# Japanese Gov't Bond Myth

## Long-term Yields Remain Low despite Massive Issues

*By Katsuhiko SAKAI*

When concerns were growing on sovereign risks – those with respect to a national government reneging on its debt repayment obligations – in the global financial market due to the Greek budget crisis in April, Japan, known as the most debt-ridden major country in the world, entered a new fiscal year. Its general account budget for fiscal 2010 hit a record 92 trillion yen. But the year's tax revenue estimate is limited to 37 trillion yen, forcing the government to issue 44 trillion yen in new bonds in addition to massive refunding bonds. Planned new government bond offerings exceeded the tax revenue estimate under an initial annual budget for the first time since the end of World War II.

As a result, outstanding long-term government debt at the end of fiscal 2010 is estimated at 663 trillion yen. Including borrowings by local governments, Japan's outstanding public debt is expected to reach 862 trillion yen at the fiscal year end in March 2011, equivalent to 181% of its projected gross domestic product (GDP). The percentage is seven points higher than at the end of the previous fiscal year. In January, Standard & Poor's Rating Services warned that the US rating agency could downgrade Japan's government bond rating, now at the second highest level of AA.

### Overseas Speculators Fan Default Risk

Discussions have grown more heated about Japan's budget sustainability. Some question if investors could continue to absorb growing Japanese government debt issues. Such a question has prompted overseas speculators to prematurely bet on Japan's possible financial debacle.

In mid-April, a research report by the Bank of Japan (BOJ) provided a topic for investors. Outstanding credit default swaps (CDSs) linked to Japan's sovereign debt default risk nearly tripled to 21.5 billion dollars in February from 7.9 billion dollars a year earlier, the report said.

But the amount represented only 1% of the global sovereign CDS market and was far smaller than for European countries, including Italy with 223.7 billion dollars and Spain with 101.9 billion dollars. Compared with Japan's astronomical government debt size, relevant CDS purchases to prepare for its possible sovereign debt default represent a mere trifle.

On the bond market, foreign funds have frequently launched short selling of Japanese government bonds (JGBs) while trumpeting a JGB freefall prediction. But such sales have been easily absorbed by dominant purchases and have never been successful. The market yield on the latest 10-year JGB issue, which is viewed as a leading long-term interest rate in Japan, has remained at extremely low levels below 1.5%.

Usually, government bond prices decline and their yields rise as bond supply grows in the secondary market. But the benchmark 10-year JGB yield has declined almost persistently even since JGB issues increased dramatically on slack tax revenues amid the burst of economic bubble in the 1990s. The relationship between the benchmark 10-year JGB yield level and outstanding JGBs is mysterious. This indicates that demand for JGBs has persistently exceeded supply.

### 95% of JGBs Absorbed at Home

The fast increase in outstanding JGBs is closely linked to slack corporate fund demand and the household sector's ample funds. The linkage emerged as fears about the future course of the Japanese economy spread in the wake of the bubble burst. The business sector grew cautious of capital spending and refrained from expanding loans from banks. The household sector restricted consumption, increased savings and bought insurance products for rainy days.

Economic activity slackened as a matter of course. The government expanded fiscal spending to stimulate the economy. Tax revenues as a major financial source declined on the economic slump, leaving the government no choice but to depend on increased borrowing through bond issues. Absorbing the swelling new JGBs were savings in the household sector.

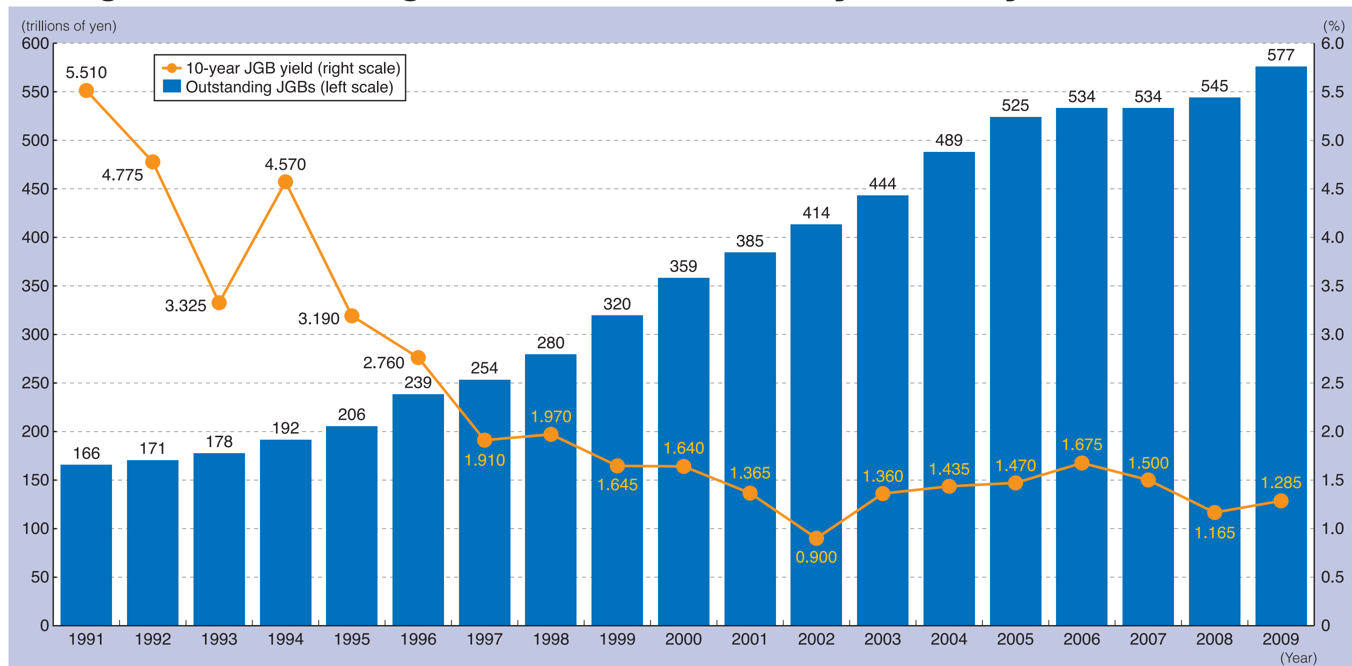
The BOJ has continued an ultra-low interest rate policy limiting interest on deposits to marginal levels for more than 20 years. Nevertheless, the Japanese household sector, which features an aversion to risk taking and preference for domestic investment, has left funds expanding in bank deposits and other domestic safe assets instead of investing them overseas in pursuit of higher returns.

