Daiwa's View

Outlook for managing yield curve control based on Summary of Opinions and minutes

➢ A battle on two fronts

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A battle on two fronts

The BOJ's recognition of, and internal debates over, its challenges are evident from its Summary of Opinions and meeting minutes. Based on how the BOJ has long recognized these issues, depending on changes in conditions it may be appropriate for it to make minor changes to its current package of easing measures.

In the report we published after the December policy meeting, we presented one scenario for the yield curve, based on the Summary of Opinions published until November 2020, that was a combination of "widening the trading band" and "strengthening forward guidance." That scenario also took into account the ambiguity of the BOJ's forward guidance on policy rates[1] and its debate over the need for a moderate steepening of the yield curve, as well as the likelihood of US interest rate increases (a Fed exit)[2].

◆ **Daiwa's View** (21 Dec 2020)

- Because the shape of the yield curve and forward guidance affect each other in some respects, an attempt to fine tune the two together makes a lot of sense. For example, by again widening the allowable trading band for the 0% 10-year yield target while at the same time clarifying its forward guidance on policy rates would probably be much more effective than doing either one of those alone. We think that would make the JGB yield curve a bit more likely to show a correlation with European and US interest rates in the long-term and superlong zones.

Reports from Jiji Press last Friday about a widening of the trading band reaffirmed how appropriate this approach is, and although there will be some detours along the way, we think the most expeditious route is to determine how the BOJ currently views the challenge based on the Summary of Opinions and minutes and then reflect any new changes to the landscape.

We now have available the Summary of Opinions for the December policy meeting, which had not been released when we published our last report. This summary includes in hiding some additional hints, including on issues that have already been addressed and comments from BOJ officials, and we want to reemphasize the key ones ahead of the January policy meeting.

◆ Summary of Opinions at MPM in Dec 2020

On 28 December 2020, the BOJ published its Summary of Opinions for the Monetary Policy Board meeting held on 17 and 18 December.

[1] Forward guidance on YCC and quantity is clear (YCC: aim for a price stability target of 2% and maintain as long as necessary to sustain it on a stable basis; quantity: until the consumer price index (excluding fresh food) reaches and stabilizes at an actual y/y rate of increase of over 2%).
[2] After we published that report, the majority of the investors who read it and commented said that they were in agreement.

At that policy meeting, the BOJ clearly announced plans to begin assessing monetary policy to ensure that monetary easing is more effective and sustainable toward achieving the 2% price stability target and committed to announcing the results of that assessment by the time it holds its March 2021 policy meeting. After that, the market was focused on whether the Summary of Opinions would provide any hints as to the direction and details of this assessment.

Unlike before, the opinions in this latest Summary of Opinions are divided into three sections: Extension of the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19), Assessment for Further Effective and Sustainable Monetary Easing to Achieve the Price Stability Target of 2%, and Others. It lists a total of 10 opinions under the second section, which concerns its assessment of the effectiveness and sustainability of monetary easing to achieve the 2% inflation target. This comes out to one opinion per board member plus a second opinion from one board member[3].

