The Fate of the Japanese Government's Debt Management Policy

By Izumi Masaki

THE debt servicing cost for Japanese government bonds (JGBs) keeps on rising. While the clean-up of non-performing loans (NPLs) in the private financial sector has been making significant progress under the government-guided financial reconstruction program, and the negative legacy of the speculative bubble economy is being cleared away, swelling public debt is now casting a dark shadow over the Japanese economy. Because tax revenue plummeted during the recession that followed the collapse of the bubble economy, bond issuance was used to fund a string of oversized conventional economic policies. The effects have exacted a heavy toll.

As of the end of March 2004, total public debt comprising bond issuance and borrowings reached ¥703.15 trillion. Compared with FY 2002, the balance increased by ¥34.39 trillion, making a new historic high. The total debt equals 1.4 times GDP, or 17 times the expected tax revenue, or a debt burden of ¥5.50 million for each Japanese.

Viewed by item, the amount of outstanding JGBs comes to ¥556.42 trillion. Compared with a year earlier, medium and long-term bonds and investment-and-loan bonds posted conspicuous growth, with an increase in outstanding ordinary JGBs of ¥35.87 trillion to ¥456.97 trillion. In addition to JGBs, fundraising snowballed to finance massive interventions in the foreign exchange markets to prevent the yen from appreciating, and in just a year the balance of short-term government securities (financial bills) climbed by ¥28.64 trillion to ¥86.13 trillion.

In the original budget for FY 2004, the issuance of ordinary JGBs increased by ¥36.59 trillion, creating a dependency of just over 44% on bond issuance in financing the national budget. This situation describes a precarious reliance on debt financing for nearly half the general budget, while total debt continues to rise.

According to calculations conducted by a private company, purchases of publicly offered government bond issues by private financial institutions during FY 2005 will reach ¥127 trillion. Of this amount, the refunding of bonds is expected to reach just over ¥104 trillion, which would reflect an increase of ¥20 trillion from a year earlier and mark the first time the figure has topped ¥100 trillion. This development is attributable to the approaching maturities of JGBs issued in large volumes by the Obuchi cabinet in 1998 to finance economic stimulus measures. Dubbed the "Year 2005 Problem," market participants are pondering the potential ill effects on the JGB demand and supply balance. Another crucial point is expected in 2008, when the refunding of bonds will increase even more powerfully than in 2005, and is likely to nurture fears that an ensuing surge in long-term interest rates could hit the Japanese economy.

Against this backdrop, the Japanese government has been working on a comprehensive debt management policy. Addressed are a range of policy objectives, such as the smooth placement of continued large JGB issue volumes while avoiding a rally in long-term interest rates and curbing the national treasury's funding costs. These goals are to be achieved, for example, by making changes to financial-product features such as maturity and the coupon rate, modifying net issue volumes for specific terms, and promoting primary market maintenance and diversification of owner strata.

JGBs for retail investors are a case in point. Since their inception in March 2003, retail JGBs have been gradually gaining in popularity because: (1) purchases can be made in units of ¥10,000; (2) repayment of the principal is guaranteed; and (3) with variable interest, redemption is possible before maturity. Thanks to these product features, orders for ¥2.97 trillion of retail JGBs were placed in FY 2003, handily exceeding the issuance target of ¥1.5 trillion. Four issues with a combined value of ¥2.1 trillion are scheduled for the current fiscal year, but demand continues to outstrip supply by a wide margin. Both financial institutions and Japan Post have been able to increase sales, with a new high of ¥1.87 trillion on a single-issue basis in the autumn of 2004, bringing the aggregate total to ¥5.56 trillion.

The JGB primary dealer system was launched in October 2004 as a means of primary market maintenance. Under this system, 25 securities companies and banks are specified as primary dealers. Primary dealers must meet certain responsibilities, including: (1) placing bids for at least 3% of the amount up for auction; (2) purchasing on principle at least 1% of the auction volume; and (3) providing information on transactions to the Ministry of Finance (MOF). In return, primary dealers receive special privileges, including attending consultative meetings on JGB issuance held by the MOF, and participation in JGB buyback auctions and non-competitive bids. While the government seeks to enhance dialogue with the markets to secure reliable fund procurement, the "Council for JGB Management Policy" was established, with input provided by people knowledgeable in the subject area.

