Prep for economic crises before they hit

Economic discourse focuses on either ordinary economic crises or crisis economics. When considering past economic events to look ahead, economists usually apply theories of ordinary economic crises. Discussions of economic and industrial matters have spread to the world economy, all based on ordinary economic concepts that work in calm times.

That said, when we recall what has really happened to the domestic and global economic landscape, it shows that an economic crisis tends to break out every five or 10 years, or so. We readily remember that financial crises engulfed Japan and other Asian countries in 1997 and 1998, and the collapse of Lehman Brothers shook financial markets worldwide in 2008.

In 2000 through 2001, regardless of whether or not it should be referred to as a crisis — the so-called dot-com stock bubble burst, with equity prices of information technology companies plummeting.

In the years following the coordinated terrorist attacks on the United States in September 2001, the world economy's growth momentum shifted markedly from developed countries toward emerging market economies. This was a situation that was difficult to explain in terms of ordinary economics, which would characterize present events as a continuation of recent past trends. Likewise, in 2012, Greece and several other eurozone member states experienced acute sovereign debt crises that plunged the euro single currency into a steep depreciation.

Therefore, when we observe an economy, there is no question that we need to refer to theories of crisis economics, given that, in reality, crises, great or small, tend to occur on a certain cycle. In doing so, there is something that vexes us — the difficulty of foreseeing precisely when and why a crisis will actually take place.

In the world, there is a widespread assertion that, against the current backdrop of asset price movements, and the swelling levels of U.S. and Chinese corporate borrowings, a horrifying market crash will happen sooner or later. Even some of those who were once responsible for policy-making have occasionally thrown out such hints. In reality, however, we have not witnessed any market collapse up to now. Therefore, many people are the users of the usefulness of crisis economics.

For many years, some scholars have continued to warn of certain disasters, such as a stock market crash. As nothing of that sort has recently occurred, society continues to basically regard such warnings as warnings. Nevertheless, once a market crash becomes a reality, such Cassandra suddenly begin attracting social attention. Similarly, when an economic crisis occurs, it seems negligible five or 10 years, that is the moment when crisis economics starts drawing attention at last.

Level-headed judgments

An economic crisis is always something that will definitely occur, even though exactly when and under what circumstances remain unknown. As such, an economic crisis can be likened to a major earthquake. In the case of earthquakes, we know that major ones will definitely occur even though we have no exact idea when they will strike or which areas will be affected.

As far as earthquakes are concerned, our mind-set is that, assuming that they will occur, we should not forget to stay prepared for them and, continuously, to keep ourselves ready to make the right judgments and do the right things from the moment the shaking begins. A similar response is essential to cope with any future economic crises. We must tell ourselves that we will inevitably come and that we must not fail to be duly prepared for any of them. In this connection, it is also indispensable for us to keep making level-headed judgments on possible economic trends in the wake of any crisis.

There are probably very few people who, judging from what they see just now in the economy, would say with confidence, "We won't encounter any crisis in the future, either."

In many countries, including Japan, interest rates have fallen to unprecedented levels. This may be an unavoidable consequence of a series of monetary easing measures their central banks have adopted to keep their respective economies from dipping into deflation. It is true that the low interest rate environment has been instrumental in enabling both the United States and Japan to achieve what economists define as "full employment.” Nevertheless, the remarkable state of the labor market has not been coupled with a similar increase in both wages and consumer prices, central banks have had to continue to implement monetary policies, stimulating rallies in stock and property markets. In the United States, China and elsewhere, both businesses and individuals are now heavily indebted, circumstances akin to those that preceded the past market crashes.

Great fiscal leeway

Next, let me shed light on the Japanese economy, especially its fiscal management. In recent years, the government has gained greater leeway regarding fiscal management thanks to the low interest rate situation. The Japanese 10-year government bond yield, at the beginning of the year stood at about 0.1% in 1990 but dropped to about 1.7% in 2000 and further to 1.3% in 2010. The secondary market yield has been below 0.1% in recent years.

