Is the rise in Japanese yields more scary than dangerous?

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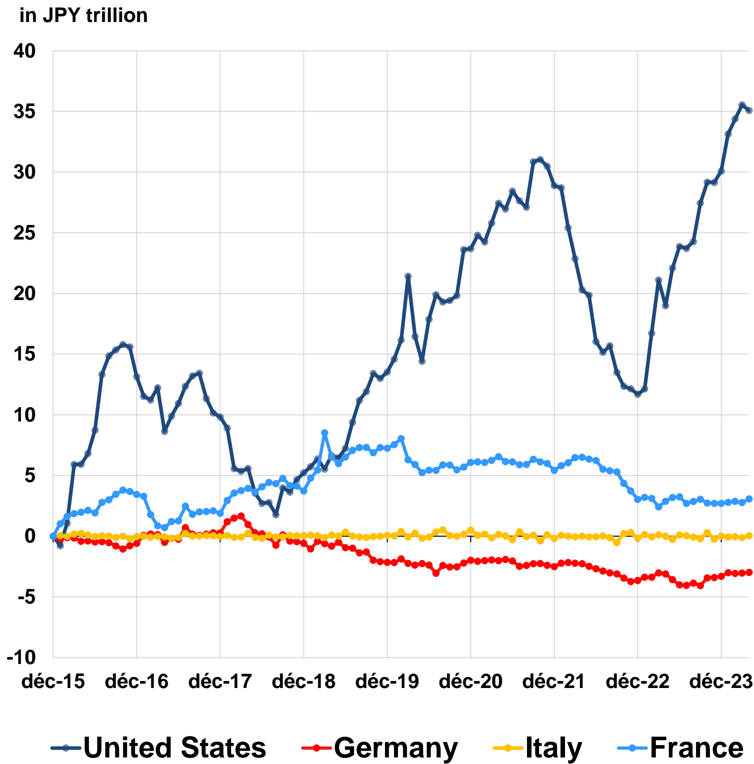
Japan is a major holder of foreign sovereign debt, thanks to its attractive interest rate differential. In 2022, the increase in the cost of hedging against currency risk led to a partial repatriation of Japanese capital. Despite fears, this disinvestment trend did not continue in 2023 and 2024 and had no discernible impact on foreign yields.

Chart 1: Net Cumulative Japanese investment flows into sovereign bonds



Source: Bloomberg, Japanese Ministry of Finance, Banque de France

With the introduction of negative interest rates and quantitative easing in Japan as of 2016, yield-seeking Japanese institutional investors (pension funds, life insurance companies and asset managers) increased their investments in foreign debt markets (see chart 1). The traditional yield differential between the Japanese domestic market and foreign markets has

been a powerful factor in diversification for three decades, accentuated by the advent of negative interest rates in Japan: in 2016, while the yield on Japanese 10-year sovereign bonds moved into negative territory (a historical low), US 10-year Treasuries offered yields of between 1.4% and 2.6%. This differential, combined with the yen's depreciation (losing 4% against the US dollar over 2016 from the time interest rates became negative on 22 February), generated strong gains for unhedged Japanese investors up to 2021. On average, life insurers and pension funds only hedge 50% of their exposure to bonds denominated in foreign currencies, a ratio that varies according to the financial intermediaries' assessment of the exchange rate risk. At the end of 2022, for example, Japan held 6% of total outstanding OATs and 3% of total outstanding US Treasuries (USTs, ECB Financial Stability Review, May 2023). Moreover, according to data published by the US Treasury, it was the largest foreign holder of US Treasury bonds at the end of 2023.

