Reconsidering the Prospects for Japan's Long-term Interest Rates by Masaki Kuwahara

Comment by

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1 Introduction and Summary

This is a very interesting paper. But there is more to be said on this subject than can be found in the paper present.

- The core argument is on page 2:

  "Rational thinking tells us that the bigger the amount of debt , the more difficult it is to pay back. And someone who is likely to have difficulty in paying back money usually has to pay higher interest rates to borrow. Therefore interest rates on Japanese bonds must be very high".

- But – Kuwahara concludes - interest rates are not predicted by the size of the debt.
- So – says Kuwahara - maybe something else could predict when interest rates will rise. Maybe that 'something else' is inflation.
- The Vines bottom line: there is no 'something else'. To understand how difficult it is to pay back debt, each case must be examined on a case by case basis. Only then can you determine whether interest rates should be high, and are likely to become high

2 Insight from the “Vines bottom line” for the US and UK

- The US
  - See paper by Altshuler and Bosworth – we are right to worry about about whether the US debt “will be difficult to pay back”. But
    - the US debt-to-GDP ratio is low
    - The US can inflate away debt as well as default
    - The US can not just inflate away debt, but it can also devalue the currency (the dollar) in which the debt is denominated.
- The UK
  - British people love knuckling under and suffering. The British debt will certainly be repaid.
  - The British inflation targeting regime is very sound. So the British debt will certainly not be inflated away.
  - It is completely crazy for financial markets to be worried about British public debt
  - It is completely crazy for the present British government to argue that the British deficit should be reduced rapidly and that British public debt should be rapidly reduced.

3 Insight from the “Vines bottom line” for the Japanese position

To understand what is going to happen to long term Japanese interest rates one needs to understand three things

(a) What is going to happen to global real interest rates and global inflation, and so understand global nominal interest rates?

(b) How likely is Japan to have inflation – inflation will push up Japanese rates relative to global rates. Deflation the reverse. The ‘inflation targeting’ anchor in Japan seems much less secure than that in the US and the UK. This is a question of public understanding, and to improve this is a question of policy design.

(c) How likely is Japan to default and so how high is the relevant risk premium?

Given my understanding of Japanese politics and society the answer is – not very.

None of these things have much to do with the quantity of Japanese public debt

4 The data in the paper

- The relationship given between long term debt and interest rates on page 4 plots two variables whose separate behaviour is determined by third, independent forces.
  - Debt had been run up during the war and was coming down slowly over time after the War
  - Inflation had been low in the depression – and the war – and gradually rose as a result of the long boom
- The relationship between long term interest rates and inflation shown on page 6 simply reflects point (b) on page 4 above – it tells us nothing about the quote on page 2 above – about how ‘difficult debt is to pay back’. So the pictures tell us nothing causal
- The relationship between long term interest rates and current account deficits on page 8 is revealing but in a straightforward manner
  - Countries with large external debt are likely to devalue and so the risk premia on their debt should rise
  - This does not tell us about ‘how difficult it is to pay back the debt’

5 More data in the paper: the British case in the 1970s and the German case in the 1920s

- To be discussed

6 Conclusion – the policy implications

- The analysis, and arguments, in this paper can be used in favour of Paul Krugman' support of further fiscal stimulus in *NYRB* for September 30
- If the institutions of inflation targeting are strong, and if there is the political strength to honour debt, then further fiscal expansion at the current time would be helpful
- Policymakers should not be rendered powerless by a case of 'self-induced' paralysis
  - A view that high debt will lead to high interest rates is a case of such paralysis
  - It all depends on the strength of policy-making institutions