THE CASE FOR A STRUCTURALLY WEAK YEN

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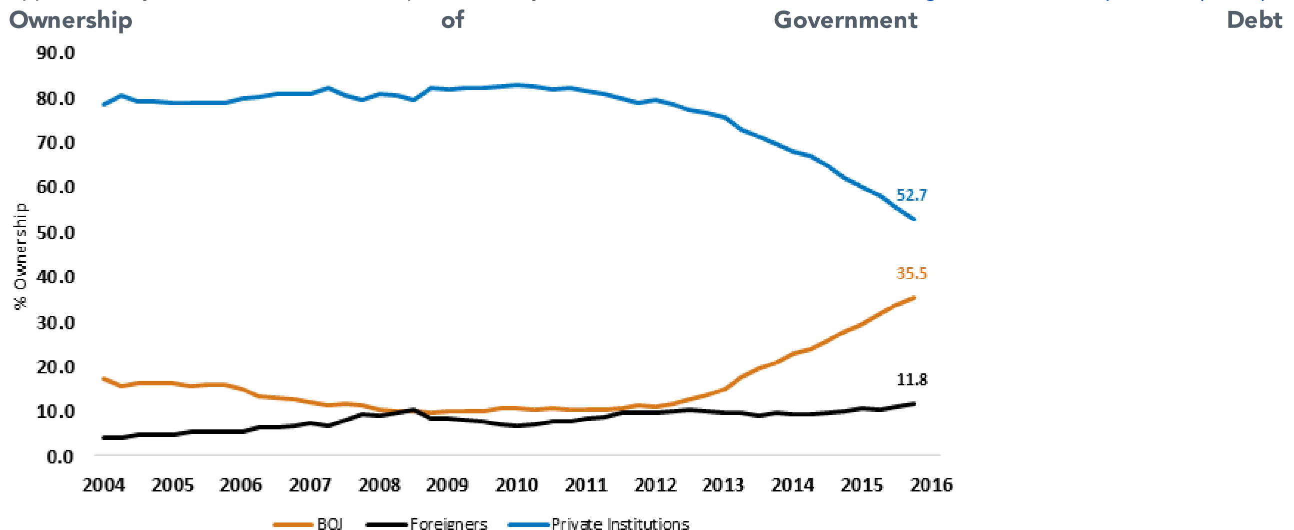
As Japan ponders more aggressive use of fiscal policy, it is important to realize that the funding dynamics of Japan's fiscal deficit have fundamentally changed: since the start of Abenomics three years ago, the only net buyers of government debt have been the Bank of Japan (BOJ) and foreigners. While the BOJ's massive quantitative easing buying spree has been well-documented, the fact that Japan's dependency on global savings has actually grown under Abenomics has received less attention: foreign ownership of government debt securities has more than doubled over the past three years, and by the end of 2015 foreigners owned 18.2% of all free-float treasury debt securities outstanding, i.e., of total government debt securities not owned by the BOJ.[1] This clearly leaves Japanese debt and currency markets more vulnerable and exposed to global financial flows. In my view, the key implication is that the yen is poised to become a structurally weak currency. The facts of Japan's public debt finances are captured best in the flow-of-funds statistics compiled by the BOJ, with the end of 2015 being the latest available data point. At that point, the central bank owned 35.5% of all general government debt security liabilities, up from 10.4% five years earlier (end of 2010). More specifically, since BOJ governor Haruhiko Kuroda assumed leadership in April 2013, the treasury's debt dependence on the BOJ shot up from 15% to 35.5%. On the other hand, Japan's private institutions—insurance companies, pension managers, banks, etc.—have steadily cut their holdings of government debt securities. While five years ago they owned 82.1% of all outstanding government debt securities, that share had dropped to only 52.7% by the end of 2015. In other words, private institutions cut their treasury debt holdings by approximately ¥170 trillion over the past three years, which is more than 30% of gross domestic product (GDP)

Ownership of Government Debt



Source: BOJ, as of 12/31/2015.

In short: Governor Kuroda has promoted a de facto swap of government debt: private institutional ownership dropped by 22.7%, while central bank ownership rose by 20.5%. Yes, the BOJ has become the buyer of last resort and Japan's debt market has been "nationalized" in the process.

