



## Japan's Debt disaster and China's (Non)Rebalancing: Stormy seas ahead?

Michael Pettis, with an introduction by R Taggart Murphy

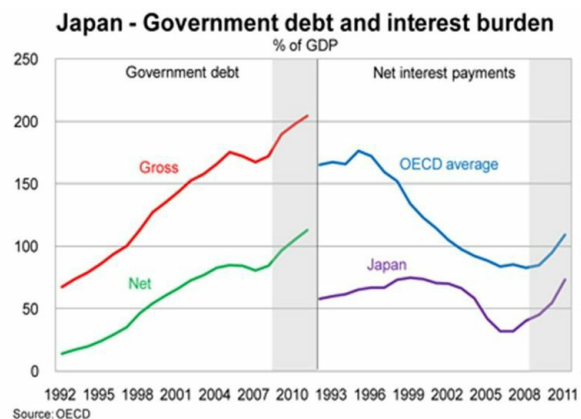
*My salary will be reduced 10% on April 1. Are students bitching about my lousy teaching? Have I been less productive on the research front? Less willing to shoulder my share of administrative burdens? All this could be true – or not – but has nothing to do with my pay cut. From slacker to Nobel Prize winner, every one of my colleagues at the University of Tsukuba is seeing his or her salary fall. As are all professors at all of Japan's national universities. And, indeed, everyone in Japan who is paid, directly or indirectly, by the Japanese tax payer – or, more precisely, paid by all the borrowing the Japanese government has been doing since taxes now cover less than half the Japanese government's expenses.*

*After all, that's the point of the exercise. With the outstanding debt of the Japanese government topping 220% of GDP, something's got to give – or so they say. Not that cutting the salaries of civil servants is going to do anything measurable to solve this debt problem, but at least it's a gesture in the right direction. Particularly when Prime Minister Noda, backed as he is by the Ministry of Finance ("MOF") and much of the ruling Democratic Party of Japan, is seeking to push a very unpopular hike in the consumption tax through the Diet. Maybe if all those bureaucrats and us useless professors are seen to suffer, the ordinary salaryman, shop owner, housewife, and construction worker will be a bit more willing to suffer along with us – swallow hard, tighten their own proverbial belts, and endure a 5% increase in the price of everything they have to buy*

*Ah yes, suffering. The Japanese have blown wads of money on white elephants – the bridges to nowhere, those endless concrete river banks and pointless sea walls that have wrecked the Japanese countryside, not to mention the cushy amakudari posts for retired bureaucrats and all that – and now everyone (including the odd gaijin professor here and there) has to suffer.*

*Problem is – it's not clear how all this suffering is going to "fix" Japan's fiscal problems. People usually react to pay cuts and tax hikes by buckling down, spending less, and saving more. Companies see this happening and put investment plans on hold, hoarding cash and doing what they can to get by with fewer people while paying them less. The government is not the only employer in Japan cutting wages.*

*So where is demand to come from if both households and companies go austere? After all, consumption taxes only generate revenues if people buy things. Orthodox Keynesian economics calls for the government to step in to fill the demand gap when households and companies can't or won't spend, and as the irrepressible Richard Koo has been reminding us now for well over a decade, it was lots of government spending over the last twenty years that kept Japan from tipping over into depression. But that's how we ended up with cumulative fiscal deficits at 220% of GDP, a number that has all kinds of folks fretting about endgames, calamities, meltdowns and other such scenarios. Now, the Japanese government still pays only a 1% annual interest rate to borrow money for ten years, and even if the yen has gotten a bit weaker in the past few weeks, there has been no global flight from the Japanese currency. So neither the bond markets nor the foreign exchange markets show any discernible sign of factoring apocalypse into their pricing. But who is to say that awful things might not soon happen if policy makers don't get serious now? When getting serious involves hiking taxes, cutting paychecks, and freezing all those white elephants dead in their tracks, however, demand is going to collapse, and with it any chance of higher tax revenues.*



