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The Government Bond Bubble

Japan is presently in the midst of a severe government bond bubble.

For many people, the term “bubble” brings to mind the image of an overheated economy such as Japan experienced during the period of the real estate bubble at the end of the 1980s. The present bubble is different, however − bubbles can occur even in stagnant economies. Understanding the nation’s bond bubble is important in considering Japan’s financial problems.

Clearly it is not a normal situation for bonds issued by the nation holding the world’s largest level of debt to have record low interest rates (i.e., record high prices). It is these abnormally high bond prices that have led to talk of a bond bubble.

As is the case of all bubbles, the bond bubble is not a problem for bond markets alone. Trends in the economy as a whole are related to the issue. First, for the past 20 years, the household sector has been extremely cautious in the area of consumption due to the sluggish economy. Other anxieties such as concerns over health care expenses and pensions have also contributed to the accumulation of a level of financial assets in the household sector that is considered excessive by comparison with other countries (the NIRA report *The Excess Savings slumbering in the Household Sector* offers a detailed analysis of this situation[*1]). These savings in the household sector have flowed into financial institutions.

Looking next at the corporate sector, Japanese companies now hold their highest level of cash reserves in history. These reserves are higher now than they were during the bubble period. For the past 20 years, Japanese companies have been engaged in desperate restructuring efforts. Due in part to the cost reductions achieved in this process, numerous companies have increased their profit margins. However, many companies are also holding the resulting funds in reserve rather than directing them towards fresh investments. To this extent, Japanese companies have declined in aggressiveness and adopted a defensive posture.

Both the household sector and the corporate sector are holding a huge amount of excess savings, and these savings flow into the financial system in the form of bank savings, etc. However, there are insufficient borrowers and investment opportunities available for financial institutions to actively operationalize these funds. With the economy in a downturn, there are no destinations for the funds, and as a result they flow into the government bond market. Even when prices are high, there is no alternative but to buy bonds.

Because the yields on government bonds are extremely low, the government is able to control interest payments to a manageable level despite the nation's huge debt. The ability to somehow conjure public funds without a spiraling burden of bond interest payments, irrespective of the existence of a massive debt – this can be pointed to as a bond bubble at work.

The problem is whether this state of affairs will continue. The present situation is not a desirable one. The outlook for the economy is poor, and deflation is ongoing. Households and companies are both on the defensive, and they are directing their funds towards government bonds. The fact that yields are low as a result is a boon for government funds. Will this situation − a stagnant economy and a bond bubble − continue for years, or will some factor cause a major collapse in this uneasy equilibrium? If there is a collapse, will it occur in the desirable form of an economic recovery, or will it result in a severe decline in the price of Japanese government bonds? As Seki Obata of Keio Business School points out in this volume, it is difficult to predict the future given the existence of numerous uncertain factors, and the future course of the Japanese economy is extremely opaque.

Market Perspectives and Economists' Perspectives

The paper by Hidetoshi Ohashi of Morgan Stanley MUFG Securities in this issue offers a very precise explanation of the view taken by financial markets with regard to Japan's present government bond market. Against a background of a nation glutted with excess funds and growing concern over deflation, Japanese government bonds have a specific appeal as a long-term investment, and, with low interest rates as a precondition, enable public funds to be generated. Given the fact that the economy is in a downturn and that for the time being the Bank of Japan displays no sign of abandoning its ultra-loose monetary policy, interest rates will remain low for the immediate future.

The view expressed by Mr. Ohashi can no doubt be regarded as one that is shared by large numbers of market professionals. It is precisely because of this that banks and life insurance companies are actively purchasing long-term bonds even at such high prices.

Here, I would like to consider once again the phenomenon of bubble development. The theory of rational bubbles is a component of economic theory. The prices of assets such as bonds, stocks, and foreign exchange assets are determined by trends in projected returns. In economic models also, asset prices are established on the basis of rational investment judgments. The problem is that this type of price-setting assumes only present trends, and there is no guarantee that the future reached through a continuation of this type of rational short-term equilibrium would not be rather strange. Put plainly, it is a matter of the condition that asset prices do not diverge infinitely. In economic theory, a bubble is thought of as a phenomenon in which profitability, etc. satisfies rationality in the short term, but in which prices diverge in strange ways over the long term. Financial markets frequently tend to exclusively pursue the rationality that presents itself immediately, without consideration of factors such as long-term consistency. This results in the formation of bubbles. If the markets continue to pursue only the immediate rationality, abnormalities eventually develop in asset prices, and finally the bubble collapses. The formation of bubbles is an instance of mismatch between the logic of markets, which are easily captivated by immediate trends, and economic logic, in which long-term consistency is an issue.

Consider the real estate bubble which occurred in Japan at the end of the 1980s. At that time, an immediate standard of rationality presented itself. Investors thought that the price of real estate would increase, and they therefore invested in real estate. This increased the price of real estate still further. It was rational to continue to invest in real estate as long as this trend continued. However, the price of real estate does not continue to climb forever, and because of this, at some stage such a bubble will collapse.

