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No Alarm Bells for Japan

Lessons from the Greek Financial Crisis

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- Classifying the causes of financial crises: Crises originating in the collapse of housing bubbles and crises originating in free spending policies
- The three indicators of sovereign risk as judged by markets
- Japan, reliant on domestic consumption of government bonds, will receive no warning of potential financial disaster

1. Why is Europe experiencing a financial crisis at this time?

How is the financial crisis that emerged from the U.S. subprime housing loan market in summer 2007 related to the Greek fiscal crisis occurring in spring 2010, and how has this developed into a crisis for the European monetary union? Several reasons for this situation can be considered. Heading the list are the global capital transactions which were the main factor in expanding U.S. financial instability into a worldwide problem. In the present international financial environment, there are few barriers to financial transactions across borders, and foreign investment swells when favorable investment opportunities exist overseas.

The impact of the subprime crisis was first felt in August 2007, when funds in Germany and France which had invested in subprime bonds began to experience financial difficulties. The U.S. was the world's largest importer of capital, and capital from both Asia and Europe, in particular the eurozone, had flowed into its markets. By contrast, in the eurozone as a whole capital transactions with non-regional entities were basically in equilibrium. Unlike the U.S., the eurozone was not a net importer of capital from outside the region; rather, capital-exporting and capital-importing nations existed within the eurozone itself. Germany was an exporter of capital, while Spain, Ireland, Portugal and Greece and others were among the importers of capital.

As was the case in the U.S. prior to the financial crisis, the capital-importing nations of the eurozone, in particular Spain and Ireland, experienced severe housing bubbles. This is the main reason for the spread of the financial crisis throughout Europe. The European bubbles collapsed with the global credit crunch in the wake of the 2008 Lehman Brothers shock, and this impacted upon the economies and finances of Spain and Ireland.

The nature of the Greek financial crisis differs somewhat. While it was the expanding fiscal burden resulting from bailouts of financial institutions which had incurred losses due to the collapse of bubbles that caused a deterioration of finances in Spain and Ireland, the effect of a bubble was a secondary issue in the case of Greece. The cause of the Greek crisis was chronic free spending, resulting in expenditure being consistently greater than income. A change in administration at the end of 2009 revealed a cover-up of the nation's fiscal deficit: The figure was 13% of GDP rather than the reported 4%. With this revelation, Greece became the center of the storm for financial crisis in Europe. The question as to what would have happened had there been no change in administration and the cover-up had been continued is a very interesting one. However, it is not an unusual phenomenon for a financial crisis to be linked to a debt crisis, and the attention of the markets was focused on suspect countries. With the call for a debt moratorium by Dubai's state-owned Dubai World in December 2009, market sensitivity to sovereign risk increased, and even if the cover-up of the nation's deficit had continued, it was surely only a matter of time before confidence in Greek bonds declined.

2. Could the Greek financial crisis have been prevented?

Greece's sovereign risk was already recognized as a significant problem by markets in January 2010. Despite this fact, however, the response by EU, and particularly eurozone, governments was slow, and it is clear that this was a factor in the worsening of the crisis. The spread (interest rate differential) between Greek bonds and German bunds in January 2010 was around 3-4%; by the end of May 2010, when the eurozone nations offered Greece a bailout package in collaboration with the IMF, the spread had risen to 10%.

While the nation's debt could be cleared at a spread of 3%, an increase to 10% naturally raises the possibility of debt default. It is possible to adopt the view that the hesitation on the part of the eurozone nations turned a manageable debt into an unsustainable debt. However, the issue is whether or not the previous 3% spread accurately reflected the fiscal capacity of the Greek economy at the time. Regarding this point, the view can be taken that markets predicted that the eurozone nations would offer substantial aid to Greece, given that sovereign default by a member nation would affect confidence in the euro and in euro-denominated bond markets. The 3% spread can be interpreted as a result of the anticipation of this aid.

Strong resistance on the part of Germany, emphasizing fiscal discipline and fearing that the euro arrangement would be transformed from a monetary union into a "transfer union" (for the transfer of funds from north to south), impeded the realization of the Greek aid package. This may have aroused the ire of the markets, and the situation saw the spread for Greek bonds increase to 10%. Considered from this perspective, it is probable that the 10% spread represented the actual fiscal capacity of the Greek economy. This is a high risk premium, similar to that for bonds issued by Argentina, which defaulted on its debt in 2001. The markets therefore viewed the probability of debt default by Greece as high.

At present, given that Greece has a primary balance deficit of 9-10% of GDP, defaulting on its debt is not an option for the nation, and it has no choice but to accept the condition of reducing its fiscal deficit by 10% of GDP in the next four years attached to the IMF/eurozone aid package. If Greece were to default, it would evade its debt service burden, but it would become unable to correct its primary balance deficit through the issuance of bonds, and the government would cease to function.

However, the probability of Greece choosing to default on its debt in 2012, when its primary balance reaches the point of equilibrium, is high. At this time, because the budget for necessary expenditure will be covered by income, the government will continue to function even in the event of a sovereign default. On the other hand, by 2012 the nation's outstanding public debt will have risen to around 150% of GDP, and even if the IMF was to apply a lenient interest rate – for example 5% – the nation's interest burden alone would be 7.5% of GDP, representing a considerable drain on its economy and finances. In the case of Argentina, which defaulted on its debt in 2001, outstanding external debt reached a figure of 50% of GDP; even this figure was judged to represent an excessive burden on the nation's economy, leading to its default.