*Unless that demand comes from overseas. You won't find many people saying it openly, but the only way this tax-hiking, pay-cutting plan is going to work is if Japanese companies start exporting more (or to be precise, export more than Japan imports). In other words, Japan is going to have to fall back on that old tried-and-true recipe that has been around since the Korean War: export-led growth. But export-led growth only works when somebody out there absorbs the extra exports – or to put it more precisely, somebody out there increases their current account deficit (or reduces their surplus) in exactly the same amounts with which Japan intends to increase its current account surplus. (The current account measures all current financial flows – as opposed to investment/capital flows – to and from the rest of the world. It consists of payments for trade in goods and services plus transfers – foreign aid; overseas workers' remittances – and dividend and interest flows. Because of all the extra oil Japan has been importing to make up for the post-3/11 loss of nuclear energy, Japan is now running a trade deficit. Interest and dividend income are sufficient to keep Japan's current account in the black for the time being, but those will not last forever.)*

*At a time when practically everybody is trying the same thing Japan is – cutting back on spending at home – news that Japan intends to pile on by increasing its own current account surplus will not be greeted with accolades elsewhere, which is why few of Japan's public spokesmen are willing to draw the dots explicitly.*

*Michael Pettis has now done so, in the article below. Pettis, a professor at Peking University and a Senior Associate at the Carnegie Endowment, brings a China-based perspective and his article begins with an analysis of the "rebalancing" in which China is said to be engaged. The rebalancing of which Pettis writes is a supposed shift away from an export/investment driven economy to one led by consumption. (This may sound familiar to Japan observers, since such a rebalancing has also been a purported goal of the Japanese government for close on thirty years now.)*

*Pettis is skeptical. His skepticism stems from his unusually keen appreciation of macroeconomic accounting principles, principles that cannot be violated as long as money is used to conduct economic affairs between countries. Although these principles can and should be understood by anyone with an elementary grasp of macroeconomics, they are usually ignored or deliberately misconstrued by politicians who do not want to explain, for example, precisely what has to happen for a trade deficit to be reversed. (Hint: Becoming "more competitive" or slapping tariffs on imports will not in and of themselves do the trick.)*

*Here are the core principles. An economy with more domestic savings than domestic investment runs a current account surplus. The savings have to be invested overseas, otherwise they are either invested domestically or they are destroyed, putting the savings/investment gap – and the current account – back into balance. Conversely, a country with more domestic investment than domestic savings by definition runs a current account deficit. If the extra investment is not financed by foreign savings, it does not happen, in which case there is no gap and thus no current account deficit.*

*Why? Because the current account is precisely equal to the capital account plus changes in official international reserves. A country running a current account deficit cannot do so unless money comes in from overseas to finance it. If a country cannot beg, borrow, or steal the financing, it cannot run the deficit any more than you can spend more money than you have; you have to get it from somewhere. Similarly, a country running a current account surplus has to be exporting capital (or accumulating international reserves – i.e., claims on other countries) since by definition it is being paid by foreigners.*

Now we get to the most important principle of them all—until we start doing business with the Moon, the sum total of all the national current account balances must be zero. If a country increases its current account surplus – which will happen automatically if its savings exceed its domestic investments – then another country's current account deficit must increase (or its surplus decrease). What happens if no such country exists? Then the country seeking to increase its current account surplus **cannot do so** and its savings are destroyed (or its bankers find increased domestic investment opportunities, perhaps because its government builds white elephants).

Pettis applies these principles to what is going on in China and the likely outcomes of that country's policy mix. He notes that China's current account surplus has declined since 2007 from ten to four percent of GDP, but says that is not because of any decline in savings (another way of saying rise in consumption) but because of an increase in domestic investment.

Other things being equal, he expects the decline of the current account surplus to reverse itself. Why? Because "Beijing is finding it impossibly hard to raise the consumption rate," and because "it is extremely important that it reduce the investment rate before debt levels become unsustainable" (if this sounds familiar to us Japan types, that's not a coincidence.)

But of course other things are not equal. Because China can increase its current account surplus only, as noted above vis-à-vis Japan, when other countries are willing and able to increase their deficits (or reduce their surpluses). Looking around the world these days, one wonders who is going to do that. The Europeans, where the countries of peripheral Europe are being forced to cut back on all kinds of spending; i.e., forced to save more? The United States, where both the Obama stimulus package and the Bush tax cuts will come to an end soon, while presidential politics degenerates into a "more austere than thou" circus? Remember, less spending means more savings and thus, other things being equal, reduced current account deficits.