How does this relate to trends in today's government bond market? Considered from the perspective of the financial markets, all the conditions are rational. However, if we consider that such conditions cannot continue forever, a crash in bond prices at some stage would come as no surprise. The government bond market is in the midst of a bubble. The higher that bond prices climb (the lower that bond yields fall) and the greater that government debt becomes, the greater the risk of a crash. When the shock comes, its effect will be felt in proportion to the scale of the bond market.

Difficulties in Public Finances and Japan's Economic Stagnation

As Toshiki Tomita of Chuo University points out in his paper in this issue, Japan is being rescued from its financial difficulties by the fact that its economy is stagnant. This is related to the issues I discussed above concerning the nation's government bond bubble. Demand for funds is weak due to the stagnation of the economy, and because of this a huge amount of funds are directed towards the bond market, despite which interest rates do not increase.

What would happen if the Japanese economy regained its vigor? As Mr. Tomita indicates, if capital investment takes off again and demand for funds increases, the funds which have previously been absorbed by the bond market will be directed towards capital investments. If this happens, we can expect interest rates to increase. When interest rates begin to rise, the burden of interest payments on public finances will increase, and fiscal management will experience difficulties.

If the fiscal deficit increases and interest rates rise, private sector investment declines − this is a textbook definition of the “crowding out” effect. Excessive public expenditure impedes the private sector economy. However, what will probably happen in Japan is the exact opposite of this. The funds flowing into public finances will dwindle to the degree that activity increases in the private sector economy, interest rates will increase, and difficulties will be encountered in fiscal management.

This type of situation darkens the outlook for Japan’s future. We desire the economy to recover, but it is likely that this economic recovery will negatively affect the nation’s fiscal management. We find ourselves between Scylla and Charybdis, where curing our economic stagnation will potentially cause the nation’s fiscal problems to increase in severity.

As Mr. Ohashi points out, the future direction of savings in the corporate sector is also a concern. As the nation’s population ages, savings in Japan’s household sector are tending to decline, but savings in the corporate sector more than compensate for this. As a result, a sufficient amount of funds are flowing into the bond market. However, unlike savings in the household sector, there is a possibility that savings in the corporate sector will be mobilized on a large scale in future.

Possessing excessive cash reserves is not especially desirable for the corporate sector. Simply accumulating cash without actively investing to create future profits puts companies in a difficult situation. Corporate managers are well aware of this, and if the opportunity arises, they will presumably seek to actively invest their cash reserves and increase their future business chances. Investments might be made in the form of M&A. Funds might also be invested overseas.

The reinvigoration of such investment activities is essential for the health of the Japanese economy, but will a high volume of funds continue to flow into the government bond market when corporate cash reserves are used in this way? This is also a point that creates concern. The excess savings in the household sector is extremely conservative money. Savings that have been accumulated, chiefly by the elderly, will not easily be diverted to other uses. One might also say that this is money with a strong domestic bias. By contrast, the excess cash reserves in the corporate sector is agile money. If an investment opportunity arises, it will be directed towards it. It is also necessary to consider the effect that this difference will have on the government bond market.

I would like to make one further comment regarding Japan’s economic stagnation and the nation’s financial difficulties. Japan’s finances have not yet collapsed. However, it is essential to be aware that the accumulation of excessive debt is restricting the functioning of the nation’s fiscal policy. If the burden of interest rate payments increases against a background of enormous levels of debt, the margin available for the implementation of flexible fiscal policy will decline significantly. Even if the stagnation of the economy continues, it will be difficult to provide any further economic stimulus.

In both fiscal and monetary policy, it is desirable to possess a margin enabling a response to an unexpected large-scale economic shock. It is necessary to possess a fiscal margin, for example, guaranteeing a standard interest rate is able to be reduced in a crisis, or enabling bold economic stimulus measures to be implemented in a crisis. Unfortunately, Japan’s margin is extremely small, both on the fiscal and the monetary fronts. Given that the nation is approaching a zero interest rate, there is no margin for the stimulation of the economy by large-scale reductions in interest. In addition, Japan has an enormous fiscal deficit and its public debt is expanding, a situation which also makes the margin available to increase expenditure in a crisis extremely small. In this sense, Japan finds itself driven into a corner in terms of policy.

The Logic of Fiscal Collapse

Historically speaking, numerous countries have experienced fiscal collapse. Japan is no exception. Greece is the most recent nation to experience this phenomenon. What circumstances result in a fiscal collapse?

As the case of Greece demonstrates, when fiscal problems produce the risk of a collapse, financial problems develop. Greece was able to maintain its finances while markets consumed the nation's bonds. However, when the markets denied the nation this option, there was little that the government could do. If the government had cut expenditure, for example by reforming the pension system and reducing the salaries of public servants, the nation may have been able to scrape by financially by increasing income through increased taxes. But the nation's citizens rejected this type of fiscal restructuring, and this was therefore not an option.

