Is Japan next?

Japan's debt levels have ballooned to a level that makes Greece look like a steward of capital. Wall Street has noticed, and it's placing its bets.

By Cyrus Sanati, contributor

FORTUNE -- With the European sovereign debt imbroglio taking a breather for the moment, there is increasing concern on Wall Street that Japan could be the next major flashpoint in the ongoing global financial crisis. It appears that the country's economic reckoning, some 20 years in the making, could finally be coming to a head in the near future as the economy weakens and its debt, relative to its economic output, balloons to a level that makes Greece look like a responsible steward of capital.

Wall Street is buying protection in the form of credit default swaps to prepare for that day Japan implodes. Trading of swaps on Japanese sovereigns has been highly volatile in the past year -- they are currently being sold at around 135 basis points, 100 basis points above Japan's debt yield, credit traders in New York and London tell *Fortune*. Credit default swaps provide a way for investors to make money in the event of a default.

While the Japanese debt bomb isn't expected to go off tomorrow, Japanese CDS is now 50% higher than where it was a year ago. Wall Street involvement in the Japanese debt market has grown in the last few years, which could bring increased pressure on the government to try and solve its debt dilemma. Eventually, though, the Wall Street bond vigilantes could drag Japanese bond yields up to levels that could cripple the government's ability to pay off its debts, setting the stage for one of the most prolific sovereign debt defaults in history.

It seems crazy to think that Japan, a country known for its efficiency and educated population, could have dug itself into such a dire debt hole. But Japan's total debt compared to its GDP is topping 235% and getting larger by the day. As a point of reference, the U.S. has a debt to GDP ratio of around 98%, while the worst off eurozone members, Greece and Portugal, have ratios of around 159% and 110%, respectively.

But Japan has been able to continue racking up the debt because of some notable debt defenses. Those defenses include the nation's strong export industry, as it allows Japan to be a net importer of capital, and the nation's loyal population, which tends to invest and spend money at home. And unlike other advanced economies, the bulk of Japan's debt is held by its own citizens, so it hasn't faced the full wrath of Wall Street's bond investors.

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Comment [JAB1]: Insolvent banks are making CDS bets with other insolvent banks.

Comment [JAB2]: Who are they buying CDS contracts from? The answer is other insolvent banks. Suckers!

Comment [JAB3]: Only if the counterparty to the CDS is solvent and willing to pay. AIG had tons of CDS with other financial institutions, but AIG was bankrupt. The guys who guessed right still weren't paid because AIG couldn't pay off their bad bets.

Comment [JAB4]: Bond traders are not vigilantes. They make voluntary exchanges when they chose. Governments don't have a God given right to low borrowing costs. The bond buyers are completely moral to not bid in the bond auction when they think the risk of default outweighs the rewards offered by the bond's interest rate. Yields must rise to clear the market unless the Bank of Japan

Comment [JAB5]: The US Great Default will dwarf Japan's government woes!!

Comment [JAB6]: The Japanese people are not the same as the Keynesian Japanese government. Keynesians believe that deficits overcome recessions.

Comment [JAB7]: A real conservative estimate of the "real" US debt-to-GDP ratio is 521% ($75 trillion for Medicare and SS divided by $14.4 trillion in GDP). The actual liabilities could be much higher; some estimate it to be over $100 trillion. GDP is a BS Keynesian concept anyway.

Comment [JAB8]: This is a stupid defense of Merchantilism. It has nothing to do with the governments unwillingness to balance their budget.

Comment [JAB9]: Stupid sheepole.

Comment [JAB10]: Everyone invests and spends money at home. The Yen never leaves Japan. US dollars never leave the US banking system. This is Keynesian BS.

Comment [JAB11]: They are stupid. They will be sheared.

But the nation announced some startling economic news this week that has exposed some chinks in Japan's debt defenses. In addition to announcing a much larger-than-expected 2.3% contraction in the country's GDP in the fourth quarter, Japan, the exporting powerhouse, said it ran its first annual trade deficit since 1980. The Ministry of Finance blamed the trade deficit on the high price of energy and the disruption in exports caused by last year's devastating earthquake. While both events did contribute to the trade deficit, the main issue here seems to be Japan's currency.

Comment [JAB12]: So what? Only Keynesian Mercantilists care. Japanese goods will be cheaper for the Japanese people to buy. More goods chasing the same number of Yen.

Comment [JAB13]: The price of energy will continue to go up. Get used to it, Mr. Minister.

Comment [JAB14]: Keynesians hate strong currencies. It hurts their Mercantilist desires.

The yen is now extremely strong versus the U.S. dollar and the euro, making Japan's exports ~~appear~~ more expensive to foreigners than ever before on the international market. Some of the nation's largest export-driven companies are reporting record losses as a result of reduced outflows. For example, **Panasonic recently said** that it was forecasting a $10 billion loss for the fiscal year, while Sony (**SNE**) announced that it was doubling its net loss to around $2.8 billion for the fiscal year, the largest loss in the company's history. The losses at Japan's biggest firms translate to reduced economic growth and a big decrease in government revenue. That forces Tokyo to borrow more money from its citizens to stay afloat.

