Daiwa's View

Background of change in BOJ stance on operations, which caused steepening

➢ Struggle with time frame prolonged due to COVID-19 pandemic

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In our 6 July report, I pointed out that the background of the steepening is not increased JGB issuance but a change in the BOJ's stance on operations. Today, I gauge the intention of the change in stance.

Yield declines can have the opposite impact, depending on the duration of the period—whether the downtrend is short term or it persists over the long term. Theoretically, this is explained by the reversal rate theory. Looking at the conclusion, which takes into account Japan-specific factors, excessively low interest rates could "diminish the monetary easing effects," as BOJ governor Haruhiko Kuroda referred to the impact of the prolongation of the low-interest rate environment on 22 July 2019[1].

◆ **Speech by BOJ gov. Haruhiko Kuroda: *Overcoming Deflation: Japan's Experience and Challenges Ahead*** (22 Jul 2019)

- Out of the two effects stemming from the prolonged low interest rates, the latter warrants more attention at this point. Excessively low interest rates could make financial institutions reluctant to lend, such as through capital constraints, and thereby diminish the monetary easing effects. In addition, if financial institutions take excessive risks under the severe profit environment in order to acquire immediate profits, the vulnerability of the financial system could increase in the longer term.

Since the latter half of 2020, the BOJ has been warning against the flattening of the yield curve more than before, referring to the concrete level of the superlong yields. Specifically, starting from the remark by Governor Kuroda on 6 September 2019—"the decline in superlong yields is somewhat excessive"—, he stated that "I won't be surprised if superlong yields rise a little bit further" in January 2020, and "in the case of Japan, superlong yields have not risen so much" on 16 June 2020.

The reason behind the BOJ's remarks on excessive decline in superlong yields is obvious. It is because such a decline lowers the rates of return on insurance and pension products, and this would have a negative impact on economic activity through deterioration in people's sentiment. Although the reason is clear, the current bottleneck lies in a time frame. Due to the COVID-19 pandemic, it has become definitive "to take a reasonable period of time for achievement of the 2% price stability target" (Gov. Kuroda). This means that we now have the outlook that monetary easing is likely to be prolonged further due to the pandemic.

◆ **Speech by BOJ gov. Haruhiko Kuroda** (24 Sep 2019)

- Second, the Bank considers that the conclusion reached in the Comprehensive Assessment released in September 2016, in which it assessed the policy effects and their transmission mechanism since the introduction of QQE, is still valid even in the present situation. For example, there is no change in our recognition regarding the impact on economic activity and prices of the term structure of interest rates, in that short- and medium-term interest rates have a larger impact than longer-term rates. On the other hand, the Bank continues to take the view that an excessive decline in super-long-term interest rates could lower the rates of return such as on insurance and pension products, and this may exert a negative impact on economic activity through a deterioration in people's sentiment.

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[1] On 30 Jul 2019, Gov. Kuroda stated that "I do not think that current situation is similar to a reversal rate condition, and the situation is unlikely to fall into a reversal rate soon."

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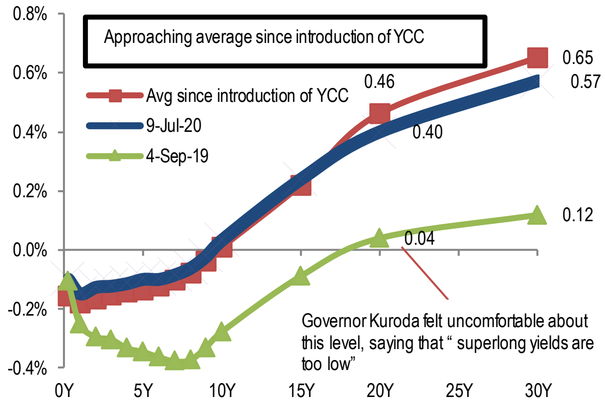
If "natural yield rises (steepening of yield curve)" temporarily occur due to an increase in JGB issuance for some reason when the above-mentioned recognition is shared, what is the appropriate BOJ action in carrying through the objective of monetary policy?

Of course, if the BOJ is concerned that "a rise in superlong yields would excessively tighten the financial environment," it should prevent the rise in yields. Meanwhile, yields in the "short- and medium-term zone" have high easing effects, which was approved in the Comprehensive Assessment in 2016 and the conclusion is still regarded as valid. If the aim of monetary easing is shifted to the "sustainability"—i.e., pegging yields in the "short- and medium-term zone" to around the ELB over the long term, we can interpret that the rise in superlong yields that could mitigate the side effects does not serve as a monetary tightening factor but as an easing factor.

The idea that "steepening is caused by increased JGB issuance" is overly simple. The real nature of the current steepening is not a sharp rise in yields due to increased JGB issuance or fiscal crisis based on the pessimism about Japan (media favorite), and such a steepening is probably caused by artificial factors controlled by the BOJ's stance on operations in a broader sense. As explained above, we think that the major points are actually (1) a change in the most appropriate shape of the yield curve when the BOJ aims to increase the monetary easing effects "from a decline to steepening" and (2) a shift in the outlook that easing will be prolonged further due to the pandemic.

If the side effects of prolonged monetary easing are caused by sluggish earnings at financial institutions, the effects to mitigate the adverse reaction via steepening mean improvement in earnings at financial institutions. In the case that this steepening is a temporary phenomenon (I assume so), we can say that now is an especially important phase. In terms of not only the micro-level (earnings at each financial institution) but also the level of national policy of monetary easing, it is desirable to prepare for the side effects of the likely prolonged low-interest rate policy by solidly building actual positions at auctions without chasing high prices in the secondary market. This is the real intention of our 6 July report—"meaningful purchases are recommended at superlong JGB auctions in this fiscal year."

Chart: JGB Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

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[Standard & Poor's]

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