So we come to Japan where Pettis notes that all the austerity talk out of Nagatacho and Kasumigaseki threatens to put Tokyo on a direct collision course with Beijing.

There is one serious problem with Pettis' analysis. He writes of the early 1990s that "rather than privatize assets and transfer wealth directly to the household sectors, the Japanese (began rebalancing) by having the government assume private sector debt." Yes, the government did assume private sector debt (if one can call the Japanese banking system "private"; given pervasive MOF control, better to write "nominally private") but I have no idea what assets Pettis is referring to. Equity and real estate assets that had been run up in the late eighties bubble lost as much 80% of their value over the subsequent decade, and as to the "assets" built after 1991 and paid for by Japanese government debt, the revenues from many of these airports-in-sight-of-each-other, bridges-to-nowhere, and billion-dollar tunnels lopping off ten minutes from commuting times don't even cover their operating costs, much less their up-front investment. While Richard Koo is absolutely right that shoveling money into the economy in the form of these "assets" kept Japan from depression, there is effectively no way to "privatize" most of them – no one would buy them. It is not a matter, as Pettis seems to think, of "reluctance" on the part of the Japanese authorities "to solve its debt problems by privatization."

Alas, however, this misunderstanding re-enforces Pettis' broader point – that the policy mix being debated in Tokyo today and seemingly championed by Noda can succeed, if implemented, only by restoring Japan's trade surplus – and thus increasing its current account surplus. That, in turn, can only happen if counterbalancing deficits increase elsewhere – or surpluses elsewhere go down, which if Pettis is correct about China, is a non-starter.

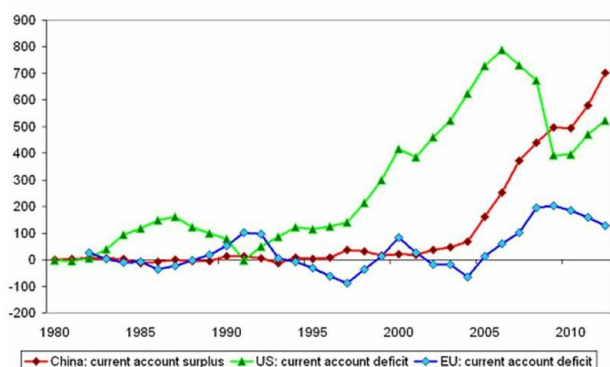
It has been ninety years now since John Maynard Keynes pointed out in the *Economic Consequences of the Peace* that squeezing money out of people does not bring prosperity. What may appear to work for the individual household, company, or even country produces only misery when everyone tries to do it at the same time. That's how we got the Great Depression. For some decades after that catastrophe, the world seemed to have learnt its lesson. But hearing what is coming out of Washington, Beijing, Tokyo, Berlin, London, Frankfurt and Brussels, one can only assume the lesson has been forgotten.

The only hope Pettis offers is a possible "reduction in commodity prices, including oil, which will help absorb some of the changes in trade balances." But he doesn't "see much other relief." Nor do I, short of global elites collectively re-discovering that making ordinary people poorer is not a formula for prosperity.  
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I want to sketch out a scenario in which rather than analyze policy announcements or make predictions I try to lay out the various possible paths open to China. The scenario concerns trade. China's current account surplus has declined sharply from its peak of roughly 10% of GDP in the 2007-2008 period to probably just under 4% of GDP last year. Over the next two years the forecast is, depending on who you talk to, either that it will rise significantly, or that it will decline to zero and perhaps even run into deficit. The Ministry of Commerce has argued the latter and the World Bank the former.

China v the US and Europe, WEO data, \$ billion



I am not sure which way the surplus will go, but I would argue that either way it is going to be a very strained and difficult process for both China and the world. On the one hand if the Ministry of Commerce is arguing, as many do, that the rapid contraction in the surplus indicates that China is indeed rebalancing and will continue to do so, I think they are almost certainly wrong. China is not rebalancing and the decline in the surplus was driven wholly by external conditions. In fact until 2010, and probably also in 2011, the imbalances have gotten worse, not better.

