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Japanese Retail Investors' Investments in Foreign Currency Denominated Bonds
-Overview and Policy Measures to Facilitate Those Investments-

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Summary

Of the various channels to recycle Japan's current account surplus, investments in foreign currency denominated bonds continuously have been the primary source of capital outflow from Japan. Retail investors' investments in such bonds have increased substantially in recent years, while institutional investors (e.g., life insurers, trust banks, and Postal Savings) have been rather cautious in taking exchange rate risks.

It would be sensible for Japan to take policy measures to further facilitate retail investors' investments in foreign currency denominated bonds, since a steady recycling of Japan's current account surplus through that channel would help stabilize global financial markets including the yen's exchange rates. Such policy measures could possibly include introducing non-yen savings products offered by Japan's Postal Savings (Yucho) after its privatization, or non-yen bonds targeted at Japanese retail investors issued by sovereign or quasi sovereign names with the highest credit ratings, e.g., foreign governments, government affiliated institutions such as JBIC, or the Japanese government.

[1] This paper is based mainly on the author's work experience at the Inter-American Development Bank (July 1999 – August 2003), where he was Deputy Manager of the Finance Department responsible for funding, investment, accounting, and asset liability management. All the statements and policy recommendations in this paper are the author's personal views, and should not be regarded as representing the official views of the Ministry of Finance.

1. Channels to recycle Japan's current account surplus

As the equation in balance of payment statistics shows, Japan's current account surplus is always equal to the sum of its capital and financial account deficit, increase in foreign exchange reserve, and "errors and omissions".

Setting the increase of the foreign exchange reserve, i.e., exchange market intervention, aside in this paper, the breakdown of Japan's capital and financial account deficit shows the following pattern (Table 1):

a. Direct investment has been consistently negative (=net outflow from Japan), but relatively small compared to the country's current account surplus.

b. Equity investment became positive in 1999, 2001, and 2003 thanks to growing investments in Japanese equities by non-resident investors.

c. Bond investment has been continuously negative since 1989. In the year 2003, net bond investment was greater than Japan's current account surplus.

d. Other investment has been very volatile, and no specific pattern can be observed.

Since investments in foreign bonds have been the biggest source of capital outflow from Japan, this paper will analyze them in greater detail, illustrating recent trends of such investments by investor category.

(Table 1) Japan: Balance of Payments (100 million yen)

CY	1998	1999	2000	2001	2002	2003
Current Account	155,278	130,522	128,755	106,523	141,397	157,668
Capital & Financial Accour	▲ 170,821	▲ 62,744	▲ 94,233	▲ 61,726	▲ 84,775	77,341
Direct Investment	▲ 27,437	▲ 11,393	▲ 25,039	▲ 39,000	▲ 28,891	▲ 26,058
Portfolio Investment	▲ 57,989	▲ 30,022	▲ 38,470	▲ 56,291	▲ 131,486	▲ 114,731
Equities	▲ 229	80,853	▲ 22,580	33,827	▲ 66,960	94,994
Bonds	▲ 57,760	▲ 110,875	▲ 15,890	▲ 90,119	▲ 64,526	▲ 209,725
Derivatives	1,035	▲ 3,305	▲ 5,090	1,853	2,630	6,074
Other Investment	▲ 67,118	1,064	▲ 15,688	35,175	77,189	216,728
Capital Account	▲ 19,313	▲ 19,088	▲ 9,947	▲ 3,462	▲ 4,217	▲ 4,672
Changes in Reserve Asset	9,986	▲ 87,963	▲ 52,609	▲ 49,364	▲ 57,969	▲ 215,288
Errors & Ommissions	5,558	20,184	18,088	4,567	1,348	▲ 19,722

(Source) Ministry of Finance, Japan

2. Overview of investments in foreign currency denominated bonds

a. Life insurance companies

Though once quite influential in global capital markets, investments by Japanese life insurance companies (Seiho) in non-yen fixed income products have not increased very much in the past decade due to the following:

- Total assets for the industry have already peaked, thus it is difficult for them to substantially increase any category of assets.

- Risk tolerance for the insurance companies has decreased because of the deteriorating quality of their assets.

In addition, a major part of Japanese life insurers' investments in non-yen bonds is hedged against currency fluctuations, thus their impact on currency markets is relatively limited.

