What About Japan?
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Discussants: Takeo Hoshi, Cristina Arellano

Gianluca Violante opened the general discussion by noting that the paper's carry-trade view of Japan's debt dynamics was convincing, while raising several questions. First, he asked why Japanese households appear to save so heavily in low-duration deposit accounts when, in principle, nothing prevents them from investing in housing or equities, asking whether the explanation lies in cultural factors, demographic structure, or financial frictions. Second, he raised a measurement question: since households own the business sector, which itself holds assets and liabilities with duration, he asked whether the paper appropriately imputes the corporate sector's duration exposure to the household sector. Third, he asked why, if the government's strategy is as risky as the paper argues, the bond market does not price in a corresponding premium, suggesting that Japan's relative discipline in controlling entitlement expenditures might render the strategy more sustainable in market participants' eyes.

Hanno Lustig addressed the questions in turn. On household portfolio choice, he argued that prior to financial liberalization, the postal savings bank held a near-monopoly in providing safety and liquidity, effectively charging a large markup, and that the conceptual distinction between financial repression and convenience yields is therefore small. Harold Cole added that the magnitude of the benefit depends on the gap between funding rates, and noted that as Japan's older, financially less sophisticated population gradually exits, the mechanism may become less stable. On low asset market participation more broadly, Lustig cited scarring from past asset market losses as one explanation, and referenced Hoshi and Kashyap (1999) as documenting that equity investing was historically expensive in Japan so that outside options were simply less developed than in the U.S.

On the bond market question, Lustig argued that for roughly a decade there was essentially no price discovery in the Japanese government bond market, with the Bank of Japan purchasing all net JGB issuance (excluding T-bills). Yield curve control imposed an explicit cap on 10-year yields, analogous to what the Federal Reserve and Treasury did during World War II. He noted that once the Bank of Japan signaled it would lift the cap, long-term yields rose sharply, with 30-year yields moving well above 3%. He also observed that the Bank of Japan continues purchasing bonds well away from the zero lower bound, which he interpreted as evidence of a fiscal motive: rolling over debt of approximately 220% of GDP at materially higher rates would be very costly. His conclusion was that Japanese government bonds remain overpriced because of financial repression, which has largely suppressed normal market discipline, helping explain why the so-called "widowmaker trade" persistently failed.

Greg Mankiw drew an analogy to Silicon Valley Bank, observing that Japan appears to run its public finances by borrowing short and lending long, a strategy that worked for SVB, until it did not. He asked how sticky Japanese depositors are and whether this constitutes a latent vulnerability. He also asked why public pension funds matter for the analysis, given that their assets and liabilities might be expected to offset one another. Lustig responded that the key feature is that these are defined benefit plans: the government has made effectively risk-free promises to

pensioners while funding them with risky asset positions, creating potential underfunding in the event of adverse returns.

Şebnem Kalemli-Özcan returned to the question of financial repression, asking why capital does not flow out of Japan given that the cost of currency hedging is not prohibitively large. Lustig responded that the paper does not claim hedging costs alone are the binding constraint. In equilibrium, if all domestic financial institutions were to invest abroad and hedge simultaneously, the CIP basis would widen substantially making the strategy far less attractive in aggregate than at the margin. He further argued that CIP deviations are complementary to financial repression: they raise the cost of arbitraging the repression by investing abroad. He referenced Du, Tepper, and Verdelhan (2018) as having documented that CIP deviations are partly a footprint of financial regulation imposed on banks and noted that the Japanese government therefore has little incentive to eliminate such regulation. Cole added that this dynamic may be fragile now that Japan has returned to positive inflation, since other countries with positive inflation tend to see faster reallocation of private assets toward foreign investments.