Against this background, the Greek government chose the easy path. Raising its hands in defeat proved simpler than taking the politically difficult path of convincing its citizens to swallow the strong medicine of increased taxes and reduced expenditure. In the case of Greece, because the nation is a member of the euro arrangement, rather than fiscal collapse, this surrender took the form of assistance from the other members of the eurozone. However, as Shunpei Takemori of Keio University points out in his paper, if this aid continues until the nation's basic income and expenditure is in equilibrium, there is a possibility that Greece will choose the option of sovereign default rather than continuing its fiscal restructuring.

The majority of nations which have historically defaulted on government and government-backed debt, i.e. which have experienced financial collapse, did so at a point at which their debt-to-GDP ratio was far lower than Japan's is at present. In addition, the majority of their debt was held by overseas investors. Presumably, it was easier to announce a collapse than to continue on the politically difficult path of fiscal restructuring.

Japan's situation is very different when considered from this perspective, given that the majority of the nation's debt is held domestically. Japanese citizens hold the nation's debt both directly and indirectly. Because of this, the nation cannot choose the easy path of debt default. This would be the same as increasing the debt ratio. The high level of confidence financial markets have in Japanese bonds is also presumably related to this point. For the Japanese government, the problems resulting from a sovereign debt default would be greater than the difficulty of continuing a stringent program of financial reconstruction. Ironically, the confidence in the Japanese government due to its inability to default has the effect of promoting the issuance of further debt. In other words, the markets do not say no to the issuance of excessive debt.

It is often pointed out that because most of its debt is held by its citizens, Japan's case differs from that of nations in which the majority of debt is held overseas. As indicated above, this is correct in a certain sense. Precisely because the nation's debt is held by its citizens, the government cannot readily choose a course of action which will damage their assets. This creates a sense of security, and bonds are traded at high prices even as debt is mounting. However, the further accumulation of outstanding debt will increase the burden of financial restructuring on citizens. The burden on future generations will also become greater. The exercise of stronger discipline by money markets in relation to a government which is increasing debt to excessive levels would be desirable. At present, against the background of a government bond bubble, such discipline is nowhere to be found.

Japanese Bonds from a Global Perspective

Global money reacted unexpectedly to the Lehman Brothers shock and the Greek financial crisis. Japan was seen as safer than Europe, and Japanese bonds were seen as safer than stocks and other risk assets. As a result, the yield on Japanese bonds has declined significantly even for long-term papers, and a trend towards a strong yen has become conspicuous in exchange markets. Irrespective of the facts that Japan's economy is in a slump, its companies are not competitive, and its level of debt is among the world's highest, global money has produced a strong yen and high Japanese bond prices.

According to one market participant, this is a matter of relative attractiveness. It is not that the yen or Japanese debt is attractive, but rather that European currencies and Greek debt are no longer attractive. In part, current Japanese bond prices and the exchange rate of the yen are a product of the Lehman Brothers shock and the global economic instability that followed it. It is essential that we tackle these issues now as factors that will affect the Japanese bond market in the future.

The phenomenon that economists term global imbalance is important in considering the global economic trends which resulted in the Lehman Brothers shock. It was the purchase of financial services throughout the world by the U.S. that produced the expansion of the world economy which preceded the Lehman Brothers shock. The fact that the U.S. had a significant current account deficit, i.e. excess expenditure, meant that other regions had current account surpluses, i.e. insufficient expenditure. This large global imbalance brought a variety of problems, but also resulted in a balance between supply and demand in the globe as a whole and contributed to expanding the global economy.

Unfortunately, the excessive demand of the U.S. resulted in a bubble, and with its collapse the world lost an engine of demand. In Japan there has been neither a financial crisis nor the collapse of a real estate bubble, but the fact that a slowing of export demand could result in such a major decline in the economy indicates the importance of the U.S. as an engine of demand.

Following the Lehman Brothers shock, the global economy still has no strong engine of demand, and has not achieved a steady recovery. Increasing demand in emerging nations, in particular China, is playing an important role, but it is difficult for China alone, representing only around 10% of world GDP, to propel the global economy. This is also true in the case of the other emerging nations. European economies are experiencing slumps, and some experts are suggesting that a double dip recession lies ahead for the U.S. This slide into insufficient demand on a global scale has raised concerns of global low interest and deflation. Interest rate trends in Japan cannot be separated from these global trends.

The markets believe that unease over the outlook for the U.S. economy will leave the Federal Reserve with no choice but to move in the direction of even more aggressive monetary easing. Federal Reserve Chairman Ben Bernanke has also indicated the possibility of further easing. Japan's monetary policy will be judged by comparison with such moves in the U.S. The appearance of a delay in monetary easing in Japan will put upward pressure on the yen. These global money trends are putting pressure on the BOJ for further monetary easing.

The important point in considering the future of the Japanese bond market is when there will be a turnaround in the global deflationary tendency. The major nations are working desperately to achieve economic recovery, and there will presumably eventually be a significant recovery in demand centering on the emerging nations. I will no doubt be considered to be jumping the gun in discussing the phase of recovery in the global economy at present, when we are compelled to be concerned about a global recession. However, that phase will surely come. It is therefore necessary that we take the direction of interest rate trends in Japan, i.e. the future direction of the bond market environment, into consideration in our thinking about future possibilities.

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