

# An Escape from 33 Years of Deflation: A Grand Upswing in Japanese Financial Securities Market (with special reference to Japanese Government Bonds)

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## Abstract

*This study examines Japan's financial market, which is showing signs of recovery after a long period of deflation. This revival, which could signal an end to Japan's three-decade economic slump, is driven by several factors. These include the Bank of Japan's (BOJ) unique monetary policies, a depreciating yen, and a recovering global economy. The Nikkei 225, a stock market index, has reached its highest point in many years, while Japanese government bonds (JGBs) continue to yield low returns. These trends have sparked hope among investors and policymakers, suggesting that Japan's economy may be reaching a turning point. The BOJ's commitment to its unique monetary policy, known as "Abenomics," has been key in revitalizing the Japanese economy. The central bank's large-scale asset purchases and negative interest rates have increased the amount of money in the financial system. This has reduced borrowing costs and encouraged investment, which in turn has weakened the yen, increased exports, and boosted corporate profits. As the global economy recovers, Japan, with its export-driven industries, has benefited from strong international demand. The country's exports have become more competitive due to the yen's depreciation, which has increased the trade surplus. The paper concludes by discussing the future of the Japanese financial market and the role of JGBs. It also addresses the ongoing challenge of balancing economic growth with fiscal sustainability and emphasizes the need for Japan to continue building a strong and resilient financial ecosystem.*

## INTRODUCTION

Japan, a major global economy, has been dealing with deflation for over 30 years. This long-lasting deflation has slowed down growth and challenged traditional economic policies. But recently, things have started to look up. Japan's financial market is showing signs of recovery, moving away from stagnation.

This paper will take a deep dive into this significant change. It will look at the complex factors at play and the crucial role of JGBs in this turnaround. While deflation is a worldwide issue, Japan's situation is unique because of its long period of stagnation. This makes it an interesting case study with lessons for

### KEYWORDS:

*Resurgence, Japanese government bonds (JGBs), Unorthodox monetary policies, Fiscal sustainability, Yen depreciation, Investor confidence.*

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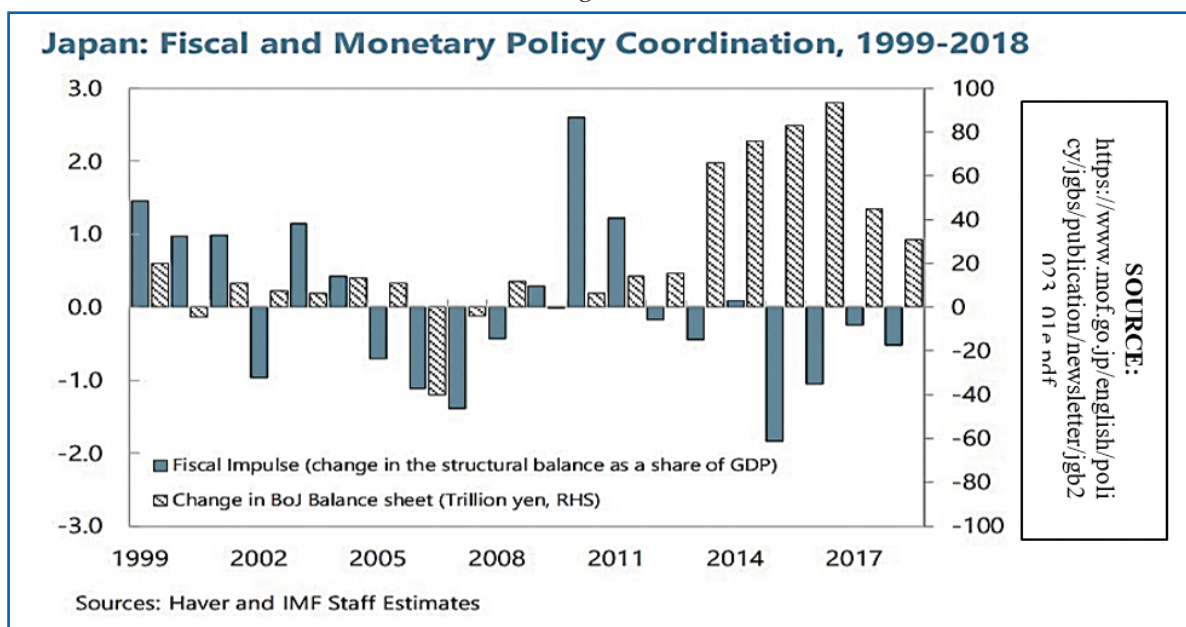
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other countries. The revival of Japan's financial market is evident in the Nikkei 225 stock index, which has reached its highest point in many years. JGBs, which often don't get much global attention, have been key to this revival. Their consistently low yields have helped rejuvenate Japan's financial scene. A variety of interconnected factors have contributed to this revival. This includes the unconventional monetary policies of the BOJ, including a massive asset purchase program and negative interest rates. These strategies have pumped a lot of money into the financial system, lowered borrowing costs, encouraged investment, and weakened the yen. This has made exports more competitive and increased corporate profits. At the same time, a global economic recovery has boosted Japan's export industries. A weaker yen has made Japanese exports more competitive, increasing the trade surplus and strengthening the economy.

