The world's two biggest economies are caught in a spiral of borrowing

THE experience of the past decade offers a good tip for predicting the next economic trouble-spot: “follow the debt”. Excessive borrowing by firms, households or governments lay behind the economic crises in Mexico, East Asia, Russia and Brazil. Who will be next? Some emerging economies, such as China, still give cause for concern. But the disconcerting truth is that the next debt crisis is more likely to occur not in the developing world, but in one of the world’s two biggest economies. Private borrowers in the United States have been on a five-year spree which increases the future risk of a hard economic landing, while in Japan, government debt is in danger of spiralling out of control, which could prove to be a potent drag on efforts to get the sluggish Japanese economy humming again.

Admittedly, American and Japanese debts, unlike those of emerging debtors, are almost all in their own currencies, so they are unlikely to suffer crises as severe as in East Asia. Nevertheless, in both countries the build-up of debt now looks unsustainable.

Consider Japan first. The country has been struggling for almost a decade with a nasty economic hangover brought on by excessive private-sector borrowing in the 1980s. The economy is now beginning to pick up, but only because the government has repeatedly tried to restart growth by spending, and borrowing, on a massive scale. The strategy has been correct, given deflation and a long (albeit shallow) recession—though it ought recently to have been accompanied by aggressive monetary expansion. But the cost has been high. Many fear that Japan is heading for a public-sector debt crisis.

As a result of countless stimulus packages, Japan’s general government deficit has widened to more than 8% of GDP. Japan’s gross public debt has become gross indeed, amounting to 128% of GDP at the end of last year, according to the IMF, up from 69% in 1990. This makes the Japanese government the biggest borrower in the rich world, with an even higher public-sector debt-to-GDP ratio than Italy, a long-time champ in the profligacy sweepstakes. The IMF forecasts that, even in the unlikely event that the government slashes its budget deficit to 1.4% of GDP by 2004, debt will by then have risen to a staggering 150% of GDP (see chart 1).
Moreover, the official figures understate the true level of debt, because Japan’s public accounts are particularly opaque. They exclude the Fiscal Investment and Loan Programme (FILP), a “shadow budget” which channels funds from the postal savings system and public pension funds into public-sector institutions, such as the Housing Loan Corporation, or infrastructure projects. Many of these projects are of questionable worth and the government may eventually have to write off loans, at a big cost to the taxpayer. If hidden debts in the FILP are included, Japan’s public debt is probably already around 150% of GDP. Add also the present value of future state-pension commitments (estimated at over 100% of GDP, thanks to a rapidly ageing population) and the total swells to more than 250% of GDP. And even this ignores other potentially large liabilities, such as the guarantees that the government has provided on bank loans. These could well turn sour.

Whatever the exact figure, it does not look as if Japan’s public debt can go on increasing for much longer.

The “trap”

How much can a government safely borrow? There is no simple answer to this question. At the end of the second world war, for example, the ratio of public debt to GDP rose to 250% in Britain. This caused much anxiety, and rationing of goods lasted well into the 1950s, partly as a result. Nevertheless, in those exceptional times, the government quickly reduced its debts. During the past four decades, no developed economy has had a public-sector debt of more than 135% of GDP, and governments that have got anywhere near that figure—such as Italy, Belgium and Ireland—were soon forced by financial markets to tighten their belts.

There are at least three reasons why a high level of public debt can be dangerous. First, if government borrowing pushes up interest rates, it can crowd out more productive private-sector investment. However, with private demand still weak, the risk of crowding out is currently low in Japan. Ten-year government bond yields are only 1.7%.

A second concern is that when debt is high, a government may be tempted to print money and let inflation rip, in order to erode the real value of its debt mountain. Borrowers throughout the ages have generally liked inflation. And yet, perversely, Japan
is currently suffering from just the opposite, deflation. A modest positive rate of inflation would, under current conditions, be a good, not a bad thing, for the Japanese economy. Last, but not least, there is the danger of the so-called “debt trap”, in which rising interest payments swell the government’s budget deficit to such an extent that total debt continues to grow even when the government is not overspending. The debt seems to take on a life of its own.