(Table 2) *Japan* : Net Investments in Foreign Currency Denominated Bonds (100 mil. yen)

CY	Life Insurance	Nonlife Insurance	Commercial Banks	Trust Banks	Investment Funds	Public* Investors	Others	Total
1989	19,228	5,549	22,415	14,668	▲ 5,233	NA	65,681	122,308
1990	▲ 10,805	1,927	10,813	5,854	▲ 8,302	NA	43,239	42,726
1991	1,838	2,560	1,697	8,900	14,831	NA	64,751	94,577
1992	3,699	4,814	5,155	7,491	▲ 4,634	NA	30,704	47,229
1993	▲ 6,189	3,591	12,327	19,984	8,187	NA	▲ 4,233	33,667
1994	▲ 12,280	6,684	2,546	4,884	13,607	NA	39,061	54,502
1995	13,490	3,963	4,156	▲ 7,556	16,476	NA	47,611	78,140
1996	26,213	▲ 2	3,280	6,049	6,295	NA	41,643	83,479
1997	12,115	▲ 3,818	▲ 16,652	▲ 7,609	6,127	NA	30,117	20,280
1998	27,215	▲ 1,851	▲ 10,141	35,948	5,613	NA	37,861	94,645
1999	▲ 1,065	▲ 3,641	25,969	38,131	▲ 8,567	NA	34,816	85,642
2000	480	▲ 3,414	58,118	11,926	▲ 14,193	NA	▲ 331	52,586
2001	45,792	867	38,454	12,736	13,406	NA	5,689	102,375
2002	10,828	▲ 1,911	44,693	8,507	7,633	▲ 19,839	38,244	88,155
2003	55,417	2,325	46,516	4,147	31,955	▲ 8,876	47,029	178,513

Source: Ministry of Finance, Japan

b. Commercial banks

Since the end of the 1990s, Japanese commercial banks have increased their investments in foreign currency denominated bonds quite substantially, making them the biggest non-yen bond investors. Because almost 100% of these investments are funded in non-yen currencies, they are free from currency risks, but subject to interest rate risks. Steeper yield curves for non-yen currencies such as the dollar and the euro compared to the yen were the main reason for them to engage in "yield curve play" in those currencies.

c. Trust banks

Non-yen bond investments from Japanese trust banks have been steadily increasing in gross terms in the past several years. However, they have been almost unchanged in the same period in net terms (acquisition of non-yen bonds minus disposition), excluding banking account transactions that are currency matched.

d. Investment funds

With the backdrop of ultra-low interest rates, sluggish equity markets until recently, and several deregulation measures, investment funds targeting non-yen fixed income products have increased substantially. This category has become one of the major channels to move retail investors' funds into non-yen bonds.

e. Public investors (Postal Savings and Insurance)

Japan's Postal Savings (Yucho) and Insurance (Kampo), which account for about 40% of the nation's total savings, have steadily reduced their non-yen portfolios in the past several years. As to the background for such a trend, quite a few officials in charge of portfolio management of Yucho and Kampo pointed out past negative experiences of substantial losses due to the yen's appreciation, and their institutional tactics to "keep their yards clean" prior to the organizational change that separated Yucho and Kampo from the Ministry of Post and Telecommunication (Yusei-Sho) and made them into a government affiliated special corporation (Yusei-Kosha) in 2003. Those officials also stated that there might be additional room for them to increase investments in risk assets including foreign currency denominated bonds, once the organizational change is finalized.

f. Others[2]

Table 2 suggests a significant increase in investments in foreign currency denominated bonds by "others," i.e., retail investors, from zero net outflow in 2000 to 4.7 trillion yen in 2003, which accounted for 25% of total net investments in non-yen bonds out of Japan (18.5 trillion yen)[3], and 30% of Japan's current account surplus in the year. As such, retail investors' bond investments have become one of the biggest channels of capital recycling from Japan to the rest of the world.

Furthermore, when this amount is added to investments by investment funds, which can be regarded as largely stemming from retail investors, the total amount (8.2 trillion yen in 2003) that can be categorized as "retail investors' money" was approximately 40% of total net investments in non-yen bonds out of Japan.

3. Characteristics and backgrounds of retail investors' investments in non-yen bonds

a. Characteristics

The following points in comparison to institutional investors' investments characterize Japanese retail investors' investments in foreign currency denominated bonds:

- Non-hedged to currency risks: Japanese retail investors' non-yen investments are usually yen funded and not hedged against exchange rate fluctuations. This