However, this revival of the Japanese financial market also brings challenges. One of the challenges is finding a balance between economic growth and fiscal sustainability. This paper will explore these challenges as it examines Japan's escape from deflation. It will also look at the importance of building a strong and resilient financial system. The insights gained from this exploration will not only shed light on Japan's economic path but also provide a valuable case study for economists, policymakers and investors around the world. It shows how countries can adapt and overcome major economic challenges and highlights the crucial role of financial instruments like JGBs in shaping a country's financial future.

### *Significant role of Monetary and Fiscal policies of Japan's deflation: Monetary Policy:*

Figure-I



The BOJ pursued a policy of low interest rates and quantitative easing (QE) to stimulate economic growth. However, the effectiveness of these measures was limited by a "liquidity trap," where nominal interest rates were close to zero, and conventional monetary tools became less impactful. The prolonged period of near-zero interest rates reduced the incentive for households and businesses to borrow and spend, leading to weak demand and deflationary pressures.

**Fiscal Policy:** The Japanese government implemented various fiscal stimulus packages to boost economic activity, including public infrastructure projects and tax cuts. However, these efforts often led to mounting public debt without substantial improvements in economic growth. The large debt burden, coupled with demographic challenges (an aging population and shrinking workforce), limited the government's ability to sustain fiscal expansion. As a result, the impact of fiscal measures on demand and inflation remained subdued.

The Joint Statement in 2013 by the government of Japan and the BOJ was an important attempt to address this coordination failure. However, the effort has not panned out as hoped (IMF,2001).

