BARRON'S

Is the Sun Setting on Japan?

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HEDGE-FUND MANAGER OF OUR acquaintance waxes apocalyptic when painting Japan's economic future. Within 50 years or so, he contends, high-tech aircraft will be taking Chinese and American tourists on fly-overs there to view the dilapidated remains of what was once the world's second-largest economy. By then, all that survives will be blighted megalopolises like Tokyo, populated mostly by the elderly, and decaying, weedchoked highways, bridges and bullet-train right-of-ways, spectral reminders of a once-vibrant society that lost its way.

There is, of course, more than a measure of hyperbole in his Spenglerian ruminations. Nonetheless, the manager's fund is positioning itself to profit from a sovereign debt crisis he sees coming in three to four years that will devastate prices of Japanese government bonds (JGBs), while sending longterm interest rates soaring. In the process, he says, the yen will plummet as domestic and foreign investors flee Japanese assets.

To many, this doom-and-gloom scenario is preposterous. But Japan's economy has been in despond since 1990, when the island nation was laid low by a crash in its stock and real-estate markets and resulting bad-debt problems slammed its banking system. Since then, massive government stimulus programs have generated huge structural budget deficits rather than the solid, self-sustaining economic growth they were designed to foster. Japan's gross national debt now equals 217% of its gross domestic product, compared with 81.2% for the often-maligned U.S. and an average of 72.5% for the G-20 nations (the 19 largest economies, plus the European Union), according to the International Monetary Fund. And the burden could become crushing as over the next 40 years, Japan's population falls by more than 20% and the number of working age Japanese shrinks by 41%.

THOSE WHO DOUBT THAT Japan faces severe problems have ready arguments. Sure, the country's debt-to-GDPratio is sky-high. But nearly 95% of that debt is financed internally by its huge residual savings, while the U.S. must go hat in hand to countries such as China and, yes, Japan to finance more than 40% of its public debt. And while much of the Japanese debt is double-counted because government and quasi-government entities hold JGBs in their portfolios— just as the Social Security trust fund owns U.S. debt—on a net basis, Japan's debt is about 100% of GDP, still significantly higher than the rate for the rest of the G-20.

Moreover, relative calm reigns today, even though the many rival nations. Interest rates remain low—the 10-year JGB yields just 1.3%, while a 10-year Treasury costs Uncle Sam around 3.4%. As economist Richard Katz of the Oriental Economist Alert notes, Japan's debt-service costs are the lowest in 20 years. And the yen remains strong, buoyed by its status as a favorite of investors who borrow funds to speculate in higher-yielding assets denominated in other currencies.

"The bears love to beat the Armageddon drum as far as Japan is concerned, but I just don't see any precipitating event to cause a crisis, such as a trade-induced international-payment crisis. One shouldn't forget that Japan currently has $1 trillion in international currency reserves that mostly have come from positive trade balances to fall back on," Katz asserts.

Some old Japan hands draw solace from the smashing victory of the Democratic Party of Japan (DPJ) in last month's national elections. The DPJ is forming a government that promises to radically reform the nation laid low by more than 50 years of increasingly sclerotic control by the Liberal Democratic Party (LDP). For too long, the LDP favored the construction industry and other vested corporate interests over consumers. In recent years, this led to heavy spending on increasingly wasteful, non-productive public works at the expense of household consumption. The DPJ has vowed to boost personal income as a percentage of GDP.

YET SOME ASIAN EXPERTS doubt Japan will reform. One is William Overholt, a senior research fellow at Harvard's Kennedy School. Overholt has built a formidable résumé in Asian economics and politics, moving between the U.S. and Asia for U.S. banks, the RAND Corp. and the Hudson Institute. He was the head of strategy and economics at Nomura's Hong Kong offices.

He says a Japanese debt default is not only possible, but increasingly likely. He argues that Japan's debt is "destined to keep rising because of unfunded pension liabilities of the aging population and contingent liabilities that the central government bears as a result of functionally insolvent local government." And he warns, "Japan is rapidly approaching a crossover point in which expectations will suddenly change and existing trends prove unsustainable. The JGB market may turn out to be the biggest bubble in world economic history."

In recent reports, Tetsufumi Yamakawa, a Tokyo based economist for Goldman Sachs, has expressed fear that interest rates on Japan's public debt may soon become persistently higher than nominal GDP growth, leading to a permanent ballooning in government liability. Goldman estimates that, partly as a result of the new stimulus programs planned by the DPJ, Japan's annual budget deficit will remain around 10% of GDP over the next three or so fiscal years. "We see considerable risk that this could send general government debt [relative to GDP] closer to a scenario of fiscal collapse," Yamakawa concludes in one report.

