



Japan's Latest Stimulus Measure: The Beginning of the End?

Japan's central bank caught most investors off guard last week when it announced plans to increase its monthly asset purchases by more than 15%, to the equivalent of \$720 billion annually in an effort to revive economic growth and end more than a decade of deflation pressures. The initial response was a significant jump in Japanese equities and bonds, accompanied by a sizeable slide in the value of the Japanese yen. Despite the positive response, the unintended consequences of such an audacious stimulus plan may yield longer-term pain for the Japanese economy and potentially the global bond markets.

The Bank of Japan's announcement last week coincided with the world's largest pension fund, the Japanese Government Pension Investment Fund (GPIF), with over \$1 trillion worth of holdings, deciding to reduce its Japanese government bond holdings from 60% to 35% of its assets, due to concerns about interest rate risks associated with the Japanese bond market and the need to achieve a higher rate of return. With the GPIF reducing its holdings of government bonds in favor of Japanese and international stocks, the Bank of Japan (BOJ) was forced to take an even larger role in the country's ability to finance its nation's deficit.

Japan is currently running an annual deficit of around 7%, forcing it to finance more than \$300 billion annually. While the low interest rates on Japanese government bonds do not pose a significant risk to the nation's ability to meet its interest obligations, the country's debt-to-GDP ratio is over 225% and has been growing nearly 4% annually over the past ten years (Chart 1). Revisiting the \$720 billion in annual purchases planned by the BOJ, it will be acquiring more than twice the number of bonds being issued by the government to finance its annual deficit. While currently owning over 20% of the nation's government bonds, it is likely that over the next couple of years the BOJ will own the majority of all Japanese government bonds (Chart 2).

Why is this important? If the massive asset buying plan fails to reignite the Japanese economy, and one only has to look at the minimal success that the U.S. Federal Reserve achieved in its latest round of quantitative easing as a potential outcome, the more the yen is likely to decline against other major currencies. As the yen declines, Japanese investors are more likely to diversify away from Japanese investments, especially their ultra-low interest rate government bonds, forcing the BOJ into another round of asset purchases to absorb the selling of government bonds and preventing interest rates from increasing.

The main concern is whether this cycle spins out of control and undermines investors' confidence in the nation's ability to meet its financial obligations and/or the value of its currency. If the BOJ ends up holding the majority of Japan's government bonds, the nation is effectively printing money out of "thin air" to cover its financial obligations, with no participation from private investors. At that point, the value of the currency could be called into question and could spark a major financial crisis. While none of these risks are new for Japan, the recently announced quantitative easing may only accelerate the financial disaster that Japan is facing.