## JAPANESE GOVERNMENT BOND (JGB)

### Key Participants of JGBs

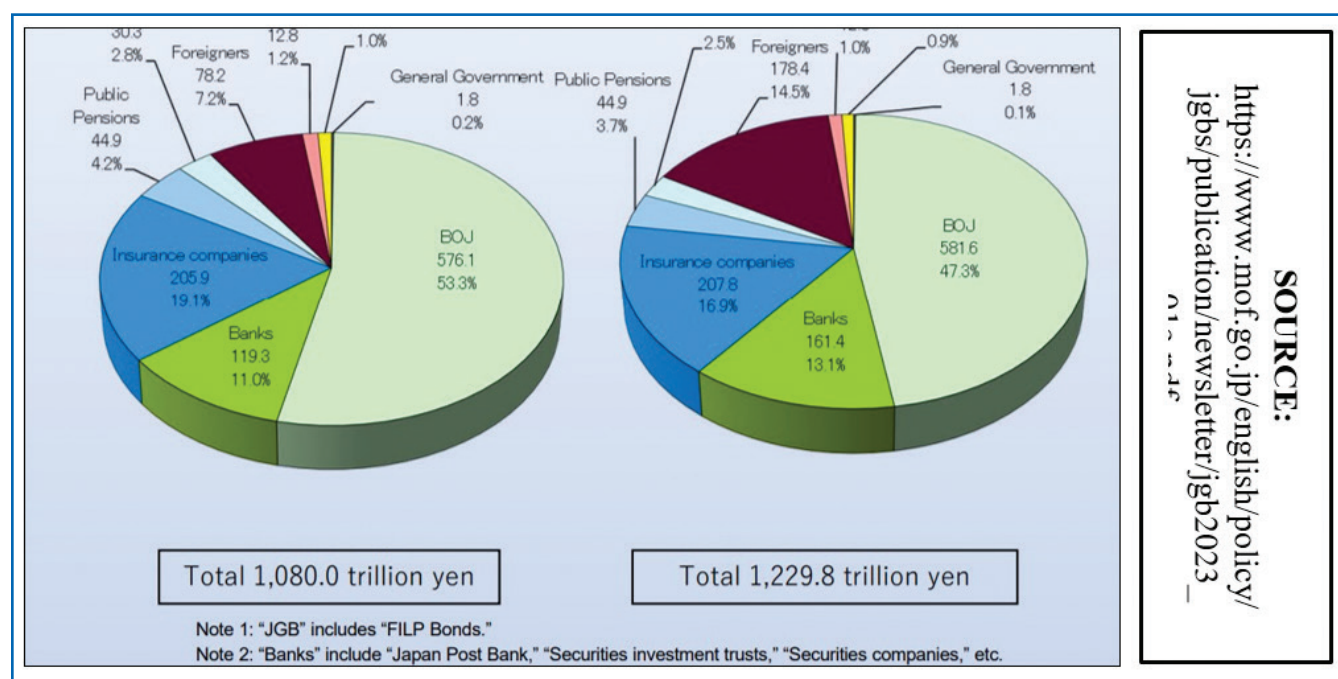
The Japanese government is the issuer of JGB, Domestic Investors, Foreign Investors, Commercial Banks and Central Bank (BOJ), intermediaries like Brokerage firms,

credit rating agencies, regulatory bodies, such as Japan's Financial Services Agency (FSA).

### Distribution of Japanese Government Bond (JGB) holders

According to the distribution of JGB holders as end of March 2023 was the BOJ held 53.3 percent, Domestic banks held 11 percent, Foreigners held 7.2 percent and the other holders included insurance companies held 19.1 percent, pensions held 2.8 percent, households held 1.2 percent, etc. (Newsletter, Ministry of Finance)

