Minutes of the Advisory Council on Government Debt Management (39th Round)

1. Date: Thursday, December 17, 2015 (1:00 p.m. to 2:15 p.m.)

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

3. Gist of the Proceedings

Explanations (Annex 1, Annex 2 and Annex 3) were given by the Financial Bureau about the FY2016 debt management policy and JGB issuance plan, 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:

<*Recent Developments in the JGB Market*>

- Foreign investors have been getting more and more predominant in the short-term bonds trading. What do authorities think on how to activate normal investors' transactions in the short-term financial market?

  → (Explanation from the Financial Bureau) It is quite difficult to say what the steady state is in the short-term money market. Under the current economic environment where many countries continue to implement unconventional monetary policies, Japanese investors show strong demand for foreign currencies in order to advance into overseas markets, while US banks are restraining their supply of funds. Those factors bring about significant movements in the basis swap market. What is important for us would be to ensure smooth matching of supply and demand via free transactions in an open market.

- The flow of funds by the Bank of Japan(BOJ) was announced today, reporting that the JGB holding of the BOJ is 315 trillion yen, 30% of the total outstanding, and that of foreign investors is 101.5 trillion yen, 9.8% of the total. Both are the largest share ever. The conventional, Japanese bank-centered market has undergone a significant change, and today, the JGB market has been dominated by the BOJ and foreign investors. Some concerns here are on the gradual decline in the share of domestic end-investors, because it is hard to predict how the JGB market will be after the BOJ achieves its inflation target, and because foreign investors are significantly affected by monetary policies overseas.

- Both the U.S. Fed's interest rate hike after the nine and a half years of zero-interest policy and the lifting of crude oil embargo after 40 years could be a trigger for the U.S. economy to retrieve its global position. On the other hand, Japan seems to be facing a turning point of whether it can maintain its national power or not, with the low fertility rate and the aging population. I think this council should intensively discuss these issues and disseminate the discussions.

- The BOJ's JGB purchase amount is quite large and its JGB holding is rapidly increasing, making it extremely difficult to figure out the actual market demand.

- Short- to medium-term yields have dropped below zero, urging Japanese investors to shift to overseas markets, while the basis swap widening raises costs for procuring US dollars and impedes their overseas activities. Negative interest rates also make it difficult for investors to purchase short-term bill, which they need for collateral. The gap between the economically natural interest rate and the current rate level is becoming larger. It is important to consider whether the current interest rate level is appropriate.

- Domestic investors are shifting their investments to longer-term bonds in pursuit of higher yields, but it does not necessarily represent real demand for those maturities; therefore, we need to discuss where the actual demand exists.

- In regard to market liquidity, unlike U.S. treasuries, JGB is currently not liquid enough for dealers to make short positions, because the BOJ holds a large portion of JGBs. That makes it extremely inconvenient for market making. In the U.S. and Germany, there are central banks facilities to lend government bonds almost unlimitedly, which allow dealers to smoothly hold short positions; therefore, their secondary markets are in shape regardless of the central banks' purchase amount. This issue should also be considered.

- After the Lehman shock, the regulatory environment for financial institutions has become more stringent, making them too sensitive on interest rate risk and sovereign credit risk.

- Today is a historic date because of the interest rate hike by the U.S. Fed; and looking back in future from a broader viewpoint, we might well think that the Japanese economy was facing a major turning point then.

- With the widening negative gap in the basis swaps, it has become easier for foreign investors to invest in JGBs, even in negative yields; conversely, such inflows could well reverse if triggered by some kinds of events. Even though this turning point seems further away, it is important to acknowledge that such possibility exists.

- A certain amount of time is required to judge whether the U.S. economy returns to normal financial conditions after the interest rate hike or it still continues to seek a new steady state.

<*Debt Management Policy*>

- Academic societies in the U.S. now discuss not only traditional but also nontraditional debt management policies. Stabilizing financial markets and managing aggregated demand are added to policy objectives, and in-depth discussions are being held, for example on the use of debt management measures to enhance liquidity in the short-term markets, and on the optimal maturity distributions in response to economic crisis situations. Discussions are also advanced on how to determine the optimal average maturity based on these considerations. In the future, we should consider conducting analyses from these nontraditional perspectives.

- In Japan and globally, both funding and investing are extremely difficult because, under the current low interest rate environment, changes in market expectations toward monetary policy raise volatilities. These problems are common worldwide and global market participants monitor government bond issuance policies of each country from the same perspective; therefore, when developing JGB issuance plans, it remains important to check what other foreign government bond issuance authorities are considering.

- A decrease in the total issuance amount in the JGB issuance plan for next fiscal year is significantly important because it concisely represents the government's intention to restrain its funding by government bonds. It is a favorable development in this sense.

- In this council, we have discussed the importance of extending the average maturity from the perspective of lowering refinancing risk and medium- to long-term financing costs and the MOF actually realized it; now we have come to the point where it would be desirable to start discussions on how much further the average maturity should be extended.

- Seen from another perspective, extending the maturities of JGBs may also mean that future generations would face an inflexible fiscal structure. In the short term, extension of the average maturity contributes to stable issuance of JGBs; however, it could bind future generations to further obligations. I think it is time to discuss these issues.

