TYCHOS

Japan Commentary 9-16-20

Japan

<u>Commentary:</u>

Japan's private debt growth rate has been very low for two decades (the period after the very rapid debt growth of the late 1980s and early 1990s), offset by very high government debt growth. However, since 2018, after 20 years generally characterized by private debt growth rate contraction, those growth rates have been positive. This data predates most of the COVID issues.

Japan's export surplus has turned slightly negative, but its current account surplus is still strong.

For the first quarter, overall country-level debt growth provides no concern, and household and non-financial corporation debt growth has been balanced, with somewhat more non-financial corporation debt growth.

Areas of non-financial corporation debt growth of greatest concern are Real Estate, Commodity Leases, and Utilities

Growth in consumer credit, which had been an area of concern, has abated.

Financial institution types that show the most concern are Financial Dealers and Brokers, Other Financial Intermediaries, Financial Auxiliaries, Insurance (Life/Non-Life and Mutual Aid), Collectively Managed Trusts, and Pension Debt. None of these have reached a level that represents systemic national risk, but all are worth watching, because in the history of financial crisis and credit risk, problems most often arise in secondary types of institutions because of lower levels of regulatory scrutiny.

Lending by Japanese institutions to entities with the US and France has been accelerating.

There has been increased risk in Interest Rate, Foreign Exchange, and Equity-Linked derivatives.

Institutions with lending growth that merits increased scrutiny are Sumitomo and Resona.

Japan's general government debt continues to grow rapidly, now reaching 228% of GDP, though net borrowing is under 130% after taking into account the large amount of financial assets held by the government.

Country Net Worth

Interestingly, Japan leads the Big Seven in its Private Sector Financial Net Worth by a substantial margin. In additional, its government net worth, while the lowest of the Big Seven, is only slightly so, since the government holds such a large stock of financial assets (and is a significant outlier in this practice). Japan's government financial net worth is -124% of GDP compared to the US -110%, even though Japan's aggregate debt is 228% of GDP.

The result is that Japan's total country financial net worth is the highest of the Big Seven.

Background:

Accelerating private debt for a country is normally a signal for some level of economic boom, which is then often followed by some type of economic reversal or calamity. The same is also true for rapid debt growth within an economic sector. At the point credit growth becomes excessive, the result is credit problems for that country or sector. The reason is this: rapid growth in credit, while usually favorable in the short run, if sustained can lead to oversupply or overcapacity—e.g. too many houses or too much oil extraction capacity—at the country level, or within a given industry or sector. In fact, overcapacity is only possible through rapid debt expansion. Significant overcapacity is generally followed by two events—a drop in sector activity and the necessity of sector layoffs during the period while demand catches up, along with high credit losses for lenders in that sector.

There is no hard and fast measure for the level of growth that leads to overcapacity, since the nature of policy responses and other qualitative variables have a significant influence on how events play out. Nevertheless, what has been a useful threshold measure is that if overall private debt to GDP increases by 20% in a five-year window, and reaches 150% in that time frame, credit problems are a likely result. Within a given sector, if sector debt to GDP increases over 40% within five years, credit problems of increased likelihood within that sector. If the sector is large enough, e.g. the real estate sector, that sectors problems can spill over into other sectors bringing systemic national risk.

Disclaimer:

All data in this report is as current as is readily available. Certain data is less timely than desirable, especially sector level data. However, most adverse volume trends must hold for more than a year or two to create significant credit concerns, so this lag in data, while unfortunate, does not preclude of significant trends.