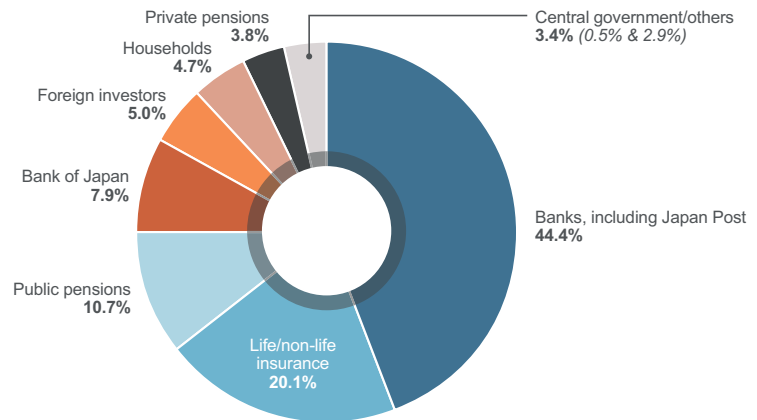
But the Sendai quake is very unlikely to trigger that day of reckoning.

NO FOREIGN MONEY NEEDED

ON PAPER, JAPAN'S LIABILITIES will hit 204 percent of GDP this calendar year, larger than 137 percent for Greece and 113 percent for Ireland, according to the Organisation for

Breakdown of JGB holders

Households' direct JGB holdings are not large



Data as of September 2010
Sources: Bank of Japan

Reuters graphic/Christine Chan

REUTERS

07/03/11

"OUT OF THIS CRISIS AFFECTING A LARGE PART OF THE POPULATION, A SENSE OF 'PUBLIC MORALITY' IS ALREADY BUILDING UP."

Economic Co-operation and Development (OECD).

But Japan is not about to follow Greece and Ireland into the emergency debt ward. Both countries have needed a bailout arranged by the eurozone and the International Monetary Fund.

For a start, the government owes nearly half of the debt to other arms of the government such as the Japan Post Bank and the Government Pension Investment Fund. The Bank of Japan also owns a tidy chunk of Japanese Government Bonds (JGBs).

Net debt, taking account also of Japan's official foreign reserves, will reach 120 percent of GDP this year, according to the OECD.

That will be the highest among major economies, but the burden is not significantly greater than that shouldered by Belgium and Italy in the 1990s, both of which avoided a sovereign debt crisis.

True, net debt has risen sharply from 80 percent of GDP in 2007, and the government is running a budget deficit of close to 10 percent of GDP even before counting the cost of the quake.

But whereas about 70 percent of Greece's public debt is held by foreigners, domestic

investors hold 95.4 percent of Japan's bonds. This gives Tokyo's policymakers a huge advantage.

"They have much more room to manoeuvre than Greece or Ireland would have in similar circumstances," said Marcus Noland of the Peterson Institute of International Economics in Washington.

"One has to assume Japanese residents are a much less footloose debt-owning class than, say, London hedge funds."

Quite apart from the fact that low-yielding JGBs have proved a good investment in recent deflationary years, Noland expects banks, insurers and pension funds will readily accede if the government asks them to buy extra quake reconstruction bonds.

In a country with a high degree of social cohesion, the loyalty of individual investors in Japan's hour of need can also be taken for granted.

"If the government says 'we're going to tighten our belts; cut expenditure in other areas and shift spending to rebuild Sendai; and we're going to issue more bonds at the margin to make that happen', I simply do not believe the Japanese public is going to dump Japanese bonds," Noland said.

Jeremy Lawson, an economist with the Institute of International Finance, a lobby group for global banks in Washington, agreed. The trajectory of Japan's debt is unsustainable, but, in the short term, "domestic residents may display even greater willingness to lend to the government as an act of national solidarity," Lawson said in a report.

A RICH, AGEING SOCIETY

THAT'S TODAY, THOUGH. What about the future?



HARDTIMES: People shop for food from almost empty shelves at a big-box supermarket in Tokyo March 16, 2011. **REUTERS/ISSEI KATO**

“NOW IS NOT THE TIME FOR BEING CAUTIOUS OR CONSERVATIVE.”

