Japan's banks transmitting lower interest rates to Asia

Japanese banks, insurance companies, and pension funds are investing in the US and other financial markets, due to the low or even negative interest rates at home. But their demand is pushing up the price of hedging, so when their dollars get converted back into yen, they lose money along the way.

Robert McCauley, senior adviser at the Bank for International Settlements, told the audience at the Asian Development Bank Institute's Annual Conference 2016 that strong demand by Japanese entities was pushing up the price of yen–dollar swaps, an instrument to hedge foreign investment. In short, it's becoming more expensive for Japanese investors to get out of yen and into dollar.

If they were to pass on this costly marginal dollar funding, this would tighten financing conditions in Asian banking markets, particularly given the sizeable role of Japanese banks in those markets. But Japanese banks seem not to have passed on the cost of their dollar–yen swaps to Asian borrowers, based on them gaining market share in practically every banking market in Asia.

As Japanese banks and financial institutions expand abroad, the price of yen–dollar swaps increases. It appears that banks don't pass on these rising costs to their Asian borrowers, however, so they are effectively transmitting low interest rates in Japan to Asian financial markets.

The Bank of Japan eases both by buying bonds and lowering policy rates. This leads to hedged outflows into foreign bonds by, say, the institutional investors of Japan, which in turn puts downward pressure on US bond yields and provokes US outflows into local Asian currency and dollar bond markets.

Low or negative interest rates in Japan not only push Japanese banks to expand into Asia, they also lead to financial outflows from Japan into the US bond market, where they push down bond yields—the compensation required by investors to hold more long-term bonds. McCauley says that this in turn pushes US institutions to expand into foreign markets as well, which pushes down yields on Asian bonds. Japanese banks are thus facing declining returns in Asian markets and rising costs of investing in those markets. But despite this, they continue to expand in Asia.

Before the 2008 global financial crisis, hedging foreign investment was less difficult. There was active arbitrage, so swap prices stayed in equilibrium. This is the essence of the so-called Covered Interest Parity theory. Since the crisis, however, swap prices have systematically diverged. So, as banks expand their market share abroad, their costs also rise.

Current swap market divergence reflects an excess of demand for US dollars. Although some US, French, and British banks holding dollar reserves are responding to this development and take advantage of profit opportunities, their arbitrage is limited and not vigorous enough to reverse the trend.

On the one side, Japanese banks want to escape their domestic market and earn higher returns outside of Japan and need to swap yen to do that. On the other side, the swap market is working against them and raising their marginal cost to dollar funds. So, who's winning?

It is clear Japan's banks are gaining market share, notably in Thailand, the Peoples' Republic of China; Taipei, China; and Viet Nam, by not passing the cost of dollar swaps on to the Asian borrowers. McCauley says this is due to strategic considerations by Japanese banks.

Japanese banks are accepting lower returns on assets or lower returns on equity in their foreign expansion, so that even though obviously the dollar–yen basis is not helping them, they are capturing new business in the rest of Asia.

Japanese banks are in a negative feedback loop. Their investments abroad increase the costs of swaps. But rather than passing these costs on to their customers or lowering their investment abroad, Japanese banks accept lower returns. Their objective is to gain a larger presence overseas. As a consequence, their actions end up easing financial conditions in Asia and continue to put pressure on swap prices.

Robert McCauley, senior adviser at the Bank for International Settlements, was speaking at the Asian Development Bank Institute Annual Conference in December 2016 on the effect of low and negative interest rates on Asian financial markets.

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