Defying Gravity: How Long Will Japanese Government Bond Prices Remain High?

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Recent academic papers have shown that the Japanese sovereign debt situation is not sustainable. The puzzle is that the bond rate has remained low and stable. Some suggest that the low yield can be explained by domestic residents' willingness to hold Japanese government bonds (JGBs) despite its low return, and that as long as domestic residents remain home-biased, the JGBs are sustainable. About 95% of JGBs are currently owned by domestic residents. This paper argues that even with such dominance of domestic investors, if the amount of government debt breaches the ceiling imposed by the domestic private sector financial assets, the JGB rates can rapidly rise and the Japanese government can face difficulty rolling over the existing debt. A simulation is conducted on future paths of household saving and fiscal situations to show that the ceiling would be

breached in the next 10 years or so without a drastic fiscal consolidation. This paper also shows that the government debt can be kept under the ceiling with sufficiently large tax increases. The JGB yields can rise even before the ceiling is hit, if the expectation of such drastic fiscal consolidation disappears. This paper points out several possible triggers for such a change in expectation. However, downgrading of JGBs by credit rating agencies is not likely to be a trigger, since past downgrades have not produced any change in the JGB yield. If and when the JGB rates rapidly rise, the Japanese financial institutions that hold a large amount of JGBs will sustain losses and the economy will suffer from fiscal austerity, financial instability, and inflation.

Acknowledgements and Disclosures

Published Versions

"Defying Gravity: Can Japanese sovereign debt continue to increase without a crisis?" (Joint with Takatoshi Ito) Economic Policy, January 2014, 5-44.

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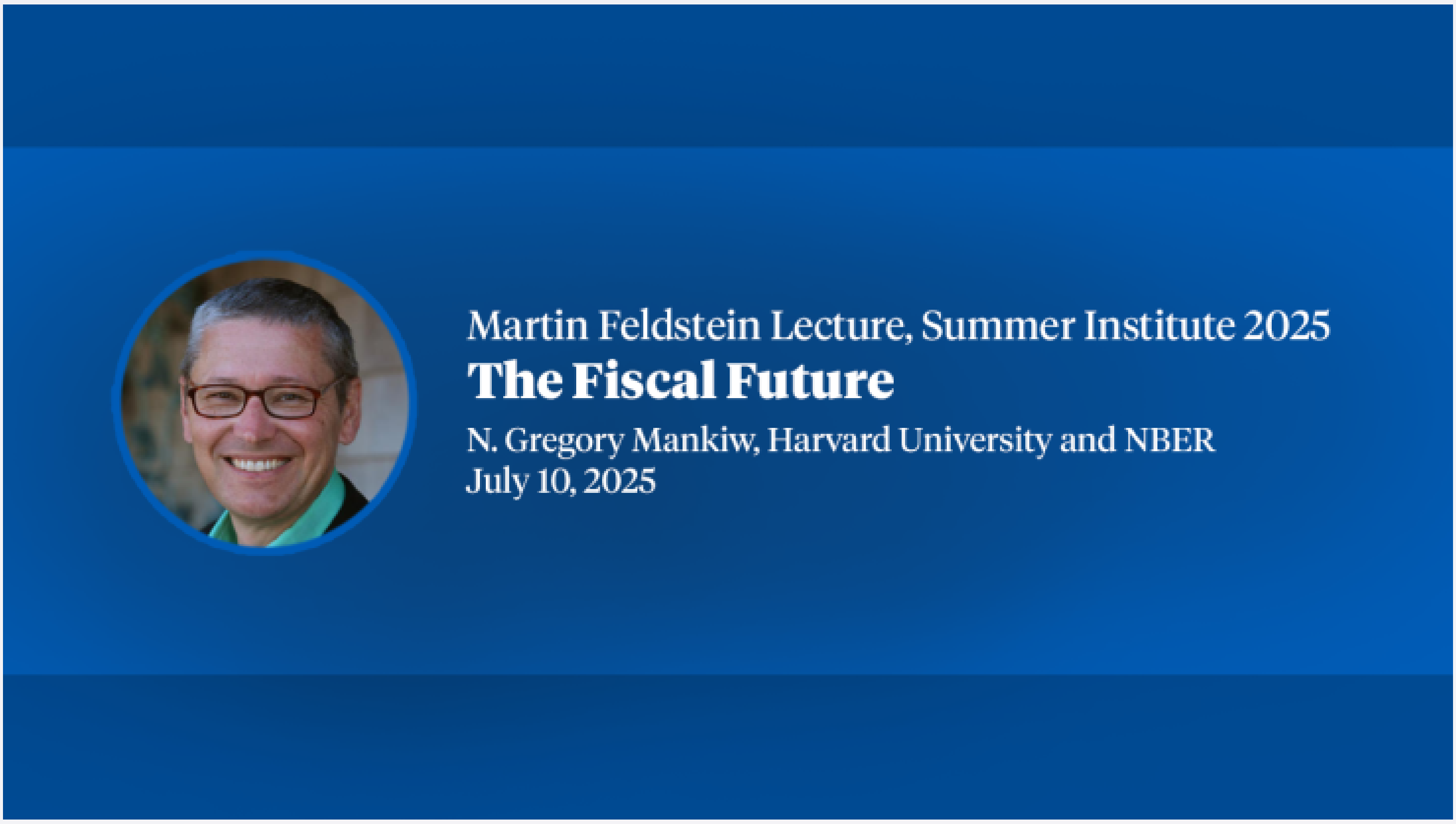