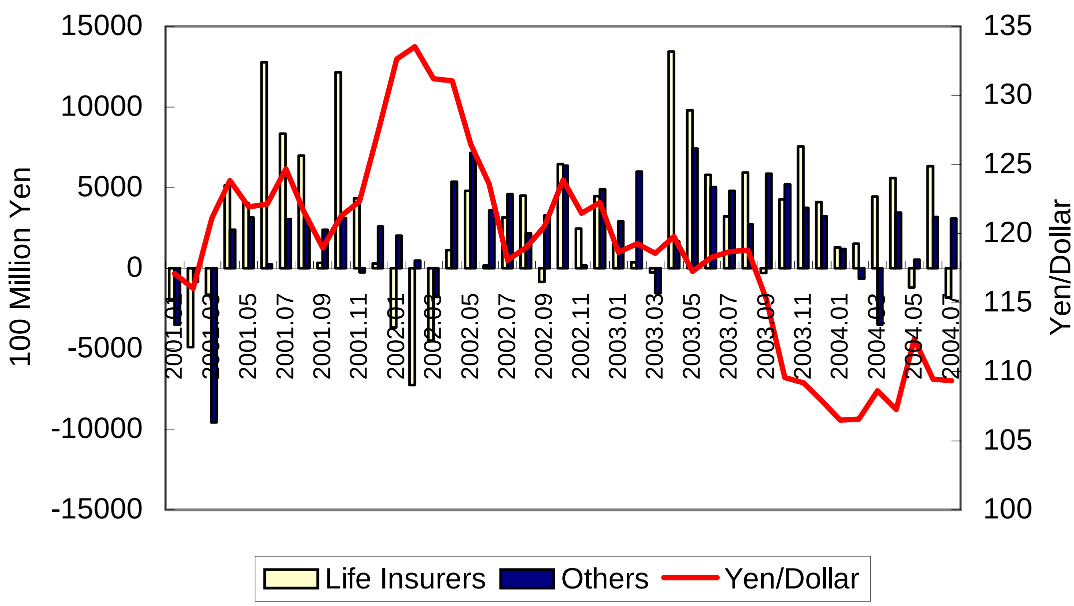
[2] This category includes investments by retail investors and securities companies' proprietary trading. In addition, "public investors" were also included in this category until March 2000. Since Japanese securities companies' proprietary trading in foreign currency denominated bonds has not been very active over the past several years, the numbers in this category after 2000 can be assumed as mostly representing Japanese retail investors' investments in non-yen bonds.

[3] In 2003, Japanese commercial banks invested 4.7 trillion yen in foreign currency denominated bonds. As most of this amount was funded through non-yen offshore borrowings, this can be deducted from the total non-yen bond investments (18.5 trillion yen) to see the volume of "real" net investments made to recycle Japan's excess savings. Of this "real" net amount (13.8 trillion yen), retail investors' non-yen bond investments accounted for 34 %, while the sum of retail investors and investment funds made up about 60%.

makes a marked contrast to the fact that most institutional investors, e.g., life insurance companies, make their non-yen investments with a full- or partial-hedging strategy, utilizing currency forwards and futures.

- Counter-exchange-rate-movement behavior: While Japanese institutional investors tend to make pro-exchange-rate-movement investment decisions, namely, buying non-yen bonds when the yen is depreciating and selling them when the yen is appreciating, presumably due to their loss-cut rules, retail investors appear to be free from such a tendency. In fact, it has been very often observed that retail investors' non-yen investments sharply increase when the yen had appreciated substantially vis-à-vis the dollar and the appreciation seemed to have come to a temporary halt (See Graph A).

(Graph A) Yen/Dollar rates and Non-Yen Bond Net Investments



- "Ready to take one risk, but not two": According to investment banks actively selling foreign currency denominated bonds to Japanese retail investors, such investors are very risk-conscious, and very clear as to which risks they are ready to take. More precisely, they don't want to take any credit risks when their investments are already exposed to exchange rate risks. Because of such clear preference among retail investors, AAA/Aaa rated non-yen bonds issued by the World Bank or Inter-American Development Bank have been in heavy demands.[4]

[4] Retail targeted non-yen (e.g., US dollar, euro, Australian dollar, and NZ dollar) bonds (Uridashi-bond) issued by the Inter-American Development Bank (IADB) expanded their market in Japan very rapidly. In 1999 when the author assumed Deputy Manager's position at the IADB, there was virtually no retail market available for the Bank's funding. In 2002, however, the IADB raised about 1/2 of its annual funding program of US $ 9 billion out of the Japanese retail market.

b. <u>Background</u>

The following factors seem to have contributed to the sharp increase in retail investors' non-yen bond investments:

- ◆ With the yen interest rates extremely low and the equity market very sluggish, Japanese retail investors have had no alternatives other than taking exchange rate risks in order to pursue reasonable returns from their investments. Strategies taking other types of risks had ended up unsuccessful. For instance:

- Credit risk: A large number of retail investors in Japan had been badly affected by Enron and Argentina default situation.
- Interest rate risk: In May 2003, 30-year JGBs yielded only 0.99%. With the yen yield curve so flat, there was no earning reasonable return by taking interest rate risks.
- Equity price risk: The Nikkei 225 index had continued sliding for more than a decade from its peak of 38,000 yen to around 8,000 yen before hitting bottom in April 2003.

