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Grey hair, red ink, but blue skies?

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A new study says that worries about Japan's public-sector debt are vastly overblown

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WHEN an economy is as troubled as Japan's, gloom can be hard to shake off. Even if its latest recovery proves lasting, pessimists warn, the past 14 years of economic torpor have rendered Japan helpless in the face of an inevitable demographic crunch. Nothing captures this belief better than chronic worries about Japan's public debt. Only this week analysts at Moody's gave warning that the debt was unsustainable: if debt keeps rising faster than GDP, the eventual result must be default.



Japan's gross debt is now half as big again as its GDP. With deficits adding 8% of GDP to the pile each year, and growing ranks of senior citizens pushing spending up further, it seems only a matter of time before Japan collapses under the weight. Indeed, a recent sharp rise in long-term government bond yields has called fresh attention to Japan's fiscal problems. Even if growth does continue for a while, many argue, the bond markets will ruin the party by reminding everyone of impending doom.

Amidst these dire warnings, it takes courage to lift one's head up for a long, hard look over the horizon. It helps greatly, however, if those doing the looking can steady themselves by leaning on first principles. That is what Christian Broda, of the Federal Reserve Bank of New York, and David Weinstein, of Columbia University, have done. In a paper* they presented this week in Tokyo, they offered a far more hopeful analysis than most of Japan's long-term public finances.

They conclude not only that Japan's debt levels are sustainable, but also that Japanese

voters will have plenty of room to decide how comfortable or how spartan they want their welfare state to be. The public sector's gross liabilities in March 2003 stood at 161% of GDP, but this figure is misleading in several ways. For one, it includes debts that different parts of the government owe to each other. Bonds held by the central bank and other government entities are assets on their balance sheets, so the net debt associated with those liabilities is zero.

After cancelling out these intra-governmental claims, the debts that Japan's government actually owes to other parties are much less intimidating: only 46% of GDP. Adjusting for questionable loans that the government has made to the private sector, the authors reckon that Japan's public sector owes net consolidated debts of 62% of GDP. That is higher than America, but lower than the OECD average.

The authors also dispute the idea that public spending is out of control. Although often accused of priming the pump, the government has barely touched the handle over the past eight years. Government outlays have risen as a share of GDP, but this is entirely accounted for by the growing number of Japanese aged 65 or over, who receive transfer payments from everyone else. Public-works spending may be excessive, and certainly supports obstructive elements of the ruling party, but it is no higher now, relative to GDP, than it was in the 1980s. Indeed, the only real stimulus the government has imparted since 1996 has been through lower average taxes. This leaves Japan, which has the second-lowest average tax rate in the OECD, next to South Korea, plenty of scope to shore up its finances.

Nor are Messrs Broda and Weinstein worried about an ageing and declining population. Japan is certainly greying, and its fertility rates are indeed low. But the authors point out that if Japan's fertility rate were to remain at its current low level, and the average woman were therefore to bear 1.3 children, the population would die out in around 800 years. They argue that this extrapolation, which is used in many long-run economic forecasts, is stupid, because it ignores the likelihood that at some point the fertility rate will rebound a bit. Rising incomes, for example, are likely to lead Japanese women to have slightly more children than they do now, eventually stabilising the population. "Once one rejects the idea that the Japanese will cease to exist," they say, tongue in cheek, "policy options abound."

Painful, but manageable

Since its population will no doubt stabilise at some point, rather than dwindling to nothing, Japan will have many years over which to spread the welfare costs of its temporary surge in elderly citizens. Messrs Broda and Weinstein make several estimates of how far taxes will have to rise to stabilise Japan's finances, based on different assumptions about economic growth, interest rates and the evolution of Japan's welfare state. Even in the worst scenarios, which seem unrealistic, Japan's tax rates would have to rise to the level of a typical European Union country in order for its debt to be sustainable. That might be uncomfortable for taxpayers, but not catastrophic.

However, Japan ought to be able to get by with much lower average tax rates. Just as more old people means more spending on benefits for the elderly, fewer young people should mean less spending on benefits for children and people of working age, such as schools and unemployment benefits. If Japan chooses to rein in spending, its average tax rates should be comparable to those in America. If it chooses to be more generous, taxes will have to rise by more. In effect, it is a political choice.

A shift of three to nine percentage points in tax rates, as the authors' range of reasonable forecasts implies Japan must one day do, will be painful. But it is manageable. The authors also calculate that today's deficits can continue for a while with little or no effect on the sustainability of the country's debts. So are the pessimists completely wrong? Not completely, because at some point Japan's voters and politicians will have to face awkward choices. But fiscal implosion seems unlikely.

* "Happy news from the dismal science: reassessing Japanese fiscal policy and sustainability". The paper will be available soon on Mr Broda's website: <http://nyfedeconomists.org/broda/pub.html>

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