The debt trap does indeed threaten to ensnare Japan. Interest rates are still close to historical lows, but if they increase as the economy recovers, this will further increase the budget deficit. And the point is not far off when mounting interest payments will make it devilishly difficult to rein in a spiralling debt-to-GDP ratio.

Just consider some unpleasant arithmetic. The future path of the ratio of debt to GDP depends on two factors: the primary budget deficit (government spending other than interest payments minus tax revenues) and the relationship between interest rates and nominal GDP growth (real growth plus inflation). The higher the inflation and growth rates, the more a government can borrow while keeping debt as a percentage of GDP constant, because the real value of existing debt shrinks faster. If, however, interest rates exceed nominal GDP growth and the government runs a primary deficit, debt will increase indefinitely relative to GDP.

Unfortunately, the latter is currently the situation in Japan. The government’s primary deficit is running at 6.5% of GDP, and over the past seven years, nominal growth has averaged only 0.7%, even less than the historical low to which bond yields have fallen. In such circumstances, balancing the budget would not be enough to stop the debt-to-GDP ratio from growing; the government would need to aim for a sizeable primary budget surplus, a dangerous thing to do when the economy itself is barely growing.

Neither economic theory nor history offers much guide to what is a sustainable level of public debt. In the end it is investors who decide, by demanding much higher interest rates on bonds.

**Some good news for Japan**

There are, however, some reasons why Japan may be able to run a bigger government debt than other countries. Japan is the world’s biggest creditor nation, with $1.2 trillion (equal to 31% of its GDP) of overseas assets, thanks to two decades of current-account surplus. Almost all other economies in which public-sector debt has exceeded annual GDP had current-account deficits.

Because the Japanese are the rich world’s biggest savers, the government is not dependent on foreign investors to finance its deficit. Only 10% of Japanese government securities are held by foreigners, compared with 40% of America’s and 23% of Italy’s. Residents are less likely than foreigners to dump bonds suddenly.

In addition, almost half of all outstanding Japanese government securities are held in the social-security funds, owned by the government itself. Indeed, on official figures, net public-sector debt is a more modest 40% of GDP, the lowest among the big, rich economies. That might seem at a stroke to eliminate the problem. But the snag is that
those social-security funds are more than outweighed by future pension liabilities.

These factors all reduce the risk of an imminent funding or currency crisis, but they do not alter the fact that the continued growth in Japan’s debt does not look sustainable for much longer. It would be foolish for the government to slash its budget deficit while the economy remains fragile—it made that mistake in 1997 and tipped the economy back into recession. But once a firm recovery gets under way, the government will have to act quickly to cut public spending or increase taxes, or some combination of the two, to prevent debt exploding.

That will be painful, especially because Japan’s ageing population is pushing up health and pension costs. And yet Japan has a big advantage over other former big public-sector debtors, such as Sweden, Italy or Belgium. In all those economies the level of taxes was already high. In contrast, tax revenues amount to only 29% of Japan’s GDP, the lowest in any rich economy and well below the average for other rich countries, which is 39%. The European Union’s tax burden, for example, is even higher, at 42% of GDP.

So Japan has considerable scope for increasing tax revenues. The best way for it to do this would be to broaden its tax base, rather than raising tax rates. The OECD estimates that total revenue forgone as a result of generous personal allowances and credits amounts to 10% of GDP. If just half of this was clawed back by eliminating such tax breaks, it would go a long way towards closing the budget gap. The OECD also suggests that there is plenty of scope for cutting spending on public works. Reducing public investment to the same level in relation to GDP as in France, say, would cut the deficit by another 5% of GDP.

Tax increases would, of course, be highly unpopular. But in theory, at least, Japan is better placed to escape the debt trap than other profligate governments before it. With well-timed and skilful changes in policy, Japan could still escape what looks like, on current trends, a looming crisis.

America’s debt problem, by contrast, looks more alarming. Many people will find this hard to swallow. Compared with Japan, the American government looks like a paragon of fiscal virtue. After heavy borrowing in the 1980s, its budget has moved into surplus, allowing the government to repay, with much self-congratulation, some debt.