While pressures grew on banks to use swelling deposits for loans to earn interest, they had difficulties finding corporate borrowers. In the end, banks easily chose to invest deposits in JGBs. Japanese banks have thus become the biggest JGB holder accounting for more than 40% of outstanding JGBs.

This unique flow of funds is likely to remain unchanged due to stubborn deflation. According to BOJ data, the household sector's cash and deposit balance at the end of 2009 increased 1.5% from a year earlier to 804 trillion yen, rewriting a record high for the third straight year. The data indicate Japanese people are tightening their belts in anticipation of deflation. As far as corporate fund demand remains slack with the future course of the economy staying uncertain, JGBs will continue to be purchased as an easy investment target.

Domestic investors, including life insurers and pension funds as well as banks, hold 95% of outstanding JGBs. This is the main reason overseas investors' freaky short selling fails to influence the JGB

## Changes in outstanding JGBs & benchmark 10-year JGB yield




*Note: Outstanding Japanese government bonds (JGBs) cover ordinary offerings alone (other than rescheduling issues) at the end of March for years to 1995 and at the end of December in and after 1996. The bencmark 10-year JGB yield is the yield on the latest 10-year JGB issue at the end of December.*

*Sources: Ministry of Finance, Bank of Japan*

market. In Greece, government bond prices have fallen dramatically with bond yields jumping on sovereign credit risks. Such a development is inconceivable in Japan at present.

### JGB Funding Sources Tapering Off

As a matter of course, the unique Japanese financial structure where long-term bond yields stay low despite a snowballing budget deficit is by no means desirable. This is because the situation in which the government has no difficulties securing JGB buyers has allowed itself to have no sense of crisis over its growing debt. Any debt management strategy that depends on deflation as a cozy helping hand is unrealistic. The domestic absorption of JGBs is not necessarily guaranteed for the future.

The greatest cause for worry is the combination of the birth dearth and aging population. The tendency will boost social security spending on the outlay side and lower tax revenues from workers on the revenue side. The household sector's role as a stable absorber of government debt issues is expected to seriously weaken. Japan's household savings rate has slipped below 4% from levels above 20% in the 1970s, according to Cabinet Office data. The number of people dipping into savings after retirement has been increasing rapidly. Domestic financial resources for JGB purchases are expected to dwindle in the long run.

Banks have little room to expand JGB holdings after their massive purchases. If the corporate sector boosts demand for funds on an economic recovery, the raison d'etre of banks complacent with JGB investment will be questioned.

### Government Required to Reduce Debt

How can Japan give hell to speculators who spread illusion-promoting rumors of the country's financial collapse? For window-dressing purposes, Japan may try to expand nominal GDP to lower the ratio of government debt to GDP. The nominal GDP expansion would boost tax revenues to improve the budget profile in the long run. Over the short term, however, an increase in nominal GDP growth may lead to a rise in long-term bond yields, which could trigger a rise in interest payments on JGBs even from the present high level of nearly 10 trillion yen a year.

To resolve the problem essentially, the government has no choice but to reduce its outstanding debt. A thorough budget reform is indispensable for the debt reduction. The situation where planned government debt issues exceed a tax revenue estimate is clearly unsustainable.

The stability of bond yields at low levels is based on domestic investors' confidence in the sustainability of the government's finances. The government has taken every opportunity to emphasize the need for budget consolidation, allowing the market to remain secure. But verbal promises alone may not permit the government to buy time any more. It is the indication of such a sense of crisis that the government has been working out a new budget strategy for announcement in June.

Fortunately, Japan has plenty of room to improve its budget structure. The consumption tax rate is still as low as 5%. A one-percentage-point hike in the tax rate can expand tax revenues by 2 trillion yen. When this article is published, the government will have narrowed down numerical budget reconstruction targets. The problem is whether the government has the capability to achieve these targets. The market is now impatient to test the government capability rather than screening vaguely worded plans or strategies. JS

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