If Japan’s households are avid buyers of bonds, it is because they are sitting on a mountain of savings -- some 1,400 trillion yen (\$17,320 billion), compared with approximately 870 trillion yen in outstanding long-term government bonds.

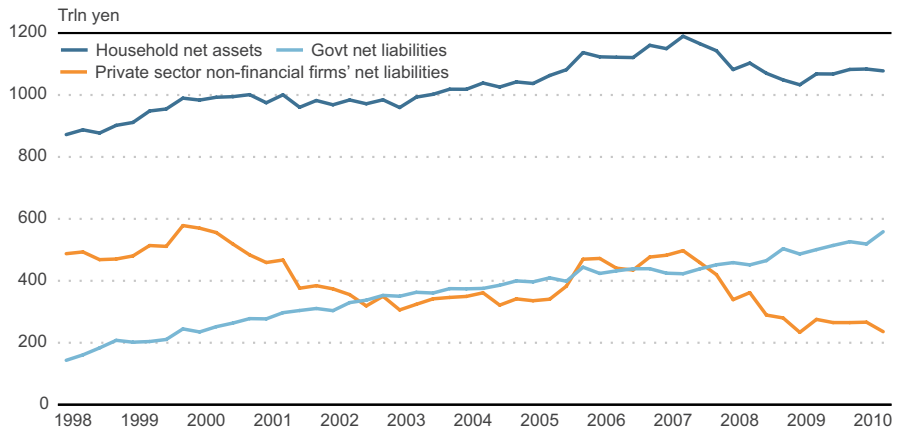
Japanese workers built up that huge nest egg as they toiled successfully to rebuild their country from the ashes of World War Two. But the young workforce that catapulted Japan ahead of West Germany in the 1960s to become the world’s second-largest economy is now ageing fast. Pensioners are now spending those savings.

Little noticed by the rest of the world, Japan’s household savings rate has in fact already plunged to about 3 percent of disposable income from a peak of 18 percent in the early 1980s.

Despite the government’s big budget deficit, Japan still enjoys surplus national savings, reflected in a current account surplus, thanks to high corporate savings and a large income stream from its overseas investments. Japan is the world’s largest creditor nation, with net external assets of

Japan’s household sector

Household sector is financing less of the debt burden



Source: Bank of Japan

Reuters graphic/Christine Chan

REUTERS

07/12/10

225.5 trillion yen, according to official figures.

The question preoccupying economists is how long it will take for the savings rate to erode and drive the current account into deficit. At that point, Japan will have to import capital to balance its books. That’s when unexpected shocks like the Sendai quake could trigger a financial as well as a humanitarian crisis by undermining the confidence of foreign investors.

LIVE COVERAGE

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“Without policy adjustment, the space for household assets to absorb public debt will continue to shrink over the medium term,” said Kiichi Tokuoka, an economist with the

INTERACTIVE

For a package of interactive graphics on the Japan disaster, click here:

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International Monetary Fund.

In a January 2010 working paper, he said Japan's gross public debt could exceed households' gross financial assets by 2015 or 2020, depending on the accounting treatment.

"Although these results do not imply any specific turning point for public debt financing, they suggest that if current trends continue, domestic financing could become more difficult toward the mid-2010s, placing a premium on other sources of funding, including from overseas," he wrote.

BE BOLD

GEORGE MAGNUS, senior economic adviser to UBS in London, guessed that three years was too short a time for Japan to reach the turning point. But 10 years was too long because the ageing of the workforce was inexorable.

"At some point in the medium term, I do think there's a sporting possibility that Japan will start to run trade deficits and have to start selling debt abroad," said Magnus, the author of a study on the economics of ageing. "And that probably is when the crunch will come, because people will want to see Japan taking material measures to manage its public debt over the longer term."

Crucially, no respected economist is arguing that Japan should think twice about spending right away whatever is needed to put the economy back on its feet.

One of the lessons from the recession brought on by the collapse of investment bank Lehman Brothers in 2008 is that the increase in the public debt ratio in Japan and other countries was not due to fiscal spending to stimulate the economy. Rather, it was more due to the abrupt slowdown in economic growth.