Chart: Summary of Opinions at MPM on 17-18 Dec 2020

	"Assessment for Further Effective and Sustainable Monetary Easing to Achieve the Price Stability Target of 2%"	Remarks
1	It is highly likely that it will take more time to achieve the price stability target of 2 percent, mainly due to the impact of COVID-19. Given that monetary easing will be further prolonged, it is important to conduct an assessment for further effective and sustainable monetary easing, with a view to achieving the price stability target.	Assessment for further effective and sustainable monetary easing
2	It is appropriate for the Bank to make the upcoming assessment, focusing on the conduct of monetary policy under the current framework and keeping in mind the duration until the March 2021 MPM.	Focus on policy operations
3	Considering that containment of the spread of COVID-19 and improvement in economic activity should be achieved simultaneously during the COVID-19 era, it is necessary for the Bank to deeply discuss how to achieve the price stability target of 2 percent.	Deep discussion amid pandemic
4	It is necessary to reexamine from various aspects what kind of strategies the Bank should take toward achieving the price stability target.	Re-examination from various aspects toward achieving the price stability target
5	The Bank should assess its strategy, tools, and communication with a view to achieving the price stability target and not allowing Japan's economy to return to deflation. Since the bursting of the bubble, Japan's economy has repeatedly failed to recover every time a sign of economic recovery was in sight. If the economy falls into deflation again, positive economic developments, such as an increase in employment, will be hampered, and the opportunity for the economy to leap forward could be lost. The Bank should conduct the assessment with determination to never allow the economy to return to deflation.	Assessment of strategy, tools, and communication to avoid deflation
6	The framework of "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control" has been working well and thus there is no need to change it. The Bank should also maintain its commitments, including the price stability target of 2 percent.	Maintaining of framework and commitment
7	The Bank should examine the positive and side effects of monetary easing measures, including asset purchases, and enhance their sustainability and effectiveness as necessary.	Examination of positive and side effects
8	As for ETFs, active purchases should be maintained for the time being. In addition, under prolonged monetary easing, the Bank should seek room to make flexible adjustments depending on market conditions while taking into consideration the Bank's financial soundness.	Flexible adjustments of ETF purchases
9	It is necessary for the Bank to enhance sustainability of yield curve control and purchases of assets, such as ETFs, through the flexible conduct and be prepared so that it can respond effectively to possible changes in economic activity and prices as well as financial conditions.	Flexible operations of YCC and ETF purchases
10	With regard to the conduct of yield curve control, it is necessary to take into account the possibility that, along with the increase in issuance of JGBs, the amount of interest-rate risk will accumulate and supply-demand conditions will be eased in the bond market. Meanwhile, with a view to simultaneously achieving prolonged monetary easing and financial system stability, it is desirable, in a sense, for the yield curve to become steeper at a moderate pace. In this situation, it will become necessary to control the yield curve more carefully and finely.	Steepening of yield curve at a moderate pace

Source: BOJ; compiled by Daiwa Securities.

◆ The opinions can be broadly broken down into three different types

The comments that reaffirmed the BOJ's official opinion as already expressed in monetary policy statements and post-meeting press conferences included: "It is appropriate for the Bank to make the upcoming assessment, focusing on the conduct of monetary policy under the current framework" as well as comments noting that the BOJ should "maintain its commitments" to the YCC framework and 2% price stability target. The first opinion in the table above as well as the opinions shown in green text were those of BOJ Governor Kuroda or deputy governors.

[3] More accurately, BOJ Policy Board members were not limited in the number of opinions but rather in the length of their opinions in terms number of characters.

In contrast, the three opinions written in blue text referring to achieving the price stability target as the most important goal of the assessment are probably from the reflationists on the board. What makes these opinions interesting is how broad reaching they think the assessment should be, including in the area of strategy, despite the fact that the assessment is supposed to be a review within the current framework (strategy). These opinions refer to the need for the BOJ "to reexamine from various aspects what kind of strategies the Bank should take" and to "assess its strategy, tools, and communication with a view to achieving the price stability target and not allowing Japan's economy to return to deflation."

Of course, it is possible to consider the opinions written in green text as pushing back against those opinions seeking to extend the assessment into the strategy sphere.

In a speech he gave on 24 December, BOJ Governor Kuroda said clearly (although it may have just been for show) that the focus of its assessment "is not on lowering costs or mitigating side effects, but rather on adopting "a forward-looking perspective of how to achieve stability in economic activity and prices." To that extent, the reflationists are in one sense making a sound argument that needs to be considered. In other words, based on the mechanical relationship between opinions arguing for achieving the price stability target and the opinion below arguing for an emphasis on lowering costs and mitigating side effects, the two can ultimately be put together as a package.

There were four opinions (in red text in the table on the previous page) arguing both for mitigating costs and side effects and improvements through raising sustainability and effectiveness.