For proof consider China's total savings rate as a share of GDP relative to China's total investment rate. The current account surplus, of course, is equal to the excess of savings over investment – any excess savings must be exported, and by definition the current account surplus is exactly equal to the capital account deficit. This is the standard accounting identity to which I have referred many times in my newsletters.

The savings and investment numbers show that the last time investment exceeded savings was in 1993-94, and during that time China of course ran a current account deficit. This was just before Beijing sharply devalued the RMB, after which it immediately began running a surplus, which has persisted for 17 years. Since 2007

savings have climbed from 50% of GDP to nearly 53% in 2010. During this time investment has climbed from just over 40% of GDP to nearly 49%. the difference between the two has declined from just over 10% of GDP to just under 4%, and this of course is just another way to say that China's current account surplus has dropped from just over 10% of GDP to just under 4%.

### Savings are rising

From the accounting identity it is clear that if the current account surplus declines, there are logically only two ways it can happen. One way is for the savings rate to decline. In that case the investment rate must either rise, or it must decline more slowly than the savings rate. The other way is for the savings rate to rise. In that case the investment rate must rise even faster.

In the first case a declining savings rate indicates that Chinese consumption is indeed rising and Chinese investment is declining (or at least rising more slowly than consumption). This is the "right" way for the trade surplus to decline because it represents a rebalancing of the Chinese economy away from its dependence on investment and the trade surplus and towards consumption. In the second case – the "wrong" way – consumption is actually declining further

as a share of GDP, and the reduction in China's dependence on the trade surplus is more than matched by an increase in its dependence on trade.

So is China rebalancing? Of course not. Rebalancing would require that the domestic consumption share of GDP rise. Is the consumption share of GDP rising? Clearly not. If consumption had increased its share of GDP since the onset of the crisis, the savings share of GDP would be declining.

And yet savings continue to rise. This is the opposite of rebalancing, and it should not come as a surprise. Beijing is trying to increase the consumption share of GDP by subsidizing certain types of household consumption (white goods, cars), but since the subsidies are paid for indirectly by the household sector, the net effect is to take away with one hand what it offers with the other. This is no way to increase consumption.

Meanwhile investment continues to grow and, with it, debt continues to grow, and since the only way to manage all this debt is to continue repressing interest rates at the expense of household depositors, households have to increase their savings rates to make up the difference. So national savings continue to rise.

What then explains the decline in China's current account surplus over the past three years? The numbers make it pretty obvious. The sharp contraction in China's current account surplus after 2007-08 had been driven by the external sector, and in order to counteract the adverse growth impact Beijing responded with a surge in investment in 2009. You can argue whether or not this was an appropriate policy response (yes because otherwise growth would have collapsed, or no because it seriously worsened the imbalances), but certainly since then as consumption has failed to lead GDP growth, investment has continued rising too quickly.

### Can China's surplus rise further?

It is, in other words, rising investment, not rebalancing towards higher consumption, that explains the contraction in the current account surplus. The savings share of GDP is still actually rising. By coincidence on Wednesday I received a [piece](#) from Louis Kuijs, formerly of the World Bank and now of the Fung Global Institute, that supports this interpretation. In it he says:

*Many a headline has highlighted how rising costs in China are putting pressure on profit margins and reducing the competitiveness of the country's huge labour-intensive, [export](#)-oriented manufacturing industry – prompting multinational companies to start shifting production to other countries in Asia.*

*However, a closer look at trade data shows that China's overall exports are still gaining market share. In 2011, Chinese exports grew by around 20 per cent in US dollar terms and 10 per cent in real terms, compared to an increase in real global imports of around 7 per cent.*

Kuijs goes on the argue that China's [export](#) growth will remain strong in the future, and he may be right, but for me what is important here is that while the world is struggling with weak growth in demand, and surplus countries are being forced to rein in their surpluses, China's share of total surpluses are probably actually expanding. This suggests that China is restraining, not leading, global trade rebalancing, and given China's difficulty in raising the consumption share of GDP this shouldn't be a surprise.