Comment [JAB15]: They need to produce goods that the Japanese people demand. Adapt or die. This would be good for Japanese consumers.

Comment [JAB16]: Good. The Japanese government wastes the capital these take from the Japanese people. They build bridges to nowhere and other government failures.

Meanwhile, the loyal Japanese consumer has started to stray a bit as the strong yen has made foreign goods ~~look~~ relatively cheap compared to domestic products, further exacerbating the nation's trade deficit. Real imports into Japan in December exceeded Keynesian expectations of a 1.4% contraction to a 4.1% increase. This trend is expected to continue as the yen strengthens and Japanese consumers become more comfortable buying foreign goods.

Comment [JAB17]: This is smart. Buy cheap Chinese goods while they last.

Comment [JAB18]: The Japanese consumers benefit from cheap foreign goods. They shouldn't give a rat's ass about the so-called trade deficit. Does Nevada have a trade deficit with California? Do residents of Las Vegas lament the cheap California fruits and vegetables they eat that would cost much more to produce in the arid Nevada desert?

The strong yen and prolonged weak interest rates are also affecting the loyal Japanese investor. While the vast majority of Japanese assets still remain parked at the bank and in government bonds yielding little interest, there has been a shift in the past two years to invest in higher-yielding international securities offered through mutual funds. At the same time, foreign ownership of Japanese debt is on the rise, going from 5% last year to around 8%, according to ~~Goldman Sachs~~ the devil. The share of short-term debt held by foreigners has now doubled in the last decade to just below 20%.

Comment [JAB19]: They have suffered almost three decades of Keynesian madness. They are coming to their senses.

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The Japanese government has **tried to weaken the yen** for a decade to no avail. It has incessantly engaged in multiple rounds of quantitative easing, which is when the central bank buys back its bonds from the banks with freshly printed cash, thus inflating the money supply. The BOJ engaged in three rounds of QE last year, but the yen kept strengthening. On Tuesday, the BOJ surprised the markets and announced an expansion of its QE program, injecting an additional $130 billion into the banking system. The yen weakened a bit, but the additional QE isn't expected to have a lasting effect on its value.

Comment [JAB20]: This is standard Keynesian Mercantilist policy. Subsidize exports. Why did all the money creation fail to weaken the Yen? Because the Japanese banks are zombie banks.

Comment [JAB21]: Wrong. The Bank of Japan buys the Japanese government's bonds from zombie Japanese banks with freshly created digital money. The Japanese banks do not lend the money, so the fractional reserve based banking system doesn't really increase the money supply.

Comment [JAB22]: Japanese banks aren't lending.

Comment [JAB23]: The BoJ is pushing on a string just like Bernanke.

With Japan's traditional debt defenses damaged and the yen increasing in value, the stage is set for the Wall Street bond vigilantes to make their mark as they did in Europe last year. The difference in yields between Japanese interest rates and Japanese CDS implies that foreigners are growing concerned as to the creditworthiness of the Japanese government. That's understandable given that the government will bring in only 40% of what it needs this year in taxes to cover its budget.

Comment [JAB24]: There will be a default in Japan. Buy high dividend Japanese stocks with earning power and strong balance sheets after the Japanese government default. This is many years away.

Despite all the clear signs of trouble and the damage to its debt defenses, Japanese sovereign debt is still trading below 1%, making it easy for the government to continue borrowing. But the volatile trading in Japanese bonds and CDS in the last year implies a vulnerability where even a mild credit event could trigger a run on the sovereign by both foreign and domestic bondholders, sending government borrowing rates skyrocketing overnight - just as it did in Italy last year.

Comment [JAB25]: And they will continue to borrow until they can't anymore. Europe will suffer much more before it is Japan's turn.

Comment [JAB26]: Italy has much higher unemployment than Japan. Italy probably has a greater welfare system than Japan, but I'm not sure.

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There seems to be no easy way for Japan to escape this debt prison. It could try to inflate its way out of the mess by doubling or tripling the entire money supply, but that would effectively decimate the nation's savings. The government could implement some draconian austerity measures to rein in spending or hike up taxes to increase revenue, but both moves would have severe consequences on economic growth. The boldest move the government is proposing is to hike the nation's sales tax to 8% by 2014, which would increase to 10% in the following year, but that isn't enough to make a dent in the debt pile.

Comment [JAB27]: Tripling the money supply would cause massive inflation. This won't happen until the Japanese commercial banks increase their lending rates. The Japanese savings rate is almost as low as the USA's. They were a nation of savers 30 years ago. They aren't any longer. They bought Japanese government bonds with their savings. Suckers

Comment [JAB28]: They won't because they are Keynesians.

Comment [JAB29]: This will put Japan into recession.

There is no way to know when Japan will finally succumb to its debts. Japan's aging population will be retiring in droves over the next few years, meaning that they will stop buying and start liquidating their bonds, eliminating the government's ability to fund itself. With Japan's debt defenses compromised, that day of reckoning could be coming up much sooner than anyone can imagine.

Comment [JAB30]: Like I said a crisis in Japan will take years to mature. Keynesians believe that deficits don't matter. They do. The European politicians are getting a lesson in that right now. Japan's day of reckoning will happen, so will the US's. Prepare for it.