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Abenomics' first arrow on track to reach institutional investors

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Executive Summary

Monetary policy is generally said to be faster-acting than fiscal policy or national growth strategies. In actuality, however, monetary policy works with substantial time lags. This fact should be accorded more recognition in discussions of policy effectiveness.

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"Already two years" or "only two years"?

Nearly two years have passed since the Bank of Japan (BOJ) launched quantitative and qualitative easing (QQE). While QQE has been widely debated, many have noted that it has not substantively changed investors' investment behavior or companies and households' spending behavior despite having lowered long-term interest rates (in addition to weakening the yen and driving up stock prices) through large-scale purchases of JGBs.

This criticism reflects a perception that monetary policy is faster-acting than fiscal policy or a national growth strategy. Because monetary policy is set by the BOJ at Monetary Policy Meetings, it indeed operates with shorter policy-making and implementation time-lags than fiscal mobilization or growth strategies, both of which require deliberation by the Diet. However, perceptions of how long monetary policy's effects take to manifest once the policy has been implemented vary widely from person to person. This difference in perceptions is a major determinant of people's assessment of QQE, with some becoming impatient after "two years already" and others believing that QQE needs more time to work after "only two years." Below I discuss policy time lags in the context of changes in institutional investors' investment behavior.

Life insurers and pension funds have stepped up foreign bond purchases in FY2014

Exhibit 1 shows life insurers' net purchases (purchases minus sales) of JGBs and foreign bonds[1)]. First, life insurers' cumulative net purchases of JGBs in the first seven months of FY2014 (April through October) were somewhat lower than in the year-earlier period. Specifically, they decreased to roughly ¥3.5 trillion in FY2014 from about ¥3.9 trillion in FY2013. In contrast, life insurers' investment behavior vis-à-vis foreign

NOTE

1) By definition, JGB trades in this data series include trades by nonlife insurers also. However, nonlife insurers' JGB holdings as of March 31, 2014, were only ¥6.2 trillion versus life insurers' JGB holdings of roughly ¥150 trillion as of the same date. We accordingly assumed that life insurers accounted for the vast majority of JGB trades. As used herein, JGBs do not include treasury discount bills.

bonds changed dramatically between FY2013 and FY2014. Whereas life insurers were net sellers of foreign bonds by a roughly ¥100 billion margin in the first seven months of FY2013, they were cumulative net buyers of some ¥3.3 trillion of foreign bonds during the corresponding period of FY2014[2). Additionally, whereas they were net sellers of foreign bonds in most months of FY2013, they were net buyers in every month of FY2014 through October. Life insurers have been stepping up investment in foreign bonds in FY2014.

2) As used herein, "foreign bonds" are defined as bonds with original maturities of at least one year (classified as "medium/long-term bonds" in the data series used). The same definition applies to Exhibit 3 also.

We attribute this pronounced difference in life insurers' investment behavior between FY2013 and FY2014 to a change in the outlook for domestic nominal interest rates.

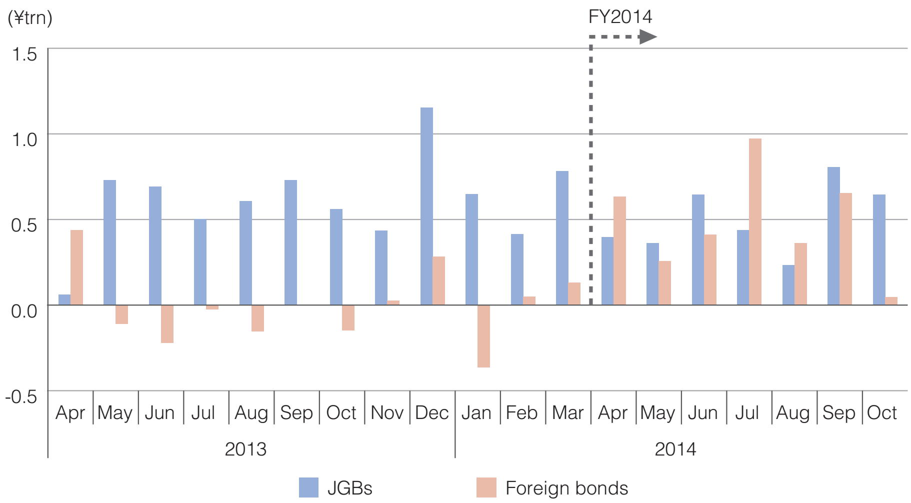
Following QQE's launch, opinion was initially split on the direction of nominal interest rates. Some expected the BOJ's large-scale JGB purchases to suppress nominal interest rates while others expected economic improvement and upward revision of inflationary expectations to exert upward pressure on nominal interest rates. The interest rate outlook remained murky for a while amid uncertainty as to whether upward pressure on domestic interest rates would outweigh downward pressure or vice versa. It was not until autumn 2013 that long-term interest rates discernibly embarked on a downtrend.