So which way will China's current account surplus move over the next few years? If we could ignore external conditions, I would argue that the current account surplus should grow in the next few years. Why? Because Beijing is finding it impossibly hard to raise the consumption rate, and yet it is extremely important that it reduce the investment rate before debt levels become unsustainable. Under these conditions I would argue that we should expect the savings rate to hold steady as a share of GDP or – if we are lucky – for it to decline slowly over the next few years.

Investment, on the other hand, should decline quickly unless it proves difficult for the post-transition leadership to arrive at a consensus about the need to slow investment growth. I would expect investment to begin dropping erratically sometime in 2013, but I confess that I have no sense of whether or not those who understand how dire the economic situation is can convince the others within the leadership during this period.

If investment rates drop more quickly than the savings rate, by definition this would result in an increase in China's current account surplus. This is why I would argue that if we ignore external conditions I would predict a rise in China's trade surplus over the next few years. But of course there is a huge constraint here. Can the world accommodate China's need to absorb more foreign demand in order to help it through its own transition?

Here I am pretty pessimistic. The first problem is that the big deficit countries have little appetite for rising imbalances. Clearly the US wants to reduce its trade deficit and at the very least it will resist a rapid increase in the trade deficit. The deficit countries of peripheral [Europe](#), who with the US represent the bulk of global trade deficits, are going to have to adjust quite quickly as the [financial crisis](#) continues and as their growth slows, and their deficits will contract sharply as their abilities to finance them contract.

Declining trade deficits around the world require declining trade surpluses. Part of the adjustment in [Europe](#) I suspect will be absorbed by a contraction in Germany's surplus, but the Germans of course are resisting as much as possible since they, too, are dependent for growth on absorbing foreign demand. I don't know how this will pan out, but certainly Europe as a whole expects its trade surplus to rise, and if instead it begins to run a large deficit, German growth will go negative and the debt burden of peripheral Europe will be harder than ever to bear.

Don't expect Europe, in other words, easily to accommodate China's need for a growing trade surplus. If foreign capital flows to Europe increase – perhaps as China and other BRICs lend money to Europe – Europe's exports will certainly decline relative to imports, but because this means much slower growth for Europe, I don't think it is sustainable.

### The problem of Japan

But a much bigger problem may be Japan, and I am surprised that no one seems to be discussing the very adverse Japanese impact on the future development of global trade balances. Japan, as everyone knows, has an enormous debt burden that is only made manageable because it is financed domestically at extremely low rates. Here is Peter Tasker of the *Financial Times* on the subject:

*When Japan's bubble economy imploded in the early 1990s, public finances were in surplus and government debt was a mere 20 per cent of gross domestic product. Twenty years on, the government is running a yawning deficit and gross public debt has swollen to a sumo-sized 200 per cent of GDP.*

*How did it get from there to here? Not by lavish public spending, as is sometimes assumed. Japan's experiment with Keynesian-style public works programmes ended in 1997. True, they had failed to trigger durable economic recovery. But the alternative hypothesis – that fiscal and monetary virtue would be enough – proved woefully mistaken. Economic growth had been positive in the first half of the "lost decade", but after the government raised the consumption tax in 1998 any momentum vanished. Today Japan's nominal GDP is lower than in 1992.*

Tokyo is clearly worried that it is running out of time to manage the debt, and the indications are that it has finally become serious about reducing its debt burden. What's more, Japan's current account surplus has already contracted substantially in the past two years, and in January it [ran](#) the biggest monthly trade deficit it has ever run – \$5.4 billion, although the early Spring Festival this year may have distorted the number.

This January deficit comes on the back of Japan's 2011 overall trade deficit, the first time Japan has had an annual trade deficit in many decades. If Japan runs a current account deficit, of course, it means that Japan must turn to foreign sources to finance government debt – a very unwelcome prospect.

How can Japan reduce its debt? I am no expert on Japanese policies but according to much of what I am hearing Tokyo is planning to raise taxes further, especially consumption taxes, and to use the proceeds to pay down the debt. According to an article in the *Financial Times* that appeared two months ago;

The government and the ruling Democratic Party of Japan agreed on Friday on a draft plan to raise the country's controversial sales tax from 2014, taking a key step towards improving the country's stretched finances.