The government should do the same today, said Sebastian Mallaby, an economist with the Council on Foreign Relations in New York.

"It should be willing to act aggressively to increase the budget deficit in order to have the money to rebuild the damaged areas promptly," he wrote on CFR's website. "Now is not the time for being cautious or conservative. Now is the time for a bold response, and I've got every reason to think that they will do that," he added.

REUTERS INSIDER

Click to see interview with Japan's Economics Minister Kaoru Yosano. :

<http://link.reuters.com/buw58r>



POLITICAL MESS

WHEN THE TIME comes to rein in the budget deficit, Japan already knows from years of experience what Greece and Ireland and other countries are just discovering: there is no secret recipe. It's "simply" a question of agreeing on a politically acceptable mix of tax increases and spending cuts.

The IMF and other agencies have zoomed in on Japan's low rate of consumption tax, five percent, as the most promising candidate to raise the revenue needed to help stabilize the government's debt-to-GDP ratio. In its 2010 review of Japan, the Fund projected that by 2015 gross debt would reach 250 percent, and net debt 154 percent, unless there was a shift in policy.

The government could raise some 2.5 trillion yen for each 1 percentage point rise in the consumption tax.

But a hamstrung political process has hobbled policymaking. Prime Minister Naoto Kan is the fifth man to hold the job since 2006, and his popularity ratings have been sinking like a stone, further reducing his chances of getting budget bills through a split parliament. Indeed, just hours before Friday's earthquake, Kan, accused of illegally receiving campaign funds, was rebuffing calls from an emboldened opposition for his resignation.

The tantalizing question now is whether the Sendai tragedy will change not only Japan's economic and fiscal outlook but also its politics.

"Kan needs to show his leadership to craft a big supplementary budget. This is the time to show his leadership by gathering ideas

from the ruling and opposition parties very quickly," said Hamasaki, the Toyota Asset Management strategist.

POLITICAL GAME-CHANGER?

PESSIMISTS SUSPECT any political truce sealed in a moment of national solidarity will be short-lived once reconstruction is under way and the economy is recouping the output lost due to the disaster.

After all, the bursting of Japan's asset bubble in the early 1990s failed to jolt the political class into enacting the difficult structural reforms the economy needed. Japan's nominal GDP is stuck at the level it was at in 1992.

But Noland with the Peterson Institute for International Economics said that successful crisis management on Kan's part would go a long way toward reassuring voters still unsure whether his Democratic Party of Japan is a credible alternative to the Liberal Democratic Party. The LDP has governed Japan for most of the past 60 years. It lost power to the DPJ in 2009.

"Cementing a real two-party system could create 'more normal' politics and push Japan into becoming a truly modern, functioning democracy in the 21st century," Noland said.

"It would make governance more complicated, but it would bring issues such as the coddling of the agricultural sector, immigration reform and defence policies out into the open in a much more transparent, democratic way," he added.

The alternative is that Sendai turns out to be Japan's "Katrina" moment, Noland said, referring to the U.S. authorities' ineffectual

VIDEO

Stratfor analyst Matt Gertken discusses Japan's economy on Reuters Insider here: <http://link.reuters.com/kyz58r>

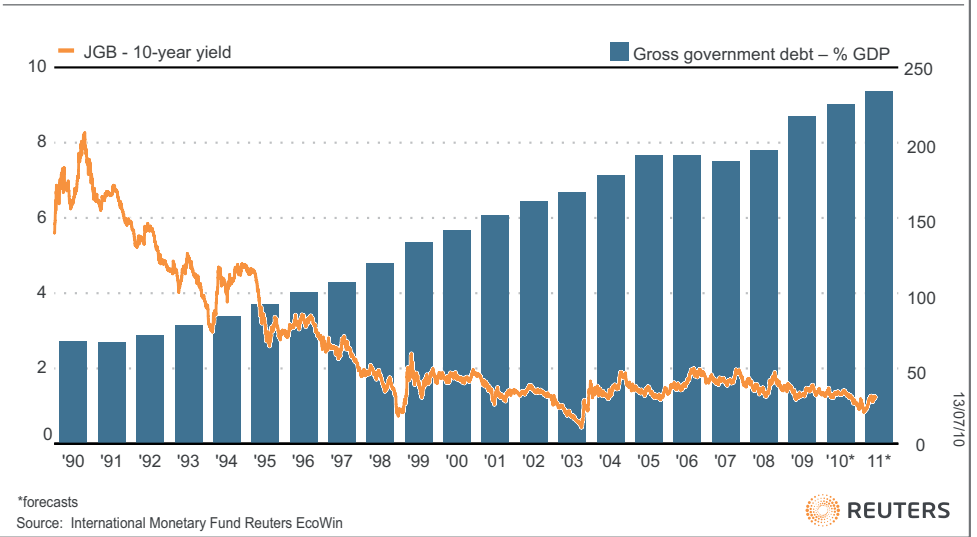
initial response to the hurricane that ravaged New Orleans in 2005.