Figure-II

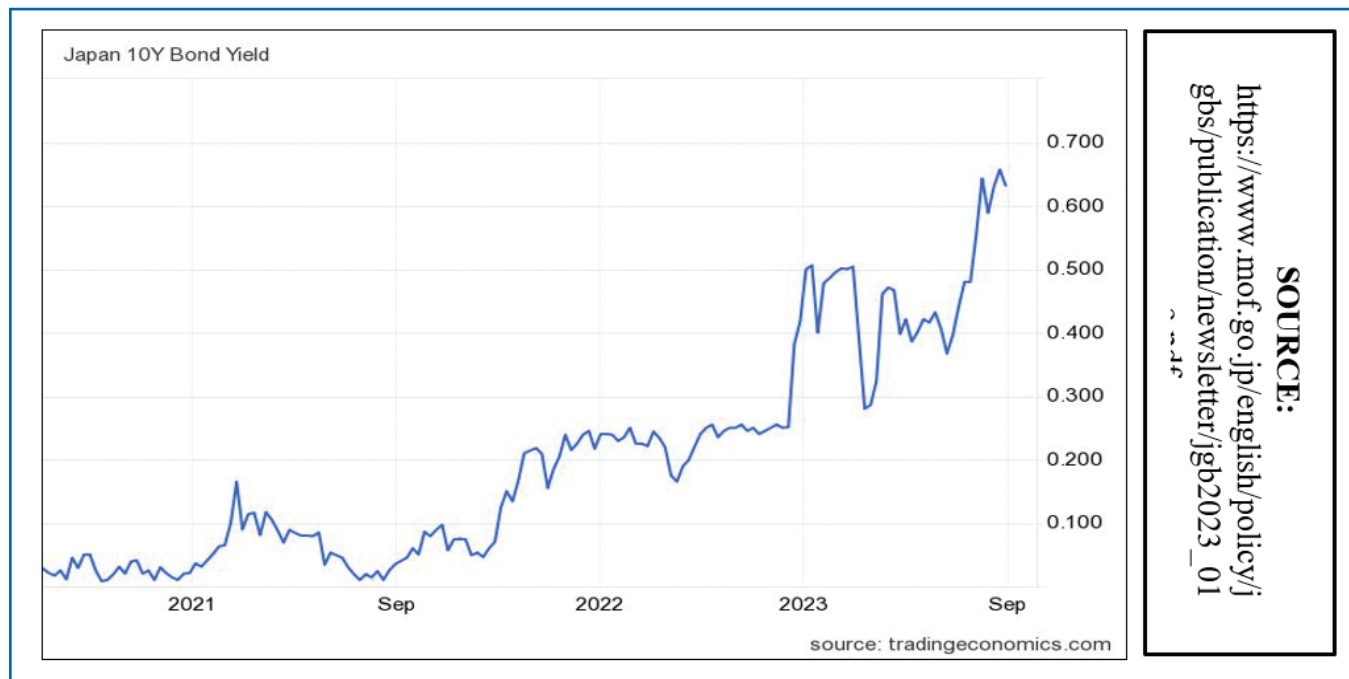


### Recent Surge of JGB

The yield on 10-year JGB rose to 0.65% on Thursday, August 03, 2023, 08:05 AM IST, the highest since April 2014, after the BOJ loosened its grip on yield curve control last week (Reuters & Reuters, 2023). The BOJ now owns

half of outstanding JGBs issued in the market, data showed Monday, a sign the bank's aggressive buying to defend its 0.25% yield cap is bloating an already huge balance sheet. (Redaktion, 2023)

Figure-III



In its statement, the bank said it would maintain its current inflation target until it could be maintained in a “stable manner,” adding that it would “not hesitate to take additional easing measures, if necessary” (Dooley, 2022).

## OBJECTIVES

1. To understand the factors that contributed to the Japanese government bond market resurgence.
2. To evaluate how preferences of investors have shifted in response to the changed JGB market conditions.
3. To study the limitations and potential adverse consequences of the monetary policy of Bank of Japan (BOJ), and its effects on the Indian as well as Japanese bond market.

## RESEARCH METHODOLOGY

In the pursuit of comprehending the profound transformation witnessed in Japan’s financial securities market—an evolution marked by the triumphant escape from three decades of deflation and the emergence of a grand upswing—a well-structured research methodology is imperative. This research employs a methodology primarily centered on secondary data analysis. Secondary

data analysis, a robust and systematic approach, relies on the scrutiny and synthesis of pre-existing data, literature, and scholarly works, fostering a nuanced understanding of the research topic. The foundation of this research draws upon a diverse array of secondary data sources, each constituting a critical building block for the narrative of Japan’s economic resurgence. Economic reports and publications, emanating from a spectrum of sources, serve as fundamental pillars. These encompass documents from Japanese government entities, the esteemed BOJ, and international financial organizations. These reports are indispensable in casting light on Japan’s economic policies, monetary strategies, and the unfolding dynamics of its financial markets. They provide the essential backdrop, lending context to Japan’s journey of economic transformation. Simultaneously, the study delves into the intricate landscape of historical financial market data. This treasure trove of information encompasses a multitude of financial indices, including the performance of stock markets, the comportment of bond yields, the oscillations of exchange rates, and the intensity of trading volumes. These datasets, both extensive and invaluable, empower the systematic tracking of trends and patterns within Japan’s financial securities market. They are instrumental in chronicling the impact of various economic policies and monetary measures, further enriching the research’s evidentiary foundation.