Certainly it is the case that these four opinions get to the true purpose of focusing on the conduct of policy. We think that two of those four opinions came from board member Hitoshi Suzuki, specifically, the ones calling for making flexible adjustments to ETF purchases and for the yield curve to become steeper at a moderate pace.

We think it is already the market consensus that ETF purchases should be made more flexible, but in order to ensure that this is not interpreted as a tightening of policy while also maintaining flexibility and increasing sustainability, we think the BOJ is likely to move in the direction of changing the guidelines for its operations to allow for unlimited purchases (i.e., removing specific numerical targets), as is currently the case with its JGB purchases, such that it can make its actual purchases on an as-needed basis.

◆ **Statement on Monetary Policy at Dec BOJ MPM** (18 Dec 2020)

- The Bank will actively purchase ETFs and J-REITs for the time being so that their amounts outstanding will increase at annual paces with the upper limit of about Y12 trillion and about Y180 billion, respectively.

  Note: As for the guideline for purchases of ETFs and J-REITs, in principle, "the Bank will purchase these assets so that their amounts outstanding will increase at annual paces of about Y6 trillion and about Y90 billion, respectively. With a view to lowering risk premia of asset prices in an appropriate manner, the Bank may increase or decrease the amount of purchases depending on market conditions.

Another important aspect of the opinions in red text is that they argue not only for revising the approach to purchasing ETFs and similar assets but also for making its yield curve control (JGB purchases) more flexible. BOJ Governor Kuroda touched on this in the speech we noted above, when he clarified in his comment on side effects and costs that he was referring to "low interest rates" and "JGBs," thereby strongly suggesting that the BOJ's conduct of YCC (JGB purchases) is also being addressed.

Unfortunately, there are no further hints as to which direction the BOJ will go in either Mr. Kuroda's speeches or the Summary of Opinions to date. Nevertheless, it is conducting its review so as to complete it by the March policy meeting, and given that this will include discussions and decisions made within its policy meetings, we think substantial changes are likely.

◆ **Speech by BOJ Governor Haruhiko Kuroda** (24 Dec 2020)

- This should be a matter of course for business managers like you all, but any measures incur costs, as with monetary policy measures. Prolonged low interest rates have a negative impact on financial institutions' profits, and purchases of various assets such as JGBs and ETFs affect the market functioning. Such costs or side effects need to be minimized.

◆ The most important opinions

In this regard, maybe the most important opinions within the Summary of Opinions for the December policy meeting are the following ones, which appears at first glance to be rather benign.

◆ **Summary of Opinions at MPM on 17-18 Dec 2020**

- It is necessary for the Bank to enhance sustainability of yield curve control and purchases of assets, such as ETFs, through the flexible conduct and be prepared so that it can respond effectively to possible changes in economic activity and prices as well as financial conditions.

The first one, already noted above, is that both yield curve control and the purchase of ETF and similar assets will be subject to review. The second one, which calls for the BOJ to "be prepared so that it can respond effectively to possible changes in economic activity and prices as well as financial conditions," uses the same wording that was a Mr. Kuroda's speech.

The BOJ staff prepare the drafts for speeches by the BOJ governor. At the time that speech was given, it is self-evident that the market was most interested in references in the speech to the BOJ's policy assessment. The fact that the exact same language in the speech was used in the Summary of Opinions suggests that it describes the essence of the assessment and is a key phrase for the BOJ staff. The board member who actually submitted this opinion was either one who is close to Governor/deputy governors or one who rendered that opinion on behalf of them.

◆ **Speech by BOJ Governor Haruhiko Kuroda** (24 Dec 2020)

- As evidenced by the sudden occurrence of the current shock of COVID-19, various shocks may happen in the future. Thus, it is necessary to be nimble in making effective responses when needed to counter possible changes in economic activity and prices, as well as financial conditions.

Even more important is that the phrase "possible changes in economic activity and prices as well as financial conditions" refers to changes in both the upside and downside directions. Specifically, at his press conference following the December policy meeting, Mr. Kuroda commented that under current conditions, it was important to keep the yield curve low and stable. He therefore predicated that importance on the economic, price, and financial conditions that prevailed at the time.