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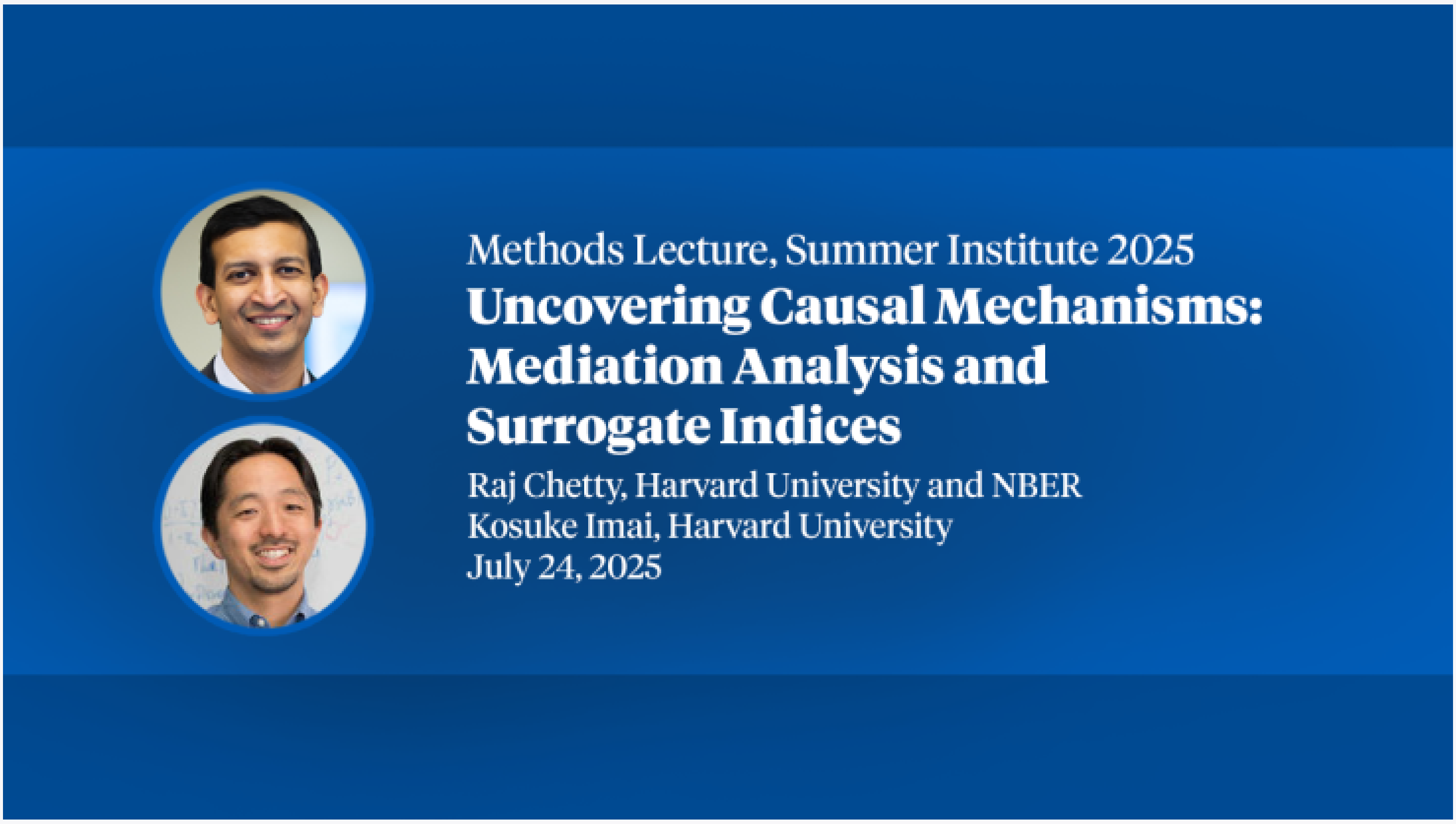

