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Daiwa's View

What's the BOJ to do? The YCC's condition is terminal

- It's important for central banks to have (1) credibility, (2) accountability, and (3) transparency

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.

What's the BOJ to do? The YCC's condition is terminal

Four weeks have passed since BOJ's surprising decision in Dec 2022

Bond issuances have been postponed amid persisting distortion of 10-year sector

BOJ indicated a stance of thoroughly defending upper limit via advance notification of irregular operations

Four weeks have passed (during which we transitioned to the new year) since the BOJ's surprising decision to modify its implementation of the yield curve control (YCC) at its Monetary Policy Meeting (MPM) on 19-20 December 2022. The statement clearly said that the modifications this time were aimed at encouraging smoother formation of the entire yield curve, while maintaining accommodative financial conditions. However, the distortion of the 10-year sector is unlikely to be resolved easily. Some issuance plans were postponed in early January, as one board member pointed out, "the functioning of bond markets has deteriorated, and if this situation persists, it could have a negative impact on financial conditions such as issuance conditions for corporate bonds." The BOJ's intended objectives have not been achieved. Rather, the 10-year JGB yield (JB369) hit 0.545% at one point on the 13th, driven by market pressure on the BOJ for policy revisions[1]. In the late afternoon of the 13th, the BOJ indicated a stance of thoroughly defending against higher yields through advance notification of irregular operations on the 16th, which are part of its flexible response. Nevertheless, the yield temporarily rose to 0.510% on the 16th, exceeding its upper limit for two consecutive days. As of the 16th, JGB purchases reached about Y17tn (the highest on a monthly basis). Purchases at this pace cannot be sustained. Clearly, we have started to see the limitations of the YCC during a time of rising yields. The policy's condition is terminal.

Experienced bond dealers reported this as being the first time seeing BOJ lose control

Market can't avoid strong reaction to prolonged unprecedented easing

Following the developments in the JGB market on the 13th, I heard many opinions (bordering on anger) from experienced bond dealers saying that this was the first time they had ever seen the BOJ lose control, and that they had never lost confidence in the BOJ to this degree. Looking back on the past, on 4 April 2013, BOJ Governor Haruhiko Kuroda started his term by breaking the JGB market via unprecedented easing. I can't help wondering if, now, ten years later, as the end of his term on 8 April 2023 approaches, he intends to wrap up by once again breaking the market, and what the past decade was all about, when the BOJ was continually aiming for the price target of 2% by working on expectations? However, looking at the situation with a level head, it goes without saying that there would be a strong reaction to prolonged unprecedented easing. You could say that the market has finally reached the point where it will have to face the unavoidable process that it was going to have to deal with sooner or later.

Decision to widen trading band because of decline in market functions led market to feel BOJ can cope with situation for different reasons than before

At the December 2022 meeting, the BOJ decided to widen the trading band because of a decline in market functions. This has led the market to feel the BOJ can cope with the situation for reasons other than the existing reason of maintaining easing measures (fundamental conditions). At his press conference, Governor Kuroda said that the latest response was aimed at increasing sustainability of easing policy, and that it was not a rate hike. He emphasized once more that it was too early to discuss an exit strategy, as it would take time before seeing a sustainable rise in wages and prices. However, the market has become more inclined to expect further policy revisions.

[1] The 12 January morning edition of the *Yomiuri Shimbun* reported that the BOJ would be re-examining the side effects from its large-scale easing, which prompted doubt and concern in the market. Although articles on the second page are not generally scoops, the market reacted to the part of the article that stated that there would be additional policy modifications, if necessary, which spurred speculation about policy revisions.

