LONG-TERM GROWTH AND DEBT IN JAPAN AND ITALY

Franco Bruni

Numerous bilateral initiatives, in various cultural, political and economic fields, were organized to celebrate the 150° anniversary of the diplomatic relations between Italy and Japan. Among them, Keio University of Tokyo, jointly with Bocconi University and the Embassy of Italy in Tokyo, gathered a conference on “The economics of Italy and Japan: Historical Development and Future Policies for Stability and Growth” (Tokyo, 23 May, 2016).

Ispi was represented by two of its Vice Presidents: prof. Carlo Secchi, also former Rector of Bocconi University, joined Keio’s President Professor Atushi Seike and Ambassador Domenico Giorgi in introducing the conference; prof Franco Bruni presented one of the two academic papers on the long run economics of the two countries. The corresponding Japanese paper was authored by prof. Shumpei Takemori.

Other contributions to the conference were offered by the Deputy Governors of the two central banks, Salvatore Rossi and Hiroshi Nakaso and by Mr Teruo Asada, Chairman of Marubeni Corporation, one of the protagonist of the deep economic interlinkages between Japan and Italy.

The following is a synthesis of the Italian academic paper by prof. Franco Bruni. Slides with the relevant data and graphs are also downloadable from here.

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Similar time paths of real growth rates

The time profile of growth of Japan and Italy has been somewhat similar for the last six decades. During the ‘60s both countries ran very fast, faster than the average of industrial countries, even if Japan grew twice as fast. During the ‘70s both slowed down, with growth rates becoming less distant from each other, but both often remained a little above the average of industrial countries. During the ‘80s both kept growing, Japan substantially faster than the average of industrial countries while Italy was slower, often substantially slower. From the ‘90s on, growth slowed down in both countries in a strikingly similar way, staying systematically much lower than the average of industrial countries.

The similarities seem sufficient to search for common factors contributing to shape the growth profiles. A well known common macroeconomic problem of Japan and Italy is the large public debt: it is therefore convenient to inspect the relation between public debt accumulation and GDP growth.

Different timing of public and private debt accumulation

Data on debt to GDP ratios put both countries among the world champions of public indebtedness. But the timing of public debt accumulation has been very different in the two countries. In Japan it started as a reaction to the slowdown in growth in the second part of the ‘90s and then continued as a tentative stimulus to get the country growing faster again. In fact fiscal stimulus is still now an official instrument of Japan’s policy to stimulate the economy. In Italy, on the contrary, public debt accumulation took place in good times, much earlier than in Japan, during part of the ‘70s, the ‘80s and the first half of the ‘90s. Later, when growth decelerated, there was no room left for the fiscal stimulus. One could even argue that excessive debt accumulation was among the main causes of Italy’s long-term growth crisis.

One is therefore tempted to contrast a Japanese debt problem induced by the growth crisis with an Italian growth path endangered by excessive public debt. But doubts can emerge about the fact that in Japan debt has only been a tentative cure of the crisis and not at all one of the causes of the latter. In fact the picture looks quite different if private debt is also considered.

It is easy to show – and, in a way, it is well known – that a surge in
private debt is far from extraneous to the building up of Japan’s growth crisis in the ‘90s. The growth boom of Japan was also nourished by excessive amounts of incautious bank credit. When Italy was exaggerating with public debt Japan was behaving in an analogous way with private debt. If we sum private and public debt, it appears that both countries have had too much, even if Japan’s total has been growing much faster in proportion to GDP. To the extent that excessive debt means fragility, Japan looks more fragile.

One can conclude that, for more than 50 years, the quality and sustainability of GDP growth, in Japan and in Italy, has been deeply conditioned by the growth path of total debt. During the years of fast to decent growth (‘70s and ‘80s), while Japan’s bubble was nourished by an explosion of private debt, Italy’s economic policy was inadequate in controlling the accumulation of public deficits.

In spite of this difference, in both cases important elements of debt-pushed, somewhat “artificial” and possibly distorted and misallocated growth seems to have been at work. The increase in Japanese public debt, starting in the ‘90s, could thus appear a “bailout” of the disasters previously caused by private debt.

In the same years Italy started to be strongly influenced by the plans, and then by the facts, of the European monetary union. In fact the euro fiscal discipline accounts for much of the difference between Italy’s and Japan’s fiscal policies in the last 20 years.

**Comparing the composition of public debt holdings**

To compare the fragilities caused by excessive public debts in Japan and Italy it is useful to compare the composition of public debt holdings in the two countries. Some important differences emerge. Foreign holdings have always been much lower in Japan: now 8% of total debt vs approximately 40% in Italy; however in Italy foreign holding have been declining fast: as recently as in 2010 their share was 10% higher. Domestic banks’ holdings are now approximately equivalent (around 20%) in the two countries: but in Japan the proportion was halved in 5 years in favor of central bank holdings. The latter are now 3 times larger in Japan if we exclude Italian sovereigns held by the non-Bank of Italy euro-system; just 5 years ago the Bank of Japan held national sovereigns in the same proportion (around 10%) as the Bank of Italy today (while at that
time the Bank of Italy held half the proportion of today).

These differences stimulate three questions. First: to what extent a small share of foreign holdings of domestic sovereigns (like in Japan) makes the problem of public debt less severe? Second: as high domestic banks' holdings of domestic sovereigns (like in Italy) are considered a serious risk in the euro area, to what extent is this a correct idea? Does Japan share an analogous risk? Third: considering that the size of the public debt of a country (like Italy) is dramatized by the absence of a domestic currency (and therefore of a lender of last resort for the Government), to what extent does this fact render the nature of the sovereign debt problem incomparable in the two countries?

