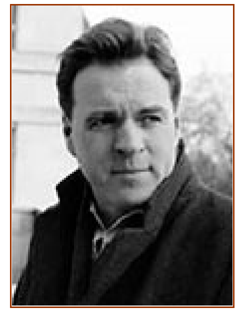
Niall Ferguson on Japan, China, and the US

By Dan Richards
June 22, 2010



Niall Ferguson is arguably today's leading economic historian. A member of both Harvard's Faculty of Arts and Sciences and the Harvard Business School faculty, he is also a Senior Research Fellow at Oxford University and a senior fellow of Stanford University's Hoover Institution, and he has been named one of the world's 100 most influential people by Time Magazine*.*

Ferguson has authored numerous books on war and on economic history, the most recent being The Ascent of Money, which was turned into a television series that won the 2009 International Emmy for Best Documentary. He also writes extensively for periodicals and newspapers in the UK and the US, and he is a contributing editor to the Financial Times.

Dan Richards, President of Toronto based Client Insights, interviewed Ferguson on May 25 in Boston at the CFA Institute Annual Conference. Below is part two of a two-part series, in which Ferguson shares his view on the U.S, Japan and China.

A video of this interview appears here.

Here are links to last week's interview on prospects for the UK and Europe.

Today's Top Economic Historian: The Path to European Stability (Transcript)
Today's Top Economic Historian: The Path to European Stability (Video)

When it comes to Japan, there are two prevailing points of views. One says its stock market valuations offer extraordinarily good value for investors. Others talk about Japan as a fairly dysfunctional society in terms of leadership. Where do you come out on the immediate period ahead for Japan?

I'm a pessimist about Japan, because if any country has a mountain of debt. Japan's exploding public debt is fast approaching 200% of GDP.

Until the very recent past, Japan has been able to finance very large deficits, because of a relatively high savings rate and a propensity for Japanese households to hold large numbers of Japanese government bonds, often through postal savings accounts.

We're fast approaching a point at which that no longer works, because of demographics. As more and more Japanese retire, and the proportion of the population over age 65 rises ever higher — it's already highest in the world — there is going to be much less support from the Japanese bond investors.

What else creates cause for concern about Japan?

You get into the really nasty fiscal arithmetic that happens when interest rates go up. You don't need nominal yields to increase by many basis points to cause a debt crisis when your debt is as large as Japan's. I worry a lot about what happens when people take a look at Japan's public finances, realize how out-of-kilter they are, and start asking for some compensation for the risk of holding a ten-year Japanese government bond.

The Greeks found themselves in a similar debt spiral — or perhaps I should call it a death spiral.

It didn't take much of an increase in nominal yields in Greek debt to cause its fiscal numbers to worsen. That's why it's a death spiral, because the fiscal numbers get worse. Credibility goes down. The yields go up. The fiscal situation gets worse. Credibility goes down and so on. And suddenly you really are tail-spinning.

That could happen to Japan in the near future. That's not really a cycle, is it? Japan has limped along for 20 years now, economically underperforming, almost stagnating, teetering on the edge of deflation, throwing fiscal and monetary stimulus at the problem, and not getting much traction. Right now it's on the edge something worse.

What's your analysis of what happened after the Japanese real estate and stock market bubble collapsed in 1989?

Japan avoided a Great Depression after its great property crash of 1989 and 1990. What it achieved was really low-growth equilibrium. Japan is a very stable society, so it can handle very low growth, but there is this danger that that pattern has played out, and a new and nasty equilibrium is coming for Japan.

Domestically, in political terms, it's a less stable country than it was. It's not in a position to make the kind of really tough decisions that have to be made.

The only upside is that Japan has benefited as an exporter from China's rapid growth. But China is right now applying the brakes. Now if China is applying the brakes, then you should not be going long Japanese equities.

One of the things that matters is political leadership. We are in an environment where many of the developed countries have relatively progressive leaders, whether

it be Barack Obama in the US, David Cameron in Great Britain, or Angela Merkel and Nicholas Sarkozy, all of whom are challenging some of the traditional assumptions.