To avoid misunderstanding, I must point out that the low interest rate environment of today has not stemmed from the Bank of Japan's monetary policy alone. The prolongation of low long-term interest rates is a phenomenon commonly seen in many developed countries, mainly because of several factors, such as a lackluster economic growth rate and the aging of the population. This phenomenon is often referred to as "secular stagnation" or "secular" in this case meaning "long-term."

In any case this year, the Cabinet Office released its latest economic and fiscal projections, showing that the fiscal balance of the central and local government has been improving owing to economic recovery and increased tax revenues that have occurred since the start of the current administration of Prime Minister Shinzo Abe in December 2012. The fiscal balance for fiscal 2019, ending in March this year, is projected to reach a deficit equivalent to 3.9% of the country's gross domestic product (GDP), which will be a marked improvement over the fiscal 2012 deficit that was equivalent to 7.7% of GDP. In terms of primary balance, which represents the fiscal balance without finance-related government debt servicing costs, the deficit-to-GDP ratio will shrink to a projected 2.7% in fiscal 2019 from 5.5% in fiscal 2012.

It is also noteworthy that, while the outstanding government debt has been on the increase, the ratio of the burden of interest payments to nominal GDP has decreased because of government's efforts to lower the fiscal deficit ratio to below 1%. Currently, newly issued government bonds' real interest rates — the inflation-adjusted rates of return demanded by the market — are in negative territory for the first time in history. This means that even when the government opts to intensify fiscal stimulus measures, knowingly ballooning fiscal deficits through the issuance of bonds, it will likely end up bearing a "negative" interest payment burden in real terms. As such, the government is increasingly expected to spur the economy further from the fiscal side now that the Bank of Japan’s additional monetary measures to buoy the economy have apparently reached their limits.

In connection with such a possibly expansionary fiscal option, we need to think of the possibility that Japan may be really plunged into a fiscal crisis. Japan's ratio of outstanding public debt to GDP stands at 237%, overwhelmingly higher relative to GDP ratios for other countries. Yet, as mentioned earlier, the ultra-low interest rate environment has kept the government considerably less burdened by the interest payments. If Japan's outstanding public debt is prodigious indeed — now totaling about ¥1,1 quadrillion — it is apparent that an increase of several trillion yen in fiscal deficits is likely to have a slight impact on the overall outstanding debt total. Even if the government dares to slash fiscal deficits to a large extent, it is unlikely to see any large-scale reduction in the outstanding debt accumulated like at present, the government is now in a favorable position to proceed with further fiscal stimulus.

Huge debt sustainable?

But we still need to ask if the Japanese economy is assured of continuing to enjoy a calm environment even while remaining saddled with huge chunks of outstanding debt amounting to more than double its GDP. This is where a crisis may begin to loom. In the event of an increase in interest rates from the current historic low, the fiscal burden of interest payments would shoot up by the equivalent of 4% of the country's GDP. This would be appallingly hefty — the government would be compelled to spend as much as the equivalent of all the revenues from a consumption tax rate of about 8%.

The continuation of the Japanese economy's stability, irrespective of the colossal amount of public debt, relies on the existing condition of interest rates remaining at an historic low. There is no guarantee, however, that such a condition can be sustained for decades. Should this condition no longer be in place, there might emerge a possibility that rampant inflation would occur to the extent that the ratio of the country's public debt to its GDP would be drastically slashed.

Such a situation would be different from one in which a borrower — the Japanese government in this case — would neither seek to default on its outstanding remaining debt to pay interest due. Even if such a discouraging event is the case, I cannot easily foresee a scenario in which Japan would encounter such a catastrophic economic situation. That said, I can still say that if the extremely swollen level of the public debt ratio had to be redressed someday in the future, Japan would inevitably find itself embroiled in a fiscal turmoil. Of course, a crisis is not expected anytime soon. But now is the time for the country to deepen discussions on such a possibility through "crisis economics."