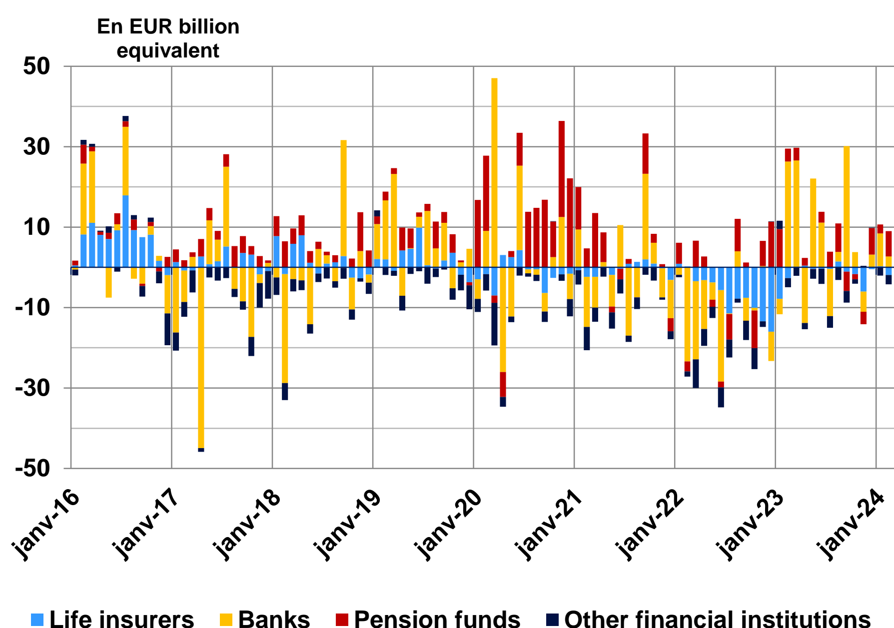
However, since 2022, the tightening of monetary policies in developed countries has reduced this financial interest for Japanese investors: the cost of hedging against the risk of fluctuations in the value of the yen against the euro or the US dollar has exceeded the long-term yield differential between foreign markets and the Japanese market. In 2022, the sharp rise in US and European sovereign bond yields was fully offset by the sharp increase in this hedging cost. However, the majority of these investors hedge against the risk of a rise in the yen when they invest in securities denominated in foreign currencies. During the 1980s, when the yen appreciated sharply, Japanese life insurers suffered significant losses on their foreign investments because they did not hedge their currency exposure. The negative net return on this carry trade strategy, once the cost of hedging is taken into account, led to significant net sales of foreign debt securities by Japanese investors in 2022 (JPY 23 trillion, or EUR 140 billion) and a decline in the investment coverage ratio.

After sell-offs in 2022, Japan was a net buyer of foreign debt in 2023

While the hedged yield differential remained unfavourable to Japanese investors, the opposite occurred in 2023, with net purchases of foreign debt totalling JPY 18.9 trillion (or EUR 121 billion), almost exclusively in USD-denominated debt.

This counter-intuitive development was mainly fuelled by Japanese banks, which are more sensitive to short-term opportunities and were net buyers of these securities. They were betting on a Fed rate cut - which has not yet happened - with the capital gains on the securities more than offsetting the negative carry resulting from the cost of the currency hedge. Life insurers and pension funds (with longer-term strategies) did not follow this portfolio repositioning strategy (see Chart 2).

