Daiwa's View

BOJ's two-pronged strategy: bringing back Mr. JGB

- Policy adjustment process to follow rising ownership share of JGBs and sharp yen weakening

Fixed Income Research Section
FICC Research Dept.

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp

Daiwa Securities Co. Ltd.

BOJ's two-pronged strategy: bringing back Mr. JGB

As expected, BOJ holds policy steady at its June policy meeting

Fixed-rate purchase operations on consecutive days set by committee for the 10yr, by the Financial Markets Department for the CTD

BOJ's two-pronged strategy is to purchase in two zones, the 10yr and 7yr

Trying to stabilize the market by relaxing terms for securities lending facility

As expected, the BOJ made no policy change at its policy meeting on 16-17 June (board member Goushi Kataoka had the only dissenting vote). The policy meeting ended before noon despite the JGB market turmoil right before the meeting, and the lack of any new dissenting votes suggests there was no heated debate[1]. Language in the written statement regarding the fixed-rate purchase operations for consecutive days did not change. After the policy meeting at 17:00, the Financial Markets Department released two statements: "Announcement on the Conduct of Fixed-Rate Purchase Operations of the Cheapest-to-Deliver Issue for Consecutive Days" and "Relaxation of the Terms and Conditions for the Securities Lending Facility of the Cheapest-to-Deliver Issues." The former statement indicated that the BOJ would conduct fixed-rate purchase operations on consecutive days on the JB356, at a fixed rate of 0.25%, for an extended period from 20 June. The directive decided at the Monetary Policy Board meeting was to conduct daily operations only for the three on-the-run 10yr JGBs, while operations targeting the cheapest-to-deliver (CTD) issue would be conducted separately at the discretion of the Financial Markets Department. This two-pronged strategy targets two zones, the 10yr and the 7yr. In the latter statement, the maximum number of consecutive trading days purchasing the same issue was raised to 70 days (from 50 days), making it possible to keep borrowing until receiving delivery of the CTD issue. Additionally, the broadening of issues to be purchased (to the JB357 and JB358) makes it easier to sell cash bonds and engage in arbitrage by purchasing futures. The BOJ has carefully devised these measures to ensure stability in the JGB futures market.

The BOJ added new language to the section on risks reflecting tripartite agreement

Japan's best response is to prevent extreme forex volatility

At his regularly scheduled press conference, BOJ Governor Kuroda was questioned numerous times about his thinking on the yen's depreciation and whether there will be a policy revision. Based on agreement at a tri-party (MOF, BOJ, and FSA) meeting on 10 June, the BOJ added new language to the section of the written statement on risks to the outlook: "...it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices." Mr. Kuroda changed how he responded to questions about yen depreciation. On previous occasions he had said that yen depreciation was "an overall positive," but this time he answered that rapid yen depreciation raised uncertainty over the future and was "a negative for the economy." The US is accepting a stronger dollar, which is effective in reining in inflation, however, and the barriers to intervention (a tool for weakening local currency) remain high. At this point, Japan is not readying any specific measures to defend the yen, and the best approach is to prevent sharp changes.

[1] We will have to wait for the Summary of Opinions for the June meeting, set for release on 27 June, to confirm whether there were any new opinions regarding the market turmoil.

In response to questions on policy revisions, he argued for the need to keep policy accommodative

In contrast, when asked about changes in policy, he made the case for having to keep policy accommodative, answering that "Japan's overall economy was still recovering and monetary policy needs to provide strong support during that process," and also said that if the BOJ were to raise the YCC yield target, "long-term rates would rise, thereby weakening the effect of easing, and we are not thinking of doing that." He made other comments suggesting the BOJ will demur on changing policy, including "we do not think limitations to YCC will arise," "we will closely watch JGB liquidity and respond appropriately," and "there is no need for further re-examination at this point."

With many of the world's major central banks hiking rates, the BOJ stands apart with its stubborn refusal to follow suit

The BOJ needs to explain why its target of ±0.25% is still appropriate

The market will probably continue anticipating a policy change leading up to the BOJ's July policy meeting

With deflation out of the picture, policy coordination between the government and BOJ needs an overhaul

Nevertheless, with many of the world central banks having announced rate hikes aimed at suppressing inflation in June, the BOJ stands out with its hard-headed focus on keeping interest rates from rising. With 15 months having passed since the BOJ clarified the allowable trading band for the 10yr yield to be ±0.25% following its March 2021 policy review, global economic and price conditions have changed dramatically. The BOJ probably needs to satisfactorily explain why this is still an appropriate target for Japan's long-term rates. The next policy meeting in July will come after the upper house elections and include release of the *Outlook for Economic Activity and Prices* report. The BOJ will be able to engage in a full-fledged debate based on its newest economic and price outlook in July. The ECB holds its policy meeting that same day in the evening Japan time, and it is expected to announce a rate hike. A market that anticipates policy change can move very fast, and the yen is likely to continue weakening while other countries are hiking rates in the context of sustained commodity price inflation. The BOJ is waiting for the appropriate expectations to kick in and lead to an increase in wages next spring, but if it does nothing until then it could be left behind by global developments. The statement (referring to the 2% inflation target) issued jointly by the Japanese government and BOJ on 22 January 2013 was entitled "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth." With the challenge of exiting deflation having become irrelevant, that statement needs to be updated, sooner rather than later. The BOJ also needs to start taking a more flexible approach to conducting policy.