Since Junichiro Koizumi, who was Japan's prime minister from 2001 to 2006, that doesn't seem to have been the case. Do you see a change in that respect, where there will be a new generation of political leadership in Japan that will tackle some of the issues you're talking about?

I'd like to think so, but it's hard to see it coming. It's visible when I talk to some of my Japanese students. The younger generation chafes at many of the rigidities of Japanese society. One can imagine a new era in Japanese politics. The trouble is that the demographics odds are stacked against young people in a way that is unique to Japan.

If you just look at the way Japan is aging between now and 2050, a huge proportion of Japanese society is going to be 65 or over in the next few decades, and that creates a real obstacle to radical reform.

The elderly are conservative with a small "c," and sometimes with a large "C." They are also very dependent on certain revenue streams from their government. It's hard to get them to vote for radical changes — for example, for a system of state or corporate pensions — any more than it's easy to get turkeys to vote for Christmas, or for that matter for Thanksgiving,.

There is a problem in Japan, which we'll see in other Western countries as the years pass. You can get a critical mass of obstruction and opposition to radical fiscal reform. The elderly would rather take that chance. They would rather gamble that their nominal claims will not be eroded by inflation. Fear of inflation in Japan is unsurprisingly pretty much at an all time low. The Japanese have not seen inflation for a long time.

For that reason, I will be surprised if we get a big change in Japanese politics.

I'd like to look at another major economy in Asia and get your perspective on China. As China looks to rival the US as one of the two great powers, is it just returning to its natural place as the world's biggest economy that it held until roughly 1800? What is your view on that?

First, the 1800 date is wrong. Economic historians argue about this, but you really ought to be talking 1600 or, at the latest, 1700 for China being the biggest economy in the world. However, we can't really get too persnickety about this.

As far as modern investors and newspaper readers are concerned, one thing is clear: there was a great divergence.

At some point in the last 400 or so years, China lagged behind. It essentially flat-lined in terms of per-capita GDP for centuries. It went backwards in the 19th century at a time when Western societies, led by Great Britain and then followed by Western Europe, and by British and other European colonies of settlement, powered ahead with commercial, financial, and industrial revolutions. The divergence unfolded to the point that there was a huge differential in per-capita income between the west and the rest, between the United States and China.

By some measures, the average American, by 1949 or 1950, was 50 times richer than the average Chinese — an absolutely huge differential. Of course, if you went back to 1700, they were quite close to parity.

We are witnessing a re-convergence after hundreds of years of divergence. This process of re-convergence began quite a while ago when the Japanese figured out that they could westernize their economic and political institutions and play our game.

So how did this happen in China?

The Chinese caught on to this a lot later. It wasn't until 1978 that Deng Xiaoping saw the need for westernization of China's economic institutions. But, since then, China has experienced the fastest and the biggest industrial revolution of the lot. It's an extraordinary explosion of wealth creation. It's taken China from being one of the poorest countries in the world to being close to the second-largest economy in the world.

One of the contrarian views is that Chinese growth has been concentrated in the coastal areas. The majority of Chinese are rural, in the primarily agricultural interior, and haven't benefited in a material way from much of that improvement. That has created some substantial tensions within China. Supposedly thousands of suppressed insurrections have occurred in local villages. To what extent is that a legitimate concern?

I must admit that I don't worry too much about China's internal stability. I find that the people who do worry about it are the people who know relatively little about China today.

It's easy to look back at all the upheavals in Chinese history from the Taiping Rebellion to the Boxer Rebellion, all the way to the Cultural Revolution. But that kind of upheaval in some ways gives people a taste for stability. One thing that all Chinese agree on, and I have yet to hear a dissenting voice, is that unity and stability are more important than anything else, including individual freedom. They've seen a lot of disunity. They've seen a lot of instability. This generation of Chinese has absolutely no desire to go back to those periods of disintegration.

And where does the Chinese government factor into this?

