Daiwa Securities

Daiwa's View

Implementation of double backstops

➢ BOJ to strengthen control of front end via two tools

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

Happy New Year! Your continued support for *Daiwa's View* is greatly appreciated.

Implementation of double backstops

BOJ to strengthen control of front end via two tools

Of the many operations conducted by the BOJ at the end of last year, the most surprising were the "Funds-Supplying Operations against Pooled Collateral" (to be conducted on 4 Jan), which will offer Y1tn in loans with a duration of two years. Since the introduction of the yield curve control (YCC) policy, the BOJ has used fixed-rate purchase operations when defending the upper limit of yields. Fixed-rate funds-supplying operations—one of the 'double backstops' put in place when the YCC policy was introduced—was set aside as an option for later use. It is noteworthy that the BOJ has finally decided to conduct the fixed-rate funds-supplying operations, and that it is being done in the form of 2-year loans.

Conduct of Funds-Supplying Operations Against Pooled Collateral (4 Jan 2023)

Interest rate on loans	Location of operations	Amount of loans (in 100 million yen)	Duration of loans
0.0%	At all offices	10,000	From Jan. 5, 2023, through Jan. 6, 2025

Source: Reprinted from BOJ materials.

When the BOJ decided to introduce the YCC policy in September 2016, it introduced two tools: (1) fixed-rate purchase operations and (2) fixed-rate funds-supplying operations for periods of up to ten years[1]. As we can see from this, fixed-rate funds-supplying operations are one of two powerful tools (the other being fixed-rate purchase operations). Its use in this case will have the effect of pulling yields with residual maturities of up to two years towards 0%.

◆ **New Framework for Strengthening Monetary Easing: "Quantitative and Qualitative Monetary Easing with Yield Curve Control"** (21 Sep 2016)
The Bank decided to introduce the following new tools of market operations so as to control the yield curve smoothly.
(i) Outright purchases of JGBs with yields designated by the Bank (fixed-rate purchase operations)
(ii) Fixed-rate funds-supplying operations for a period of up to 10 years (extending the longest maturity of the operation from 1 year at present)

One characteristic of these fixed-rate funds-supplying operations is that it allows investors to ensure that yields are effectively contained, even if they don't think the BOJ will continue this policy. (The other characteristic is that is does not result in an increase in the amount of JGBs held by the BOJ.) With these operations, two-year funds are raised at an interest rate of 0%. So, if financial institutions using the operations buy JGBs carrying positive yields in maturities corresponding to the loan period, they will be able to secure risk-free profit margins. (Purchases of JGBs can be made without any concerns about collateral bonds to the BOJ as purchased JGBs can be used as collaterals.)

[1] More specifically, the longest maturity for fixed-rate funds-supplying operations was subsequently extended from the original one year to ten years.

In that sense, it can be said that fixed-rate funds-supplying operations are the most suitable tool for yield control in the current yen bond market, where doubts and concerns have been mounting since the BOJ surprisingly decided to widen the trading band at the December meeting. Combined with fixed-rate purchase operations, fixed-rate funds-supplying operations for a period of up to two years expresses the BOJ's intention to defend at all cost the front end of the curve, which has a strong easing effect.

◆ A countermeasure against further turmoil?

Among the opinions on economic and financial developments in the Summary of Opinions at the Monetary Policy Meeting on 19-20 December (released on 28 Dec 2022), a statement was made regarding prices indicating "progress toward achieving a situation where Japan's economy will not return to deflation." The wording "Japan's economy will not return to deflation" is in line with the government's definition of an end to deflation[2]—Japan's economy emerging from a situation in which prices continually fall, and being unlikely to return to such a situation (i.e., declaration to end deflation).

◆ **Summary of Opinions at BOJ Monetary Policy Meeting on 19-20 Dec 2022** (released on 28 Dec 2022)

Consumer prices in Japan are approaching the state seen before the deflationary period, as suggested by the price change distribution for CPI items and by the level of the CPI excluding fresh food and energy. This could be considered a sign of progress toward achieving a situation where Japan's economy will not return to deflation.

In some speculative articles at the end of last year and beginning of this year, the media reported about the emergence of a suggestion that the BOJ raise its FY24 price projection to nearly 2% in the next *Outlook for Economic Activity and Prices* report (*Outlook Report*). The supposed absence of the government's measures to cope with inflation is cited as a factor behind the upward revision for FY24. Therefore, it would not necessarily mean that the 2% price stability target would be achieved in a sustainable manner. However, the fact that 2% was projected in the final fiscal year of the *Outlook Report* could become a factor that would be considered when shifting to a 'normal mode' of monetary policy.

We need to understand this 'normal mode' in relation to the YCC. When explaining the appropriateness of controlling long-term interest rates in his January 2017 speech, then BOJ Executive Director Masayoshi Amamiya referred to "the dichotomy between normal and crisis periods," such as "during the crisis periods—or phases of overcoming long-lasting deflation, like the case of Japan." Based on this dichotomy, the above-mentioned statement from the Summary of Opinions suggests a shift towards a normal period in accordance with the government's declaration to end deflation that would be equivalent to the removal of the YCC policy.

When considering the fixed-rate funds-supplying operations, which are being conducted for the first time, together with this related information, we need to also keep in mind that, in addition to it providing stronger control of the front end of the curve, which is equal to a measure for further accommodation, the BOJ has reminded us that there are measures available to it that allow it to respond in case of further turmoil in the yen bond market (due to factors such as speculation about the *Outlook Report*) that won't lead to an increase in its balance sheet due to an increase in the amount of JGBs held by the BOJ.

◆ **Speech by BOJ Executive Director Masayoshi Amamiya: History and Theories of Yield Curve Control** (11 Jan 2017)

I believe the dichotomy between normal and crisis periods is a good starting point for the normative discussion of long-term interest control. If this dichotomy holds, during the normal periods, the central bank should control the short-term interest rates exclusively and let the long-term interest rates be determined by financial markets so that the price discovery function operates; during the crisis periods -- or phases of overcoming long-lasting deflation, like the case of Japan -- it should employ policy measures that are different from those adopted during the normal periods.

[2] From materials submitted by the Cabinet Office at the Upper House Budget Committee on 15 Mar 2006.

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