Minutes of the Advisory Council on Government Debt Management
(45rd Round)

1. **Date: Wednesday, October 18, 2017 (10:00 a.m. to 11:30 a.m.)**

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

3. **Gist of the Proceedings:**
   1. Current Debt Management Policy
      ・Current Debt Management Policy (Material①)
      ・Reference Material (Material②)
      ・Member Yoshino’s Opinion (Material③)
   2. Shortening JGB Settlement Cycles (report)
      ・Shortening JGB Settlement Cycles (Material④)

1. Current Debt Management Policy

▶ The MOF explained current debt management policy as follows.

(JGB issuance based on medium- to long-term (mid-long) market demands)

▪ Traditionally, the basic objectives of the debt management policy have been -“Implement secure and smooth issuance of JGBs” and -“Minimize medium to long term financing costs.” In order to achieve them, the MOF aims to promote dialogue with the market and issues JGBs based on market demand. Although market demand-based issuance is important, excessive response to temporary demands may raise funding costs by harming predictability for market participants or causing distortions of the market. Therefore, it is important to aim at “more stable and predictable issuance of JGBs” considering medium-to-long term market demand.

▪ In this regard, the MOF analyzed expected supply and demand trends of JGBs in the mid-long term as follows. On the supply side, to reduce the interest rate risks in the future, the annual issuance amount of super-long-term bonds has increased in recent years, while that of short- and medium-term bonds has decreased under the low interest rate environment. As a result, the outstanding amount of super-long-term bonds has increased significantly and that of medium- and long-term bonds has increased slightly.

- If the current JGB maturity composition will keep unchanged, a considerable amount of super-long-term issuance would be supplied to the market over time, despite netting out of the redemption. On the other hand, the redemption amount of medium- and long-term bonds tends to exceed the issuance amount.

- On the demand side, the MOF analyzed investment trends in JGBs by banks, the main investors for short- and medium-term bonds, and by life insurance companies, the main investors for super-long-term bonds.

- Looking at banks, deposit inflows have increased under the quantitative easing policy. Meanwhile, loans have not increased drastically and the deposit ratio declined. Amid these circumstances, banks declined JGB holdings, resulting in an increase in their outstanding amount of the BOJ current deposit. Supply and demand of medium-and-long term JGB have balanced in recent years, while the outstanding amount of those term bonds have only slightly increased, as the main investors, which are the banks, have declined their JGB holding amount.

- However, JGB holdings of banks have seemed to stop declining. It has been pointed out that there is a limit to the decline of JGB holdings, due to collateral demand and other factors. It is important to understand how banks' asset composition changes, upon considering supply and demand of future medium-and-long-term zones.

- Additionally, both city and local banks have been seeking yields since 2014, increasing their possession of super-long-term bonds supported the supply and demand balance of super-long-term bonds. However, city banks have anticipated the interest rate risk regulations on bank accounts and are starting to lower their super-long-term bonds holdings, which local banks may also follow, one year later.

- Looking at life insurance companies, since 2008, increased JGB holdings, while replacing medium-and-long-term bonds of those short residual terms with super-long-term bonds.

- Behind the increase in outstanding amount of super-long term bonds in recent years, life insurance companies, the main investors of those term bonds, have supported that, by replacing their medium-and-long-term bonds with super -long-term bonds.

- However, since the past two to three years, the increase in JGB holdings and replacement of super-long-term bonds, which have both supported the increase in outstanding amount of super-long-term bonds have taken a break. In case they proceed the maturity matching of asset and liability under the low interest rate environment, negative spread may be fixed. In other words, if interest rates increases, there is a possibility of resuming replacement of their assets for lengthening the average maturity. However, in connection with the liability side, it is also necessary to hold a certain amount of JGBs with short residual terms. It is important to determine how the liability side of life insurance companies changes to consider the future supply and demand balance of super- long-term bonds.

- Annualized premium income of life insurance companies is growing smoothly. On the other hand, income and expenditures deducting insurance and other expenses are making progress at around 7 to 8 trillion yen. In addition, the FSA analyzed in its previous year's "Progress and Assessment of the Strategic Directions and Priorities" that core group of insurance subscriber, who are in their 30s and 40s, will decrease in numbers and may shorten the insurance premium volume or may switch the needs from whole life insurance to medical and nursing care security, due to the changes in future population composition. The liability side of life insurance companies may change hereafter, both in qualitative and quantitative ways.

- Thus, in recent years, life insurance companies increased their super-long-term bond holdings, while banks decreased JGB holdings, which resulted to the demand for super-long-term bonds to be on the same trend as the supply side in a significantly increased outstanding amount. However, this structure may change hereafter.

- To aim at "more stable and predictable issuance of JGBs," it is important to determine the change in market demand in the mid-long term and set the JGB maturity composition consistent with the change.