If JGBs hypothetically offer favorable prospects of high coupon income, Japanese life insurers would have little incentive to invest in foreign bonds at the cost of incurring currency risk or hedging expenses. Under such circumstances, increasing one's JGB holdings would be more sensible than investing in foreign bonds. However, investors were presumably hesitant to make investment decisions on the assumption that nominal interest rates would rise, at least during the first half of FY2013 as explained above. Amid the market environment of FY2013, investors reached a firm consensus that the BOJ's JGB purchases would have a major suppressive effect on nominal interest rates for a while. As a result, life insurers likely decided to increase their foreign bond investments when formulating their FY2014 investment plans.

Increased appetite for foreign bonds is not limited to life insurers. Foreign bond trading activity through trust accounts[3), which are regarded as a proxy for Japanese public and private pension funds, has also changed since the start of FY2014. Specifically, foreign bond purchases via trust accounts have picked up relative to the previous year, with net purchases in the first seven months of FY2014 nearly doubling to around ¥2.3 trillion from ¥1.2 trillion in the year-earlier period (Exhibit 3). The trust accounts' trustors are of course not identifiable from these data. We therefore cannot

3) Includes trust accounts held at both trust banks and commercial banks.

Exhibit 1. Life insurers' net bond purchases/sales



N o t e: Data are purchases net of sales.
Source: NRI, based on Japan Securities Dealers Association's Government Bond Trading Volume by Category of Investors and Ministry of Finance's International Transactions in Securities

Exhibit 2. 10-year JGB yield

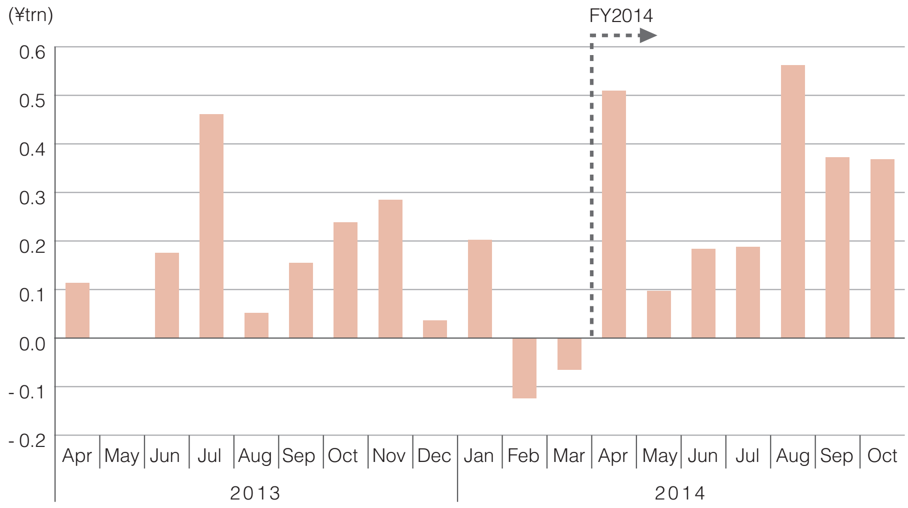
Source: NRI, based on Bloomberg data

unequivocally conclude that Japanese pension funds are stepping up investment in foreign bonds. However, in light of the entrenched downtrend in domestic long-term interest rates, Japanese pension funds, like Japanese life insurers, have ample incentive to increase their foreign bond investments. The fact that pension funds use fair-value accounting is all the more reason for them to increase their foreign bond investments to hedge against the risk of a backup in domestic interest rates[4].

4) A J.P. Morgan Asset Management survey of major Japanese corporate pension funds (published on June 27, 2014) reported that the pension funds were decisively reducing domestic bond holdings and increasing their allocations to foreign bonds and/or alternative investments.

The foreign bond investment data discussed herein are just one example. Additionally, the amounts of foreign bonds purchased in FY2014 are small in comparison to life insurers and pension funds' total assets. Nonetheless, the relatively long time that

Exhibit 3. Foreign bond net purchases/sales in trust accounts



N o t e: Data are purchases net of sales.
Source: NRI, based on Ministry of Finance's International Transactions in Securities

QQE's effects have taken to diffuse through financial markets and manifest in the form of changed investment behavior by institutional investors is important. In light of this fact, the portfolio rebalancing effect that QQE was initially expected to have may yet materialize on a broad scale. At the least, policy effects should be dispassionately discussed based on a recognition that the effects that ensue from implementation of putatively fast-acting monetary policy are not without time lags.

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