Further widening of trading band would not improve market functionality

Accountability should be fulfilled to review YCC framework

Three important codes of conduct for central banks

The BOJ's subsequent communication with the market has not been going well. Repeated fixed-rate purchase operations and irregular JGB purchases appear to be responses to keep the upper limit of the 10-year JGB yield of 0.5%. However, these operations lack consistency as it is unclear how they will have an impact on each maturity zone.
Under current conditions, a further widening of the trading band for the long-term yield would probably neither fix the yield curve distortions nor improve market functionality. If that is the case, it would probably be better to just eliminate the guidance target for the long-term rate, although that would highlight its accountability for rethinking the YCC framework. Given that the BOJ argued in its March 2021 policy assessment that the framework was working, it now needs a process to review or verify the reasons why it is no longer working. If the BOJ were to just abolish the framework without doing anything else, it would probably be leaving some potential landmines right before bringing in a new governor. It's important for central banks to have (1) credibility, (2) accountability, and (3) transparency. I hope the BOJ will adhere to these codes of conduct.

BOJ to discuss impact of Dec decision at Jan MPM; I predict BOJ will maintain the status quo

It is urgent that BOJ restore proper communication with market

The top priority item on the agenda at the first MPM in 2023 on 17-18 January will be to discuss and discern the impact of the decision in December 2022. I predict that the BOJ will maintain the status quo. However, as it is urgent that the BOJ restore proper communication with the market, I want the BOJ to provide detailed explanations. If the BOJ wants to increase the sustainability of this framework, despite seeing the limitations of the YCC, it will also need to review its operations. Some ingenuity will be needed in order to tell the market about the review. For example, the BOJ might rethink its views regarding the current policy or provide attached documents related to operations. Even if Governor Kuroda repeatedly emphasizes at the press conference that the BOJ will not rush to modify the YCC again, this may not hit home with the market. Therefore, to prevent that from happening, the BOJ should send messages carefully and persistently from now on via speeches by top BOJ officials.

Jan *Outlook Report* is important message when considering policy operations heading to spring

Macro output gap is expected to turn positive in 2H FY22 in line with BOJ projections

Another important issue at the Jan MPM will be the announcement of the January *Outlook for Economic Activity and Prices* report *(Outlook Report).* In a situation in which the market is demanding policy revisions, I am concerned that market participants might just confirm forecast figures without carefully reading the report. Nevertheless, the report will be an important message when considering policy operations starting spring, when the new governor takes office. Because the level of FY21 GDP was revised upward, we expect GDP growth projections (median of the majority) to be slightly lowered for both FY22 and FY23 (Chart 1). Production has started to weaken, reflecting a decline in demand for semiconductors. From FY23 onwards, downside risks to the economy will remain significant as we only expect moderate growth due to downward pressures from the global economic slowdown. In its previous *Outlook Report* in October, the BOJ projected the output gap "to turn positive around the second half of fiscal 2022 and then continue to expand moderately." The figure is close to positive territory (Chart 2).

Changes over past three months include lower crude oil prices and stronger yen in currency market

Turning to the BOJ's price (core CPI) outlook, changes in the external environment over the past three months include a decline in crude oil prices (the WTI decline from $85/bbl in late Oct to below $80/bbl recently) and a strengthening of the yen (the USD/JPY decline from above Y148 then to below Y130 recently). With commodity prices no longer rising and the yen no longer weakening, import prices should start coming down. Unlike before, however, companies have been passing on higher prices and there have been numerous reports of price hikes to be implemented by spring.

Chart 1: Forecasts of Majority of Policy Board Members (median, y/y %)

	Real GDP			Core CPI		
	Oct 2022*	**Jan 2023****	My forecast	Oct 2022*	**Jan 2023****	My forecast
FY22	+2.0 %	**+1.7 %**	+1.7 %	+2.9 %	**+3.0 %**	+2.9 %
FY23	+1.9 %	**+1.6 %**	+1.3 %	+1.6 %	**+1.8 %**	+1.9 %
FY24	+1.5 %	**+1.5 %**	+1.0 %	+1.6 %	**+2.0 %**	+1.9 %

Source: BOJ, various materials; compiled by Daiwa Securities.
**BOJ projections.*
***My estimates for policy board member forecasts*

