Minutes of the Advisory Council on Government Debt Management (38th Round)

1. Date: Wednesday, October 21, 2015 (14:00-16:00)

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

3. Gist of the Proceedings

(1) Fiscal consolidation efforts (Budget Bureau)
(2) Current situation of the JGB market and the environment of investment in JGBs (Council members Inaida and Fujito)
(3) Immediate issues on the debt management policy (Financial Bureau)

(1) The Budget Bureau explained fiscal consolidation efforts (Annex 1), followed by a free exchange of opinions among the attendees.

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

- If market participants thought that fiscal discipline would be lost, we would see considerable disruption in the market. This would have a significant impact on the overall Japanese economy. Now that the basic data for the discussion toward establishment of fiscal discipline is publicly offered, do the authorities grasp and consider what is discussed, estimated in, and requested to the Government from, the private sector on fiscal discipline?
- With regard to the medium- to long-term fiscal estimation, private think tanks survey and publish proposals about the required fiscal reforms on both revenues and expenditures. Although the level of requirement depends on economic assumptions, it is noteworthy that the government debt will expand even in the economic revitalization case of the Economic and Fiscal Projections for Medium to Long Term Analysis by the Cabinet Office (which assumes that the economy would grow at 3% or more on average in nominal terms). It would be difficult to avoid expansion of the debt outstanding without social security system reform.
- The medium- to long-term estimation by the Cabinet Office is prepared up to 2023. In discussing the JGB issuance plan at this council, the longer-term viewpoint is indispensable. We would like to refer to the longer-term fiscal estimation explained today.

(2) Council members Yosuke Inaida of Nomura Securities Co., Ltd. gave explanations about the current situation of the JGB market and the environment of investment in JGBs, and

Masahito Fujito of Sumitomo Life Insurance Co. about the investment by life insurance companies, respectively, 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.

- In the gradual negative trend of the USD-JPY basis swap spreads, JGB is relatively attractive for overseas investors. However, it is doubtful whether such situation would be maintained for a long period since it depends on the trends of interest rates in the U.S. and Europe and credit conditions at that time. This widening of the negative basis swaps would be changeable by credit conditions, but if credit cost of Japan as a whole had generally risen in the medium term, this tendency could persist and it could also affect the foreign investors' stance.
- It is difficult to forecast or identify an equilibrium point of basis swaps. At present, Japanese industrial companies and financial institutions are increasing overseas investment to seek better returns, while trying to avoid exchange rate risks. As far as there are many such investors, it would take a long time to correct the negative trend of basis swaps.
- The basis swaps widening is adversely affecting Japanese financial institutions' overseas operations. In addition to an increasing demand for the dollar, the introduction of the leverage ratio makes the U.S. banks restrained in offering U.S. treasury repo and the risk weighting for currency swaps was raised.
- The downgrade of JGBs to single "A" made by the credit rating agencies does not have a significant effect (on financial institutions) at the present time. However, an additional downgrade to "BBB" would deprive JGBs of its value as collateral security on cross-border funding and clearing. Considering such a significant effect of another downgrade, therefore, it is getting more important both to communicate with credit rating agencies and to achieve fiscal consolidation on schedule.
- While the Bank of Japan (BOJ)'s Qualitative and Quantitative Monetary Easing (QQE) has transformed the JGB market structure, market participants have difficulty in foreseeing how long the current monetary policy will be maintained. Therefore, this council needs to continue discussion on measures to enhance market liquidity.
- In next 5-10 years, Japanese economy, financial markets and flow of funds would see some significant consequences of low birth rate and aging society now in progress. Given such changes, maintaining the market capacity to absorb JGBs and stabilizing the market at the same time is a long-term task.
- It seems that JGBs trading volume of city banks or life and non-life insurance companies is lower and foreign investors have more influence on the market. The authorities need to monitor trading by foreign investors more than ever.
- City banks, whose JGBs holdings have fallen due to low interest rates, will face a

significant challenge posed by developments in global financial regulation. Besides reviews on Interest Rate Risk in the Banking Book (IRRBB) and sovereign credit risk, the regulation on Total Loss-Absorbing Capacity (TLAC) in the event of bankruptcy of a global systemically-important bank will have large impact. Japan's megabanks are forced to control their JGBs holdings, taking such regulation factors into account.

- The amount of JGBs held by securities firms, or brokers, have long functioned as shock absorbers in the market. Against the recent decrease in its volume, the authorities should monitor the situation carefully so that it should not lead to further decline in market liquidity.
- Active market-making, particularly taking short-positions, has become more difficult for security firms because of shortages in market liquidity. Efforts are called for, including expansion of scale or term of BOJ's Securities Lending Facility to support repo market function.
- Alongside the continuing QQE policy of the BOJ, foreign investors' presence in the JGBs market is increasing. Recently, however, they cast more harsh views on fiscal discipline and exit of the QQE.

(3) The Financial Bureau explained immediate issues on debt management policy (Annex (4) and (5)), followed by a free exchange of opinions among the attendees.

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

- In formulating the JGB issuance plan, the authorities may have considered measures based on ordinary times practices. Do authorities take some event risks into account?

→ (Explanation from the Financial Bureau) With regard to the JGB issuance plan for FY2016, we focus on appropriate measures in light of the current domestic and foreign economic and financial environment. Of course, there is some possibility that risk events would occur, so it is necessary to constantly examine measures against risk events.

- Complementing page 14 in the Annex (5) on the outlook of life insurance contracts, the falling trend in total amount of insurance is seemingly due to insufficient reflection of shift from death protection to protection in life in accordance with aging. Given this, annualized insurance premiums may show the actual premium income.
- (As for the product-design of future life insurance) It is also expected that insurers would launch products based on a variety of viewpoints as the interest rate rises. In the situation where the saving product market is likely to expand in future, Inflation-Indexed Bonds could be one of potential assets to purchase, though there will be broader needs for diversified assets.

- I understand that the average maturity has been extended based on the fundamental objectives of the JGB management policy; smooth issuance of JGBs and minimizing medium- to long- term financing costs. Is it right to consider that the extension of the average maturity would continue?

→ (Explanation from the Financial Bureau) There is no change in the fundamental objectives of the debt management policy. Under these objectives, it can be said from the supply side viewpoint that, while the issuance amount is expected to generally increase, extending the average maturity would be meaningful from a viewpoint of controlling refinancing frequency and mitigating refinancing risk. On the other hand, refinance cost depends on the balance of supply and demand in the market. As the current environment surrounding JGB issuance may change in future, we would take into account the medium-term trend in investor demand in making judgment on whether to maintain the policy of extending average maturity going forward.

- As China strengthens presence in global financial markets, it would be important how to isolate the Japanese economy from the financial developments in China in case that some kinds of Chinese risk materialized. It is necessary to recognize that Japan's fiscal discipline and debt management policy would be exposed to global attention if Chinese financial market got unstable, and to thoroughly discuss measures to be taken.

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