Japan's Official Reserves Top $1 Tril.
Calls Grow for Creating SWF

By Katsuhiko SAKAI

JAPAN'S official reserve assets exceeded $1 trillion at the end of February this year. Japan thus became the world's second country with official reserves above $1 trillion, following China. The Japanese reserves more than double those of Russia, ranked third. As the official reserves have continued to swell, discussions have grown more heated on desirable levels of the assets and how best to invest them. Within the ruling Liberal Democratic Party (LDP), an initiative has emerged for creating a sovereign wealth fund (SWF) for investment of some portion of the reserves in stocks and other financial products to earn higher returns. On the contrary, some people are urging the government to cut the reserves to reduce relevant risks.

Market Interventions Boost Reserves

At the end of 2002, Japan's official reserves were less than half the present level. But they snowballed as the government sold more than ¥30 trillion worth of the Japanese currency for dollars in unprecedentedly massive foreign exchange market interventions through the Bank of Japan (BOJ) between 2003 and 2004 to prevent the yen from appreciating against the US currency. Even though the government stayed away from the currency market since its last intervention in March 2004, the assets have increased on investment income. *(See Chart 1)*

As indicated by published data from the International Monetary Fund (IMF) and national governments, China boasted the world's biggest official reserves of $1,647.1 billion at the end of February this year. Japan was second with $1,007.9 billion and Russia third with $490.6 billion. Next came India with $301.2 billion, followed by Taiwan with $277.8 billion, South Korea with $262.3 billion, Brazil with $192.9 billion, Singapore with $171.7 billion, Hong Kong with $160.2 billion and Germany with $153.0 billion.

The BOJ has defined the official reserves as "government funds to conduct foreign exchange intervention, also used as reserves to pay foreign currency-denominated debt to creditor countries at times of currency crises or on other occasions when repayment of such debt becomes difficult." Some official reserve assets are indispensable for any country to stabilize its currency value against foreign units. But views are divided over appropriate levels of official reserves. Frequently cited benchmarks for official reserves include the equivalent of three months' imports in value or of one year's short-term debt. Emerging market economies with high levels of official reserves have accumulated foreign currency holdings to prepare for external debt repayments, learning lessons from the 1990s currency crises. In contrast, industrial countries have generally tended to cut official reserves. Japan is an exceptional industrial country that has an unusually high level of official reserves, equivalent to 16 months' import value, while being the world's largest net creditor nation.

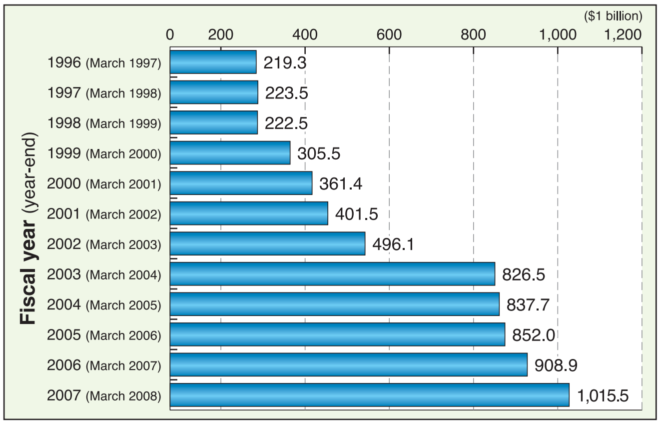
Gov't Debt Swells as Reserves Rise

Japan's official reserves are managed through the government's special account for foreign exchange funds. The reserves at the end of February included $979.1 billion in foreign currency assets, $23.9 billion in gold and $3.1 billion in IMF special drawing rights (SDRs). The foreign currency assets consisted of $856.7 billion in securities and $122.4 billion in deposits. *(See Chart 2)* Any currency-by-currency breakdown of these assets has not been made available. Given the past foreign exchange market intervention record, however, most of the foreign currency assets are believed to be US government securities or dollar-quoted deposits. The fast-growing official reserves pose a problem in this connection, as described below.

The government issued debt in the form of financing bills (FBs) to raise financial resources from the private sector for dollar-buying market intervention. The foreign exchange funds special account receives interest income on US government and other securities while paying interest on FBs. Japan's public finance law requires government revenues and expenditures to be booked in yen. Interest income in dollars would have to be sold for yen before being booked as revenues. Nevertheless, the government has refrained from selling dollars, which will lead the yen to rise against the dollar. Instead, it has issued FBs amounting to interest income and booked yen proceeds from FB issues as revenues. The practice means an annoying problem – government debt increases as official reserves expand. The government's fiscal 2006 account settlement data indicated outstanding FBs increased by nearly ¥4 trillion during the year to March 2007 to exceed ¥100 trillion.

