Lessons from Japan's postwar sovereign debt crisis

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On Dec. 1, Moody's Investors Service downgraded its rating on Japanese government bonds by one notch to A1. On the surface, financial markets reacted calmly to the news, but concerns are gradually growing about Japan's ability to whip its debt-laden finances back into shape.

What would happen if the country lost its ability to ensure fiscal stability? Given that about 90% of JGBs are held by domestic investors, the country is unlikely to default on foreign debt obligations the way Greece virtually did in 2012.

Defaults on foreign debt obligations -- which require debt forgiveness by foreign creditors -- are usually well-documented, so it is relatively easy to later study the details of how the debt crisis was managed even by foreign observers.

But in the case of a default on domestic debt obligations, which cause investment losses for domestic investors, government authorities tend to try to conceal "embarrassing" facts, often making it harder for foreign observers to examine how the debtor country dealt with the liquidation of too much debt.

In their book "This Time is Different: Eight Centuries of Financial Folly," which analyzes cases of sovereign debt defaults, Carmen Reinhart and Kenneth Rogoff write, "For most countries, finding data, even a couple of decades old, on domestic public debt is an exercise in archaeology."

But there is one rare example of a domestic debt default for which the details are readily available: Japan's default immediately after the end of World War II.

At the time, Japan's Ministry of Finance and outside experts compiled a book to document in detail the harrowing experience of the government's financial collapse to help future fiscal policymaking. Called "Showa Zaiseishi" (the history of fiscal management in the Showa era), the book is available to the public, though it is only in Japanese.

According to the book, Japan's outstanding government debt as of the end of March 1945 was equivalent to about 267% of national income. At that level, the government's finances were in a state of near-collapse as of the country's surrender on Aug. 15, 1945. Inflation, which was already a problem before the war, worsened at an accelerated pace during the war. By the time the war ended, cash and bank deposits were virtually the only assets of any value belonging to the public.

The government began defaulting on foreign debt obligations in 1942, a trend that continued until 1952. At the time of Japan's defeat, 99% of outstanding government debt was built on domestically issued bonds whose coupon rates were held artificially low. Most of these bonds were underwritten by the Bank of Japan and the deposit bureau of the government.

Extreme measures

From around September 1945, when Japan signed the Instrument of Surrender, the Ministry of Finance and outside experts began studying ways to cope with the country's financial and economic chaos. Specifically, the ministry considered several policy options, such as selling off state businesses and assets, collecting property and other taxes, reneging on debt obligations, managing inflation and lowering interest rates on government debts. The ministry finally concluded that rather than relying on the mandate of the General Headquarters, it should take the initiative in dealing with the colossal debts by liquidating as much debt as possible and paying it off using money collected in the form of a huge property tax.

In February 1946, the government took the public by surprise by making a pre-emptive move to block bank accounts and exchange old yen with new yen at a one-to-one ratio. Specifically, on the evening of Feb. 16, the finance minister announced the measures, and on the morning of Feb. 17, all private bank accounts were blocked. At the same time, all cash and old bank notes held by the public was deemed invalid until deposited at banks. People could withdraw only 100 new yen per month from their bank accounts -- just enough to survive on.

Japan's Ministry of Finance, pictured here, took matters into its own hands to tackle the country's massive postwar debt problem.

These policies were explained as measures to tame extremely high inflation to help the public, and the government stuck with that explanation as time passed. But the true purpose of these policies was to overcome the difficulty of fiscal management and force defaults on domestic debt obligations.

The ministry thus foreclosed on people's financial assets and prevented the public from hoarding cash prior to imposing new taxes. In autumn of the same year, the government imposed a huge, one-time tax on private properties and financial assets, regardless of whether the owners were rich or poor. These measures

Major Japanese fiscal, financial measures after World War II

Year	Date	Political, economic events	Fiscal measures	Financial measures	Cabinet
1945	Aug. 15	World War II ends in Japan			Higashikuninomiya cabinet (Aug. 17-Oct. 9, 1945)
	Aug. 28		Postwar currency committee set up at Ministry of Finance		
	Sept. 2	Japan signs surrender documents			Shidehara cabinet (Oct. 9, 1945-May 22, 1946)
1946	Jan. 21		General Headquarters issues directive to limit government borrowing, payments		
	Feb. 17	Government introduces food-distribution controls, issues order against hoarding goods	Government announces probe into people's assets	**Government blocks all private bank accounts, issues new yen bills**	
	Mar. 3	Government issues price-control directive			First Yoshida cabinet (May 22, 1946-May 24, 1947)
	July 24		Cabinet decides to completely end wartime reparations		
	Aug. 11			Government divides bank deposits into two categories	
	Aug. 15	Government announces law on finances of nonfinancial institutions		Government announces law on finances of financial institutions	
	Oct. 19	**Government announces law on special measures on wartime reparations**			
		Government announces law on corporate rehabilitation		**Government forecloses on second category of bank deposits**	
	Nov. 12		**Government imposes property tax**		

Source: Compiled by Japan Research Institute based on book compiled by Yoshimasa Nishimura

enabled the government to repay both the principal and interest on its domestic debts. People were forced to use all the assets they owned as of Feb. 16 to pay back the capital and interest of the huge government debt.

The government also offset payment guarantees it had made during the war to citizens and domestic companies to cover war expenses by imposing a special tax, a tactic that resulted in the government defaulting on this portion of its debt obligations. Money from blocked bank deposits was used to pay this special tax, as well as the property tax, and also make up for private financial institutions' curtailed debt repayments.

All this happened under the highly unusual circumstances of a post-surrender Japan, but it still constitutes an example of how a country that owes most of its huge debts to domestic creditors is forced to eventually make good on its financial obligations.

Although Japan is no longer at war, the ratio of its sovereign debt to gross domestic product is 250%, nearly matching the post-surrender figure. And just as in the wartime days, the bulk of government debt is owed to domestic creditors, and the country is at a loss for ways to stop the swelling.

Time to get radical

I know interest rates for Japanese government bonds continue to hit historical lows, but this is because the Bank of Japan is buying up huge amounts of JGBs. Because the liquidity of the bond market is now extremely low, it is possible that interest rates may shoot up for some reason. If an event such as a rise in interest rates or a capital flight caused by an extreme weakening of the yen makes Japan's fiscal condition untenable, the country may be forced to take draconian measures similar to those imposed after the war.

Such a situation must be averted by all means. Japan would need to shrink the budget deficit by some 40 trillion yen ($332 billion) a year over the medium term to keep its outstanding debt at a constant level. That cannot be achieved merely through economic growth, stop-gap tax increases or cuts in wasteful spending. To improve its fiscal efficiency, Japan needs to embark on radical reforms by devising new rules on fiscal management, strengthening its governance or shifting to an arrangement similar to a federal system. A recommended measure would be to establish an independent organization that manages fiscal administration from a specialized and objective perspective. If a federal system is introduced, each state can decide how to prioritize spending and how to improve the efficiency of spending.

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