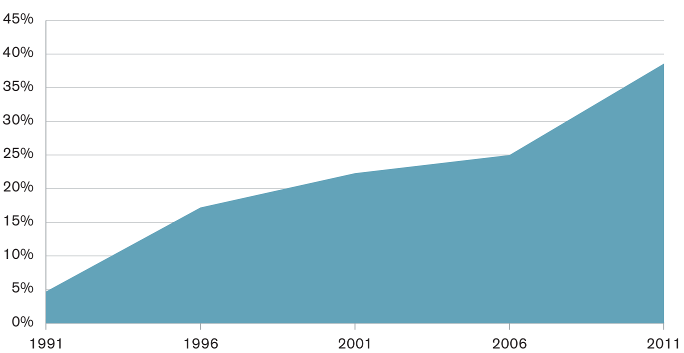
Japan's capital formation enigma and the role of its life insurers

Stephen H. Conwill, FSA, MAAA

What has happened to capital formation in Japan? The life insurance industry, once a critical conduit of private sector savings into productive investment, seems to have become the funder of first resort for Japan's national government debt. Over the past 20 years, 90% of the increase in assets of Japanese life insurers has been allocated to Japanese government bonds. Additional funds have been lent to local governments.

Currently 40% of life insurer assets, excluding those of the Postal Life Insurance Company, are invested in obligations of the national and local governments. When the vast assets of the recently incorporated postal system are reflected, this figure increases to nearly 50%. The following graph illustrates the remarkable trend in total company assets over the past 20 years.

FIGURE 1: GOVERNMENT DEBT AS PERCENT OF TOTAL JAPANESE LIFE INSURER ASSETS



The life insurance industry played a critical role in capital formation during the post-war reconstruction of the Japanese economy. Complementing the role of banks and trust banks, life insurers provided both short- and long-term financing for the development of the business infrastructure that supported Japan's emergence as a dominant force in the global economy in the early 1980s.

By the 1980s, however, the role of the life insurance industry was changing. The development of Japan's capital markets and the flood of cash earned on Japanese exports diminished the need for domestic financing by banks and insurers. At the same time, fuelled by exceptional growth in savings products, life insurer balance sheets continued to expand dramatically. Looking for new avenues of investment, insurers funnelled money into equities, real estate and real estate loans, contributing to the now famous bubble.

DERISKING THE BALANCE SHEET

As Japanese insurers rebalanced their portfolios away from riskier asset classes in the slow post-bubble economy, an increased allocation of funds to government bonds was a natural result. But this rebalancing has continued for more than 20 years and even accelerated following the 2007-2008 financial crisis.

LIMITED PRIVATE SECTOR DEMAND FOR MONEY

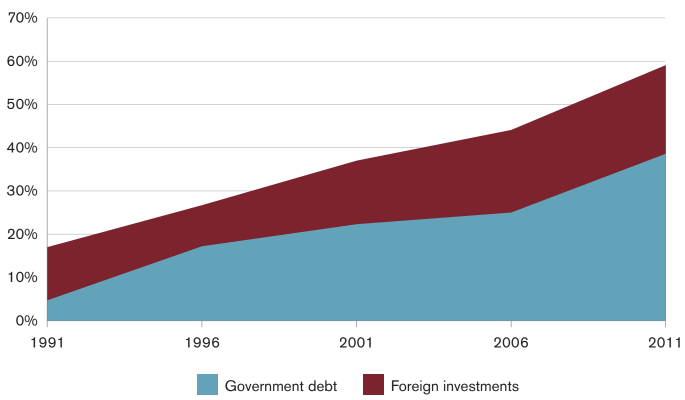
We should no longer view this as simply a matter of asset rebalancing by Japan's life insurers. There are macroeconomic implications. Once a critical source of capital formation, Japan's life insurers have become a conduit of funds from the public into government debt.

This raises fundamental questions about the nature of Japan's economy and the sustainability of its current course. Is Japanese government borrowing crowding out lending to the private sector, or is there simply no demand for money? It would appear to be the latter. Very low interest rates and other indicators–such as the US$2 trillion cash hoard on the books of Japan's non-financial firms–suggest that there is simply very little demand for money.

INCREASING INVESTMENT ABROAD

When thinking about the issue of private sector demand for money and private sector funding, it is instructive to look at the growth in life insurer allocation of funds to foreign investments, as shown in the following graph.

FIGURE 2: GOVERNMENT DEBT AND FOREIGN INVESTMENTS AS PERCENT OF TOTAL LIFE INSURER ASSETS



Over the past 20 years, the allocation of funds by Japan's life insurers to entities beyond the domestic private sector has increased from less than 20% to approximately 60%; this figure is closer to 70% if the funds of Postal Life are reflected.

A significant majority of life insurer funds are now invested abroad or in domestic government debt. An excess of capital in the private sector and a paucity of development ideas help explain why life insurer funds continue to flow abroad or into domestic government debt.

IMPLICATIONS AND A VIEW FORWARD

Should we be concerned?

If foreign investments are generating value that Japan can draw on as its society ages, this should be a positive. If government is channelling funds towards the education and infrastructure investments needed to support an aging society, this could be positive as well.

Although Japanese investments abroad are often in low-yielding assets, foreign funds will in fact be repatriated to support the ever-growing needs of Japan's aging population. The efficacy of Japan's government spending is dubious. Almost certainly we are witnessing ill-defined stimulus as much or more than focused infrastructure investment that will benefit future generations.

A central premise of Abenomics is that monetary and fiscal policy coupled with structural reform can stimulate domestic consumption, promote domestic investment and lead to healthy economic growth. Allocation of ever-greater amounts of insurer funds towards the public sector and abroad would seem counter to this goal.

A NEW NORMAL?

Are we simply witnessing a new normal? Are low interest rates and a low private sector demand for money inevitable features of an aging post-industrial society? In such a society, would one expect an increase in the government sector's role in the economy? Is it possible that the national government's voracious appetite for funds is simply a reflection of this growing role? If so, in absence of higher taxes, borrowing–and growing government debt on insurer balance sheets–may be the byproduct of this increasing role.

New normal or not, the current trajectory is not sustainable. With gross national debt now well above 200% of GDP, borrowing will need to diminish. Insurer ownership of government debt as a percentage of total assets will need to level off or decline. Taxes will need to replace borrowing as the primary source of government funding.

Though Japan's economy may move gradually towards a new equilibrium, the unwinding of government debt and reallocation of insurer assets towards the private sector will be a formidable task. A significant increase in demand for funds by the private sector or a significant decrease in demand for public debt could lead to rising rates and severe challenges for insurer balance sheet management.

From this perspective, one may almost hope that we are in a new normal–a gradually evolving new normal in which current imbalances are resolved over decades and not years.

Stephen H. Conwill, FSA, MAAA, is CEO Japan in Milliman's Tokyo office. He can be reached at stephen.conwill@milliman.com.