Prime minister Yoshihiko Noda has faced an uphill struggle to convince some members of his own party, the opposition and the public that the tax is needed to help restore Japan's fiscal health at a time of global fears over sovereign debt. The tax has been opposed on the grounds that it could damage an already weak economy. The consumption tax, which is the government's most stable income stream at about a fifth of total revenues, has long been an obvious candidate for reform.

In addition Tokyo and the business community are putting downward pressure on wages in order to increase the competitiveness of the tradable goods sector. Here is another [article](#) from the *Financial Times*:

Bonuses have been coming under heavy pressure in Japan for years as part of a wider effort to restrain incomes. And while workers around the developed world have been complaining of a squeeze on incomes over the past two decades, in Japan thinner pay packets fuel wider deflation. That makes it even harder for the government to rein in its runaway debt and for the central bank to use monetary policy to boost growth.

The National Tax Agency says average annual salaries, including bonuses, fell in nominal terms every year but one in the decade to 2010, sliding from ¥4.61m to ¥4.12m. The Japanese Trade Union Confederation (Rengo) says the average size of workers' bonuses has fallen from a peak of 4.27 times monthly salaries in 1992 to just 2.83 times in 2010.

More recently, a faltering of Japan's recovery from its deep 2008-2009 slump is threatening to further tighten the screws. Total cash earnings for Japanese salaried workers were down 0.2 per cent in December compared with the previous year, while special payments, which are mainly winter bonuses, fell 0.3 per cent.

### Japan reverses course

Yikes! This could turn out to be a huge problem for China and the world. Why? Because raising consumption taxes and reducing wages will push up the Japanese savings rate substantially. Either action pushes the growth rate of disposable income down relative to GDP growth, and lower disposable income usually means lower consumption – which is the same as higher savings.

These policies will probably also reduce the investment rate. Lower Japanese consumption, after all, should reduce business profits and so reduce the incentive for expanding domestic production, while pressure for austerity should restrain or even reduce government investment.

By definition more savings and less investment mean that Japan's trade surplus must rise. Japan, in other words, is planning to move backwards in terms of rebalancing. Remember that until 1990 Japan had the same problem that China did: its rapid growth was largely a function of policies that transferred wealth from the household sector to subsidize growth.

These policies – an undervalued currency, repressed interest rates and low wage growth, which of course are the same as China's – restrained consumption and encouraged debt-fueled investment. This investment, we now realize, was wasted on a massive scale and the eventual government absorption of all the bad debt caused government debt to rise.

After 1990 Japan began the slow rebalancing process, but rather than privatize assets and transfer wealth directly to the household sector, the Japanese did it by having the government assume private sector debt. This was politically much easier than privatizing and removing interest rate and capital allocation distortions, but it also meant much slower growth and burgeoning debt.

Now Japan is faced with the same difficult options that it faced twenty years ago and that China faces today. It can privatize government assets, or it can revert to the bad old days of consumption constraining policies. But if it constrains consumption growth and does not replace consumption with a surge in investment, how can it possibly grow except with explosive growth in the trade surplus? Domestic consumption, domestic investment, and the trade surplus are, after all, the only sources of demand growth for any economy.

So where does all this leave us? It's all pretty clear to me. Of the two big trade deficit entities, neither the US nor peripheral Europe can allow their deficits to rise and we may even see, in the latter case, a sharp drop in the deficit. Of the three big surplus countries, Germany is reluctant to allow its surplus to decline by much, and certainly if it declines faster than the European deficits decline, Europe's debt crisis will be much worse than ever.

China's surplus can decline only if we see a very improbable decline in its savings rate or a very unwelcome increase in its investment rate – and my guess is that the internal pressures are for the savings rate to hold steady as the investment rate declines. And Japanese reluctance to solve its debt problems by privatization requires that it resolve them with an increase in the trade surplus.

Needless to say this isn't going to work, and at least one of the above is going to be extremely disappointed. The "good" news is that if this conflict leads to much slower global growth, as it certainly will, the resulting reduction in commodity prices, including oil, will help absorb some of the changes in the trade imbalances as commodity exporting countries see their exports fall sharply. But I don't see much other relief.

This is an abbreviated version of the author's newsletter which appeared at *China Financial Markets* (found [here](#)) on March 20, 2012.

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