Chart 2: Monthly net purchases by Japanese investors on foreign bond markets



Source: Japanese Ministry of Finance Bloomberg, Banque de France

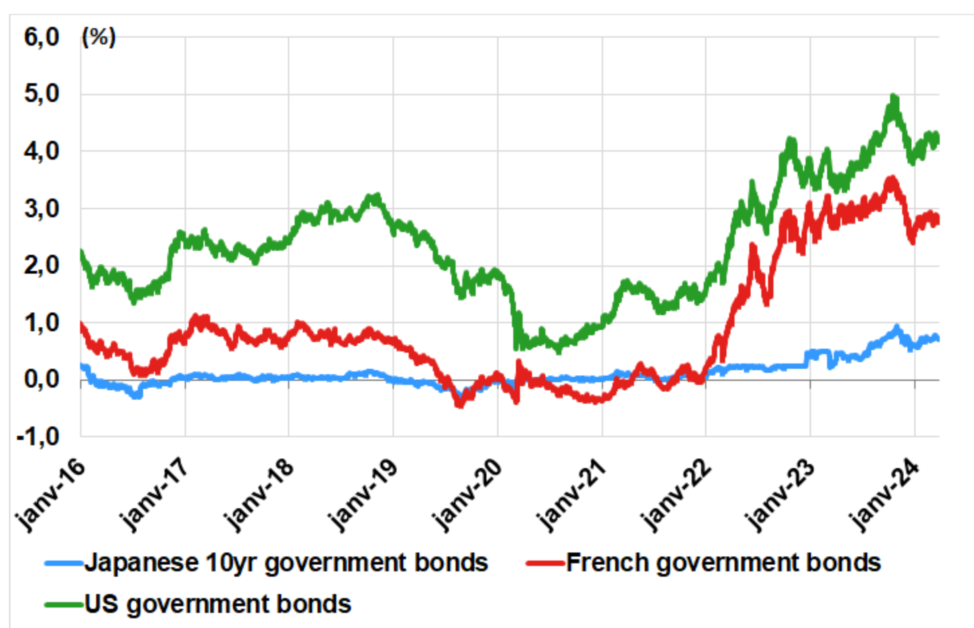
Note: Net buyer flows by investor profile. The negative net flows in 2022 from life insurers therefore show that these investors sold more foreign bonds than they bought in those months.

Rising interest rates in Japan are expected to have a limited impact on capital repatriation flows

The Bank of Japan (BOJ), which introduced interest rate controls as of 2016 to support the reflation of the Japanese economy, finally put an end to them in March 2024, after gradually relaxing them from December 2022.

Nevertheless, the BOJ has continued to intervene and is still buying on a scheduled and unscheduled basis, amounts equivalent to half the Japanese government's gross issuance (JGBs) across the yield curve. Nonetheless, Japanese long yields rose moderately in 2023, although by much less than their equivalents in the other advanced economies (Chart 3).

Chart 3: Sovereign government bonds' 10-year yields since 2016



Source: Bloomberg, Banque de France

Further increases in Japanese long-term yields now hinge on market expectations of the BOJ's ability to normalise its monetary policy. The exit from negative interest rates (then set at -0.1%) finally took place in March 2024, but does not necessarily herald a sequence of further rate hikes, given the uncertainties surrounding Japan's future inflation regime.

Aside from this factor relating to changes in the BOJ's key rate, the continued rise in Japanese long-term yields, which has accelerated across the curve since the start of the year, is likely to remain contained:

- the end of the quantitative and qualitative easing (QQE) programme, i.e. the central bank's purchases of Japanese government bonds (*rinban*), should accentuate the rise in yields, but the BOJ is expected to try to keep long-term yields under control, with the 10-year yield unlikely to exceed 1% in the short to medium term
- moreover, no mention has yet been made of reducing the size of the BOJ's balance sheet, which, like other central banks, has expanded considerably as a result of its massive purchases of government securities, and this is in any case is unlikely to happen before 2025-26, after the end of QQE.
- after peaking at the end of 2023, the gradual decline in US interest rates, in line with falling inflation, should curb the rise in Japanese yields because of the leading role played by the US market;
- the repatriation of capital by Japanese domestic investors, lured by the rise in Japanese long-term yields, is likely to contain the extent of this rise.

Even if Japanese yields continued to rise, the repatriation of capital would have a limited impact on foreign bond markets, but should lead to a strengthening of the yen. Indeed, there are still factors driving investment into foreign bond markets:

- Structurally, the Japanese economy remains an exporter of capital: the size of Japan's net international investment position, which exceeds 70% of GDP, is unparalleled in the developed world, resulting in a persistent current account surplus due to the income received from these foreign investments;
- a normalisation of the euro and dollar yield curves in the form of a re-steepening, i.e. short-term yields falling below long-term yields again, could increase the attractiveness of foreign bond investments, while Japanese yields could remain persistently lower than those on foreign markets due to weaker growth and inflation developments in Japan;
- to limit their balance sheet risk, Japanese life insurers have promoted the development of insurance policies denominated in foreign currencies, particularly in dollars, creating a natural demand for fixed-income products denominated in foreign currencies