A Time of Change for Japan's Local Government Debt Market

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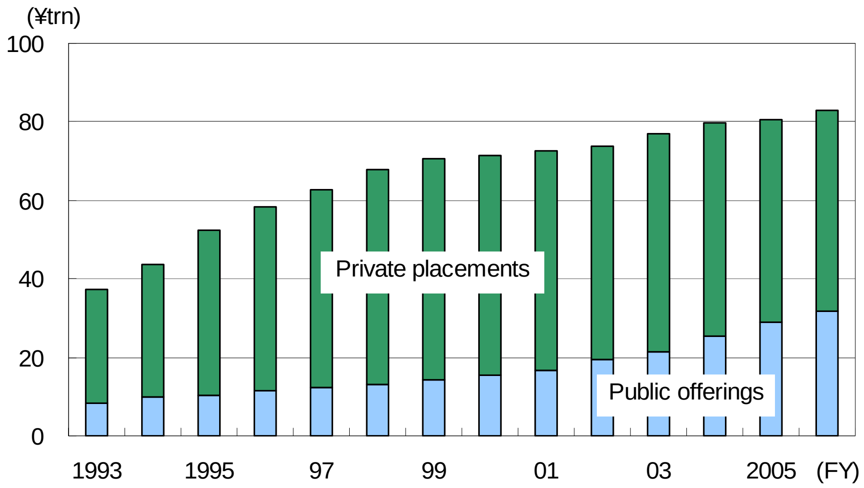
I. Japan's growing local government debt market

This is a time of change for Japan's growing local government debt market. If we define Japan's "local government debt market" as the market where local authorities in Japan raise private capital directly, we can say that this market has roughly doubled in size since the early 1990s to ¥83.0 trillion (as of the end of fiscal 2006) (Figure 1).

Figure 1: Issuance of local government debt in Japan



Note: The above data are for privately funded local government debts only.
Source: Nomura Institute of Capital Markets Research, based on Japan Local Government Bond Association statistics

It can be divided into two segments: one where local authorities borrow from local financial institutions, either by signing a loan agreement or by issuing bonds (private placements), and one where they issue bonds in the open market in order to raise capital from a broader range of investors, especially institutions (public offerings). Until not so long ago, more than 80% of the local government debt market consisted of private placements. However, most of the growth since 2000 has come from public offerings. While the outstanding amount of private placements on issue declined by ¥5.0 trillion from ¥56.1 trillion as of the end of fiscal 2000 to ¥51.1 trillion as of the end of fiscal 2006, that of public offerings more than doubled, from ¥15.3 trillion to ¥31.9 trillion during the same period.

II. The changing conditions facing the Japanese local government debt market

Japan's growing local government debt market faces three main changes: (1) mounting local authority debt, (2) a decline in the amount borrowed via central government as a result of changes in the Fiscal Investment and Loan Program (FILP), and (3) greater devolution.

1) Reasons why Japan's local government debt market is growing

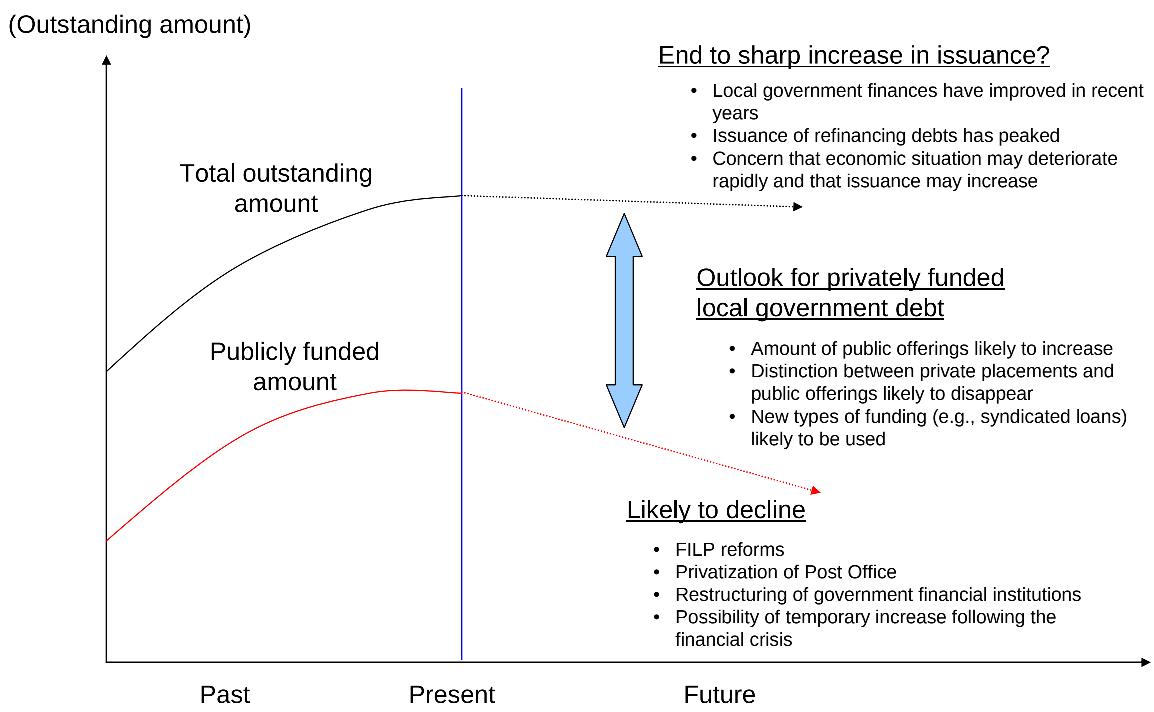
In the 1990s Japan experienced a long period of sub-par economic growth (its "lost decade"). During this period the central government launched a series of major economic stimulus packages that combined tax cuts with increased expenditure. Local authorities were expected to shoulder some of this burden by issuing debt to fund either all or part of the construction of public works such as roads and airports. As a result, local authority debt nearly doubled from ¥111.2 trillion at the end of fiscal 1993, not long after the asset boom of the 1980s turned to bust, to ¥198.7 trillion at the end of fiscal 2006. This is more than double the local authorities' annual revenue of about ¥90 trillion.