**Some bad news for America**

And yet, even as the American government has weaned itself from its old borrowing habits, American households and firms have been borrowing hand over fist, lifting their combined debts to a record 132% of GDP (see chart 2). It is these debts which could make the economic consequences of a stockmarket collapse more serious, and more damaging, than most people expect.
In the year to last September, the total debts of non-financial firms increased by 12%, the fastest pace since the mid-1980s. “So what?” retort some economists. Most of this borrowing is to finance a high-tech investment boom which will boost future productivity and profits. For some of this borrowing, that is undoubtedly true, but a worryingly large slice has in fact been used to finance share buy-backs. During the past two years, non-financial corporations increased their debts by $900 billion, while they retired a net $460 billion of equity. The main reason for these buy-backs is so that firms can pay employees in share options without depressing the share price. In effect, therefore, firms are borrowing to finance their pay bill and to prop up share prices.

At the same time, rising share prices have made households feel wealthier, and so encouraged them to borrow still more to pay for a spending spree. Total household debt has jumped from 85% of personal income in 1992 to 103% last year. Most worrying of all, margin debt (borrowing to buy shares) has tripled over the past five years; it has jumped by 25% in the past two months alone. If share prices fall, some of this would have to be repaid immediately, forcing investors to sell shares—and so send share prices lower still.

Optimists claim there is nothing to worry about, because the increase in debt has been more than matched by an increase in financial assets. On the surface, balance sheets do indeed look healthy. Households’ net wealth (assets minus debt) has increased from just under five times personal disposable income in 1990, to a historic high of more than six times. Meanwhile, the ratio of corporate debt to the market value of equity has fallen from 0.6 to 0.35. If (a big if) the stockmarket is a reliable judge of future earnings, then there is no cause for alarm.

But that cushion may be less comfortable than it seems. Other measures of corporate leverage, such as the ratio of debt to companies’ net worth (the value of tangible assets minus debt), have increased.

More fundamentally, the problem with borrowing on the back of rising asset values is that debt is fixed in value, whereas the value of assets, such as shares and property, is not. And what goes up can come down. In other words, the apparent health of balance sheets hinges on whether equities are fairly valued. Debts can only be serviced from income; assets can pay the interest bill only if they are sold, and if lots of debtors are forced to sell at the same time, asset prices will plummet. A better measure of the debt burden therefore is debt-service payments as a percentage of income. Despite low
interest rates, households’ debt-service ratio is currently close to a record level (see chart 3). Corporate debt-service, on the other hand, is still relatively low, thanks to bumper profits.

Japan offers a chilling example of how seemingly healthy balance sheets provide little protection. The debt of Japanese households rose from 89% of their disposable income in 1985 to 112% in 1989, an increase only slightly larger than that recorded by American households in the 1990s. Yet as the value of shares and property also soared, Japanese net household wealth rose from five times disposable income to 8.5 times over the same period. Companies’ net worth also rose sharply relative to GDP. But when asset prices went sharply into reverse, debtors and banks found themselves in big trouble.

The quality of loan portfolios in America has already deteriorated in recent years as banks, facing more competitive pressure, have been forced to lend to riskier borrowers. Despite a booming economy, non-performing loans have increased. The number of companies defaulting on their bonds also hit a record level last year, and Moody’s, a rating agency, downgraded twice as many American companies as it upgraded.

Rising debt is not necessarily a bad thing. Long-term economic growth will be faster if spare savings are channelled into productive investment rather than sitting idle under the mattress. It is natural, therefore that, as financial systems have become more efficient in channelling funds from those with surplus income to those who need to borrow, America’s ratio of private-sector debt to GDP has increased. The snag is that, within this trend, a sudden, excessive surge in debt can have nasty consequences.

The sensible level of debt for an economy depends on interest rates, expected future growth in income, and the variability of growth. Industries with a more stable cash flow can afford to take on bigger debts than highly cyclical businesses. If (a very big if) the business cycle really has been tamed and there is little risk of a recession, firms and households can safely borrow more.