Behind the fast growth in official reserves, risks of interest and foreign exchange rate fluctuations have been increasing. Over the recent years, the government has been able to raise financial resources at extremely low cost. If Japanese interest rates exceed US rates, however, investment losses may emerge. If the dollar falls sharply, the value of assets bought with debt issues will plunge. According to the Ministry of Finance, the dollar's ¥1 fall against the yen leads to an appraisal loss close to ¥1 trillion on the official reserves. Assuming the dollar at ¥100, an appraisal loss comes to as much as ¥18.5 trillion.

Chart 1 Japan's official reserves



Source : *Data from Ministry of Finance*

Chart 2 Composition of Japan's official reserves (%)

(As of March 31, 2008)

Foreign currency reserves	97.25
Securities	85.37
Deposits with	11.88
Foreign central banks and BIS	0.63
Banks headquartered in Japan	2.56
Banks headquartered outside Japan	8.69
IMF reserve position	0.14
SDRs	0.31
Gold	2.26
Other reserve assets	0.04

Source : *Data from Ministry of Finance*

LDP Lawmakers Spurred to Create SWF

In a bid to break through the present deadlock where the government has growing dollar assets that cannot be sold, more than 40 LDP lawmakers from both houses of the Diet launched a parliamentary league last December seeking to create an SWF. In February this year, the LDP set up a project team headed by former Financial Services Minister Yuji Yamamoto. Prompting LDP lawmakers to consider the SWF creation have been high-profile moves of foreign SWFs whose presence has grown fast in international financial markets. SWFs from oil-rich Middle East countries and China invested in major US and European financial institutions plagued with losses on the US subprime mortgage crisis. In Japan, a Singaporean SWF took advantage of its rich financial resources to acquire a luxury hotel in Tokyo in late January.

Pro-SWF lawmakers are preparing to submit an SWF creation bill to parliament within this year, emphasizing that the government could take advantage of state assets for fiscal consolidation. According to their SWF scheme, some ¥4 trillion in annual investment returns on the official reserves would be invested in Japanese and overseas stocks and other financial instruments, with the reserves left untouched. Several tens of excellent fund managers in the world would be employed to manage the investment to secure a 10% investment return, some 2.5 times as much as the present yield. The investment return would finance FB redemptions.

In his Internet blog, House of Councillors lawmaker Koutaro Tamura, who serves as secretary general for the project team, has unveiled a plan to launch an SWF next spring. "Investment risks cannot be reduced even if investment is left in the hands of government officials. The best of professional fund managers who are well versed in various risk-hedging tools should be mobilized to produce higher returns at lower risks. The SWF scheme should help invigorate slumping Tokyo financial markets," says Tamura.

Some economists recommend that the government give priority to safety and liquidity for some $700 billion out of the official reserves but pursue higher investment returns on the remaining reserves worth $300 billion. The amount of $700 billion, equivalent to Japan's annual import value, is viewed as a required level of official reserves while the rest is seen as surplus.

SWF Debate Should Lead to Breakthrough

Japan has expanded its official reserves together with government debt, while some foreign countries have created SWFs to effectively utilize surplus oil money or budget surpluses. Not a small number of experts have made cool responses to the SWF discussions within the LDP, arguing that if fiscal consolidation were a priority goal, the government would have to work out measures to lower the official reserves that have grown to a far higher level than in any other industrial country. This is because investment through an SWF may fail to reduce risks even if massive outstanding FBs are left untouched.

The Government Pension Investment Fund that invests some 30% of public pension reserves in Japanese and foreign stocks booked ¥3 trillion in investment losses in the second half of 2007 alone. Therefore, the Ministry of Finance is still cautious about aggressive investment or diversification of the official reserves. None doubts the importance to diversify the official reserves concentrated in dollars into other foreign currencies, including the euro, to reduce risks and stabilize the asset value. In reality, however, such diversification is not easy. If Japan, with heavy dollar assets, hints at any dollar-selling plan, it may trigger market speculation, exerting even greater pressures on the dollar to depreciate further.

A realistic breakthrough may be a plan to gradually reduce dollar assets over 10 years or so without affecting currency markets. SWF discussions might have provided Japan with opportunities to seriously consider solutions to the official reserve problem that have been left untouched. JS

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