If the possibility of the nation's defaulting is high even at an interest rate of only 5%, it would have been impossible to avoid the Greek crisis from the first. Greece allowed its outstanding public debt to reach a level too high for a nation with no industries save for tourism and shipping, and which does not have recourse to the sovereign remedy of devaluing its currency in order to stimulate exports. However, if the eurozone had displayed greater alacrity in its response to the crisis, it is likely that its spread to other nations with fragile finances – Portugal, Spain and Ireland – could have been avoided. In fact, the meaning of the establishment of the fund decided on in June by the EU in collaboration with the IMF was in preventing the spread of the crisis to Spain.

3. How far will sovereign risk spread?

In a press conference following the 2010 election for the House of Councillors, an election in which the poor performance of the Democratic

Party of Japan was blamed on his remarks regarding an increase in consumption tax, Prime Minister Naoto Kan made a deep impression by stating that he had raised the issue of the tax increase because witnessing the Greek financial crisis had indicated to him the necessity of rebuilding Japan's finances. Observers were uncomfortable with regard to the Prime Minister's belief that the Greek crisis carried a warning for Japan. In terms of market reactions, the effect of the Greek crisis on Japan has actually been the opposite. Since the occurrence of the crisis, the interest rate on Greek two- and three-year bonds has increased to more than 10%, while in Japan the interest rate even for 10-year bonds fell to 1.1%. The value of the euro fell with the intensification of the crisis, while the yen increased in value.

Judged on the basis of the signals being sent by the markets, the risk to Japan's finances due to the crisis is evaluated as low rather than high. Greece and Japan do not have an especially deep economic relationship, and the only way that the Greek crisis could exert a negative effect on Japan's finances would be through the reactions of the markets. If the markets were to judge that Japan was "the next Greece," the Greek crisis would have an effect in driving Japan's finances to the wall. Prime Minister Kan's statement that the Greek crisis had provided the impetus for him to seriously consider an increase in consumption tax registered as odd precisely because, as can be seen from the discussion above, the crisis actually induced markets to back the purchase of Japanese bonds.

Naturally, I am not suggesting that there is no danger of financial collapse in Japan, and it is not the case that I believe that market judgments are necessarily always correct. However, in this case, markets have focused on specific types of indicator, and have passed consistent judgments with regard to sovereign risk. These indicators are: 1) The magnitude of external debt (the higher the debt, the greater the danger is considered); 2) The size of the country (the smaller the country, the greater the danger is considered); and 3) Whether or not the country's debt is denominated in its own currency (danger is considered to exist when debt is denominated in foreign currencies). A perspective based on these three indicators produced diametrically opposed results for Greece and Japan, with Japan's level of sovereign risk evaluated as low in the course of evaluation of Greece's risk as high.

4. Will the EU's fiscal restructuring measures slow the pace of recovery in the world economy?

That member nations will not aid another member nation in the event of its experiencing a financial crisis is a principle held by the EU, and this principle is of considerable importance in the eurozone, which shares common financial policies. This principle has broken down in the case of the Greek financial crisis. Not only has the equivalent of approximately 90 trillion yen in public funds been committed to financial aid for Greece, but the European Central Bank (ECB) has been forced to conduct a buyback of bonds issued by vulnerable nations, including Greece, Portugal and Spain. These facts represent a headache for both the EU and the eurozone. Because of this situation, political fissures have developed between Germany, a nation which emphasizes fiscal discipline and fears inflation above all else, and other EU member nations.

Fiscal discipline and financial restructuring will be important key phrases in repairing these fissures and enabling the continuation of the euro arrangement into the future. The issue is how significant a negative impact the pursuit of financial restructuring by the nations of Europe will have on a fragile world economy which is still experiencing the lingering effects of crisis. What should be taken into consideration here is the fact that the budget of the equivalent of 70 trillion yen established for economic stimulus measures in the early days of the Obama administration will be largely exhausted in 2010.

In Europe, Greece, Portugal, Spain, Ireland and other nations with high sovereign risk have already introduced fiscal austerity programs, as have the Eastern European nations outside the eurozone. France and Germany will continue their economic stimulus measures throughout 2010, and will make the transition to fiscal austerity in 2011. The UK, which experienced a change in administration in 2010, will follow suit.

In 2011, all the major nations of Europe will therefore be implementing fiscal austerity programs. The opinion exists that the scale of this austerity will not be remarkably great, at around 0.5% of GDP, but it will be necessary to be cautious with regard to the effect of cuts in public expenditure – which is at present supporting the world economy – by a group of major nations.

Considering historical examples, we find that the introduction of financial restructuring measures by Roosevelt during the Great Depression in the 1930s resulted in a major economic collapse, and that the implementation of financial restructuring in 1997, during Japan's "lost decade," ushered in two years of negative economic growth. Europe's major nations should give sufficient consideration to these precedents, and implement a style of fiscal management in which they immediately halt their austerity programs and emphasize economic recovery if the possibility of economic collapse becomes conspicuous.

5. Lessons to be learned by Japan

The Greek crisis holds few lessons for Japan's fiscal policy. One of these, however, is the fact that should a financial crisis occur in Japan, it will be of a different nature to the crisis in Greece. In the case of Greece, awareness of the nation's financial difficulties had been increasing from several years prior to the crisis, and the interest rates of Greek bonds had steadily risen. Put another way, the markets were playing the role of an alarm clock for the Greek government. Given the mechanism by which government bonds are consumed by domestic savings in Japan, the nation is unlikely to receive a warning from the markets. As a result, there is a possibility that the alarm will not go off, and we will oversleep – while a financial collapse occurs. Given this, we must not be idle despite having received positive signals from the markets in the form of reductions in the interest rates of Japanese bonds.

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