Daiwa Securities

Daiwa's View

Second fork in the road is approaching

➢ Will quantity be rendered toothless or just be withdrawn?

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Second fork in the road is approaching

◆ **First fork in the road**

At the beginning of the Kuroda easing, the policy variable seen as most important was quantity, i.e., the monetary base[1]. If the BOJ continued to increase its JGB holdings at an annual pace of Y80tn, if the 2% inflation target could not be reached, at some point the day would surely arrive when an excessive decline in interest rates created problems. That was the first fork in the road.

JPY rates reached this first fork in the road in 2016. That year in January, when market interest rates dropped too low after the BOJ introduced its policy of quantitative and qualitative monetary easing (QQE) with negative interest rates, the BOJ followed up in September with its policy of QQE with yield curve control. The BOJ made interest rates its prime policy variable, while also adding a commitment to overshoot[2] in order to tie its price stability target to its policy of expanding the monetary base and prevent quantity from declining (quantitative tightening, or QT[3]). This preventative action will later wind up leading to the second fork in the road.

◆ **Second fork in the road**

If expansion of the monetary base is continued while adhering to the overshoot commitment, stock effects would become cumulatively stronger, meaning that the flow of JGB purchases needed to maintain interest rate levels would decline. This means that yield curve control is a policy that entails a passive form of tapering.

If the reduction in JGB purchases is kept within the confines of tapering (i.e., purchase amounts are reduced but still positive) it is not a problem, but when the amount of (the y/y increase in) purchases required to maintain interest rates approaches zero, it starts creating tension with the overshoot commitment.

When will be the day that we reach this second fork in the road?

As we reported previously, on 29 June the BOJ announced a Y250bn reduction in its JGB purchasing operations. We estimate that if it continues reducing its purchases at this pace every quarter, the y/y change in its JGB holdings will turn negative before 2023. In other words, there is a possibility that the BOJ will reach that second fork in the road as early as next year (see chart on next page).

[1] The Monetary base is equal to bank notes outstanding + currency in circulation + balance of current accounts at BOJ.
[2] This refers to a continued expansion of the monetary base until the actual rate of increase in consumer prices exceeds the 2% price stability target on a stable basis.
[3] Why did it include this second factor? Although only speculation, we think it was a result of a necessary compromise to avoid rejecting its policy to date and/or to satisfy the reflationist board members that thought it important.

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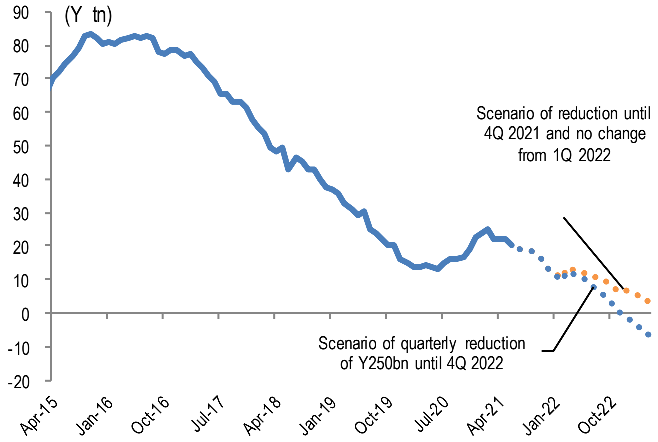
Increase in Amount Outstanding of JGB Holdings at BOJ (y/y)



Source: BOJ; compiled by Daiwa Securities.

◆ **Will quantity be rendered toothless or just be withdrawn?**

When this second fork in the road is reached, it will become difficult to target both the interest-rate level and quantity. What route will the BOJ take when that happens? One strong option would be to render quantity toothless, and another would be to withdraw quantity.

If quantity becomes toothless, we think the BOJ would replace JGB purchases with some other life extending measure (such as fund-provisioning measures to address climate change) to adjust the size of its current account and keep the monetary base roughly flat. Even if the monetary base declines somewhat, it may be able to buy some time if it emphasizes that it is sticking with its policy of expanding it.

When looking at this from the perspective of what the overshoot commitment implies, the design of the fund-provisioning measures to address climate change that the BOJ plans to announce an outline of this coming Friday may be of some interest to JGB market participants. I will leave the detailed discussion of how these measures may be designed to the economists and BOJ watchers[4], but if the measures wind up being well-designed (i.e., likely to lead to expansion of the monetary base), we expect that will have the effect of making it easier to choose the "rendered toothless" route from the second fork in the road.

If the BOJ instead chooses to withdraw quantity, that would constitute a change in framework and would require a second comprehensive review of its policy to date. Originally, quantity was introduced after a joint statement made by the government and BOJ in January 2013. Given Japan's political calendar and the upcoming lower house election, the leadership of the next administration will be decided in the fall. This will make it difficult for the BOJ to make any major directional changes related to quantity until the new administration's political will becomes clear.

BOJ Governor Kuroda's term ends on 8 April 2023, right around the time when the second fork in the road is reached. We think it will be Mr. Kuroda's successor as BOJ governor rather than Mr. Kuroda who decides which route to take from that fork.

◆ **Market implications**

Thinking in terms of impact on JGB yields, whether that is the BOJ's JGBs purchases or an expansion of the monetary base from its financing support of COVID-19 measures, if the BOJ maintains its policy regarding quantity we expect interest rates will remain under some downward pressure. Even if it becomes possible for deposit-taking institutions to park funds in their current accounts at the BOJ under favorable terms based on their being

[4] Our chief economist, Mari Iwashita, thinks it will be interesting to see what sort of investment guidelines the BOJ comes up with, and whether, to maintain market neutrality, it opts not to use the IOER as an incentive but rather just makes the term of operations more flexible and raises the macro add-on balance.

incentivized by an IOER, if that incentive is insufficient, we expect deposit-taking institutions will park cash in those current accounts (which for the BOJ would have the effect of expanding the monetary base) while building off-balance-sheet positions using interest rate swaps, which do not require a source of funding. In that case, swap spreads would become more deeply negative (swaps would outperform), and by making assets swaps a more attractive investment this would indirectly put downward pressure on JGB yields.

Additionally, deposit-taking institutions already have enormous deposit-loan gaps. Even if deposit-taking institutions get back financing from the BOJ under favorable conditions through its fund-provisioning measures to address climate change, if the funds that were allocated to lending until then were turned into investment funds, it would wind up increasing the amount of funds that deposit-taking institutions have to invest, and we expect that would put downward pressure on yields in the 10-20-year zone that those institutions invest in.

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