"If they do a bad job, then Japan's ageing and risk-averse electorate could go flocking back to the LDP and essentially re-establish the status quo ante of the last 60 years," he said.

Seen in this light, the implications for Japan's economy and investment outlook are profound.

Like everyone, Jim O'Neill, chairman of Goldman Sachs Asset Management in London, is waiting to see how fast-changing events at the Fukushima plant play out. But he said the crisis could act as a catalyst in much the same way that the second oil price shock of the late 1970s prompted an all-out

Japan's debt to GDP and 10-year bond yield



national effort by Japan to improve energy efficiency.

"My hunch is that this is so big it will galvanize change and force Japan's leaders to do more," he said in an email.

(Additional reporting by Chikafumi Hodo and Stanley White in Tokyo and Noah Barkin in Berlin; editing by Jim Impoco and Claudia Parsons)



GREYING JAPAN: People on their wheelchairs rest at an evacuation centre in Kesennuma, Miyagi Prefecture in northern Japan, after an earthquake and tsunami struck the area, March 15, 2011. **REUTERS/KYODO**

ECONOMISTS' ESTIMATE OF JAPAN QUAKE IMPACT

FACTBOX

THE FOLLOWING IS A SUMMARY of analysts' assessments of the likely economic impact of the devastating earthquake and tsunami that struck the northeast coast of Japan.

Most assessments were published before the latest explosion at a quake-hit nuclear plant caused the release of radiation and prompted some people to flee Tokyo.

JP MORGAN

ECONOMIC IMPACT:

- The bank revised down its Q1 and Q2 growth forecasts for Japan's economy to 1.7 percent and 0.5 percent respectively, from previous growth forecasts of 2.2 percent in each quarter; in Q3 and Q4, estimates were raised to 4.0 percent and 2.5 percent from 2.5 percent and 2.0 percent, respectively
- Full-year growth in 2011 was revised down to 1.4 percent from 1.7 percent; 2012 growth estimate revised up to 2.0 percent from 1.8 percent.

COMMENT:

"The economic cost of the disaster will be large. There has been substantial loss to economic resources, and economic activity will be impeded by infrastructure damages (like power outages) in the weeks or months ahead. However, the rebuilding effort will be a significant boost particularly in H2."

IHS GLOBAL

ECONOMIC IMPACT:

- Based on preliminary estimates, Japanese real GDP growth could be cut by 0.2 to 0.5 percentage point this year and boosted by 0.2 to 0.5 percentage point next year.
- Rough estimates suggest that the negative impact on global growth this year will be negligible -- at most in the 0.1 percent to 0.2 percent range, with a correspondingly small boost to growth next year.