The academic realm, specifically in the form of academic journals and research papers, is another invaluable trove of insights. These scholarly sources provide a wealth of empirical studies, theoretical frameworks, and in-depth analyses, all of which enrich the research by providing a deeper understanding of the multifaceted factors that have facilitated Japan's economic resurgence. This body of scholarly work is underpinned by rigorous research methodologies and the latest economic theories, making it a vital reference for the research's conceptual framework. To further contextualize the research and offer a more comprehensive perspective, books and monographs authored by eminent experts in the fields of economics and finance are consulted. These authoritative volumes deliver expansive overviews and historical context, thus enhancing the research's depth and breadth of comprehension. The global perspective is also considered through reports and publications from international financial institutions such as the International Monetary Fund (IMF) and the World Bank. These reports offer a panoramic view, enabling the evaluation of Japan's role in the larger international economic tableau and the potential global implications of its resurgence. The secondary data analysis methodology adheres to a meticulous and systematic approach. It commences with data collection from the diverse array of sources. Subsequently, the amassed data is organized with precision, categorized thematically, and chronologically structured to ensure a coherent narrative. A comprehensive literature review follows, entailing the identification and analysis of academic papers, expert opinions, and scholarly publications. This literature forms the foundational underpinning for the research's theoretical and conceptual framework. The process culminates in data synthesis, a nuanced exercise involving the identification of prevailing trends and patterns. This synthesis facilitates the discernment of causal relationships and allows for the formulation of hypotheses and conclusions, enriching the understanding of the research topic. While the secondary data analysis methodology offers a potent means of research, it is not without its limitations. The reliability and quality of the data hinge on the credibility of the sources. The potential for bias within the data or the sources themselves poses a challenge to objectivity. Moreover, the scope of the study is inherently confined to existing sources, potentially omitting specific details or the most recent developments.

To address these limitations, the research methodology incorporates a rigorous approach to data quality, diversity of sources, and the mitigation of potential bias.

In summation, the secondary data analysis methodology stands as the cornerstone of this research, offering a systematic and profound exploration of Japan's financial resurgence. It encapsulates the essence of an endeavor committed to unraveling the complexities of a significant economic and financial narrative. The narrative of Japan's escape from deflation and the remarkable ascent of its financial securities market, with special reference to the role of Japanese Government Bonds, is an essential component of the contemporary economic landscape, and this methodology serves as a robust vehicle for comprehending its intricacies.

## LITERATURE REVIEW

Japan's financial landscape has been marked by a prolonged period of deflation, a unique economic phenomenon that has puzzled both policymakers and investors for over three decades. This period, often referred to as the "Lost Decades," began in the early 1990s following the burst of an asset price bubble. The deflationary spiral was characterized by falling prices, weak consumer demand, and sluggish economic growth. Despite numerous attempts at economic revitalization, Japan remained trapped in this deflationary cycle. Previous research has extensively analyzed this period, examining the economic policies implemented and their outcomes. These studies provide valuable insights into the complexities of deflation and the challenges faced by policymakers in combating it.