But even if the optimal level of debt has increased, a sudden surge in borrowing can leave households and firms horribly vulnerable to shocks, such as higher interest rates, a fall in asset prices or an economic slowdown. All three are possible, indeed likely, in America over the next few years.
America’s high debt levels are unlikely by themselves to trigger an economic collapse, but they do threaten to amplify any downturn, turning it into a deeper recession if debtors are forced suddenly to cut their spending in order to service or reduce their debts. It is no coincidence that in the early 1990s the deepest or most protracted recessions were in economies that had seen the biggest increase in private-sector debt in the 1980s—namely Britain, Canada and Sweden. America’s recovery from its recession in the early 1990s was also hindered by an overhang of private debt accumulated during the previous boom.

America’s private-sector debt problem may not yet be as serious as Japan’s in the late 1980s, when banks engaged in imprudent lending on a massive scale. America’s banking system is also (fingers crossed) in better shape than Japan’s. But to the extent that much of America’s recent borrowing has been on the rosy assumption of everlasting growth, low interest rates and rising share prices, many borrowers and lenders may, sooner or later, be in for a rude shock.

**The kindness of strangers**

Moreover, the United States is vulnerable in a way that Japan never was. America is already the world’s biggest foreign debtor, with net foreign liabilities of $1.5 trillion, around 20% of GDP. As a credit-fuelled spending binge has sucked in more imports, America’s current-account deficit has widened to about 4% of GDP. If it remained at this level, America’s net foreign debt would rise to more than 50% of GDP within ten years.

This leaves the American economy dependent on foreigners’ willingness to hold more and more dollar-denominated assets. But there is surely a limit to this. If foreigners’ appetite for dollars dries up, the currency will fall. America would then need to offer progressively higher interest rates to convince foreigners to put a growing share of their wealth into dollar securities. Higher interest rates, and hence lower share prices, would be a blow to American debtors.

During the 1970s and 1980s, the main source of economic instability in rich economies was inflation. Now that inflation is under control, excessive debt may be the new enemy. Ironically, the move to lower inflation is partly to blame for this.

In Japan deflation has not only forced the government to borrow heavily in an effort to pull the economy out of recession, it has also caused the real burden of existing public debt to swell. Stabilising the debt ratio would be easier with a low positive rate of inflation, which is why it is essential that the Bank of Japan keeps monetary policy loose.

In America, too, low inflation has encouraged heavy borrowing. The apparent defeat of inflation, combined with the longest expansion in American history, has helped to create the unrealistic expectation that the boom will last forever. This, in turn, has encouraged firms and households to borrow more and lenders to relax their standards. When inflation is low, interest rates look cheap, thanks to “money illusion”, even though real interest rates are no lower. And low nominal interest rates mislead firms and households into believing that they can safely afford to borrow a much bigger multiple of their income.
Yet the same low inflation that encourages a surge in borrowing also makes excessive debt potentially more dangerous, because, unlike in the past, borrowers can no longer rely on inflation to erode their real debt burden if things go wrong.

In both America and Japan, the path of debt is unsustainable. But it is in America where the immediate risks are greatest. Japan’s massive public borrowing was necessary to prevent an even nastier recession. The government’s real policy test therefore lies ahead, namely how quickly will it act to cap the level of debt.

America’s private-borrowing binge, by contrast, should never have been allowed to go on for so long. It has contributed to a perilous overheating, which is likely to make any “landing” hard rather than soft. It looks as if American policymakers learned nothing from the errors of their Japanese counterparts in the 1980s, when private borrowing was also allowed to rip. The cost to Japan was years of recession and sluggish growth. Americans, not to mention the rest of the world, should be praying that their economy will not have to pay the same price.

LINKS

See the Japanese Ministry of Finance’s website for more information about the Fiscal Investment and Loan Programme. On January 13th, the US Treasury announced a programme to buy back public debt. The Treasury has also published a report From Widening Deficits to Paying Down the Debt: the Benefits for the American People, which can be downloaded in PDF format. The Federal Reserve Board compiles statistics on: household debt; consumer credit; and loan delinquency rates. The OECD collects internationally comparable statistics on debt for member countries.

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