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Chart 1

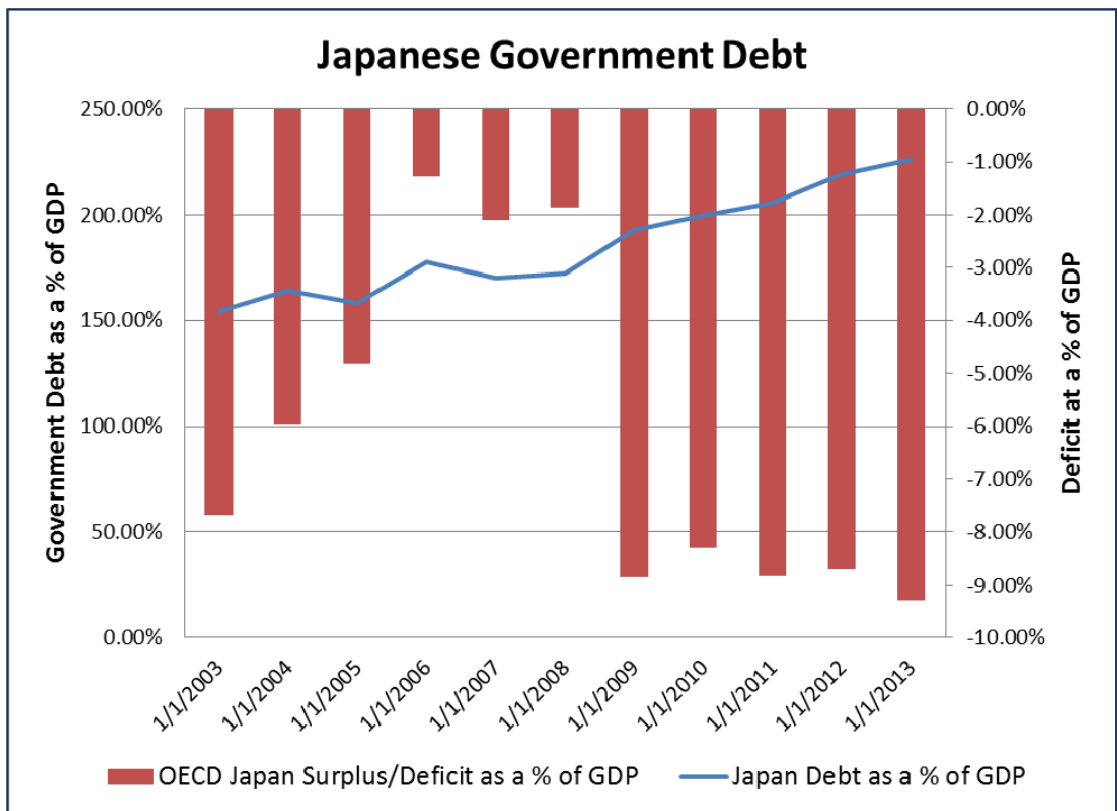
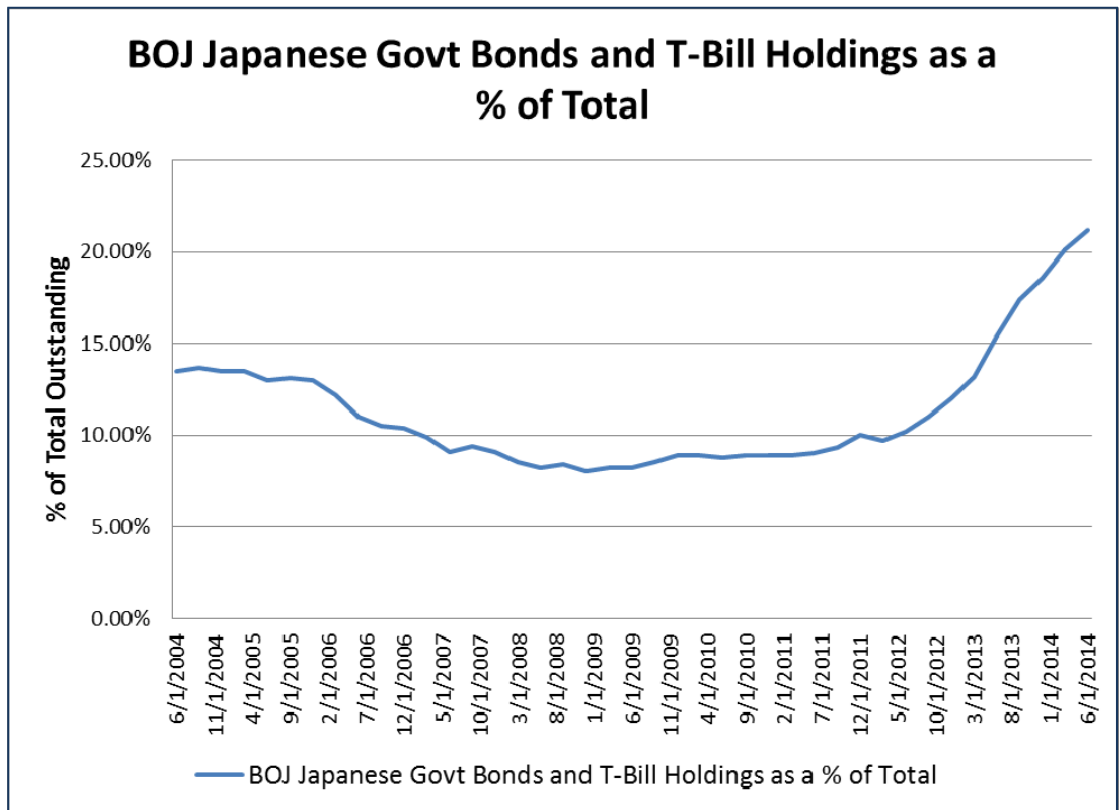


Chart 2



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