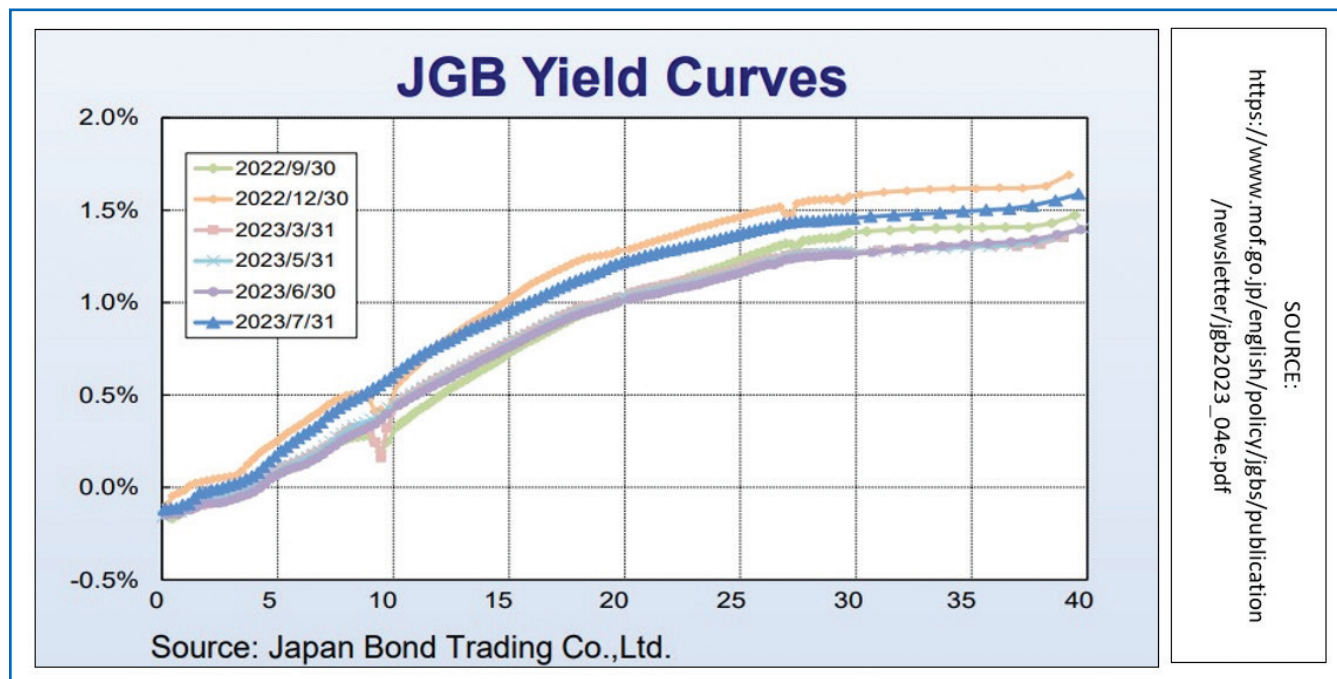
The catalyst for change arrived with the advent of "Abenomics," an economic revival strategy championed by Prime Minister Shinzo Abe in late 2012. This strategy consisted of "Three Arrows" - aggressive monetary easing, flexible fiscal policy, and structural reforms aimed at promoting economic growth. The first arrow, monetary easing, was implemented by the BOJ under the leadership of Governor Haruhiko Kuroda. The BOJ introduced unorthodox monetary policies, including quantitative and qualitative monetary easing (QQE). This policy marked a decisive departure from traditional monetary strategies and had a multifaceted impact on the economy. It included the massive purchase of government bonds, which drove

up their prices and suppressed yields. This not only helped to reduce borrowing costs but also influenced the broader financial market by injecting substantial liquidity.

JGBs have played a crucial role in Japan's financial system. The JGB market is one of the largest and most liquid bond markets in the world, attracting both domestic and foreign investors. The historically low yields on JGBs have been instrumental in influencing borrowing costs across

various sectors of the economy, fostering a climate of affordability. JGBs also play a significant role in shaping Japan's fiscal policy. They serve as a benchmark for interest rates, influencing not only government spending but also private sector investment decisions. Furthermore, the BOJ's massive purchases of JGBs have provided a channel for monetary policy transmission, fostering liquidity and influencing broader financial markets.