◆ **Press Conference by BOJ Governor Haruhiko Kuroda** (18 Dec 2020)

- With the resurgence of covid-19 cases now battering the economy, it has become critical to maintain stability in the bond market and keep the overall yield curve low and stable.

Meanwhile, if the possible changes in economic activity and prices as well as financial conditions materialize as a result of the pandemic being brought under control, the appropriate shape of the yield curve will also change. We interpret this comment to mean a change to allow for (make possible) a modification (increase) in the yield curve when that happens. This should therefore be seen as a battle on two fronts, which fits the skill set of BOJ Deputy Governor Masayoshi Amamiya.

◆ Rethinking the approach to YCC

Given the context of this discussion, we consider next the possible changes to how YCC is conducted.

◆ **Statement on Monetary Policy at Dec BOJ MPM** (18 Dec 2020)

- The long-term interest rate: The Bank will purchase a necessary amount of JGBs without setting an upper limit so that 10-year JGB yields will remain at around zero percent. While doing so, the yields may move upward and downward to some extent mainly depending on developments in economic activity and prices.

  Note: In case of a rapid increase in the yields, the Bank will purchase JGBs promptly and appropriately.

JGB purchases have already had their specific numerical targets removed and are now unlimited. On the other hand, as long as the BOJ is committed to an inflation overshoot and is assessing policy aimed at achieving the 2% price stability target, it will be difficult for it to adopt an approach that could be easily seen as a change contrary to that or as a move in the tightening direction. This makes it unlikely that the BOJ would sell JGBs or raise the 10-year yield target above zero.

However, it does have the option of changing how it interprets "around 0%" by once again widening the yield's allowable trading band. If it were to move in the direction of showing greater awareness of side effects, it could add "financial conditions" to the list of developments that allowable moves in 10-year JGB yields will depend on. The current language is "upward and downward to some extent mainly depending on developments in economic activity and prices."[4]

If it were to pay more heed to market functionality, it could move its statement "In case of a rapid increase in the yields, the Bank will purchase JGBs promptly and appropriately," currently relegated to a footnote, into the main text, and when the upper end of the range becomes difficult to maintain, change to an interpretation of JGB purchases that is closer to a cap[5].

Of course, to avoid an increase in short-term to intermediate yields caused by a reduction of its JGB purchases, it could strengthen forward guidance to offset those upward pressures[6].

In all honesty, this debate still remains at the level of a mental exercise (not to mention the possibility that it will make only perfunctory revisions). Nevertheless, it is meaningful that it committed to announcing the results of its assessment by March. This will give the market time to engage in this mental exercise (i.e., form expectations), and the BOJ should have a better understanding of where the pandemic is heading, both domestically and overseas, by this spring.

In other words, although the resurgence of covid-19 cases is causing economic conditions to worsen, particularly in Europe and the US, there is a possibility that spring will bring more clarity, including through increased vaccinations[7]. For its part, the BOJ is prepared to pursue several options at this point, and it should be able to put together a package with the right combination of measures based on the economic, price, and financial conditions prevailing at the time[8].

That is, we expect the current assessment to enable the BOJ to make revisions that can accommodate whichever direction that possible changes in the economy, prices, and financial conditions wind up taking. Thus, the easing package that it comes up with will also depend on the economic, price, and financial conditions prevailing at that point.

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[4] The staff conducting operations would make revisions in accordance with the written statement (directives) reflecting decisions made at the policy meeting.

[5] A good reference in this regard is the version of yield curve control conducted by the Fed in the 1940s. Furthermore, the BOJ's YCC as it is currently conducted appears to have stronger stock effects than it did when it was first introduced in 2016 and when policy was modified in 2018.

[6] We of course expect more detailed modifications than just revising the three-layer IOER structure.

[7] The political situation and monetary policy trend in the US is likely to become clearer.

[8] Depending on the status of the pandemic, the BOJ could decide to either put more emphasis on strengthening easing or lean more toward mitigating side effects.

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Daiwa Securities

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