How is Japan managing its debt?

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Over the next few years, it will become obvious that the Bank of Japan (BOJ) has monetized several trillion dollars of government debt. The orthodox fear is that printing money to fund current and past fiscal deficits inevitably leads to dangerous inflation. The result in Japan probably will be a small up-tick in inflation and growth. And the financial markets' most likely reaction will be a simple yawn.

Japanese government debt now stands at more than 230% of GDP, and at about 140% even after deducting holdings by various government-related entities, such as the social-security fund. This debt mountain is the inevitable result of the large fiscal deficits that Japan has run since 1990. And it is debt that will never be "repaid" in the normal sense of the word.

Figures provided by the International Monetary Fund illustrate why. For Japan to pay down its net debt even to 80% of GDP by 2030, it would have to turn a 6%-of-GDP primary budget deficit (before interest payments on existing debt) in 2014 into a 5.6%-of-GDP surplus by 2020, and maintain that surplus throughout the 2020s.

If this was attempted, Japan would be condemned to sustained deflation and recession. Even a modest step in that direction – the sales-tax increase of April 2014, for example – produced a severe setback to economic recovery.

Instead of being repaid, the government's debt is being bought by the BOJ, whose purchases of ¥80 trillion per year now exceed the government's new debt issues of about ¥50 trillion. Total debt, net of BOJ holdings, is therefore falling slowly. Indeed, if current trends persist, the debt held neither by the BOJ nor other government-related entities could be down to 65% of GDP by 2017. And because the government owns the BOJ, which returns the interest it receives on government bonds to the government, it is only the declining net figure that represents a real liability for future Japanese taxpayers.

The stated aim of the BOJ's giant quantitative easing operation is to raise asset prices, reduce interest rates, weaken the yen's exchange rate, and thus stimulate business investment and exports. These indirect transmission mechanisms are certainly having some positive impact on inflation and growth: private credit has turned positive since QE was launched. But the bigger economic stimulus derives from the government's continued large fiscal deficits, effectively funded with BOJ-created money.

That reality is not yet openly admitted. The official doctrine is that the BOJ eventually will sell back all of the government bonds that it has acquired. But it

need not do so. Indeed, the BOJ could maintain its current level of government-debt holdings indefinitely, making new purchases as existing bonds mature. And if the money created – in the form of commercial bank reserves at the BOJ – ever threatened to support excessive credit growth and inflation, the BOJ could offset that danger by imposing reserve requirements on the banks.

The Japanese authorities are thus doing what former US Federal Reserve Board Chairman Ben Bernanke proposed in 2003 – using monetized fiscal deficits to put spending power directly into the hands of companies and households. The BOJ rejected Bernanke's advice at the time, insisting instead that all deficits must be financed with bonds; now, however, the BOJ is effectively monetizing past and current deficits alike. If it had done so earlier, Japan would have experienced less deflation and slightly higher growth, and would now have smaller public debts. But better late than never.

The Japanese authorities could make their monetization explicit by replacing some of the interest-bearing debt held by the BOJ with a perpetual non-interest-bearing bond. But, regardless of whether they do so, the economic reality will become increasingly obvious over the next 2-3 years, and financial and political commentary will increasingly focus on the government's consolidated debt burden, net of central bank holdings.

As that process plays out, there is a small risk that financial markets will be spooked by orthodox fears that monetization implies excessive inflation, and that large increases in government bond yields and dramatic yen depreciation will result. But the more probable market reaction will be a collective shrug of the shoulders, accepting permanent monetization as the only possible safe way to alleviate an otherwise intractable debt burden.

Japan will end up having monetized, post facto, the large public deficits that it ran after the end of 1980s credit boom, and which usefully offset the impact of sustained private deleveraging in the 1990s and 2000s. Doing so earlier would have been better; but, even without such radicalism Japan's "lost decades" were not quite as disastrous as is commonly assumed.

Japan was already one the world's richest countries in 1990, and its per capita income has continued to grow, albeit slowly. Its unemployment rate, now 3.6%, has been consistently below European levels. And its "public debt burden" will turn out to be an illusion.

It is the eurozone, not Japan, that should worry us. Tight constraints on fiscal deficits and an absolute prohibition on monetization by the European Central Bank have prevented an effective response to the post-2008 debt overhang, driving the eurozone unemployment rate to 11.2%. The potential social and political consequences of lost decades of slow growth and high unemployment would be far more serious in Europe, with its diverse national identities and imperfectly integrated ethnic and religious minorities, than in culturally and ethnically homogeneous Japan.

While Europe is playing with social and political fire, Japan simply needs to tweak its accounting entries. A shrug of the shoulders is well justified.