Mind the Gap—Foreign Savings Needed However, the massive private-to-public swap was not quite sufficient to absorb and keep all the treasury's securities funding needs covered and self-funded in Japan alone. Foreign savings were needed to fill this gap—global investors' ownership of Japan's debt securities has risen from 9.6% to 11.8% since Governor Kuroda took over. Here, the vast majority of the flows appears to be driven by global central banks and global treasuries raising the yen exposure for their foreign reserve management purposes.

Focus on ex-BOJ

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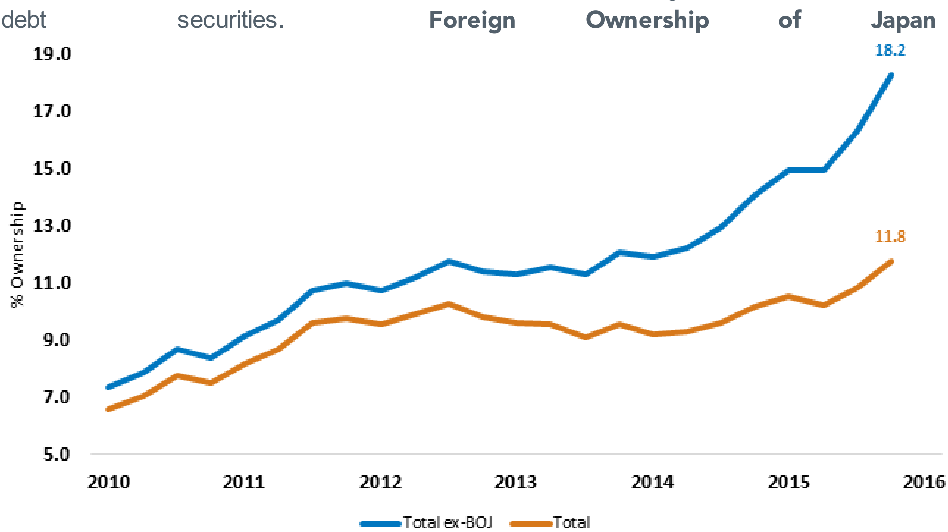
"Debt Free-Float"—Foreign Ownership up to 18.2% In my view, the 11.8% foreign ownership of Japan's public debt securities actually understates the true proportions of Japan's growing dependence on global savings flows. Surely the public sector issuing debt via the treasury and buying debt via the central bank is a self-funding circular system that for all intents and purposes operates independently of the private sector. We should therefore exclude the BOJ's ownership of Japan's debt markets from our calculations; and doing so reveals that foreign ownership has surged from 11.3% to 18.2% between March 2013 and December 2015. In other words, foreigners own almost one-fifth of Japan's free-float government debt securities. **Foreign Ownership of Japan Government Debt**



Source: BOJ, as of 12/31/2015.

More importantly, on a flow basis, foreign investors have become the only private sector buyers of Japan's government debt securities. So far, this new dynamic of Japan's government debt finance has resulted in a de-facto stable equilibrium: bond yields have continued to decline, while the currency has seen a full cycle, first weakening towards ¥125/$ and then strengthening back towards ¥108/$ (recall that at the start of Governor Kuroda's regime, the yen was at around ¥95/$). In other words, there are, so far, no signs of market distress. The de facto "nationalization" of Japan's government debt securities market by the central bank appears to be going smoothly. **A Structurally Weaker Yen** However, stress points are poised to emerge, with the sharp rise in Japan's dependence on global savings to fund the fiscal deficit a clear point of concern. Japan has become more vulnerable to global financial flows; and if it is correct that the majority of the increase in foreign ownership of yen-denominated government debt is for global reserve management purposes, any reversal of global reserve accumulation flows could become a problem for Japanese debt markets. Here, the relentless slowdown in global trade flows, i.e., global balance of payments flows, leaves no room for complacency. More tangibly, the key implication of Japan's new debt security market dynamics is that the yen should be a structurally weak currency, in my view. [1]Source: Bank of Japan as of 5/27/16.

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Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Swap : A swap is an agreement between two parties to exchange payments based on a reference asset, which may be a currency or interest rate but also may be a single asset, a pool of assets or an index of assets.