FT.com
FINANCIAL TIMES

Worse still to come after Japan's lost decades

By Henny Sender
Published: November 3 2010 16:53 | Last updated: November 3 2010 16:53

A large portion of the Mitsubishi Corp pension fund is invested in Japanese government bonds. And for many years, it has been a profitable investment as yields on 10-year JGBs dropped down to their current level of about 1 per cent.

But can the long rally in JGBs continue. At this point, there isn't much more potential upside – and with every point drop in yields, the potential downside looms larger.

One person involved in the management of the big trading company's fund says that falling yields enabled it to enjoy big profits. But he concedes this will be very difficult in the future.

Indeed, a growing number of market players that investment in JGBs in future will be far more risky than in the past.

Foreign investors have long been cynical about the market, (albeit to their detriment). But today – for the first time – a growing number of Japanese investors are joining the doubters. Even some government finance and Bank of Japan officials are beginning to make cautionary noises.

One BoJ official points to current low and stable JGB yields. But he warns that Japan should not count on this state of affairs forever, adding that if people think Japan does not have the will to deal with its deficit, JGB yields will be affected.

Recently, for example, Sumitomo Mitsui Banking Corp, which has a strong risk management culture, began to shift its investment strategy. Today, almost all of the bank's holdings of JGBs are either one or two-year holdings, out of a fear that yields cannot remain at these low levels forever.

One senior government official says he believes the JGB market will remain stable for the next year or two but warns that the fiscal situation will collapse in several years.

The maths are sobering. By the end of the year, Japan's fiscal deficit will total about 200 per cent of gross domestic product, swelling to about 300 per cent by 2014, according to Masaaki Kanno, chief Japan economist for JPMorgan in Tokyo. So far, though, those alarming numbers have been offset by household and corporate savings.

But by 2015, Mr Kanno notes, domestic private savings will fall short of the fiscal deficit. Indeed, today, the savings rate – at 2 per cent – is below that of traditionally profligate US households.

Moreover, Mr Kanno expects Japan's current account surplus (once the source of so much friction with the US) will have totally evaporated soon after.

At present, foreigners only hold about 5 per cent of the JGB market. But in coming years, Japan will finally have to look beyond its own borders for help in financing those deficits, competing with other sovereign debtors in the process.

If the Bank of Japan wants to prevent the bubble from bursting, it should raise rates now, Mr Kanno says. However, he warns that the BoJ mandate is to end deflation and that raising rates now is against that mandate.

The Japanese government, like most other governments, essentially rigs the game to make its debt attractive. Banks are encouraged to invest in sovereign debt because they do not have to hold capital against those holdings — especially at a time when capital requirements for other exposures are set to rise dramatically.

As one retired official from the Government Pension Investment Fund of Japan explains, the government's priority is to get cash flow into government securities. Meanwhile, it and the central bank are not focused on return.

Meanwhile, many pension funds and banks have not yet begun to address the potential risk in their bulging portfolios.

Mr Kanno notes that JGBs account for 65 per cent of all bank assets. Since the end of the bubble years in Japan two decades ago, the banks have increased their holdings by a factor of five.

Analysts predict that if yields rise significantly, this will also be a disaster for Japan's Postal Savings Bank, which has a Y200,000bn exposure to the JGB market. Japan's officials at the Japanese Financial Supervisory Agency fret about the ability of regional banks in particular to manage their portfolios.

If yields start to rise abruptly so will losses on these portfolios, given the extent of bank holdings of JGBs. That, in turn, could damage financial stability.

Meanwhile, the Government Pension Investment Fund of Japan has Y60,000bn worth of JGBs in its portfolio with an average duration of six or seven years — by far, the bulk of its holdings. Officials at the fund say that a rise in yields would offset any capital losses on their current holdings although this process will take many years.

But to some analysts, such as Mr Kanno, this dire outcome is virtually a given. And that suggests that two lost decades could soon turn into something much worse

henny.sender@ft.com