The people know that unity and stability is government policy. It's one of the reasons that the government in China enjoys tremendously high popular regard. If you look at surveys around the world, China's government is probably the most legitimate in the eyes of its own people. That's not just because it has a coercive censorship apparatus. Ordinary Chinese genuinely feel that their government is putting China back where it belongs, which is firmly in a position of parity with the great western economies.

There clearly are outbreaks of unrest and local party officials periodically find themselves in hot water if they engage in dodgy land deals. There's plenty of that going on, but this is not actually system-destabilizing. When one reads about these rural disturbances, it's important to have in one's mind something more like a fracas outside an English pub on a Saturday night, not the French Revolution.

As China continues to grow in importance economically, do you see it taking more of a global geopolitical role, in keeping with what a great economic power would normally assume?

I do see it. It's already happening. China can look at forecasts by an American Investment Bank, Goldman Sachs, that say by 2027 China's GDP will equal that of the United States. It may not be exactly that year, but it's in that range. Within the next 20 years, this could be the biggest economy in the world.

They've also seen economy number one, the United States, screw up massively in the financial crisis. The Chinese no longer need to hear lectures about the wonders of the Washington consensus, and the need for them to Americanize their banking system. On the contrary, they feel bolstered in their self-confidence. They feel that their economic model has actually proved itself to be the best in this crisis.

There's a new self-confidence in Chinese policy, not only at the level of economics, but in diplomacy, and even in the realm of military power. Their navy is more assertive. They are more overt in cyber warfare that they are practicing. That incidentally, is one of their big strengths, and one of our big worries in the West, because that's a gap they can close really quickly, whereas it takes years, even decades, to catch up with the US navy.

And how else does this new confidence translate into Chinese behavior?

We're in a world in which China's playing an entirely new role. They are not quite saying they are the masters now, but there's a new tone of self-confidence and assertiveness, sometimes even a rather shrill assertiveness that clearly distinguishes this era from what I call the "Chimerica" era

That was when China and America were kind of partners. China was clearly the junior partner in a nice marriage in which the Chinese did the saving and the Americans did the spending. The Chinese did the exporting, and the Americans did the importing, and all was hunky dory. That's gone since the breakdown of the Western financial system. The Chinese are now clearly going it alone in a whole range of different ways.

Let's now turn to the impact on the US of turmoil across the globe. Concerns about Greece have raised issues and apprehensions about sovereign debt, not just in Greece, but in Portugal, Ireland, and the rest of the PIIGS countries. There is also a growing sentiment that the United States may face similar issues. What's your view on the fiscal and debt situations in the U.S.?

A few months ago I wanted to write a piece for *The Financial Times* on this subject, and I recommended the following headline, "PIIGS-R-US." That headline was sadly vetoed by the editor, but it summed up my argument pretty clearly.

If you look at the fiscal position of the United States, it is in some respects worse than the fiscal position of Greece or any of the other so called PIIGS.

Take, for example, the measure that the International Monetary Fund has of what a country would have to do to stabilize its debt-to-GDP ratio at 60% over the next 20 years. The IMF says you would have to tighten monetary or fiscal policy by "x" percentage points of GDP to stabilize the situation. The United States actually comes in between Greece and Portugal on that measure, with a necessary tightening of 8.8% of GDP, compared with 9% for Greece. So it's two-tenths of a percentage point of GDP better off than Greece.

The Bank for International Settlements did a projection of what debt-to-GDP will be like by 2040 if nothing changes in current fiscal policy. It is in fact worse for the United States than for Greece, because the United States ends up with a debt-to-GDP ratio of something like 430% compared with Greece, which is more like 400%.

Why hasn't this become an issue to this point in time?

We are in a situation in the United States in which the structural crisis for public finance is as bad if not worse as the crisis in Greece. The reason that there isn't a crisis in the US bond market is that investors persist in regarding the US as a safe haven because of its reserve currency and very liquid capital market.