(Increasing liquidity of JGB market)

- Liquidity of the JGB Market is another important issue. According to the BOJ's "Bond Market Survey," the JGB market function continues to be evaluated as low (or not very high).

- Also, the supply-demand balance of specific JGB issues may become tightened. The supply-demand balance of some JGB issues may be unbalanced, as one of the causes of this is that the BOJ purchases issues broadly including off-the-run issues by market operations, while the MOF mainly supplies on-the-run issues by auctions.

- The MOF has focused on conducting “Auctions for Enhanced-liquidity,” to supply off-the-run issues that are short of liquidity structurally or due to rising demand. The annual issuance amount of this auction has increased in recent years, and the scope of eligible issues has expanded. With regard to “Auctions for Enhanced-liquidity,” issuance amounts of each zone are determined in every quarter, in response to the market environment, based on discussions with market participants. It is considered that this flexible measure will become more important to enhance the market liquidity by the MOF.

▶ Summary of opinions and such from the members (put together by the MOF) are as follows.

- Arguments on monetary policy’s tapering may be premature at the present stage, but FRB and ECB have already stepped toward tapering, which Japan should always bear in mind that tapering will come at any timing. The current financial market situation is being paralyzed, due to the BOJ’s QQE and yield curve control, however, Japan will experience second phase of interest rate liberalization and commercialization, in a different meaning of that in the 1980s, upon QQE tapering.
  As being explained by the MOF, JGB’s holdings structure may change dynamically in the future, such as financial institutions being controlled by IRRBB. Hence, it is important to discuss how to deal with such changes on an occasion like the Advisory Council on Government Debt Management. In addition, a framework enabling the MOF, the BOJ and the market to prepare as one is required in order to tackle any contingent situations.

- Increase in super-long-term bonds are remarkable in the future estimation of outstanding amount of JGB by maturity types in material①, but there are various viewpoints of the actual situation. For example, this may show a different aspect, if you see material②, where analyzed by remaining maturity.
  There are redemption funds, besides insuring income and expenditures, regarding operating capital of life insurance companies, so the scale of operation seems to be similar to annualized premium.
  In addition, it is obvious that demand for products with a savings component is expected to increase, while that of products providing protection of life insurance companies is expected to decrease as stated in the FSA’s analysis, under the aging society with declining population. However, there are whole life type products in products with a savings component, and a different form of investment demand may

appear, if the mortality rate continuously declines. Therefore, it is not always the case that liability duration will be shortening on a large scale. Moreover, the current structure of life insurance companies is that liability duration is longer than that of assets, and there is a certain demand for super-long-term bonds, under the current low interest environment, from the point of view to fill the duration gaps, as interest rate risk will actualize if interest rate tends to decline.

- It can be estimated that the BOJ's JGB holdings ratio will exceed 50% in 2019 with the current BOJ's JGBs purchasing pace. Considering that the holdings ratio of central banks in postwar foreign countries was around 20% at the most, the situation of current Japan has been unprecedented. Therefore, it is necessary to consider at a level different from that of conventional on how to tackle future monetary policy, if drastically changed.
  Although this matter is supposed to be considered at each financial institution level, we should deal this matter in this meeting as well.

- BOJ Governor Kuroda stated that liquidity of JGB market seems to be rather improving at an interview after the monetary policy meeting on September 21. Please explain the point of his statement.

  → (Explanation by the BOJ) BOJ is hearing opinions, concerning a reduction in liquidity from market participants. On the other hand, some of the various indicators of liquidities, which our bank is referring to, seem to be rather improving. The statement has been made with intention that BOJ will observe indicators closely, as the sense of market participants and the actual data may diverge, along with conversing with market participants properly, based on these facts.

- Until recently, there had been some advantages to lengthen the average maturity of government debt, to control refunding risks for government, and also to fulfill demands of investors seeking higher yield. However, the presence of foreign investors and HFT (High Frequency Trading) have increased in recent years, as opposed to domestic demand which is expected to decline hereafter under the declining population. The time to change the debt management policy towards well-balanced issuance is expected to come.
  In addition, what is important as the debt management policy toward the normalization of monetary policy is to restore fiscal consolidation. Not only is the market function being paralyzed, but also tone on emphasizing fiscal discipline has been reduced in current days, which seems to be a serious issue.

- There is no sense of discomfort on the analysis that banks started to retain their holding amount of JGBs for collateral use, but it should be noted that collateral demand of the bank, including cross currency repos are mainly covered by JGBs with terms less than 2-year, and there are few cases covered by 5-year bonds.
  In addition, trades in the current JGB's holdings structure, where more than 90% is held by domestic investors, tends to lean to one-way, so "globalization" of JGBs should be promoted from the point of view to enhance holdings ratio of foreigners.
  Moreover, JGB's reuse value may raise and can be covered stably by foreign investors by solving challenges, such as settlement cycles and how to deal as eligible collateral.

