Minutes of the Advisory Council on Government Debt Management (40th Round)

1. Date: Friday, February 26, 2016 (15:00-17:00)

2. Place: Ministry of Finance, Special Conference Room 3

3. Gist of the Proceedings

1. Environmental changes in domestic and overseas bond markets and the trends of foreign investors
   - (1) Views of foreign investors on the JGB market
   - (2) Environmental change in bond markets
2. Current status of the Bank of Japan (BOJ)'s monetary policy
3. JGB issuance plan for FY 2016 (Ex post briefing)

1. Environmental changes in domestic and overseas bond markets and the trends of foreign investors

Tomoya Masanao, Managing Director of PIMCO Japan Ltd., explained the views of foreign investors on the JGB market (Annex 1), and Council member Shimamoto explained the environmental change in bond markets (Annex 2), both followed by a free exchange of opinions among the attendees.

▶ The following is the summary (arranged by the authorities, the same hereinafter) of the views and opinions presented by the Council members in attendance:

- The interest-rate levels of Japan and the U.S. have a high correlation with each other, and therefore it is essential to grasp the trends of the U.S. economy and the Fed's monetary policy. The impact of Chinese factors on Japan's financial markets has been indirect so far; however, it may have direct effects from now on.
- Because of the widening currency basis swaps, the yields of short-term JGBs with foreign exchange hedges to US dollars are higher than those of the U.S. treasuries. The long-term JGB yields seem undervalued, considering the forward interest rate, which is likely to motivate foreign investors to invest in JGBs.
- After the introduction of the negative interest rate, investors are faced with a delicate situation, stuck between the need to avoid negative yields and the rising hedging costs. With home country biases, the demand for JGBs maturing in twenty years or around may be propped up.

- An economic analysis with IS-LM models may indicate that the IS curve line has become vertically straight, which would mean that investments are not all affected by the interest rate. In this theory, then, the needed policies would be Keynesian fiscal stimuli that moves the IS curve to the right, rather than monetary policy. Now that the interest rate sensitivity of investment is low, the focus is on how Japanese firms could, structurally, improve their profitability in an efficient manner.

- Behind the boosting demand for JGBs by foreign investors are mainly the extremely cheap costs of currency hedging, particularly for the US dollar-based investors. In other words, for Japanese investors, the hedging cost for acquiring US dollar assets and switching to the Japanese yen is sky high. In this situation, foreign investors bring forth the arbitrage dealings. There seem to be two key factors that may reverse the activities of foreign investors; a tightening of currency basis swap rates, and a change in market sentiments from confidence in the Japanese economy to doubts about the ability to redeem JGBs.

- If the negative interest rate remains in place for an extended period, it may also affect the long-term interest rates. Under the low interest rate environment globally, how do institutional investors, such as pension funds, view the current investment environment?

- Japanese pension funds have their liabilities denominated in Japanese yen; however, facing difficulties in keeping their funds in JGB investment, they are searching for alternative investment destinations. It would be one of the future options for them to invest in corporate credit with high-quality, investment-grade credit ratings.

- The foreign investors' JGB transactions and holdings are increasing. After the BOJ introduced the Quantitative and Qualitative Monetary Easing (QQE), those who are remarkably increasing their JGB positions are limited to the BOJ and foreign investors. Specifically, it seems that foreign investors mainly invest in short- to medium-term bonds. Under the circumstances where the sovereign rating has been downgraded, JGBs are now classified as a taxable asset in the UK if they are on balance sheet at end of term. Thus, foreign investors have become increasingly conscious about the credit risks, and the counterparty risks associated with currency hedging, of JGBs.

- It is not always the case that foreign investors can hardly purchase super long-term bonds, but statistical data proves that transactions and holdings of JGBs by foreign investors are concentrated heavily on short-term bills. It appears that funds managed directly by foreign central banks are allocated in relatively short- to medium-term bonds.

- So far, purchases by foreign investors using basis swaps have been seen for short-term bills; in view of the low yields at present, however, real money of foreign investors is coming to invest in JGBs. In general, fund inflows from foreign investors are favorable; but there are some potential risks of reversal at the same time.

