# Fall in Long-Term Interest Rates Reflects Distortion in Japanese Economy

*By Tani Sadafumi*

Japan's finance capital markets are somewhat unusual. While the stock market has fallen over the long term, bond market prices have steadily increased, that means long-term interest rates have dropped to a historic low. In the short-term money markets, we see negative interest transactions, in which borrowers can actually receive interest. The markets are a mirror: they reflect the health of the economy. The distortions of the deflation-plagued Japanese economy are clearly reflected in this mirror.

The Nikkei stock average fell below ¥8,000 on March 31, the date that marks the end of the fiscal year for many Japanese firms. This represents a fall of close to 30% from the level of ¥11,000 at the end of the previous fiscal year. In just one year, ¥71 trillion has been erased from the aggregate value of stocks on the First Section of the Tokyo Stock Exchange. As we enter a new fiscal year, the bear trend continues, especially in the share prices of the major banks. Those associated with the market normally tend to be optimists, but they are now avoiding expressions that might hint at any expectation of a real recovery in stock prices.

While the stock market is sagging because of the lack of a way to counter deflation, there is also the problem that, at the back of it all, there are more sellers than buyers, creating a demand-supply imbalance. By the end of September, financial institutions are obliged to include their shareholdings in the framework of core equity (Tier I), and so are quickly unwinding their cross-stockholdings. At the same time, many managers of employees' pension funds, the most typical form of corporate pensions, have been administering the pensions themselves, instead of having the national government do it. But to avoid an increase in losses created by the stock market slide, they are now trying to put the deputed part back into government control, and are selling their investment securities. This supply-demand problem is compounded by negative factors, including the risk from Iraq and North Korea, and the unexpected threat of severe acute respiratory syndrome (SARS).

But where have the funds that have fled the highly risky stock market gone? Overseas investors have given up on Japanese securities and are pulling out their funds, while domestic investors will tend to move their portfolios to offshore investments. However, quite a large part of the funds flowing out of the Japanese stock market is going into the bond market. As a result, the bond market is suddenly rising, meaning that long-term interest rates are substantially falling.

The distribution yield on newly issued 10-year bonds, an indicator of long-term interest rates, broke through the 1% per annum rate for the first time in the fall of 2002, and by the beginning of May 2003, had fallen to the level of 0.5% per annum. But a look at recent history shows just how low the current Japanese government bond (JGB) interest rates really are. Long-term interest rates were around 5% in 1992, the year when Japan's economic bubble is said to have burst. In 1980, when a 6.1% coupon rate for JGBs was said to be too low, many investors steered clear of the bond market.

The market mechanisms that determine long-term interest rates can be roughly divided into the supply-demand balance and the future economic outlook. Of these two, the balance of supply and demand indicates a large oversupply of JGBs, and from this standpoint alone, the JGB market must fall (long-term interest rates rise). Theoretically, this means that market participants believe the outlook for the economy is gloomy and that long-term interest rates will not rise. Certainly, this is broadly true, but there are several other factors that will spur a fall in long-term interest rates.

When long-term interest rates fall like this, it would be expected that, eventually, investors would regain their appetite for capital investment for company managers. However, according to a survey by the Development Bank of Japan of the capital investment plans of major corporations for fiscal 2003, companies plan to spend 3% less than the previous year, representing a third successive year of falling capital expenditure.

Since the bursting of the economic bubble, the government and the Bank of Japan (BOJ) have opened the throttle on fiscal and monetary policy in an attempt to lift the economy. This policy appeared temporarily successful, but in the end the economy failed to achieve real and lasting recovery. There are several reasons for this. The policy was applied sporadically, the government and the BOJ were not always in step, deregulation did not go far enough, the weight of the non-performing loan (NPL) problem impeded recovery, and the worldwide deflationary trend hit Japan particularly severely. I would like to point out here that despite the implementation of several economic stimulus programs, the capital investment that is essential to the full recovery of the economy stubbornly failed to occur. It was just as economists like to say: "You can lead a horse to water, but you can't make it drink."

In particular, the quantitative easing policy implemented by the BOJ starting in March 2003 ultimately failed, strictly speaking, to gain traction. The balance of current deposits held by the BOJ, which stood at ¥5 trillion at the time the quantitative easing policy was introduced, expanded to between ¥22 and ¥27 trillion, and the long-term JGBs purchased by the BOJ expanded from ¥400 billion to ¥1.2 trillion a month. Certainly, the quantitative easing policy

obviated any need for financial institutions to worry about fund management. It definitely also played a role in supporting Japan's fragile financial system, but its effectiveness in improving the all-important real economy was limited.

