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Japanese Savers Yield to Low Returns on 10-Year Bonds

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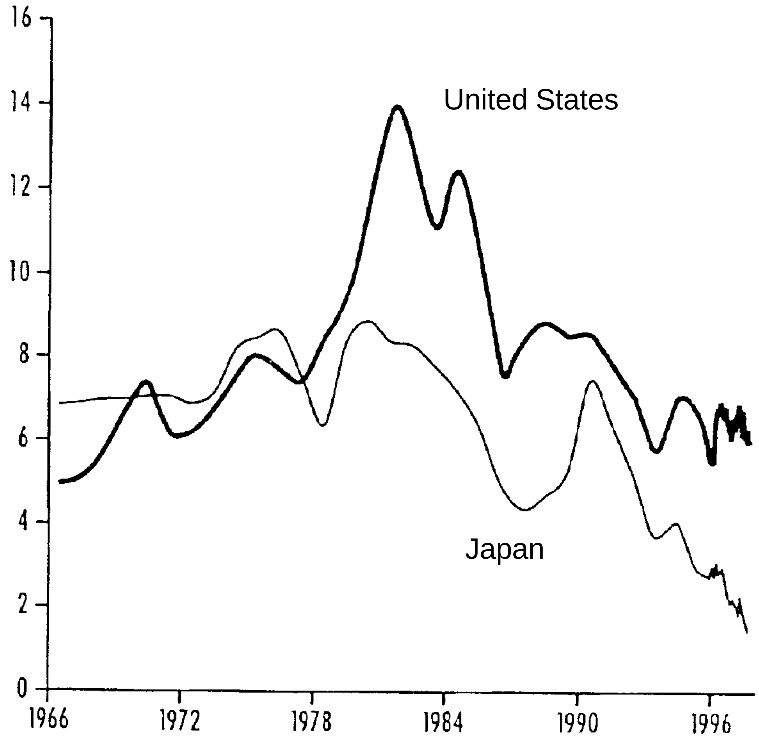
Editor's Note: *The following article originally appeared in the November 1997 issue of* International Economic Trends, *and is reprinted courtesy of the Federal Reserve Bank of St. Louis.*

In October 1997, nominal yields on 10-year Japanese government bonds declined to a modern international record low of 1.605% per year. The yield on a bond on a given day is the average annual return on the bond if it is held from that day to its maturity. The *Financial Times* reports that these yields were the lowest yields on any long-term security since 17th-century Genoa [1]. The figure shows that the Japanese long-bond yield is now well below both its historical levels and the yield on a comparable U.S. government bond.

Why are yields so low? Long-term bond yields primarily reflect expectations of two factors: inflation and real economic activity. Lower expected inflation tends to reduce interest rates because borrowers need to compensate savers less for declines in purchasing power. After rising faster than 3% in 1990 and 1991, the Japanese CPI inflation rate fell to virtually zero in 1996. Lower expected output growth tends to lower interest rates by reducing investors' demand for credit. Real output was also relatively strong in 1990 and 1991 but has grown at only a 0.96% annual rate since January 1992. The current very low yields on 10-year Japanese bonds probably reflect expectations that these recent inflation and output trends will continue. In addition, the depressed state of the Japanese stock market and the heavy regulation of Japanese financial markets have contributed to low yields on long-term bonds by reducing the alternatives to savers who wish to seek a better return on long-term investments.

10-Year Bond Yields



Japanese and U.S. government 10-year bond yields from 1996 to October 1997. Data are annual until 1996 and weekly thereafter.

Still one might ask: Why have Japanese bond yields declined further to record lows only in the last few months? Several special factors explain this timing. First, the unanticipated magnitude of the contraction in output in the second quarter of 1997 (–11% at an annual rate) may have reduced projections of future growth. Second, the decline in the government deficit has led to decreased issuance of 10-year bonds, driving down yields. Finally, the prolonged stagnation of the Japanese economy may have made Japanese investors more willing to accept very low returns on very safe investments like the 10-year bond.

It seems likely that, as the Japanese economy recovers and the financial sector is deregulated, yields on 10-year bonds will again rise. Returns to investment rise with the level of economic activity, and deregulation will permit Japanese savers other options for their investment decisions.

End Note

1. The *Financial Times*, August 22, 1997, "Japan's Stormy Weather," by Gillian Tett.