Columbia Business School
Center on Japanese Economy and Business

Mitsui USA

"The Global Debt Crisis: Will Japan Be Next?"

13th Annual Mitsui USA Symposium

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Left to right: David Weinstein, Takeo Hoshi, Robert Hodrick

The Center on Japanese Economy and Business (CJEB) and the Mitsui USA Foundation presented the 13th Annual Mitsui USA Symposium, "The Global Debt Crisis: Will Japan Be Next?" at Columbia Business School (CBS). The symposium featured Takeo Hoshi, Pacific Economic Cooperation Professor of International Economic Relations at the School of International Relations and Pacific Studies at the University of California, San Diego as speaker. Robert J. Hodrick, Nomura Professor of International Finance at CBS, served as discussant, and David E. Weinstein, Carl S. Shoup Professor of the Japanese Economy at Columbia University and Associate Director for Research at CJEB, moderated the event.

Noting the increased scrutiny being given to sovereign debt sustainability in the midst of the European debt crisis, Professor Hoshi discussed whether Japan would be the next victim of the bond market. He examined why there has not yet been a crisis in Japan despite its huge debt

David E. Weinstein

burden, presented potential triggers for a crisis, and finally looked at the fiscal impact of Japan's post-tsunami reconstruction efforts. Professor Hodrick evaluated Professor Hoshi's calculations, concluding that while Professor Hoshi's recommended fiscal reforms are imperative, Japan is unlikely to fall victim to a debt crisis situation. Finally, Professor Weinstein moderated a question-and-answer session.

Professor Hoshi's presentation was based on a paper he co-authored with Takatoshi Ito, Professor at the University of Tokyo entitled, "Defying Gravity: How Long Will Japanese Government Bond Prices Remain High?" He opened by showing that Japan's debt burden was the highest in the world; its gross and net debt relative to GDP is 200% and 120% respectively, and its gross debt in U.S. dollars is $9.465 trillion. Japan has also averaged a negative 7% fiscal deficit relative to GDP for the past three years, and new bond issues have exceeded tax revenues the past two years. He offered his conclusions in advance, saying that Japan's high level of debt was supported by: 1) a large amount of domestic savings with a home bias; 2) a stagnant economy that depresses interest rates; and 3) the expectation of future fiscal consolidation. He noted that any substantial change in these factors could result in a crisis.

Professor Hoshi then discussed three potential triggers for a debt crisis. He labeled one a "savings trigger," or a situation where the large savings rate becomes much smaller. When and if Japan must rely on foreign investors to buy Japanese government bonds (JGBs), those investors may demand a higher yield. He added that Japan's rapidly aging population will certainly lead to a decline in the domestic savings rate in coming years. Next, he identified a "fundamental trigger" or a situation in which alternative Japanese investments offer a higher risk-adjusted return, and domestic investors reduce their ownership of JGBs. Professor Hoshi argued that there has been little opportunity cost to owning JGBs thus far, but that this may change. Finally, he labeled the third trigger an "expectations trigger": if people begin to lose trust that the Japanese government is serious about fiscal reform, this can drive up interest rates and precipitate a crisis.

Takeo Hoshi

Professor Hoshi explained that a possible upcoming crisis can be identified by determining the point at which the amount of outstanding JGBs will exceed private sector financial assets. In an attempt to forecast when that inflection point may occur, he outlined several scenarios, comparing debt ratios in different

Robert Hodrick

contexts. Noting that interest rates are very difficult to predict, he used a 1.3% interest rate (reflective of current expectations) as a starting point for each scenario, as well as a static assumption of per-worker labor productivity. The results of his calculations showed that the amount of outstanding JGBs may exceed private sector financial assets between 2021 and 2024 and noted that a crisis would strike in advance of this time frame as a result of the financial markets anticipating the new reality.

Professor Hoshi next turned his presentation to the aforementioned "expectations trigger," which depends on Japanese fiscal reforms. He focused on taxation as the tool for fiscal consolidation and determined that an increase in the overall tax rate from 30% to 45-50% in several years could stabilize debt levels, although it would still take several decades before Japan begins to deleverage. The cost of earthquake and tsunami reconstruction comprised the additional dimension of indebtedness. He observed that the total property cost was estimated at 3-5% of Japan's GDP, and that the government had issued reconstruction bonds to fund the rebuilding. While he did not feel these expenses would be "fatal" to the path of Japan's debt burden, the main risk was that the reconstruction could cause Japan's government to delay needed tax increases. In conclusion, Professor Hoshi stated that unless fiscal consolidation was successfully implemented, the Japanese debt situation could end badly.