- It is reasonable to maintain the policy of extending average maturity from a long-term standpoint. On the other hand, in regard to the maintenance and enhancement of market liquidity, turnover-ratio, particularly outright sales or outright purchase turnover-ratio, is lowering. I think this would pose a more serious problem in the future.

- As issues with remaining maturity of 1 - 5 years are added to the coverage in auctions for enhanced-liquidity (tapping auctions), further organizational reinforcement in personnel allocation would be needed at the MOF for smooth operations of these auctions.

  → (Explanation by the Financial Bureau) In regard to the auctions operations, the problem is not just the insufficient number of staff. Auctions are held in consideration of the schedule of BOJ's operations. If both auctions overlap within a day, it would increase operational risks for securities firms. For this reason, for the time being we hold the tapping auctions twice per month; however, for market participants, it would be better for us to have as many opportunities to offer liquidity enhancement as possible. We consider this a medium-term issue, including whether we could execute them more often through the improvement of our operational flow.

- Measures to deal with market liquidity continue to be important. I heard from a foreign hedge fund that JGB futures market shows sufficient liquidity but the liquidity in the spot market is declining. Foreign investors state that even though they try to enter the JGB market, they cannot compete with Japanese dealers because the JGB market is too unique. In the short term, we need to continuously pay attention to how the tapping auctions in the new zone with remaining maturity of 1-5 years would affect the super-long term bonds market.

- Tapping auctions is expected to gain importance in the future. For long-term bond investors, even if the auctions for bonds with remaining maturity of 15.5-39 years are held every other month, issuance of a certain amount of these bonds should be ensured.

- High demands for tapping auctions can also be seen as a signal that the market is not functioning well. Conventionally, securities firms as brokers held some positions and used the repo market to make adjustments of issues. Such adjustments are getting more intractable; as a replacement, the demand for tapping auctions is rising. I understand the need for tapping auctions, but making this auction too convenient could turn out to cause low market liquidity in the future. Attention must be given to this point.

- Behind the decline in the functioning of the repo market are strengthened financial regulations. When the leverage-ratio requirement is introduced from 2018, securities firms will have less incentive for repo transactions, because of an increase in costs from balance sheet restrictions. While it is not that everything would be fine if tapping auctions are to be expanded, these auctions should be well planned in view of the changing market environment.

- What can be the response to the comment that the more tapping auctions are to be reinforced, the more market voice could be erased in the long run?

→ (Explanation by the Financial Bureau) The objective of tapping auctions is not to erase the market voice but instead to listen carefully and respond attentively. In implementing JGB management policy, the most important thing is to have as smooth interfaces between markets and authorities as possible and to advance policies that are mutually advantageous.

- Measures responding to contingencies, including overseas financial environmental changes, are quite important points that need to be discussed.

- The market appears to be in good condition now. However, some factors are coming into being that could trigger the unwinding of the market if a certain event occurs. I hope that the JGB management policy will continue to be undertaken with sufficient dialogue with market participants.

<*Others (Fiscal consolidation, etc.)*>

- What is needed to prevent a further downgrade of JGB sovereign ratings? It is essential to obtain a broad understanding that another rating downgrade could cause a huge problem.

  → (Explanation by the Financial Bureau) In the past year, the three major rating agencies downgraded JGB for different reasons. One of them exhibited concerns over the slow progress of fiscal consolidation while another raised the waning impetus for growth by 'Abenomics' as a reason. These rating companies thus have differing standpoints. However, the background of the downgrades in the past is common: they are all brought about by deterioration of the fiscal position. We understand that there is an anxiety that further downgrades would increase the costs of foreign currency funding for Japanese banks. From this point, warning signals from the market regarding the need for fiscal consolidation are becoming more important.

- Ultimately, nothing is more important than the credibility of public finances. Through this council, we need to appeal as much as possible the significance of fiscal consolidation, or the JGB market would move toward an undesirable direction.

- Beginning with the market turmoil in China, I feel something is unusual with global flow of funds in recent days; and behind this, there are always unevenly distributed funds. In the U.S., for example, the providers of funds are concentrated in some specific funds, while borrowers are concentrated in low-rated companies. This is the background of the current turmoil in the high-yield bond market.

- The reason why major developed countries have been able to keep the interest rate low is in the traditional structure of fund flows; that is, the main borrowers of the funds have been sovereigns, while lenders of the funds have been banks. Hereafter, however, the regulations for banks are getting stricter; there would therefore be no guarantee that banks or life insurance companies would continue to be stable fund providers when sovereigns need funding, in the absence of material progress in fiscal consolidation in major countries.

- In order for such anxiety not to come into surface, it is obviously imperative that governments commit toward fiscal reforms; at the same time, we must always be aware that behind these self-evident discussions, the money flow is now unevenly distributed on a global scale.

- In regard to fiscal affairs, a further downgrade of JGB ratings will produce some kind of adverse effect. It is important to establish a framework, including this meeting, under which the market keeps an eye on the financial conditions of the government, and the market participants and authorities are ready to coordinate.

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