- Although it may be true that foreign investors' real money have been invested in super long-term JGBs, what we should consider is that these are of short-term trading and not long-term, stable investments. It is better to assume that the widening of currency basis swap rates is creating trading opportunities and making the JGB market a useful place for foreign investors to pool their cash, in comparison with the current U.S. market situations.

- In addition to resolving demand deficiency, raising inflation expectations is pointed out as the imperative present challenges for the Japanese economy. However, it is hard to address this challenge.

- Needless to say, fiscal consolidation in Japan is indispensable. From the standpoint of demand management policies, however, some foreign investors argue that it is better to postpone the planned hike of the consumption tax rate, considering the current economic conditions and the impact of the past tax hikes. This argument may come from the viewpoint that fiscal policy should not impede the increase in aggregate demand in an effort to close output gap.

- With regard to the argument about raising the consumption tax rate, the market may be worried that a further downgrade of JGB credit ratings by reason of the postponement of the tax hike could adversely affect the operations of Japanese banks since it may have impact on the costs of US dollar funding by these banks.

2. Current status of the BOJ's monetary policy

Deputy Director-General Koguchi of the BOJ explained the current status of the BOJ's monetary policy (Annex 3), followed by a free exchange of opinions among the attendees.

▶ The following is the summary of the views and opinions presented by the Council members in attendance:

- From the standpoint of economics, the inflation rate is decided on the intersection point of the aggregate supply and aggregate demand curves. It is natural to lower the inflation target when the oil price, an exogenous variable, gets lower; therefore, it might be questioned whether maintaining the 2% target all along is appropriate.

- Even with a lower interest rate, capital investments by private companies have not increased and the production activities not accelerated. The problem here would be that private companies should enhance profitability themselves and that there seems little that monetary policy could support. The BOJ may have to clarify and disseminate to markets what is feasible and what is not by use of monetary policy.

- Introduction of the negative interest rate enables BOJ to conduct additional monetary easing. On the other hand, Governor Kuroda publicly stated that "the introduction of the negative interest rate is not planned at the moment" up until the decision, which triggered surprise to financial markets. Such surprise may increase uncertainty and negative impact on financial markets. Communication with markets is essential in future additional easing in order to move forward the positive momentum of the economy as a whole.

- It is noted that an additional future monetary easing would be conducted after the verification of the expected outcomes and effectiveness. First of all, we want to know when and what kind of verification the BOJ plans to have about the impact of the introduction of the negative interest rate on the operations of financial institutions and on financial markets. At present, not only financial institutions but also individuals face the shortage of opportunity to invest in fixed income products, increasing the amount of retained funds going nowhere. Meanwhile, the market functions are deteriorating, accompanied by the sharp decline of the transaction volume in the call market, which shrank to less than 5 trillion yen from 20 trillion yen. The transaction volume of JGBs is also decreasing. These developments should be considered in reviewing the effectiveness of the introduction of the negative interest rate.

- The funds that cannot be managed in Japanese domestic markets flows out to foreign markets. As a result, the funding cost of the US dollar rises, which impedes overseas operations of Japanese banks. At the same time, foreign investors, taking advantage of acquiring yen cheaply, buy JGBs at negative yields. This is a dreadfully unstable condition, since foreign investors are only exploiting their arbitrage opportunities, and their appetites for long-run investments in JGBs have not increased. When foreign funds withdraw their money following further downgrades of JGB ratings or a tightening of financial regulations, a huge shock could arise in the absence of a domestic market that could absorb the unwinding flows.

- Regarding the latest monetary policy decisions by the BOJ, the negative interest rate may transform the Japanese currency into, so to speak, perishable goods. It could be interpreted that the BOJ might be encouraging financial institutions to strengthen their primary functions as intermediates, such as matching of demands and supplies of funds and creation of information.

3. JGB issuance plan for FY 2016 (Ex post briefing)

The Financial Bureau briefed Council members on the "JGB Issuance Plan for the FY 2016" (Annex 4.)

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