Daiwa Securities

Daiwa's View

Government bonds held by central banks and stock effects

➢ Increase in government bonds held by central banks may continue to push down long-term yields via stock effects

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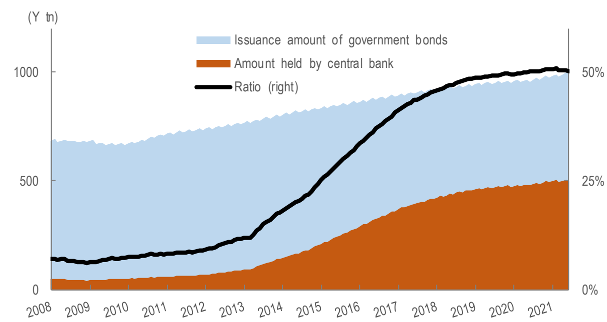
During the spread of COVID-19, government policy packages of fiscal expansion and central bank monetary easing have had a powerful effect. However, with around 18 months having passed since the outbreak of the pandemic, fiscal expansion has let up. Under the circumstances, due to quantitative easing, the ratio of government bonds held by central banks has been rising. Given the timeline and difficulty of an exit strategy, we think stock effects from the rising ratio of these holdings are likely to continue to have the effect of pushing down long-term yields.

Regarding stock effects in the JGB market, the BOJ conducted a quantitative analysis in "The Background" report of the assessment meeting in March 2021. It has been verified that a 1% rise in the ratio of JGBs held by the BOJ has the effect of lowering the 10-year JGB yield by 2bp. In the current situation in which the ratio of JGBs held by the BOJ is above 50%, it is calculated that the stock effects have pushed down the long-term yield by more than 1%.

The phenomenon of 'crowding out by government bonds'—a decline in the ratio of government bonds held in the private sector due to a rise in the ratio held by the central bank—used to be a Japan-specific issue. However, this phenomenon is becoming pronounced globally. In the US, the ratio of (marketable) Treasuries held by the Fed had temporarily declined to 13%, but it has approached nearly 25% amid ongoing QE. This tendency is more pronounced in nations in which the size of the government bond market is relatively small. For example, the ratio of Australian government bonds held by the central bank rose sharply from the 5% level at end-2019 to 20% in March 2021. While the Fed is steadily proceeding with the process of heading towards tapering, the RBA also decided to scale down purchases from September. One of the factors behind this decision may have been the issue of massive purchases of government bonds by central banks.

Japan: Amount/Ratio of Government Bonds Held by Central Bank



Source: BOJ; compiled by Daiwa Securities.

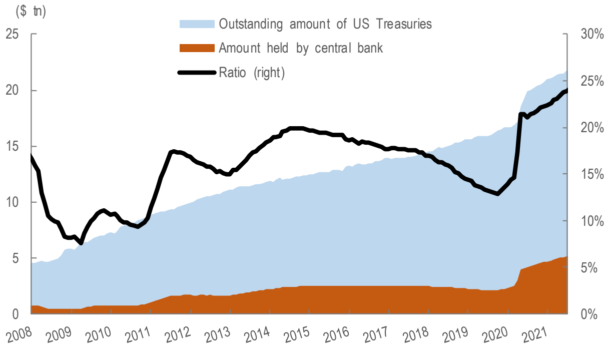
Impact of BOJ's JGB Holding Ratio on Long-term Interest Rates

JGB yields (10-year, %)
= 0.25*
+0.16* × U.S. Treasury bond yields (10-year, %)
+0.45* × Expected real GDP growth rate (%)
- 0.02** × **The Bank's share of JGB holdings (%)**

Estimation period: Jan. 2005 to Feb. 2021. Adjusted R-squared: 0.95.
Newey-West standard errors are used.

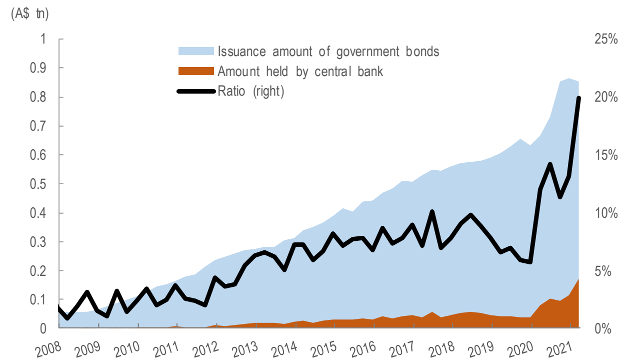
Source: Extracted from BOJ materials.

US: Amount/Ratio of Government Bonds Held by Central Bank



Source: Treasury Department, Fed; compiled by Daiwa Securities.

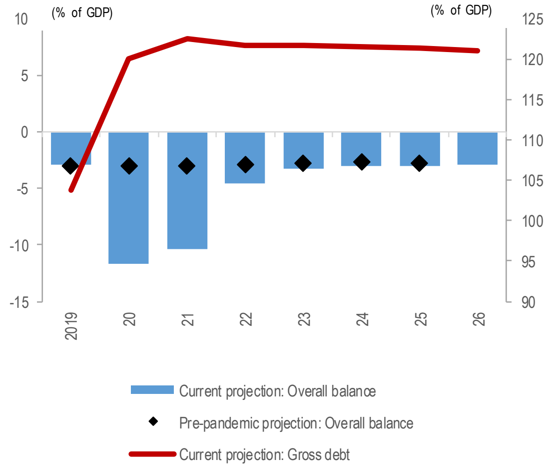
Australia: Amount/Ratio of Government Bonds Held by Central Bank



Source: Australian Bureau of Statistics' national accounts; compiled by Daiwa Securities.

Few people would object to the view that such a global increase in the ratio of government bonds held by central banks has been pushing down long-term yields worldwide via a lack of investment in the private sector. Accordingly, key points going forward will be (1) changes in government bond issuance caused by fiscal policies and (2) central banks' balance sheet policies. However, given concerns about fiscal deterioration due to aggressive fiscal policies in 2020 and 2021, we anticipate a slowdown in fiscal expenditures. That said, the spread of COVID-19 infections is not stopping in Japan, leading to discussion about a supplementary budget ahead of the lower house election.

IMF's Projections for Fiscal Balance in Advanced Economies



Source: IMF's Fiscal Monitor (Apr 2021); compiled by Daiwa Securities.

Regarding balance sheet policies, the Bank of England changed its policy rate, the threshold for reducing the stock of purchased assets by suspending re-investment in redemption money, from 1.5% to 0.5%, in its *Monetary Policy Report*[1] issued on 5 August. In addition, we saw a full-fledged discussion regarding the exit strategy, as witnessed by a reference to the sale of assets at the time the policy rate is raised to 1%. However, in the past we have seen that it took as long as three years and nine months for the Fed to start reducing the balance sheet in September 2017 via suspension of investment in redemption money after the December 2013 decision on tapering. Moreover, this process continued for only a little less than two years, ending with a preemptive interest rate cut in July 2019. The sensitive issue of reducing balance sheets definitely requires a certain amount of time, as policymakers need to take a cautious stance when it comes to communicating with the market. During that time, stock effects from government bonds booked on assets at central banks are likely to continue to serve as a factor in pushing down long-term yields.

[1] Refer to Box A: The MPC's strategy for the mix of monetary policy instruments to deliver tighter policy.

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