



S&P Downgrades Japan: Harbinger for US

Standard and Poor's gave plenty of reasons for its downgrade of Japan's credit rating yesterday such as increasing annual deficits and soaring national debt, an aging population, shrinking workforce, and a government in gridlock. With their national debt approaching \$11 trillion and a gross domestic product of just under \$5.5 trillion, Japan's ratio of debt to GDP is now 200 percent, the highest of any industrialized nation in the world. And it's going higher. As S&P noted in its announcement:

The downgrade reflects our appraisal that Japan's government debt ratios - already among the highest for rated sovereigns - will continue to rise further...and will peak ... in the mid 2020s.

We do not forecast the government achieving a primary balance before 2020 unless a significant fiscal consolidation program is implemented beforehand.

Growing itself out of the fiscal difficulties is no longer an option. With an aging population and a shrinking workforce, revenues to the state are continuing to drop. As they age, citizens will be less likely to add to the economy, and more likely to start drawing down their pensions and their savings. S&P notes that "the nation's total social security related expenses now make up 31 percent of the government's 2011 budget, and this...will rise."

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Any further austerity measures or major cuts in welfare state spending are highly unlikely given the impasse in government. The Democratic Party of Japan has announced a study of their welfare state with possible suggestions due out later this year. But, says S&P, "We think there is a low chance that [those reviews] will lead to material improvements to the ... solvency of the state."

Previous efforts to revive the Japanese economy following its "Lost Decade" using typical Keynesian strategies like quantitative easing have failed miserably. S&P expects GDP growth, which has languished since the 1990s, to remain stagnant for the foreseeable future.

There are options but they aren't pretty. Already saddled with the world's highest corporate and individual tax rates, Japan has a 5 percent sales tax as well. Politicians have publicly stated that an increase in the sales tax rate would work nicely in bringing the budget into balance. This would allow the government to tap into the \$17 trillion individual citizens have saved over the years, but such suggestions are meeting with great resistance.

With S&P reducing Japan's rating to AA-, it isn't that far from junk status. S&P said that Japan could have its rating reduced to BBB status as early as 2015, "and by 2025, the country's fiscal indicators might weaken to the extent that they would be more typical of the performance we currently associate with speculative-grade sovereigns." All of this only adds to the speeding up of the ticking fiscal clock. If interest rates continue to rise world-wide, and the costs to Japan increase as demanded by bondholders to offset the increasing risk of default, more and more of its revenues will be absorbed just for interest payments on the debt. As one commentator [expressed it](#):

The Japanese government [is] much like a man who carries a huge balance on an ultra-low interest rate credit card. His salary may never be large enough to pay the bill in full, but he can always cover the minimum payment.

Up until now, Japan's government has been able to "cover the minimum payment" by borrowing from reserves in its Government Pension Investment Fund and selling its debt to Japan's life insurance



Written by [Bob Adelman](#) on January 28, 2011

companies. But as seniors, which now number nearly one in four, start drawing down those assets, those avenues will be closed to further purchases of bonds issued by the state. In fact, they will soon become net sellers of their existing holdings in order to support the new pensioners, and then, “who will buy?”

Japan’s government revenues of \$1.6 trillion annually fall short of its expenses of \$2 trillion, creating an annual deficit of \$400 billion. Kyle Bass, who runs Hayman Advisors, estimates that debt service eats up \$244 billion every year. He calculates that if investors demand just an additional two percentage points in interest, that would double that debt service. Bass concludes that “the Japanese have created the circumstances for the greatest financial failure in world history.”

What about the United States? Although the parallels aren’t exact, they’re close enough to be unnerving: with 10,000 baby boomers retiring every day for the next 19 years, a workforce that is still suffering from unemployment and partial employment of 20 percent, an increasing demand for welfare state promises such as Social Security, Medicare, and now healthcare, it’s only a matter of time.

Moody’s Investors Service, just hours after the S&P downgrade, [issued its own warning](#) that the US could face similar downgrades unless strong austerity measures are implemented here:

Recent trends in and the outlook for government financial metrics in particular indicate that the level of risk (to the U.S. rating), while still small, is rising and likely to continue to rise in the next several years.

Although no rating action is contemplated at this time, the time frame for possible future actions appears to be shortening, and the possibility of assigning a negative outlook in the coming two years is rising.

Aaron Costello, a global investment strategist at Cambridge Associates, says “Like all government debt, Japan faces a confidence game,” adding:

If Lehman Brothers was too big to fail, then Japan would be too big to save. In some respects Japan is ahead of the curve, because Europe and the United States are eventually going to have to deal with this....



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