So where did the money supplied so plentifully by the BOJ disappear to? The answer is JGBs. If financial institutions have large amounts of funds at their disposal to make free use of, they will normally lend that money to companies in an attempt to obtain a margin of profit. However, well-run companies were making no attempt to borrow, and if the funds were lent to the companies seeking it, there would be fear of defaults. Accordingly, financial institutions hit on the idea of buying JGBs with their excess funds.

If for some reason the JGB market were to crash, there would be no end of organizations and individuals that would suffer. Among others, because institutional investors like the major banks and life insurance companies depend on bond-related investments for quite a large part of their earnings, they would suffer a large degree of damage. To reduce their risk, financial institutions who have some financial reserves are shifting the weight of their investments to JGBs with short redemption periods of two to six years. At the same time, some financial institutions cannot contrive to raise the enormous funds needed for disposing of their NPLs, without earning bond-related profits. A JGB market crash would be a nightmare that would rock Japan's financial system, which is already plagued by doubts as to its stability.

Japan's economic bubble burst. The U.S. stock market bubble and the worldwide IT bubble also burst. So what about the "bond bubble?" Deutsche Securities chief strategist Mizuno Atsushi said in a paper published in early April: "The high bond prices from early in the year depend not on simple supply-demand factors but on a complex set of factors, including fundamentals, the fiscal policy outlook and overseas factors, and the high prices seem reasonable." In other words, the recent rise in the bond market is not a "bubble," but a phenomenon with sufficient cause.

This is a convincing view and as the opinion of experts, deserves to be respected. However, there still remain some anxieties. That the rise in the bond market was not caused by supply-demand factors was stated earlier. However, if the market watchers change their outlook, it is very probable that supply-demand problems will affect the market.

The value of new JGB issuance for fiscal 2003 is ¥36.4 trillion, meaning that 44.6% of the government's general accounts budget is dependent on JGBs. According to the mid-term provisional budget presented to the Diet by the Ministry of Finance in February this year, with nominal growth assumed to be zero, new JGB issuance for fiscal 2004 is expected to total ¥42.1 trillion (for the dependency rate on JGB of 48.3%). JGB issuance for fiscal 2005 is expected to total ¥44.1 trillion (a dependence of 48.9%) and by fiscal 2006, issuance is expected to climb to ¥45.5 trillion (49.4%). If Japan can overcome deflation and achieve nominal growth of 0.5% in fiscal 2004, 1.5% in 2005 and 2.5% in 2006, its dependence on JGBs in fiscal 2006 will still be 46.8%, hardly a figure that is "under control."

Because of the generous effects of past economic countermeasures, the cumulative long-term debt of the national and local governments combined will reach 151% of gross domestic product (GDP) at the end of 2003, according to forecasts by the Organization for Economic Cooperation and Development (OECD). This greatly exceeds Italy's level of 108% and is the worst of all the developed nations. In consideration of this, the world's three largest rating agencies all downgraded the status of JGBs last year. In particular, we still have fresh memories of a kind of nationalistic reaction of the Japanese people to Moody's Investors Service rating JGBs below those of Botswana in southern Africa.

The negative interest seen recently in short-term money markets is related to Japan's downgrading. When Japanese banks that do not enjoy a high level of confidence move yen to foreign banks and purchase dollars or euros, they exchange yen in an unprofitable transaction. The foreign banks who receive the yen have no place to invest those yen so they deposit the yen, risk free, in the current accounts of the BOJ, making zero profit on it. However, because doubts about Japan's repayment ability have arisen, the headquarters of the foreign banks have set upper limits for their local branches in Japan to follow regarding deposits at the BOJ. The local branches that brush up against these limits lend to other foreign banks with spare capacity in their BOJ current account deposit balances, paying them interest to "borrow" the funds. This is because depositing in this way is cheaper than paying storage fees to store the money. This is the mechanism behind the common-sense-defying "negative interest" transactions where the lender pays interest to the borrower.

Up to now, JGBs have been placed tolerably smoothly, but this is because of the two reasons mentioned above. The first is that risk for JGBs is lower than for stocks. The second is that there is little demand for funds. Money with nowhere in particular to go finds its way into JGBs, beating the alternatives simply by default in a sort of unpopularity contest.

The reason that the JGB market continues to post high prices despite the rating downgrade is that the proportion of JGBs held by foreigners is a low 5%. However, if the demographics of a large elderly population combined with a low birth rate really start to kick in, Japan will have to induce overseas investors to buy huge amounts of JGBs. At that time, will JGBs be an attractive product? We may look back and see the recent fall in long-term interest rates as an aberrant phenomenon triggered by certain specific conditions. JJTI

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