Contributing to the government's sense of danger is a distorted JGB ownership structure. As loan books were shrinking in Japan's deflationary economy, financial institutions hard pressed to identify financing opportunities rushed to purchase government bonds, and they now own over 20% of outstanding JGBs. By the same token, the postal saving system allocated roughly one-quarter of its massive ¥230-trillion deposit holdings to government bonds, bringing its share of total JGB ownership to some 15%. By contrast, retail and foreign investors, respectively, hold only a few percent. If demand for loans perks up in tandem with the economic recovery, this could prompt banks to reduce their JGB holdings. If JGBs were also to be sold in large volumes in the course of the privatization of Japan Post, this would cause a diastrophic shift in the ownership structure of JGBs and render a surge in long-term interest rates unavoidable.

This concern appears to be shared by Bank of Japan (BOJ) Governor Fukui Toshihiko, who during testimony to the Diet in autumn 2004 said that "financial markets are littered with landmines, given the cumulative rise in bond issuance." Termination of the current policy of quantitative easing required comprehensive judgment of both the economy and finances. Acting prematurely could encourage excessive speculation and possibly cause long-term interest rates to soar. According to Fukui, since this would indeed be tantamount to stepping on a landmine, his exit policy from quantitative easing entailed implementation with elbow-room, no hurry, and no surprises.

According to a summary of the meeting minutes of the Council on Economic and Fiscal Policy, Minister of Finance Tanigaki Sadakazu at a conference held in the spring of 2004 in connection with the privatization of postal services asserted that "how to secure the smooth clearance of JGB issues and prevent markets from being thrown into unexpected confusion are matters of great concern." Fukui reacted by noting that "for the transition process to privatization, the problem should meet with an adequate solution if management policy is able to respond to retail investors' need for a risk-less product." His appeal for government to broaden retail bond offerings addressed the same situation.

In the summer of 2004, a research committee of the MOF Policy Research Institute published a research paper describing how debt management policy coordinated with the privatization of postal services led to the migration of postal savings into retail JGBs. The paper posits that "government-guaranteed postal savings are very similar to retail JGBs," and asserts that if the government guarantee is revoked as a result of privatization, a broadening of retail JGB issuance as a receptacle would correct the bias toward institutional investors in the JGB

Photo: Kyodo News

Fukui Toshihiko, the Governor of the BOJ (left) and Tanigaki Sadakazu, the Minister of Finance (right)

ownership structure, and also help secure stable market clearance for JGB issues.

As a measure of fiscal rehabilitation, achieving the primary balance surplus by the early part of the second decade of the century has been a stated objective of the government. The primary balance describes the condition where expenditures (excluding interest payments and debt redemption) are covered by revenues excluding bond revenues (deficits). This is a basic measure of fiscal income and expenditure to the extent that black figures can be maintained, debt can be reduced and further deterioration in public finances prevented. This can be described as the minimum necessary goal to be attained. Ahead of the budget drafting for the coming fiscal year, the MOF released a calculation suggesting that, if current fiscal conditions were left unchanged without expenditure cuts or tax increases, the only remaining means would be raising the consumption tax rate to 21% or cutting public expenditures by 33%, given that 10 years later the primary balance would have extended its deficit from ¥19 trillion in FY 2004 to ¥27.8 trillion in FY 2014.

The strong economic growth rates and tax revenue expansion of former times cannot be expected, however, and in the absence of clear structural reform policies that would resolve the issues surrounding pension systems and surging social security costs resulting from a declining birthrate and an aging population, it is questionable whether this goal of a black primary balance is even attainable. In October 2004, when Fukui attended the Fiscal Systems Deliberation Council for the first time as the BOJ governor, together with an appeal that "it is essential to proceed with fiscal rehabilitation and create conditions in which interest rates properly reflect the economy and prices," he again stressed the necessity of diversifying JGB owner strata and maintaining efficient markets.

In order to achieve low and stable long-term interest rates, the government and the MOF truly believe that the BOJ must maintain its policy of quantitative easing. The BOJ, for its part, shows no signs that it is seeking to put an end to quantitative easing any time soon. As for now, the views of the two institutions are therefore fully aligned. If debt were to keep growing at the current pace, however, the concern is that JGB management policy could enter a maze that has no exit. Additionally, in terms of the economy's process of transition back to a stable recovery path, the result could be a door slammed shut at the exit from quantitative easing before we even get there. JS

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