- Issuance amount of refunding bonds, which is currently showing a declining trend, is expected to increase after 5 or 10 years. The banks may still be available to purchase a certain amount under IRRBB control, but there will be no option but to rely on foreign investors, that supposed to require certain additional returns, to cover the issuance amount at tapering phase.
  In addition, new approach is required to create demands, if funds gathered to life insurance companies are expected to decrease, due to changes in population composition. Individuals have funds after all, so promoting JGB holdings in retail market may be worth considering.

- I agree to the MOF's explanation that predictability in the JGB market is very important. The ECB and the FRB are making efforts, such as to announce the principles in advance to enhance predictability. It is necessary that Japan strives to enhance predictability as well.

- This may be a bit unreasonable argument, but the status quo is that the BOJ is purchasing most of the JGBs issued by the MOF with its current deposit as capital, which is nothing but circulating funds within the same government. Thus, even if lengthening the average maturity is promoted, the situation of the average maturity is not sought, seeing as a whole government including the BOJ.
  Since life insurance companies currently have strength to cover super-long-term bonds, increasing super-long-term bonds issuance, while promoting fiscal consolidation is rather preferable.

- I totally agree to the MOF's policy that issuance by regular auctions at calendar base should be made stably, while using the Liquidity Enhancement Auctions to deal with the market environment changes.
  Even if the interest rate returns to the original level with it, consideration should be

made, taking into account that there are some sectors which do not return to the JGB demand, as a result of environment changes, including introduction of IRRBB.
Demand survey that seizes the structural changes of each investor group, such as foreign and individual investors and pension funds is required.
In addition, although it was mentioned to aim “investment rather than saving”, low risk and low return products to be provided to individuals are no longer available with the current low interest rate environment. It is necessary to consider the way of taking risks of individuals and what kind of products can be sold.

- It is important to discuss the debt management policy from a mid-long-term perspective, as the MOF explained. It may appear to be contradictory but at the same time, it is also important to secure flexibility to continue stable issuance. For the flexibility, it was mentioned that active use of Liquidity Enhancement Auctions continues to be favorable.
  Fundamental risk of JGB market is fiscal confidence. It is important to achieve fiscal consolidation when the BOJ step towards tapering in the future. Even if the achievement time of fiscal consolidation target is to be changed, it is necessary to maintain the policy of achievement itself and to show concreate ways to achieve the target clearly.

- It is important to discuss government’s debt duration policy considering the market when Japan defeat deflation and the BOJ’s monetary policy is to change.
  Since improvement in productivity is required to achieve fiscal consolidation, effects on productivity with the duration policy need also be considered. For example, capital efficiency needs to be enhanced, if the interest rate increases, so increase in interest rate may have positive impact on labor productivity in the present situation.
  In addition, there were many opinions in today’s discussion that lengthening the average maturity may currently possible, but it has to be shortened in due course. Since I have been receiving more inquiries on Japan’s fiscal discipline from foreign investors, regarding this point, policy of lengthening the average maturity of government’s debt needs to be reviewed from now, if it is to be shortened in the future.

- JGB is acting as a benchmark role for private corporate bonds and such, in a way acting as public goods, by meeting various needs of investors, while being issued all over the yield curve. Assistant Treasury Secretary Gensler of the US had mentioned “the promotion of efficient capital markets” ,in addition to “sound cash management” and “achieving the (medium to long term) lowest cost financing for the taxpayers” listed on P2 of Material①, as the basic targets of the debt management policy from this sort of point of view.

In addition, in a situation where concerned opinion on public finance is not reflected into interest rate, the meaning to conduct lengthening the average maturity of government's debt should be considered. It could be seized as a signal that the government has abandoned fiscal consolidation if lengthening the average maturity of government's debt is opportunistically conducted under current low interest rate.

2. Shortening JGB Settlement Cycles (report)

▶ In conclusion, the MOF explained the Shortening JGB Settlement Cycles as follows.

- We will briefly report the results of review on shortening JGB settlement cycles, as explained in the last meeting of the Advisory Council (May).

- First, we will explain the environment of this examination. This has been reviewed, following the request to shorten JGB settlement cycles from the point of view to reduce settlement risk, regarding JGB which term from auction to issuance is being long, as shown in P1 of Material④.

- This review is planned to be implemented from May 2018 to coincide with the review in the secondary market of JGB, as shown in the upper right part of the figure in P3. Specific system design, as shown in the thick frame, is to issue 5-to-30 year bonds, which are issued in March, June, September and December, at T+1 in accordance with the principle. That is to issue them on the next business day of the auction, 2-year bonds will be issued on the first day of the following month of the auction, based on the setting condition of the current auction.

- The MOF would like to implement the shortening JGB settlement cycles smoothly in cooperation with market participants.