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Fiscal Management at a Crossroads: Part 3

# Quantitative Assessment of the Impact and Risks of Fiscal Deterioration on the Japanese Economy

## Strengthening growth potential and fiscal consolidation to mitigate the risk of future fiscal crises

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**Summary**

- This report, the third in a three-part series titled "Fiscal Management at a Crossroads," assesses the risks that could arise if fiscal conditions deteriorate.

- If Japan's fiscal situation deteriorates and doubts about its sustainability intensify, there is a risk that the credit rating of Japanese government bonds could be downgraded. Should such a situation arise, it is important to note that the ratings of Japanese financial institutions could also be downgraded in tandem due to the sovereign ceiling.

- Estimating the impact of a credit downgrade on the GDP gap over the subsequent year using a panel quantile regression model suggests that it typically reduces the GDP gap by about 1%pt, but with a 25% probability of reducing it by 1.5%pt.

- A more serious risk is the potential occurrence of a fiscal crisis. Our estimates indicate that factors such as a country's status (whether it is an advanced or emerging economy), the public debt-to-GDP ratio, and the external public debt-to-GDP ratio significantly influence the probability of a fiscal crisis occurring.

- Applying this model to Japan, the public debt-to-GDP ratio significantly increases the probability of a fiscal crisis occurring, while Japan's status as an advanced economy and the low external public debt-to-GDP ratio reduce the probability of a fiscal crisis

occurring. However, unless fiscal consolidation efforts are advanced going forward, increased government bond issuance will not only further raise the public debt-to-GDP ratio, but the rising share held by foreign investors will also cause the external public debt-to-GDP ratio to surge substantially. Consequently, the probability of a fiscal crisis occurring could rise to around 75% in 2040.