

Outlook for BOJ's JGB purchases (Feb. 2021)

Strong expectation on purchase reduction in the 3-5Y zone

- ✓ The BOJ will revise down the range of offer amount in the up-to-1-year zone (leaving the number of operations unchanged). We expect the Bank also to revise down the range in the 3-year to 5-year zone (leaving the number of operations unchanged). There would be no changes made in other zones with a high probability.
- ✓ We expect the initial offer amount in the over-3-year to 5-year zone to be Y370 billion, down from Y420 billion in January, if the BOJ moves to adjust.
- ✓ We hope that the BOJ's findings from the current "assessment of monetary policy" will be something to improve market functionality.

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Expecting the range of offer amount in the over-3-year to 5-year zone also to be downward revised

The BOJ will announce its *Monthly Schedule of Outright Purchases of Japanese Government Bonds (Competitive Auction Method) (February 2021)* this Friday, January 29. We expect the BOJ to lower the range of offer amount in the up-to-1-year zone relative to January (with the same number of operations). We expect the Bank also to revise down the range of offer amount in the over-3-year to 5-year zone (leaving the number of operations unchanged). There would be no changes in February JGB purchase operations in other zones with a high probability.

The 10-year JGB yield, the benchmark for the BOJ's long-term policy rate, has been remaining extremely stable at around 0%. The yield curve (particularly the superlong zone) has not shown any significant flattening (relative to what the BOJ views as the optimal curve shape) (Chart 1), either. In such a situation,

- ✓ We think the BOJ is very likely to lower its offer amount range in the **up-to-1-year zone** in February as the Bank reduced its purchase in the zone at the operation it offered on January 25 from Y150 billion yen to Y100 billion yen.
- ✓ The BOJ lowered the range of offer amount in the **over-1-year to 3-year zone** and reduced its offer amount in January. This makes another adjustment in this zone unlikely anytime soon.
- ✓ Accepted bid levels tend to fluctuate in the closely watched **over-3-year to 5-year zone**, in part owing to widening differences in market preference among issues. The market's demand for purchase reductions is well entrenched. The frequency with which the bid-to-cover ratio wound up below 2x in the operations prior to the 5Y JGB auction increased this month. Although the BOJ is currently addressing how it purchases JGBs in the on-going monetary policy assessment, of which results will be released in March, there is the fact that it did lower the offer range and reduced the offer amount in the over-1-year to 3-year zone, which was put in a similar situation with the over-3-year to 5-year zone facing now, in January. Expectations on the BOJ's adjustment of its purchases in the zone are getting stronger.
- ✓ We think the BOJ is very unlikely at this point to make any adjustments to the **over-5-year to 10-year zone**, the key zone under the yield curve control policy, given that 10-year JGB yields have remained low and extremely stable, as already noted, amid the process of assessing monetary policy.
- ✓ On the over-10-year zone, which the BOJ says it wants to "leave up to market forces," although we have been seeing some flattening of the 20-40-year zone in January, it is still questionable whether the flattening will go further or not. We think the BOJ is for now unlikely to feel compelled to adjust those offer amounts in the **over-10-year zone**. That being said, the bid-to-cover ratio has been high at over 4x recently, and the BOJ may start viewing this as more of a problem moving forward. We think the BOJ is likely to make a move after its monetary policy assessment in March, particularly in the over-10-year to 25-year zone.

The initial offer amount in the over-3-year to 5-year zone may be set to Y370.0 billion but those in other zones likely unchanged from their last offers in January

Our forecast of offer range and initial offer amount in each zone is as in Table 1. We think the initial offer amounts in February are likely to be unchanged from the last offer amounts in January in all zones except the over-3-year to 5-year zone. If the BOJ lowers its range of offer amount for the over-3-year to 5-year zone, it may reduce its initial offer amount from the current Y420 billion to about Y370 billion. We expect the BOJ to manage its operations flexibly in order to restore market functionality. It will probably continue making decisions on which issues to purchase in each zone based on its ownership share of the issue and the supply-demand balance.

The BOJ assessing monetary policy to improve market functionality

Chatter within the JGB market about the BOJ's monetary policy assessment has been heating up since last week. Talks within the market about the specific issues to be addressed in the assessment since the Bank announced it last December have not progressed to the point where market consensuses are formed. Given a media report mentioning a widening of the allowable trading band for the 10-year JGB yield on January 16 and the monetary policy meeting on January 20-21, especially the post-meeting press conference of Governor Kuroda, market participants grow their recognition that the BOJ's JGB purchases would be one focus of the assessment. If the BOJ does wind up rethinking how to purchase JGBs, it would not be surprising that the costs and benefits of canceling announcements of its schedule, restructuring the zones where it targets purchases, abandoning the purchase of 40-year JGBs and so on would be reviewed.

