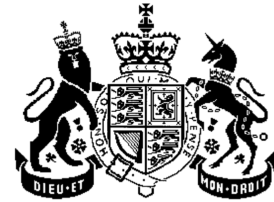
25 November 2014



British Embassy

Tokyo

JAPAN: ECONOMY: EXTERNAL IMBALANCE LEADING TO JGB SHARP SELLING-OFF?

Withdrawn 21 May 2019

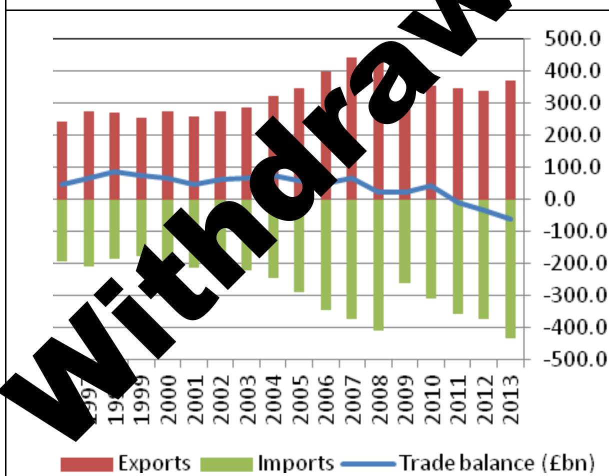
SUMMARY

Japan's record trade deficit and smallest current account (CA) surplus in 2013 have raised concerns about the risk of a potential sharp rise in Japanese Government Bond (JGB) yields.

INTRODUCTION

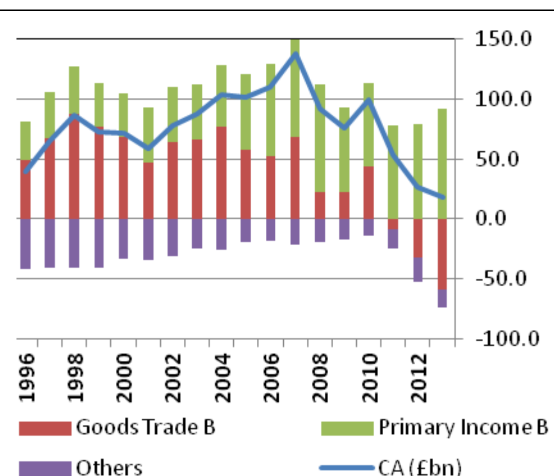
1. In 2013 Japan paid an extra 10 trillion Yen (£56bn) for its annual fuel bills compared to the same period before March 2011, resulting in its largest deficit of 10.6 trillion Yen (£59bn) (**Chart 1**). In the same year, Japan's annual CA surplus hit an all time low of 3.2 trillion Yen (£18.7bn), (**Chart 2**). Japan's sustainable CA surplus had been the source of financing for its public debt but this shift could trigger a change in the JGB market equation.

Chart 1: Trade balance breakdowns



Source: MOF

Chart 2: CA breakdowns



Source: MOF

WHY CA DEFICIT MATTERS?

2. CA deficit indicates that national investment exceeds savings, suggesting the difference is financed by borrowing from external sources, in principle. CA balance (regardless of surplus or deficit) does not tell anything about the economy or public financing or about its bond markets (e.g. share of foreign ownership) as long as their public finance is perceived to be healthy (**Chart 3**). The US and the UK enjoy their relatively stable bond markets even though they have large CA deficits and relatively high share of foreign ownership. Germany does so as well with a high CA surplus and a high foreign ownership.

3. Japan's CA matters because its public finance is the worst of all the developed nations (**Chart 4**) and the deficit could increase dependence on foreign capital for its finance. This could potentially lead to higher interest rates if its fiscal conditions are regarded as out-of-control by the markets. Increased foreign ownership does not necessarily mean higher interest rates but such dependency does increase the likelihood for this to happen..

Chart 3: CA balance vs. foreign bond share	**Chart 4: International debt comparison**
Current Account (% GDP) and foreigners' JGB holding share (%) Foreign share (LHS) CA (% GDP) (RHS) FR GR PT DE IT SP UK US JP Source: Bloomberg, IMF	Canada France Germany Italy Japan UK US 2013 (gross debt, % of GDP)
Source: Kokusai Asset Management Co.	Source: IMF

Withdrawn 21 May 2019

CA BECOMES A SUSTAINABLE DEFICIT?

4. There are basically two schools of thought. The first believes that sooner or later Japan's CA balance turns into a sustainable deficit. The declining competitiveness of Japanese firms, their increasing off-shoring manufacturing operations and falling household saving rates coupled with an ageing, shrinking population have played a major role towards this. Some further claim that as Japan's economy moves into a more mature stage of development, like the US and the UK, Japan's income surplus would be insufficient to offset the trade deficit.

5. The second school believes temporary factors have reduced the CA surplus and as more Japanese firms locate their operations abroad, a greater income surplus would offset any trade deficit. Thus CA would not necessarily become a sustainable deficit. Supporters point to Japan's increasingly, large net foreign financial assets (the largest in the world) and overseas investments to justify their proposition.

6. Neither theory is entirely perfect, but they help policy makers take positions in CA-related policy formulation.

IMPLICATIONS: SO WHAT?

7. The shrinking CA surplus and growing likelihood of CA deficit are increasing the risk against a surge in interest rates (i.e. a sharp sell-off in JGB markets) for the longer-term. This risk will increase if the Bank of Japan (BOJ) starts tapering its Quantitative and Qualitative Easing (QQE) programme of purchasing massive amounts of Japanese Government Bonds (JGB) after achieving its inflation target. If tapering begins, the demand loss from BOJ's will need to be covered by others. With portfolio diversification by Japanese banks and pension funds such as Government Public Investment Fund (GPIF) away from JGBs to riskier assets, it is possible that foreign investors may fill the funding gap.

8. To attract foreign investors, interest rates are likely to increase at considerable cost to the economy and public finance. A 1% increase in interest rates would cause 5.6 trillion Yen (£31bn) loss to banks (BOJ estimates) and is likely to result in an additional 4.1 trillion (£23bn) extra expenses for the Government (MOF scenario estimate). A sharp sell-off in JGB markets would not be easily contained and could spill over into global financial markets, which is why the G20 is keen that Japan commit to its fiscal consolidation pledge.

Please contact Akira Maekawa with any comments or questions

Withdrawn 21 May 2019