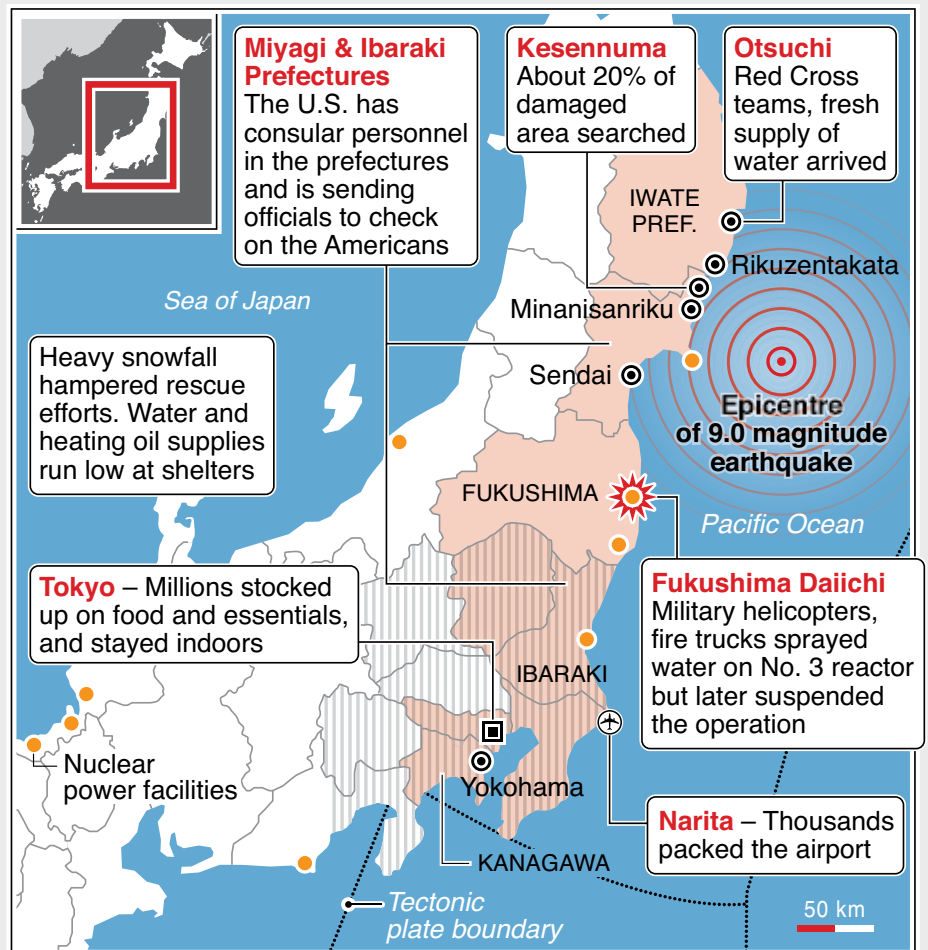
COMMENT:

On the GDP outlook: "If the nuclear crisis turns into a full-blown catastrophe, then the negative effect on growth this year will be much larger."

"The big uncertainty about this disaster (and what sets it apart from other such disasters) is that roughly 10 percent of electricity generation capacity (both nuclear and coal) may be off line for a few months, until oil- and gas-fired plants can ramp up. In the near-term, this could have major negative ramifications for the

JAPAN QUAKE TOLL

■ Prefecture reporting deaths, missing / injured ||||| Affected by rolling blackout



OFFICIAL FIGURES – Five hardest-hit prefectures, as of 0900 GMT on Thu.

Some 450,000 people are staying in more than 2,600 shelters

	5,457 dead	9,508 missing	2,409 injured
TOTAL	5,457	9,508	2,409
Miyagi	3,004	2,157	722
Iwate	1,824	3,853	143
Fukushima	574	3,491	220
Ibaraki	19	1	640
Chiba	16	5	173

Sources: Reuters news reports, Japanese media, Japan National Police Agency

Japanese industrial sectors; some steel and automotive factories have already been closed."

CREDIT SUISSE

ECONOMIC IMPACT:

- Total economic losses could be 14-15 trillion yen, less than half that of the 1995

Kobe earthquake; recovery could cost 4-5 trillion over next three years

- Initial disaster relief could cost 2 trillion yen, mostly funded from contingency reserves so only limited need to increase Japanese government bond issuance
- Cuts 2011 growth rate estimate by 0.2

percentage points but sees a “decent risk” of 0.5-1.0 percentage point hit to Japanese growth this year

CITIGROUP

ECONOMIC IMPACT:

- 5-10 trillion yen (up to \$122 billion) in damage to housing and infrastructure
- Growth to be slower than previously forecast in H1, but faster in H2 because of reconstruction

■ 2011 GDP growth forecast: 1.7 pct (unchanged)

■ 2012 GDP growth forecast: 2.3 pct (up from 1.9 pct)

COMMENT:

“It may be too early to discuss how much damage was done to housing and infrastructure, but we suspect it could match that of the Great Hanshin Earthquake in 1995.