Professor Hodrick disagreed with aspects of Professor Hoshi's analysis. Primarily, he felt that the private sector financial assets that were key to Professor Hoshi's calculations were being understated because they did not include the private sector's equity holdings. To demonstrate that Japan's debt situation was not dire, Professor Hodrick first presented Japanese bond yields and credit default swap spreads as evidence that the market perceives Japan's risk level to be

Richard Katz, Editor, The Oriental Economist Report

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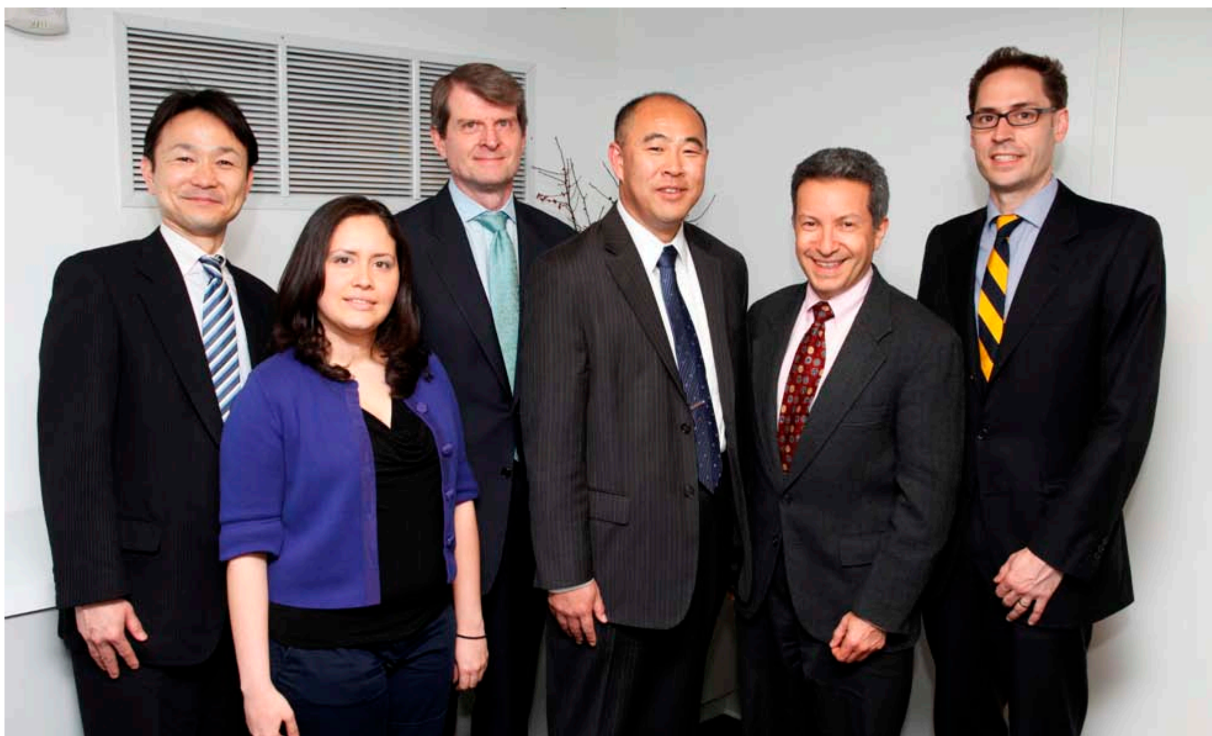
low. He then calculated the Japanese government budget and national income accounting. Finally, he stated that Japan could run a current account deficit of 3% of GDP for twenty years before it would need foreigners to support the JGB market, and that any crisis was unlikely before 2020. He agreed with Professor Hoshi that uncertainty surrounding fiscal consolidation was the main risk, pointing out that this problem was similar for the United States.

In a short question-and-answer period, Professor Hoshi responded to a variety of questions regarding his assumptions and forecasts. He explained that Japan had been aided by its long-standing current account surplus, but that the surplus could easily become a deficit in the coming years, exacerbating the situation. He also noted that raising taxes was not the only means to fiscal consolidation, since the government could also find ways to reduce expenditures or boost inflation. Finally, he pointed out that the home bias of domestic savers to hold JGBs would not necessarily continue; local investors will stop buying JGBs if they become unhappy with the associated risks and returns.

By Ehsan Iraniparast, MIA Candidate, School of International and Public Affairs



Left to right: Masaya Watanabe, Mitsui USA Foundation (Mitsui); Sue Vargas, Mitsui; Robert Hodrick, Columbia Business School; Takeo Hoshi, UC San Diego; David E. Weinstein, Columbia University (CJEB); Eric Campbell, Mitsui