- ◆ Sales forces at Japanese securities firms who traditionally had been focusing on equities had shifted their sales priorities from Japanese equities to foreign currency denominated bonds. In other words, they recommended non-yen bonds to their retail customers as an alternative to equities.

- ◆ The need to diversify their investments had come to be more widely recognized among retail investors, particularly among senior citizens who hold more than half of Japan's household savings. Quite a few wealthy seniors allocated a certain share of their financial assets (e.g., 20%) to non-yen bonds with the aim of getting higher interest rates and reinforcing their cash flow, while preparing for the risk of living longer than expected by investing the rest in yen-denominated fixed income products and thus securing the principal in yen terms.

4. Possible policy measures

As analyzed above, strong demand from Japanese retail investors for foreign currency denominated bonds seems to have been supported by a couple of cyclical conditions, such as the ultra-low yen interest rates and sluggish equity markets. Therefore, when these conditions finally change as the Japanese economy continues to recover, retail investors' demand for non-yen bonds may recede considerably.
In addition, retail investors' non-yen bond investments might be limited by the supply side, namely, the names currently favored by the investors might not be able to supply enough retail-targeted non-yen bonds to meet the demand in the future.

However, in view of the above-mentioned characteristics of retail investors' non-yen bond investments, i.e., their readiness to take exchange rate risks, counter-exchange-rate-movement behavior, and relative stableness in comparison to those by institutional investors, steady capital outflow from Japan through that channel will certainly help stabilize the currency market and eventually the global financial markets. Therefore, it might be a sensible policy agenda for the Japanese authorities (and other authorities as well) to further facilitate such investments.

Initiatives to facilitate retail investors' non-yen bond investments can include various policy measures. For instance, deregulation of registration requirements for retail targeted bond issuance (Uridashi-sai) might make it easier for investment banks to syndicate retail-targeted bonds issued by corporations other than the supra-national institutions.[5]

Furthermore, more far-reaching policy measures would be also worth considering. For example:

- Foreign currency denominated savings products to be offered by the Postal Savings (Yucho) would attract very solid and stable demand from Japanese retail investors because of the familiarity of Yucho to those investors and their tendency to avoid taking any credit risks with their non-yen investments. Although it is quite unlikely that the current nationalized Postal Savings will dare to offer such "risky" products, it might not be totally unrealistic to assume that the privatized Postal Savings in the future will be allowed to engage in a wider range of activities including selling non-yen savings products. In that case, Yucho would be required to have a very high standard of code of sales conducts with those products, e.g., stringent inner rules that requires its sales force to give sufficient information on the risks associated with those products to the customers.

  In addition, having foreign currency denominated liabilities would make it a natural ALM choice for the Postal Savings to have more non-yen investments on its asset side. This would facilitate a substantial increase of investments in foreign currency denominated financial products by the institution.

- Government bonds issued by foreign countries would also facilitate non-yen retail investments, provided they are issued by countries with the highest credit ratings, denominated in the currencies of the issuing countries, and properly designed to target retail investors. If, for instance, the United States government issues savings-bond type treasury notes targeted at non-resident retail investors, they would be welcomed by Japanese retail investors with solid demand.

- If the Japanese government were to issue foreign currency denominated JGBs, they would also appeal to retail investors. In that case, it would be sensible for the Japanese government to allocate the non-yen funds raised by issuing such bonds to certain government expenditures such as defense-related procurements from foreign countries, oil imports for strategic reserves, or official development aid (ODA), whose original prices are denominated in non-yen currencies. Such a mechanism would not only alleviate the currency risks the government is currently exposed to with those expenditures, but also facilitate non-yen investments from Japan through governmental channels. Even though introducing foreign currency denominated JGBs might appear to be too far-reaching, it would be realistic enough that a government affiliated agency such as JBIC (Japan Bank for International Cooperation) issues retail targeted non-yen bonds to finance its non-yen lending.

[5] Supranational institutions to which Japan is a member country (e.g., World Bank, Inter-American Development Bank, and Asian Development Bank) are exempted from the registration requirements, and that is one of the reasons why those institutions have had many opportunities to issue retail targeted bonds in Japan. If the registration requirements are lifted or made more flexible, it would become much easier for other institutions with very high credit ratings to issue bonds targeted at retail investors.