With accommodative monetary policy currently predominating worldwide under the context of a pandemic, the 10-year JGB yield has been low and stable in a range of 0.00-0.05% for an extended period. Although reaction of Japan long-term rates to the recent upward movement of US long-term rates has been limited, it appears to be not because the trading band for the 10-year JGB yield is perceived to be about double the $\pm 0.1\%$. Given this, any discussion about widening that trading band would seem fairly abrupt. However, what could be posited as an issue in the on-going assessment are the side effects on the JGB market from declines in liquidity and the deterioration of market functionality resulting from the 10-year JGB yield remaining low and extremely stable. From that point, if the BOJ reassess the stock effect of JGB purchases and finds an appropriate amount of purchases for controlling the yield curve, that should enable the Bank to manage purchases in a more flexible and balanced manner. We do not think the market would mistakenly see the purchase reductions that could result from the assessment results as a shift in policy toward tapering and normalization. In fact, there is relatively large leeway for purchase reductions from a policy perspective (Chart 2). The commitment to overshooting inflation is a core component of the framework of the quantitative and qualitative monetary easing with yield curve control, which the BOJ says it will not change. Therefore, it will be a difficult task for the BOJ, but we expect the BOJ to assess the monetary policy with focus on the costs vs. benefits of widening the trading band via reductions in purchases.

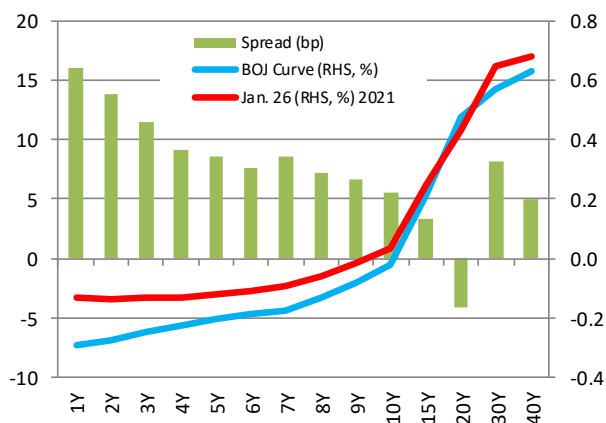
It should continue aiming for T-bill purchases within a range of Y500 billion to Y3 trillion

We do not expect any changes to its *Outline of Outright Purchases of Japanese Government Securities* in February as well. We therefore expect the wording on its T-bill purchases to be the same as it was in its *Outline of Purchases* dated 27 April 2020: "the Bank will decide the purchase size per auction considering the effects on financial markets. The Bank will purchase about 500 billion to 3.0 trillion yen of T-Bills per auction for the time being." Expectations for the BOJ to modify the three-layer structure of its reserve account in conjunction with its assessment of monetary policy are simmering in the short-term market. Although some observers argue that under the current set up the BOJ already has room to improve the functionality of short-term markets and exercise more discretion than it has thus far under the three-layer structure of its reserve account, with monetary easing expected to persist, we would like to see the assessment address that three-layer structure from the perspective of achieving greater stability in short-term yields.

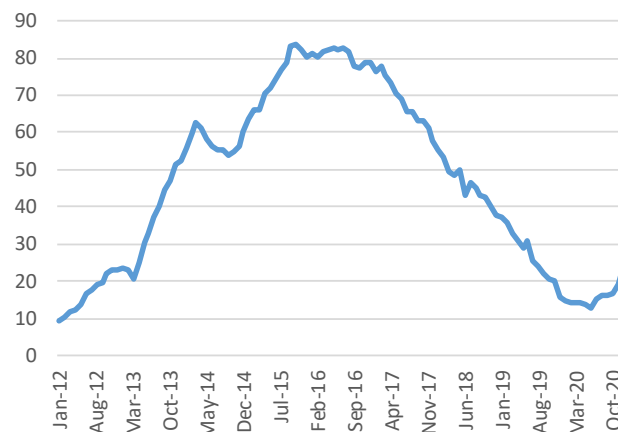
Table 1: BOJ's JGB Purchase in February 2021 (exp.) (Yen billions)

	Offer size per operation			Number of Offers (per month)	First offer size exp.		Monthly Total exp. in Feb. (a)	MOF issuance in Feb.* (b)	(a)/(b) (%)	
	Min	Max	Mid		Min	Last offer in Jan.				
JGBs ex Linkers and Floaters										
1 year and less	50	-	150	100	2	100	100	200	-	-
Over 1 to 3 years	300	-	600	450	5	450	450	2,250	3,000	75.0
Over 3 to 5 years	200	-	550	375	5	370	420	1,850	2,500	74.0
Over 5 to 10 years	250	-	600	425	5	420	420	2,100	2,600	80.8
Over 10 to 25 years	50	-	200	125	2	120	120	240	1,200	20.0
Over 25 years	0	-	50	25	2	30	30	60	1,400	4.3
Linkers	30			-	2	30	30	60	-	-
Floaters	50			-	1	50	-	-	-	-
TOTAL**:							6,700	10,700	62.6	
Jan.:							7,000	10,700	65.4	

(Note) Change expected from December in red; "Last offer size in Jan." is actual for 1Y or less, 1-3Y and 10-25Y as of Jan. 27 * Excluding auction II and AEL **Excluding JGB floaters and JGB linkers *** Based on the sum of 30Y JGB issuance amount and one-half of 40Y JGB issuance amount
 Source: Bank of Japan, Ministry of Finance (MOF), Daiwa Securities.

Chart 1: JGB Yield Curve Comparison


Source: Daiwa Securities.

Chart 2: Annual Increase of BOJ JGB Holding (Yen trillions)


Source: Bank of Japan, compiled by Daiwa Securities.

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[Standard & Poor's]

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