The March 2021 policy review was conducted under assumptions formed based on the long-term rate having traded in a 50bp range over the preceding six months

As the BOJ's ownership share of JGBs rises it fuels speculation that the trading range will be revised

The process your author expects to lead to a policy revision is that after repeated fixed-rate purchase operations, the BOJ's ownership share of the three on-the-run 10yr JGB issues rises (it was at 63.9% as of 17 June) to the point where concerns over the market becoming dysfunctional arise. In a previous episode of the long-term rate's trading band widening back in July 2018, that ownership share had risen to about 80%. The March 21 policy review[2] analyzes the impact that interest rate volatility has have on business investment and found that monetary easing's impact on business investment is roughly constant except for when the trading band of the long-term rate (the 10yr JGB yield) over the previous six months exceeded 50bp (Chart 1). Japan's 10yr yield has shifted upward since the beginning of 2022 in step with the change in global economic and price conditions, and market conditions provide good justification for changes in interest rate levels in terms of the trailing six-month trading band. Although an immediate change in the allowable trading band may be unreasonable, an increase in the BOJ's JGB ownership share would probably strengthen expectations of that trading range shifting upward.

[2] Refer to PP8-9 and P56 of BOJ's *Assessment for Further Effective and Sustainable Monetary Easing: The Background* (appendix chart 3, 19 Mar 2021).

Can rapid yen depreciation be dealt with by the government wishing for a BOJ policy change?

The period after the upper house elections becomes critical; will there be a change in the Kishida administration?

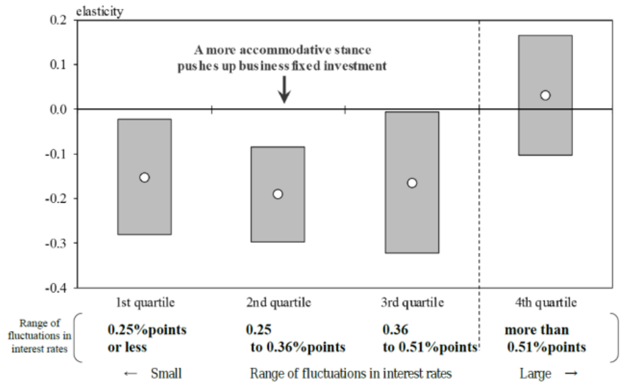
Another conceivable scenario if there is a rapid further weakening of the yen (by about Y10 over a one-month period; Chart 2) is that the government will have to hope that the BOJ responds with a policy change to defend the yen. Appearing on Fuji TV on 19 June and commenting on the conduct of monetary policy, Prime Minister Kishida said "although it affects exchange rates, it also affects loan rates and other costs to SMEs" and "there is no need for change at this time." With the upper house elections looming on 10 July, the time is not yet ripe. Even still, the period after the upper house election is a critical one. The typical division of duties has been one in which the government devises measures to offset the pain of higher prices and the BOJ provides support with an accommodative environment, and unless that changes and the government gives the BOJ flexibility in conducting policy, we think the BOJ is unlikely to move forcefully on its own.

Good news for the yen bond market: the resurrection of Mr. JGB

The BOJ needs cooperation from the MOF's debt management policies to pursue an exit strategy

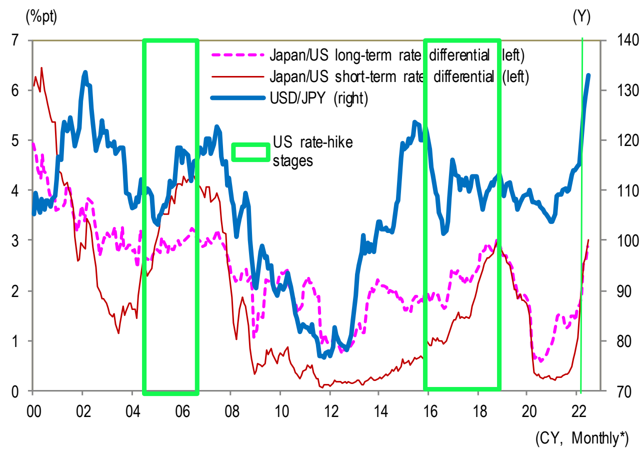
The change of personnel in the upper echelons of the MOF announced on 17 June was good news for the JGB market. It was reported that government debt policy pro Michio Saito, currently head of the MOF's Tokai bureau and known as "Mr. JGB," will take over as head of MOF's Financial Bureau on 24 June. Your author has long believed that the BOJ's large JGB holdings make it impossible for it to pursue an exit strategy without MOF's cooperation. The MOF positions that have been attracting the most attention are the Deputy General Director (in charge of coordinating policy adjustments with the BOJ) and the Financial Bureau Chief. Given that it happened immediately after JGB market disruptions caused by the global rise in interest rates and expectations of a BOJ policy change, this appointment of an experienced JGB market specialist to this key position instead of considerably more senior bureaucrats is highly significant. We would like to see Mr. Saito strengthen the MOF's cooperation with the BOJ to ensure the stable absorption of JGBs. The Kishida administration has initiated gradual changes in high-ranking government positions, including through its selection of new BOJ Monetary Policy Board Members. We are hopeful that this means that Mr. Kishida will establish his legacy by shifting policy to a new trajectory, sooner rather than later.

Chart 1: Impact of Interest Rate Fluctuations on Business Fixed Investment



Source: Excerpted from BOJ's Assessment for Further Effective and Sustainable Monetary Easing: The Background *(appendix chart 3, 19 Mar 2021).*

Chart 2: USD/JPY Rate, Japan/US Rate Differentials (from 2000)



Source: Bloomberg; compiled by Daiwa Securities.
**Average during 1-17 Jun is used as Jun 2022 data.*

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association