Strong economic growth would be the panacea for the debt problem. But after weathering about two decades of subnormal growth punctuated by recession and bouts of deflation, the Japanese face a rapid decline in population, with their workforce falling even faster than their overall population. Combined with Japan's historical hostility to immigrants, who could provide new impetus for the economy, that will make GDP growth even harder to achieve.

Nominal growth averaging 1.5% is about the best that can be expected over the coming decade, and that would barely produce the tax revenue needed to service the national debt with JGB 10-year rates at 1.3%. Higher interest rates would amplify and accelerate the crisis by pushing the gross debt-to-GDP ratio relentlessly higher.

Japan's two decades of economic lethargy have surprised Westerners who, by the late 1980s, had concluded Japan would win global economic supremacy. But even then, much economic rot lurked beneath the surface of a nation boasting champion exporting concerns like Toyota (ticker: TM) with its revolutionary just-in-time inventory techniques, lean manufacturing, high quality and beautifully choreographed production techniques.

In fact, the world-class export sector never accounted for more than 15% of Japan's GDP. The rest came from domestic companies like food processors, small manufacturers, retailers, ma-and-pa shops, textile firms, construction companies and postage-stamp-sized farms. Most are inefficient; all are shielded from domestic and foreign competition by complex regulations. Japan has been crippled by high consumer costs, substandard profit margins and poor productivity. Output per man-hour in Japan trails that of the U.S. by 30%.

Structural reforms could have changed this. But the LDP was captive to vested interests such as banking, heavy industry, agriculture and the powerful construction contractors, in exchange for fat campaign donations and kickbacks. Says The Oriental Economist's Richard Katz: "At the heart of Japan's malaise is that the government has morphed from promoting winners to protecting losers."

Even the export sector is beginning to encounter difficulties. Japan has long embraced manufacturing and a vertical, hierarchical corporate structure as engines of prosperity. Any product innovation comes from within these keiretsu corporate families, and proprietary hardware and software standards are rigidly imposed.

But Japan seems to be losing ground in innovation to the U.S., China, Korea, Taiwan and others who favor open sourcing, entrepreneurial culture and flatter, more collaborative structures, according to a paper by the **Harvard Business School's Andrei Hagiu** and Temple University Japan expert Robert Dujarric. They cite Japanese mobile phones, technical marvels with little presence outside Japan in comparison with devices made by Finland's Nokia (NOK), Korea's Samsung (005930.Korea) and LG Electronics (066570.Korea), or the U.S.'s Motorola (MOT). That is because Japanese mobile phone companies dictated the products they wanted, and were interested only in the domestic market.

Michael Zielenziger's 2007 Shutting Out the Sun says these structural problems have kept such storied giants as Sony (SNE) and Panasonic (PC) from emerging as strong players in the U.S. cellphone, digital television or MP3 music-player markets.

The old saw about demographics being destiny certainly applies to Japan, which is graying at an alarming rate because of longtime low fertility rates; its post-World War II baby boom petered out almost a decade before America's ended in the mid-1960s.

The latest United Nations median forecast estimates Japan's population will fall from a current 127 million to just 101.6 million by 2050, while the U.S. count will rise from 317 million to 404 million. Even worse, Tokyo itself predicts, the number of Japanese of prime working age (15 to 64), which totaled 83 million in 2007, is likely to tumble to 49 million in 2050, while the over-65 cohort jumps from 27.5 million to nearly 38 million. That would mean more than 77 elderly dependents for every 100 workers by 2050, compared with just 33 per 100 now.

Certainly Chinese, Koreans, Filipinos and other foreigners could fill the gap and would covet permanent resident status in Japan. Yet most foreign workers are issued only temporary visas, and single males are preferred. Citizenship remains an almost insuperable barrier for foreigners, or gaijin, who often are viewed as crime-prone.

In addition, from 2002 to 2007—the boom years of the global recovery—real disposable income and the real wage both fell in Japan. One result: Japan's household savings rate—more than 20% in the early 1970s—has dipped to about 3%. That's less than U.S. households' 4.2% as of July.

The DPJ platform promises to rectify some of these imbalances, by reducing outlays for unneeded construction projects, by reining in the central government bureaucracy that exerts such suffocating control over the economy, and by boosting household incomes, via measures such as $280-a-month per-child family allowances, eliminating hefty highway tolls, ending fees at public high schools, enriching university aid programs, and providing free health care for children up to 15 years old. The DPJ wants to raise the minimum wage and curb the use of temporary workers to enhance wage and benefit levels.

However, the DPJ has been somewhat vague on where it will find the money for its programs, which when fully in place by fiscal 2013 would cost 16.8 trillion yen—about $185 billion—a year. Party functionaries argue the program will pay for itself by giving the economy a powerful and sustained boost. Yet many economists see only bigger structural deficits ahead.

In its long history, Japan has weathered typhoons, civil strife and wars. How it handles the demographic and debt tsunami bearing down on it will provide one of the 21st century's most fascinating—and important—dramas.