As things deteriorate in Europe, US bonds rally, and investors pile out of Eurozone bonds and into US Treasurys. This creates the illusion that the US is an authentic safe haven, but I tried to argue in that FT piece that US Treasurys are a safe haven the way Pearl Harbor was a safe haven in November 1941. It's safe until it's attacked.

Do you see that kind of an attack on the US currency?

An attack on the US Treasury market is perfectly conceivable, because our fiscal pattern is not sustainable.

Crucially, there is no obvious way our domestic political arrangements can solve that problem because of the near-gridlock in Washington DC on fiscal questions. At some point, the Greek-style crisis comes here. The issue, of course, is when. If you had to ask me to name a date, I would say that it's probably going to be some time next year, certainly after the mid-terms, but before the next presidential election.

Certainly there have been lots of cases historically of what appear to be very solid reserve currencies whose status disintegrates quite suddenly and quickly.

Yes, ask any British subject. The pound was the reserve currency of choice for most of the 19th and the first half of the 20th century. The standard rate was $4.86 to the pound. Well, it fell from grace.

Why did it fall from grace? Excessive debt.

Clearly, there are some issues in terms of fiscal discipline and debt levels in the US. Offsetting that, some would say that the US has at least a couple of advantages.

One of them is a kind of a unique Horatio Alger-type of resiliency — a level of innovation, an entrepreneurial spirit, and a willingness to tear down traditional ways of doing business that isn't very common elsewhere.

The other advantage is that, until now, the US has been the one country that the best and brightest, particularly the young from around the world, aspire to enter. They don't want to come to Canada or Great Britain. Take a look at the most talented younger students, or at Silicon Valley, and the impact of students from Eastern Europe, China, and India. Do those factors offset the challenges the US faces?

There's a reason I'm teaching at Harvard and not at Oxford, or for that matter McGill. I'm part of that "brain drain."

My students are astonishing in a whole range of ways. It's a wonderfully multinational community, the Harvard student body, and it's also a fantastically dynamic and ambitious one. I've been impressed by how many of my star students have said, in the current economic envirnoment, I think I'll go down the start-up route.

If one thing can save the United States, it's innovation and the entrepreneurship. The only worry I have is that if the wrong decisions get made about fiscal policy, those golden geese could end up being killed off. If you get the tax mix wrong and hammer the incentives to innovate and hammer the entrepreneurship — make life difficult for venture capitalists for example — then you might fail to grow out of the debt trap.

Is growth the answer to the debt problem?

Growth is of course the ideal way out of the debt trap.

If you've got a really big debt-to-GDP ratio, what you want is the GDP to grow faster than the debt. But right now I'm not entirely convinced that we are on that track. If you look at small-business creation and growth, right now it is really flat-lining.

In this respect, the recovery is not happening, and that is problematic, because it's small businesses that create jobs, not "too-big-to-fail" banks. Although the United States traditionally has those strengths, I do not see evidence that we are building on them. If anything, we may actually be reducing them.

Do you see the US hitting a potential point of no return on fiscal problems?

Fiscal arithmetic has no respect for tradition and culture. It's just arithmetic. There comes a point when a certain percentage of your tax revenues are going toward interest payments.

Prior to the crisis, the US was maybe spending 7% of tax revenue on interest on the federal debt — nothing!

Very quickly that could be 20% and then 25%. It has a way of compounding if the bond market doesn't like what it sees.

Of course, that's when the nasty fiscal arithmetic wins over political objections to higher taxes. It wins over traditions of entrepreneurship and innovation. It, frankly, dominates.

And where does Washington factor into this?

The big concern is that no matter what entrepreneurship and innovation there is in the United States, in Washington decision-making is paralyzed by Republican tax-cutters and Democratic public-spenders. There is no political will in Washington to tackle this problem — really, none.

A handful of Republican Congressmen led by Paul Ryan want radical fiscal reform before this thing blows up. I mean a handful — maybe, three. That is the most disturbing thing in the United States today: a complete absence of political will and leadership on what could prove to be the most important issue of the day, namely fiscal reform.