Insight: The ugly side of Japan's balance sheet

Japan is rarely at the forefront of discussions about stimulus, national debt burdens and global economic recovery but, in financial markets, chatter about potential future weakness in the Japanese yen and Japanese government bonds is growing.

The rationale is ostensibly sound: a few weak JGB auctions are raising concerns about an upward spike in Japan's net new borrowing requirement, precisely the opposite of what was promised during the election campaign. Throw in current yen levels making Japan's economy extremely uncompetitive, the fact that Japan's debt/GDP ratio is within a hair's breadth of 200 per cent, a collapse in tax revenues and Japan's rapidly ageing population laying bare the need for radical reform of its pensions and social security system, and Japan's "goose" looks to be "cooked".

Concerns about public debt are exacerbated by the Bank of Japan's projection that Japan will suffer from deflation for the next three years, increasing the debt burden in real terms. The inexperience of the Democratic Party of Japan in managing the economy is also unsettling markets.

A sharp devaluation of the yen would appear to be a textbook way of dealing with some of Japan's problems. But it would do nothing to address the issue of Japan's population structure with growing numbers of pensioners and low inward migration.

But, while these are medium-term issues requiring urgent attention, they do not address the issue of the potential for a near-term shock. For that, other structural factors need to be considered. Those who think that the yen may be vulnerable to a sharp, disorderly setback, should be comforted by Japan's $1,056bn of foreign reserves, a sizeable buttress against a run on the yen.

Foreign JGB holders are also a marginal market influence. Last year saw a pick-up of foreign ownership of JGBs to 7.9 per cent, but this has since fallen back to 6.8 per cent. This is in stark contrast to the US, where foreign ownership of Treasuries is 32.9 per cent.

Far more critical to assessing the JGB market is Japan Post Holdings, holder of the world's largest savings pool of Y170,000bn ($1,900bn), of which roughly Y136,000bn is invested in JGBs, about 20 per cent of all JGBs. It is thus unsurprising that one of

the new government's first acts, to scrap the privatisation of Japan Post, raised concerns.

An even greater concern was that Shizuka Kamei, the financial services minister, was very vague in his suggestion that the government would use Japan Post's balance sheet to spur regional development and expand into overseas lending, adding that the post office network could also provide new services in healthcare, pensions and education.

A natural suspicion was that this might herald a return to the worst forms of ill-discipline and pork-barrel politics associated with the fiscal investment and loan programme (Filp), whose funding was heavily reliant on money channelled from postal savings and insurance and public pension funds. Budget allocation for Filp, which finances state-run banks and other public corporations to facilitate infrastructure construction and support small companies and housing loans, does not require parliamentary approval like the nation's general budget. At its peak in 1998 the Filp budget was around Y40,500bn. Koizumi's Filp reforms saw that budget cut down to Y13,900bn in 2008, though 2009 has seen a pick-up to Y15,900bn.

Outstanding Filp issuance has also slid from a peak of Y417,800bn in 2000 to Y205,200bn in 2009. While that injection of discipline was clearly necessary, it robbed Japan Post of some higher-yielding returns, given that Filp-related returns were set at 10-year JGB yields plus 20 basis points. Therefore, if Messrs Kamei and Fujii were to reinvent the Filp programme, or create a disciplined and properly regulated and overseen investment and lending programme to leverage Japan Post's vast balance sheet, then the potential benefits could be enormous. Obviously that is one of the biggest "ifs" ever posited. The key problem is of course how to achieve this without sending JGB yields sharply higher. If JGB yields were to spike higher on a persistent basis, it would not only raise the government's debt servicing costs, but would almost certainly result in repatriation flows, particularly if the current low interest rate/ government bond yield environment persists elsewhere in the G7 group of leading industrialised nations.

Until other G7 countries' short and long-term interest rates start to revert to pre-crisis levels, the risks for JGBs and the yen look to be overstated. An ageing domestic population will continue to have little risk appetite, and while the asset/liability side of Japan's balance sheet is ugly, the picture elsewhere is deteriorating more rapidly, and

solutions are as difficult, if not more so.

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