

Recent studies have shown that the Japanese debt situation is not sustainable. The paper identifies three conditions that have supported the high indebtedness of Japan so far. Those are (1) large amount of domestic savings with extreme home bias, (2) stagnating economy that depresses the rate of returns everywhere, and (3) expectation of future fiscal consolidation. Any substantial change in these conditions can lead to a debt crisis. The debt may be expected to hit the ceiling of the private sector financial assets soon. Economic recovery may raise the interest rates and make it harder for the government to roll over the debt. Finally, the expectations can change without warning. The government decision on how to finance the reconstruction after the earthquake/tsunami disaster can critically influence the expectations. When the crisis happens, the Japanese financial institutions sustain losses and the economy will suffer. There may be negative spillovers for trading partners. If Japan wants to avoid such crisis, the government has to make a credible commitment for fiscal consolidation before it is too late. IMF could help by issuing a strong early warning.