However, the source of funding of most of this debt was, until recently, more or less guaranteed by FILP, which was designed to enable the central government to provide financial assistance for projects deemed to be politically important. Under FILP the proceeds of central government bond issues and, under the old system, funds raised by the Post Office's savings and insurance schemes were made available to the central government (special accounts), government agencies and local governments in the form of loans.

However, as a result of reforms in fiscal 2001 FILP was downsized from ¥417 trillion as of the end of fiscal 2000 to ¥245 trillion as of the end of fiscal 2007. Similarly, funds from the Post Office, which had been one of the main sources of FILP funds under the old system, were also cut off as a result of the reforms, and the Post Office itself was privatized in 2005. Furthermore, the Japan Finance Organization for Municipalities (formerly the Japan Finance Corporation for Municipal Enterprises), a government agency specializing in loans to local authorities and local public enterprises, is also due to be downsized as part of the process of restructuring government financial organizations. As a result of all these reforms, Japanese local authorities now find themselves with a bigger overall debt burden but no direct access to cheap long-term loans from FILP—at least not the easy access they used to have. Whereas FILP loans used to account for about 70% of local authority debt at the beginning of the 1990s, this figure had fallen to 58.2% in fiscal 2006.

We expect this trend (i.e., for the local government bond market to grow) to continue—at least for the time being (Figure 2). Until recently Japanese local authority debt had stabilized, partly as a result of fiscal consolidation at local authority level. However, now that the effects of the global financial crisis originally triggered by the US subprime mortgage problem have spread to Japan, this debt may start to mount again as Japanese local authorities find themselves having to spend more once again. At the same time, however, the impact of the various reforms aimed at downsizing the role of the public purse (e.g., the FILP reforms, the privatization of the Post Office and the restructuring of government financial institutions) can be expected to become increasingly apparent in the local government debt market. On an issuance (i.e., flow) basis, public funds now account for only 26.3% of the market, while private-sector funds account for 73.7%, with publicly offered bonds accounting for 35.5%.

Figure 2: Likely development of Japanese local government debt market



Source: Nomura Institute of Capital Markets Research

2) Growth of local authority powers and responsibilities

Japanese local authorities therefore have an increasingly important role to play in securing the funds they need.

In the past, local authorities had to obtain central government permission in order to issue debt. In the case of publicly offered bonds in particular, the Ministry of Internal Affairs and Communications, whose job was to supervise local authorities, would negotiate the terms of issue with financial institutions on behalf of all the local authorities and fix the same yield for all new local government bond issues.

Following the reforms of fiscal 2006, however, Japanese local authorities now have similar debt-raising powers as their counterparts in Europe and the US. In other words, those local authorities that are deemed to be financially sound now, as a rule, have the discretion to issue debt as they see fit without having to obtain prior permission from central government. Furthermore, local authorities now have to negotiate with financial institutions on a case-by-case basis the terms on which they issue publicly offered bonds.

At the same time, local authorities also have to deal with the impact of reforms on their revenue. While more sources of tax revenue are transferred from central government, the subsidies from central government that used to account for some 30% of local authority revenue have been cut. Local authorities therefore increasingly need to be able to raise the funds they need to balance their books, including service their debt, from the fiscal resources available to them.

III. Recent developments and future prospects following the growth of the local government debt market

As a result of the above growth of the Japanese local government debt market and the concomitant increase in local authorities' powers and responsibilities, local authorities will have to make even greater efforts to raise capital on a regular basis from the private sector while keeping their costs as low as possible. It has also been reported that investors have been paying increasing attention to the fiscal position of individual local authorities following the reforms of fiscal 2006 and, in particular, the de facto bankruptcy of the city of Yubari in Hokkaido, which had to be bailed out by the central government after running up massive debts. The local government debt market therefore faces two major challenges: (1) the need to offer a greater range of issue terms and (2) the need for information infrastructure.