**Foreign holdings of sovereigns**

The implications of a large share of foreign holdings of public debt are widely discussed both in the academic literature and in the policy discussions. Foreign holdings can be thought to be more volatile. Which is often true; however, without financial repression and with free capital movements the “home bias” of the demand for sovereigns should be limited and domestic holdings should be volatile as well. In fact sudden stops or reversals of capital inflows, even if directed towards private investments, can make domestic financing of public debt more difficult. The Italian experience with cross-border interbank capital flows in 2011-2 is a relevant example.

Interpreting the meaning of foreign holdings of a country's sovereigns is a controversial and multifaceted issue. Instead of a signal of riskiness of public debt a large share of foreign holdings could appear as a symptom of trust in the country and in its currency. But their size also depends on the international investment position of the country: small foreign holdings of Japan's sovereigns are also a consequence of Japan's large positive position (+70% of GDP), while Italy has a negative IIP (-26%) and selling sovereigns abroad can be a way to finance current balance of payment deficits. Servicing sovereign debt is in principle easier when it is held domestically, as high levels of taxes and austerity should seem more acceptable to service domestic creditors; moreover, default can appear less probable when sovereigns are held domestically, as the government is all the more reluctant to default when domestic actors (who have also voting power) are
involved in sovereign debt holdings. However, domestic holders are in part compensated from default with less taxes, while this is not the case for foreigners: therefore holdings could become more domestic endogenously, when the risk of default is higher. Which would mean that high domestic holdings do not make the situation less risky as they can indeed be a symptom of riskiness.

Unsustainable sovereign debt is bound to be accepted by domestic holders who, as previously recalled, tend to oppose default and make it less probable thus trigging more fiscal discipline or, on the contrary, allowing a vicious circle of continuously booming debt, eventually making default inevitable!

The issue is therefore complex: foreign holdings of Italy’s public debt can cause sustainability problems but the risk of Japan’s public debt must not be downplayed simply because the country’s sovereigns are mostly held domestically.

**Banks’ holdings of sovereigns**

In the euro area the “bank-sovereign interdependence”, that tends to segment the money market of the euro area along national borders, has been a crucial issue since 2012 and has stimulated the planning of the European Banking Union. The latter has been conceived to de-nationalize banks, thus avoiding that borders become obstacles to the free circulation of money and credit, helping the reduction of interest rate differentials among member states and enhancing the homogeneity of the impact of ECB’s monetary policies. The problem emerged with a significant re-nationalization of sovereign debt through banks’ purchases of domestic government bonds that characterized the “periphery” of the euro area during its crisis in 2011-2.

In fact there is resistance in decreasing banks’ home bias in holding sovereigns. The issue of home bias is heavily searched in studying sovereign debts. The bias can be caused by government pressures and/or by incentives to shifting (and leveraging) sovereign risk to bank creditors (valued by bank stock markets!), as a bank’s default risk is highly correlated with its government’s. There is good econometric evidence of risk shifting phenomena in euro area’s periphery. Be it caused by political pressures or by the incentive to risk shifting, the bias distorts risk premia, crowds out credit to private sector, increases international financial segmentation, reduces market discipline to public finance. Ideas
circulate in the euro area to limit banks’ home bias with caps on bank holdings of domestic sovereigns or other measures, including the introduction into Basle rules on minimum banks’ capital ratios of positive weights for sovereigns.

**Central banks and public debts: in defense of the Maastricht model**

As for the third question inspired by confronting national sovereign holdings in Japan and Italy, it should be obvious that central banks’ commitments (more or less explicit) to act as lenders of last resort (LLR) to their governments support the international placement of sovereigns as it decreases the perceived risk of sovereign default. The lack of a LLR function of the ECB, as far as sovereign debts are concerned, is a characteristic of the Maastricht Treaty but also a source of controversy in the debate on the role of the ECB.

On the contrary, LLR for government debt is clearly a function of the Bank of Japan. Could this “safety net” support larger foreign holdings of Japan’s public debt, in spite of the fact that its size is often considered technically “unsustainable”? The answer is that probably this could happen only if a credible consolidation plan were in place. To consolidate and to internationalize are two processes that can reinforce each other. This could be considered a European recipe for Japan to imitate.

Japan can free its banks from sovereign holdings with BoJ purchases; Italy cannot. But the ECB’s “quantitative easing” tries to do it in disguise. Is Europe imitating the Japanese recipe (even if avoiding favors to sovereigns of individual member states)? This imitation would be dangerous. The European recipe looks sounder. Central bank purchases could deepen moral hazard weakening market discipline. Debt sustainability could suffer and financial fragility increase.

Being denominated in an internationally accepted domestic currency should help the global placement of Japan’s sovereigns, as in the US and UK cases. But Japan has a tradition of dislike of yen internationalization. One can wonder whether the current evolution of Chinese finance, seeking a smooth path towards currency diversification, could favor the internationalization of Japan’s sovereign debt, fostering the continuation of the recent increase of the very small foreign holdings of Japan’s sovereigns.
Some insist that the growing scarcity of risk free assets is a serious problem. The globalization of holdings of sovereigns, backed by LLR in national currencies, could be of help on this front, provided debt accumulations remain within limits of sustainability. With the same proviso, the issue of (more or less “synthetic”) euro-bonds could also provide the world new “risk free” assets.

However we cannot but keep “risk free” written in inverted commas: with insufficiently rapid reductions of debt/GDP ratios, both in the private and in the public sectors, in Japan, in Europe and a bit everywhere in the world, there will be no truly risk free assets around the globe as global financial stability will be increasingly precarious. Japan and Italy are both in the position to try and offer a substantial contribution to a sound deleveraging of the world economy.