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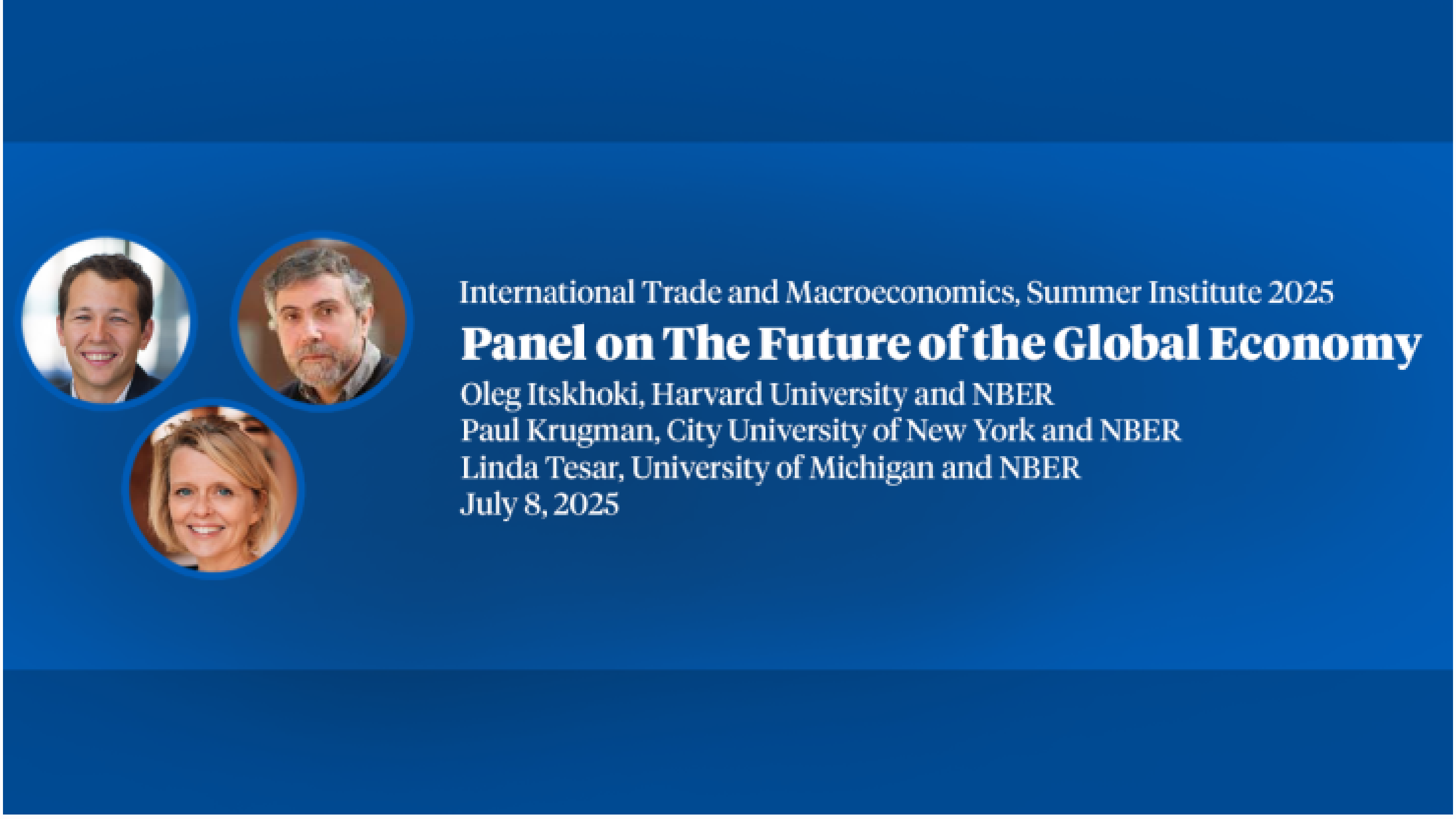

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