1) Need for greater range of issue terms

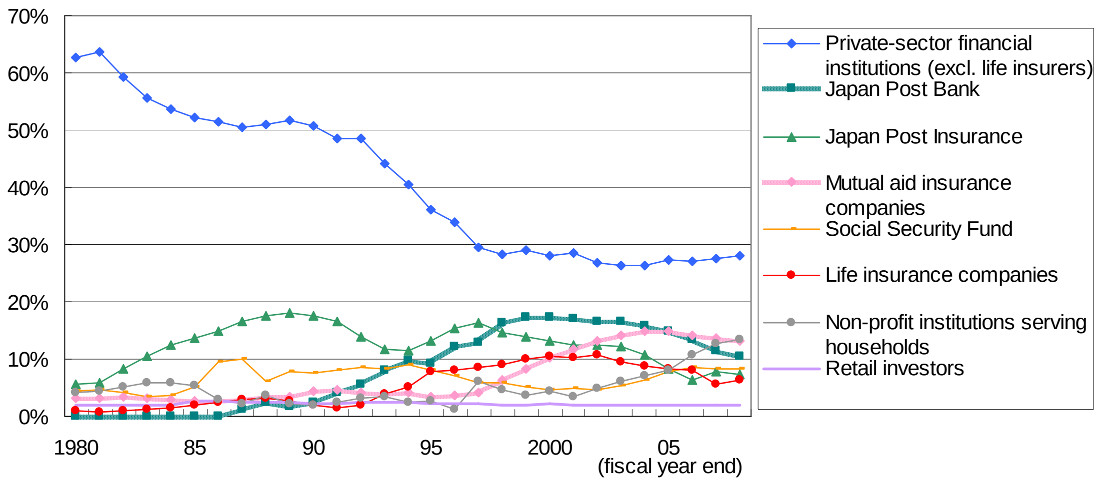
As far as the first of these challenges (namely, the need to offer a greater range of issue terms) is concerned, there have already been some developments. In the case of publicly offered bonds, for example, these include (1) the issue of five-, 20- and 30-year bonds alongside the usual 10-year bonds, (2) regulatory provision for joint bond issues by several local authorities, and (3) the targeting of local government bonds at the retail market. In addition, some local authorities have apparently originated structured products incorporating the use of derivatives.

Hopefully, local authorities will continue to offer more diversified terms of issue. Also, guidelines are probably needed to ensure that local authorities do not incur excessive risks when they issue bonds because of their increasingly complex issue terms. One good way of doing this might be to enlist the help of outside financial specialists.

2) Need for information infrastructure

The second challenge is the need for infrastructure. We think this is likely to become increasingly important if local authorities hope to raise capital from retail investors, who have some ¥1,500 trillion of financial assets, and overseas investors, both of which have invested very little in Japanese local government debt thus far (Figure 3).

Figure 3: Ownership of Japanese local government bonds



Notes: 1. The data for the private sector exclude amounts raised by loan agreements.
2. Data for the end of fiscal 2008 are for end-September 2008.

Source: Nomura Institute of Capital Markets Research, based on the Bank of Japan's Flow of Funds Accounts

The first type of market infrastructure that is increasingly needed is information infrastructure. Japan's system of public control of fiscal information on local authorities has been undergoing reform since about 2000, and all local authorities are due to start producing consolidated accounts (including balance sheets) in fiscal 2011. Also, some local authorities have started to develop investor relations as part of an effort to make accounting information more accessible to investors and more focused on their areas of interest. In 2008, the Ministry of Internal Affairs and Communications held a briefing for overseas investors in cooperation with Shizuoka Prefecture and the cities of Kyoto and Kawasaki. Furthermore, a growing number of local authorities have been using credit rating agencies to analyze such information on investors' behalf in order to obtain a rating on the bonds they issue.

3) Possibility of local government bond funds

Although we expect local authorities to continue to try to do more to improve their information infrastructure, we also think that the launch and spread of new financial products will play an important role in attracting investment. One possible product would be a local government bond fund. In the United States, for example, which has the world's biggest local government bond market, local government bond funds have a 35.6% share of the local government bond market, while local government bond funds account for 21.5% of the value of US bond funds and are therefore a force to be reckoned with. It is well known that mutual funds offer investors three main benefits (namely, the ability to invest small amounts, a diversified portfolio, and expertise). In the US local government bond market, investors, who are mainly individuals, can choose anything from AAA/Aaa-rated bonds to high-yielding bonds, and local government bond funds, which offer investors these benefits, are a force to be reckoned with.

By extension, the fact that the terms of issue of Japanese local government bonds are becoming more varied and the fact that yield differentials are widening suggest that bond funds may play an important role in this market. Hopefully, the emergence of such products will make it easier to invest in this market and give local authorities access to a wider range of sources of capital, thereby reducing their cost of capital. Similarly, the financial institutions that originate these funds may benefit from new business opportunities if interest rates return to a more normal level.