Return of the Japan Premium:
Structural Fragility of Dollar Funding by Japanese Investors

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This study is an extension of the recent study by Suzuki (2016) that investigated factors contributing to the deviations from covered interest parity (CIP) in euro/dollar cross currency swaps during the European debt crisis. The recent widening of the cross-currency basis swaps, or deviations of foreign exchange swap spreads from the short-term CIP, has been typically associated with financial stress. However, this study explains new sources of the basis in U.S. dollar/yen swaps observed mainly in 2015. It assumes that the basis is mainly determined by imbalances caused by strong hedge demands by Japanese investors that have increased investment in U.S. dollar assets under the backdrop of Bank of Japan's quantitative easing. Such hedge needs are too large to be fully met by U.S. and European banks' capacity to provide dollars as they became keen to squeeze assets due to recent regulatory changes.

Keywords:
Basis, Foreign Exchange Swaps, Japan Premium, Covered Interest Parity