Figure-IV



The changed conditions in the JGB market have led to a shift in investor preferences. As the yields on JGBs remained low, investors started looking for higher returns elsewhere. This led to an increase in investment in riskier assets, such as stocks and real estate. The shift in investor preferences has been studied extensively, with research examining the factors influencing investment decisions in the context of the JGB market.

The shifting preferences of Japanese investors in response to changing JGB market conditions have been influenced by a variety of factors as follows -

- Japanese investors include institutional players like pension funds and insurers, are now seeking alternative investments that offer higher yields to meet their income requirements. This search for yield has led them to explore foreign markets, including emerging

markets like India, where higher yields can be found. Japanese investors are increasingly recognizing the importance of diversifying their portfolios to manage risk and enhance returns. The concentration of holdings in JGBs exposes them to interest rate risks and limited capital appreciation potential. As a response, investors are looking beyond their domestic market to include a broader range of assets, such as equities, foreign bonds, and alternative investments.

- Regulatory bodies' changes both domestically and internationally, can impact investor preferences. Japanese authorities' policies and regulations related to overseas investments can influence the ease with which investors allocate capital to foreign markets like India. Tax considerations, such as withholding taxes on foreign investment income, can also influence decisions. As well as financial institutions including

banks and security firms, are affected by changing investor preferences. These institutions may need to adapt their product offerings and strategies to align with the evolving demands of their clients.

- Japan's aging population and declining birth rates have implications for its investor landscape. Pension funds and insurers, which cater to these demographics, face challenges in generating sufficient returns to meet their liabilities. This encourages a broader search for higher-yielding assets beyond the JGB market.
- The literature review concludes by summarizing the key points discussed. It highlights the interplay of historical, policy, and global factors that have contributed to Japan's escape from deflation. It emphasizes the need for further research in this area, particularly in understanding the long-term effects of the BOJ's monetary policies and the evolving role of JGBs in Japan's financial system. The review also underscores the interdependence of domestic policies and the global economic environment, illustrating that Japan's escape from deflation is not an isolated phenomenon but a part of the broader economic landscape.

## **THE IMPACT ON INDIAN FINANCIAL MARKET**

Present Study carries implications that reverberate far beyond the shores of Japan. This resurgence holds the potential to exert a discernible impact on the Indian financial market, even though the two nations might seem, at first glance, to be disparate players in the global economic theater.

Firstly, the Japanese upswing, with a revitalized global economy as a backdrop, provides an expanded avenue for Indian investors to diversify their portfolios. As Japan's financial securities market regains its vibrancy, it may become an attractive destination for Indian investors seeking to allocate their resources into international assets. A dynamic and stable Japanese market can offer a haven for Indian investors in times of global economic volatility. Moreover, the resurgence of the Japanese financial market, underpinned by the BOJ unorthodox monetary policies, can impart important lessons for Indian monetary authorities and policymakers. The BOJ's commitment

to combat deflation, accompanied by its massive asset purchases and negative interest rates, offers insights into the toolkit that India's central bank, the Reserve Bank of India (RBI), can potentially employ to address its own economic challenges. The study, by shedding light on the effectiveness of these policies, can inform the RBI's future strategies. The study's emphasis on the role of JGBs is particularly pertinent for Indian policymakers. As India navigates its own fiscal and monetary policies, it can draw valuable lessons from how JGBs have been leveraged as financial instruments to stimulate Japan's economy. This includes the influence of JGBs on borrowing costs, which can guide Indian policymakers in their management of domestic government securities. Furthermore, the study's exploration of the global economic context and its impact on Japan's resurgence underscores the interconnected nature of international markets. As the Indian financial market remains integrated into the broader global economy, Japan's revival has implications for the prospects of Indian exports and the overall health of the Indian economy. The synchronized global economic recovery, as witnessed in the study, can augur well for Indian trade and industry. Resurgence of the Japanese financial securities market, detailed in the research paper, casts a substantial shadow that touches the Indian financial landscape. From offering diversification opportunities for Indian investors to serving as a source of policy insights and lessons, the study underscores the interwoven nature of global financial markets and how events in one nation can cascade across borders, influencing financial dynamics in seemingly distant regions like India. As such, the study serves as a valuable resource for Indian financial analysts, policymakers, and investors navigating the intricate world of international finance.

