InvestmentNews
The Leading News Source for Financial Advisers

# Forget Europe, this is the global economy's elephant in the room

**By Barry Glassman**

December 13, 2011

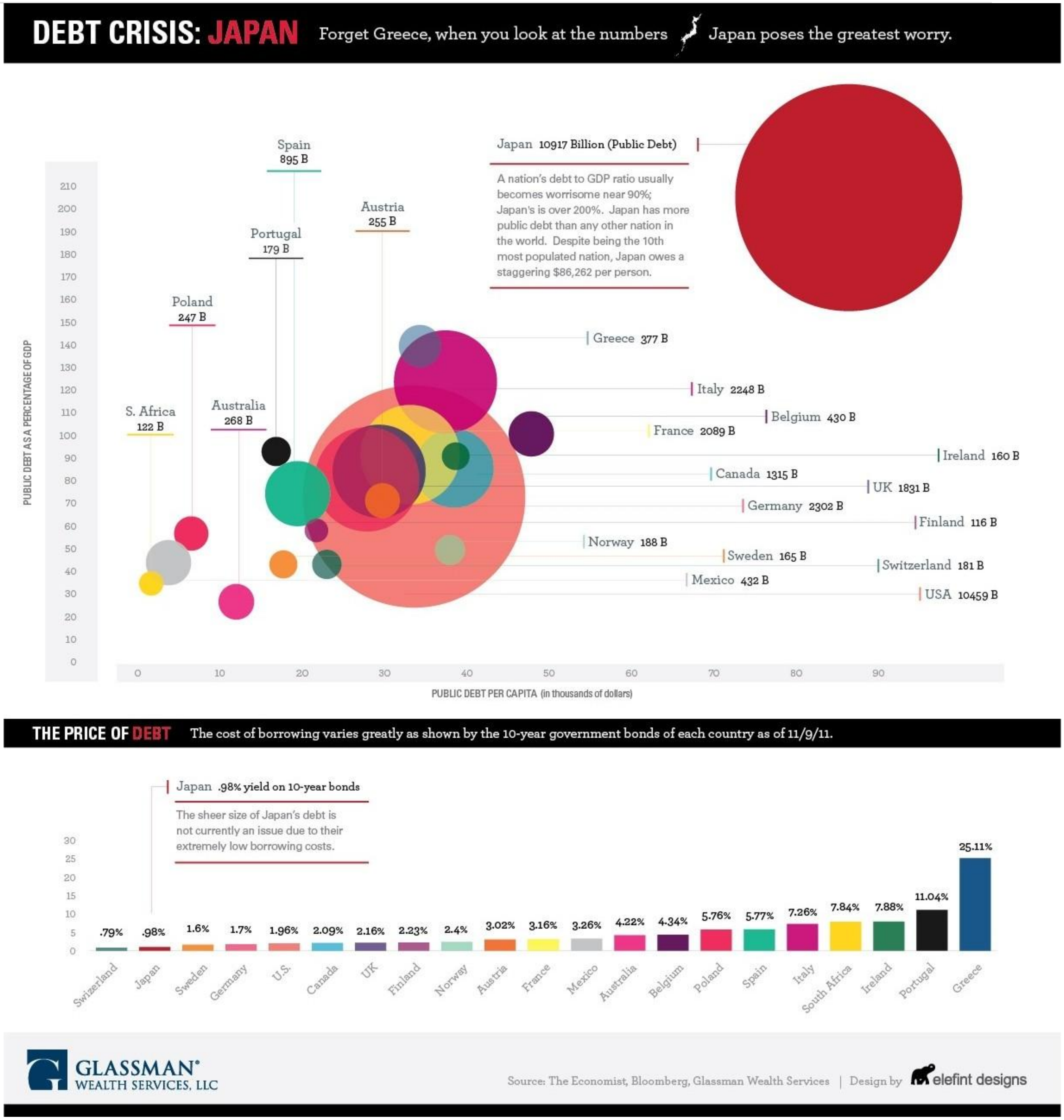
Anytime you have to redraw or resize a chart to accommodate one piece of data – a severe outlier, if you will – you have to talk about it. Since it likely means something is amiss, you ignore it at your own peril. It begs the question, then, as to why the media, economists and politicians of the world continue to furiously debate the potential ripple effects of debt-laden economies like Greece, Spain, Italy and, to a lesser extent, the U.S., while ignoring the elephant in the room: Japan.

Let's take a step back and get some perspective. With the benefit of hindsight, most of us can look back at different points in our lives and wonder, “How did I miss that?” Take, for example, the dot-com bubble. Anyone who got burned when the bubble burst wishes they could go back in time and do things differently. But in 1998, when valuations for companies that were little more than business plans fetched millions of dollars, everyone seemed to have a reason or two to overlook the obvious flaws in this model.

Similarly, just about everyone hopped on board the real estate express train – and got burned when it derailed in spectacular fashion. When we look back at the signs – such as the 2006 home affordability index – it's clear that the gains in home prices simply could not continue.

If we were to go back, then, and create charts using the valuations of houses and dot-com stocks as data points, we would have needed to redraw the scale of the chart to accommodate a few stratospheric outliers – a clear sign that something wasn't quite right. Spider-Man's “Spidey Sense” would have been ringing off the hook.

Well, what we see from the chart below should be causing our early-warning systems to shift into full air-raid mode. Not only is the bubble representing Japan's debt crisis a big giant outlier, it looks just overripe enough to burst. Or, as John Mauldin puts it in his book, The End Game: “Japan is a bug in search of a windshield.”




What Mauldin means by this is that any entity, whether it is an individual, family or a nation-state, can handle debt a whole lot easier when interest rates are low. But when you're already deeply leveraged, as Japan is, even the slightest upward tick in the cost of that debt will have a massive impact on that entity's ability to keep servicing their debt. Translation: Bug meets windshield.

Case in point: Maluden estimates that a 1% hike in Japanese interest rates would eat up a full 10% of the nation's tax revenue. Compounding the problem is that any additional small changes in the nation's savings, growth or inflation rates could easily increase the cost of servicing its debt to a point of no return. Compare that to the U.S. where a bump in the interest rate from 2% to 3% could easily be digested.

So why hasn't Japan made the headlines for risk?

1. First off, Japan has the lowest borrowing rate in the developed world. Even with the fallout from their recent earthquake, tsunami and nuclear meltdown, the country's bond yields plummeted and its currency soared. Demand for government bonds has kept constant due, at least in part, to high private savings rates combined with the requirement of their multi-national banks to own Japanese bonds.

2. Japanese citizens and banks own the vast majority, some 94% of the country's bonds. That's why Japan, unlike the U.S., is able to fund its own debt.

3. Japan has experienced long-term deflationary pressures, which has helped to keep interest rates low.

Add in Japan's rapidly aging population, which could soon cause a downward shift in the nation's savings rate, and you're left without any good long-term solution to this equation. I'm fond of saying that growth solves everything. But in the case of Japan, growth – and the accompanying spike in inflation and borrowing costs – could be its worst nightmare. While no one might want to admit it, therefore, Japan might just be too big to save.

Knowing the exact point when a bubble is going to burst is hard to predict, however, as our examples of the dot-com and housing markets show. That means that Japan might not find itself in any further dire straits for some time to come. The idea, then, is that we need to keep Japan on our radar so we can monitor any fluctuation in the nation's borrowing rate due to things like inflation or even just plain old fear.

*Barry Glassman, President of Glassman Wealth Services in McLean, Virginia, is passionate about educating his clients with the use of infographics and through the firm's GWOG (Glassman Wealth Services Blog). You can follow him on Twitter at @BarryGlassman.*