“Some of the damage will likely generate reconstruction demand and bolster activity in the coming months as actual restoration begins.”

UBS

ECONOMIC IMPACT:

■ 2011 GDP growth forecast: 1.4 pct (down from 1.5 pct)

■ 2012 GDP growth forecast: 2.5 pct (up from 2.1 pct)

COMMENT:

Duncan Wooldridge, chief Asia economist at UBS in Hong Kong:

“It remains to be seen, but I would think the impact most likely would be temporary. So you will have a drop in economic growth, but after that, of course, a recovery process.

“Because of disruptions to power supplies and transport, you tend to find drops in (economic growth). But as that infrastructure is repaired in the months ahead, you get a re-acceleration in economic growth. This is by far the most likely outcome.

BARCLAYS CAPITAL

ECONOMIC IMPACT:

■ Losses of 15 trillion yen, or 3 pct of GDP

COMMENT:

“The final damages are expected to exceed those from the Kobe earthquake. As noted above, there is also a need to consider the potentially negative impact on other regions due to the Tohoku region’s “trade economy” character.

“Earthquakes not only curb effective demand (eg. consumption, capex) but also lower potential growth through damage to



BIG CLEAN UP: A ship brought in by the tsunami is seen at a devastated area hit by the earthquake and tsunami in Kesennuma, north Japan, March 17, 2011. **REUTERS/Kim Kyung-Hoon**

tangible fixed assets and human capital. In terms of the CPI, we believe the impact will be neutral.”

NOMURA

ECONOMIC LOSSES:

■ Power cuts to subtract 0.29 pct from nominal GDP

COMMENT:

“Based on what occurred after the Kobe earthquake, we think an all-out slump in the Japanese economy caused by the Sendai earthquake is overly pessimistic. However, a V-shaped recovery supported by a rapid upturn in demand driven by rebuilding work in the affected areas is also unlikely.

“We now expect the Japanese economy to take longer than we expected to exit its current soft patch owing to the earthquake and tsunami.

“The consensus forecast on the timing for this exit was Jan-March 2011, while we had projected April-June. However, we now think July-September or possibly October-December is more likely. We expect solid economic recovery to be confirmed in October-December.”

STANDARD CHARTERED BANK

ECONOMIC IMPACT:

■ Rebuilding costs to be at least 1 percent of GDP

■ Likely to see negative GDP growth in the first quarter

COMMENT:

“Provided that the authorities can successfully contain a nuclear-plant crisis, we now expect most economic activity to take a substantial hit in March/April but to rebound in the following months.

“In terms of assessing the damage, this is still a developing situation. It is now feared that energy rationing could continue until the end of April. This, plus damage to supply chains, could hit production even for

companies far removed from the scene of the disaster.

“Also, confidence is fragile, and there are fears that the situation at the nuclear plants may deteriorate. If so, this could hit confidence further.”

OCBC BANK

ECONOMIC IMPACT:

■ Reconstruction costs may hit 3 percent of GDP

COMMENT:

“The Bank of Japan announced to double its asset purchase program on Monday. Meanwhile, it injected a record 15 trillion yen into the banking system to ease liquidity concerns. The additional easing action taken by the BOJ is likely to turn Japan’s inflation slightly positive in the near future.

(Compiled by Kevin Yao; editing by Vidya Ranganathan)

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In Chernobyl, a disaster persists:
<http://link.reuters.com/dyn58r>

Can Japan find new deal after triple whammy?:
<http://r.reuters.com/mak58r>

Advanced economies recover faster in disaster:
<http://r.reuters.com/mak58r>



TUMBLING: A man wearing a mask walks past an electronic board displaying the NASDAQ average outside a brokerage in Tokyo March 16, 2011.
REUTERS/ISSEI KATO

COVER PHOTO: A Japanese man walks before a prayer ceremony at Dharma Persada University in Jakarta March 17, 2011 for victims of the earthquake and tsunami in Japan. Around 500 Japanese and Indonesian citizens gathered for the ceremony on Thursday night. REUTERS/BEAWIHARTA

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