## **LIMITATIONS**

The comprehensive analysis of Japan's departure from a protracted era of deflation and its subsequent financial resurgence, with a specific focus on the JGB market, is a subject of considerable significance. However, it is imperative to acknowledge the inherent limitations that temper the scope and depth of this study. This research relies on historical data and information sources, which may possess limitations in terms of accuracy and comprehensiveness. Data availability, especially for

specific timeframes and precise financial transactions, can be constrained. The absence of real-time data may further restrict the paper from capturing the most recent developments and their immediate impacts. The complexity of financial markets, especially one as multifaceted as Japan's, presents inherent challenges. The multitude of interrelated factors influencing market behaviour may not be exhaustively explored in this study, potentially overlooking subtle nuances. Additionally, the intricate dynamics within financial markets can make it challenging to establish definitive causality, and the study may only unveil correlations. The generalizability of the findings may be limited. While the research strives to shed light on Japan's unique economic trajectory, extrapolating these findings to other nations or regions might oversimplify the complexities of different contexts. Japan's unique historical, cultural, and economic attributes might render its experiences less applicable to other economies.

Dynamic nature of financial markets is subject to change, potentially rendering certain conclusions in this study outdated. Financial markets are susceptible to frequent fluctuations and unforeseen events, which may significantly alter the trajectory of Japan's financial securities market. Unforeseen events and exogenous factors can exert profound influences on financial markets. This study does not account for unforeseen events, such as geopolitical conflicts, natural disasters, or global economic crises, which can disrupt market dynamics. Lastly, changes in government policies and regulatory frameworks can substantially affect financial markets. This study assumes a relatively stable policy and regulatory environment, potentially overlooking the impact of future shifts in government policies or regulatory approaches on Japan's financial securities market. While this research paper contributes valuable insights into Japan's escape from deflation and the revitalization of its financial securities market with a special reference to Japanese Government Bonds, it is imperative to recognize the inherent limitations that are intrinsic to such studies. These limitations underscore the complexity and ever-evolving nature of financial markets and the necessity for future research to build upon and refine our understanding of these intricate dynamics.

## CONCLUSION

The revival of the JGB market, driven by the BOJ's policy adjustments, has had far-reaching effects on investor preferences and foreign markets like India. Expectations about future inflation can impact bond yields. Higher inflation expectations tend to lead to higher yields, as investors demand compensation for eroding purchasing power. Significant shifts in global bond markets, including JGBs, may influence RBI's monetary policy stance and its decisions regarding policy rates and liquidity measures otherwise large-scale withdrawal of Japanese investment from Indian bonds can experience spillover effects on other segments of the Indian financial markets, including equities and currency markets.

Citi Bank have quoted that BOJ will eliminate YCC before the end of 2023 *"We expect that the Bank of Japan will purposefully exit its ultra-loose monetary policy, which could take place in the second half of this year. If this happens, the yen has room to strengthen further,"* says Citi Bank. However, the case study also underscores the limitations and potential side effects of the BOJ's monetary policy on the bond market. It is essential for policymakers and banks to carefully navigate these challenges while seeking to achieve stability and growth in bond market or else investors sentiment can quickly shift in response to unexpected events, such as bank collapses of Silicon Valley Bank (Reuters & Reuters, 2023). If investors become less optimistic about economic stability, they may revise their expectations for central bank actions, including the BOJ's policy on JGB yields. It can also affect geopolitical events, including trade tensions, political instability, and global conflicts, can create uncertainty in financial markets and influence investor behavior of Japan and India. This interplay between policy, investor behaviour, and market dynamics highlights the complexity of modern global financial systems.

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