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The Determinants of Long-Term Japanese Government Bonds' Low Nominal Yields

Levy Economics Institute, Working Papers No. 818

30 Pages

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Date Written: October 13, 2014

Abstract


During the past two decades of economic stagnation and persistent deflation in Japan, chronic fiscal deficits have led to elevated and rising ratios of government debt to nominal GDP. Nevertheless, long-term Japanese government bonds' (JGBs) nominal yields initially declined and have stayed remarkably low and stable since then. This is contrary to the received wisdom of the existing literature, which holds that higher government deficits and indebtedness shall exert upward pressures on government bonds' nominal yields. This paper seeks to understand the determinants of JGBs' nominal yields. It examines the relationship between JGBs' nominal yields and short-term interest rates and other relevant factors, such as low inflation and persistent deflationary pressures and tepid growth. Low short-term interest rates, induced by monetary policy, have been the main reason for JGBs' low nominal yields. It is also argued that Japan has monetary sovereignty, which gives the government of Japan the ability to meet its debt obligations. It enables the Bank of Japan to exert downward pressure on JGBs' nominal yields by allowing it to keep short-term interest rates low and to use other tools of monetary policy. The argument that current short-term interest rates and monetary policy are the primary drivers of long-term interest rates follows Keynes's (1930) insights.

Keywords: Japanese Government Bonds (JGBs), Long-Term Interest Rates, Monetary Sovereignty, Nominal Bond Yields

JEL Classification: E43, E50, E60

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