Japanese investors are looking overseas for returns, but avoiding developing Asia

Negative interest rates in Japan are leading banks, pension funds, and other investors to look overseas for better returns, but they are mostly ignoring developing Asia, and with rates rising in the US and Europe, that is unlikely to change.

Alicia Garcia-Herrero, a prominent economist who has worked at the International Monetary Fund and is now chief economist for Asia-Pacific at the French investment bank Natixis, told the annual conference of the Asian Development Bank Institute that investors were being driven from Japanese markets by the low rates used by the Bank of Japan to boost economic activity and end decades of deflation.

Pension funds, which need steady returns, have been especially affected by negative rates on Japanese government bonds, or JGBs.

Of course, it's obvious that a lot of money has been leaving Japan since rates have become negative on JGBs in particular. The question is, "Where are they heading and is this making a difference for emerging Asia?" Most investments were in the developed world: the US, followed by the European countries, and EU countries in particular.

It would perhaps have made sense for Japanese investors to look at developing Asia as rates headed down in Japan, the US, and Europe after the global financial crisis.

With interest rates dropping elsewhere, currencies in developing Asia gained against the yen.

That made any investments in those countries even more successful in yen terms. And yet, says Garcia-Herrero, the amount of money Japanese investors allocated to developing Asia remained very small.

I'm afraid that the change in environment is not going to help this happen, has not really resulted in a large part of portfolio flows going into what you would imagine would be a search for yield right there, in your neighborhood, in emerging Asia.

With hindsight, that might not be such a bad thing, says Garcia-Herrero.

Had they invested more in developing Asia, it could have been a problem for those markets, since it would have added to the rush for the exits once the Federal Reserve and other central banks indicated they would start raising rates again.

Thank God it wasn't bigger. If they had put all that money into Asian emerging markets at the time when the Fed was reluctant to hike rates, it would have probably caused more trouble than anything else. The question is what happens now. Hopefully, they manage to rethink their risk strategy and put more eggs into this basket. Unfortunately, I don't think this is going to happen.

Japanese investors appear to be stubbornly conservative when it comes to investing in neighboring countries in Asia, even though there is a high price for investing elsewhere. Investing in the US and Europe or lending money there, in the case of banks, means they pay high rates to swap their yen for dollars or euros.

In reality, no matter how bad the profitability may be—I am talking about the US and Europe, where they are heading—both cross-border lending and investment is actually better than their domestic profitability. So even though they lose money with these aggressive cross-currency swaps which, I imagine, can only get worse as the Fed hikes rates, it is actually nothing given how low profitability is for their domestic business so they're forced, no matter what, to continue with this strategy. It's helping them to keep their low profitability at bay, or at least not to see additional reductions, given very low yields, which were negative until recently for the 10-year JGB for Japan. Of course, they continue. They have to. The problem is that, at the moment, they're really not going to emerging Asia, or at least not to the extent that it would make a big difference.

That was economist Alicia Garcia-Herrero, who has worked at the International Monetary Fund and a number of central banks, talking at the annual conference of the Asian Development Bank Institute. She is chief economist for Asia-Pacific at the French investment bank Natixis.

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