Prices are expected to remain stable at around +2% from FY23 onwards

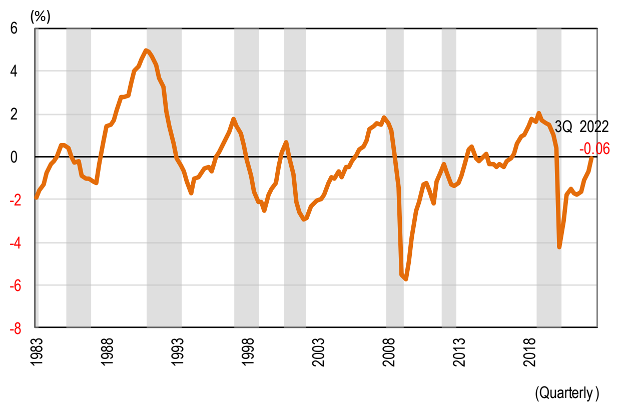
We should note Box analysis section of Jan *Outlook Report*

Meanwhile, the momentum for wage hikes is spreading, albeit mainly among large companies, which is good news to hear. If the output gap turns positive with an increase in wages, we can anticipate the formation of a virtuous cycle with wages and prices, which is what the BOJ is aiming for. According to a *Nikkei* article on 31 December 2022, the BOJ intends to raise price projections. Specifically, proposed changes would show core CPI rising to around 3% in FY22, at least 1.6% but less than 2% in FY23, and nearly 2% in FY24 (Chart 1). If Governor Kuroda's final *Outlook Report* indicates an outlook in which prices remain stable at around +2% from FY23, he will be able to step down from his post with his head held high. We should note the Box analysis section of the January *Outlook Report* (to be released on the 19th) as it is expected to include overseas economic trends and a new analysis on prices.

Next move should be to hold discussions on revising BOJ/government joint statement with new governor

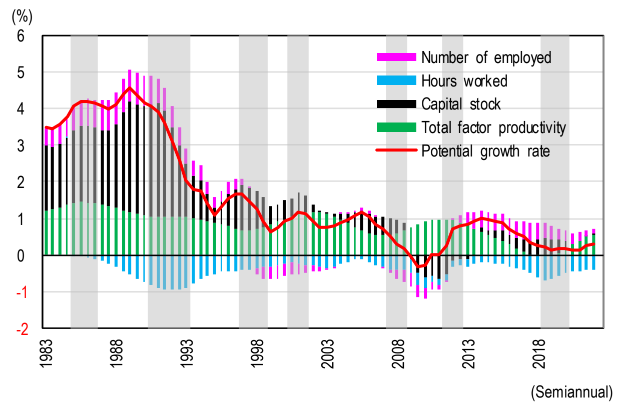
However, even if such a desirable picture is depicted, it has yet to become a reality. The BOJ still does not have sufficient factors in place in order to make decisions about policy changes. The next move should be to consider the normalization of monetary policy operations under the new BOJ governor, after holding discussions on revising the BOJ/government joint statement. The BOJ needs to await confirmation of the key conditions involving fundamentals, specifically (1) an economic recovery to pre-coronavirus levels, (2) a positive output gap, and (3) the budding formation of a virtuous cycle of higher prices leading to higher wages, taking into consideration the annual spring labor-management wage negotiations. The BOJ should probably conduct a comprehensive assessment in order to revise its framework at a time when US policy rates remain high.

Chart 2: Trend of Output Gap Estimated by BOJ



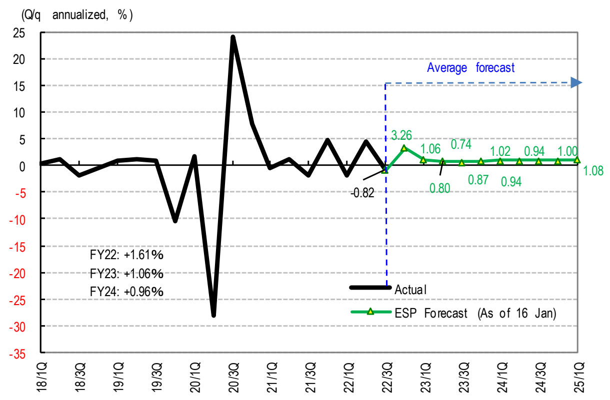
Source: BOJ; compiled by Daiwa Securities.
Note: Shaded areas indicate recessions.

Chart 3: Trend of Japan's Potential Growth Rate



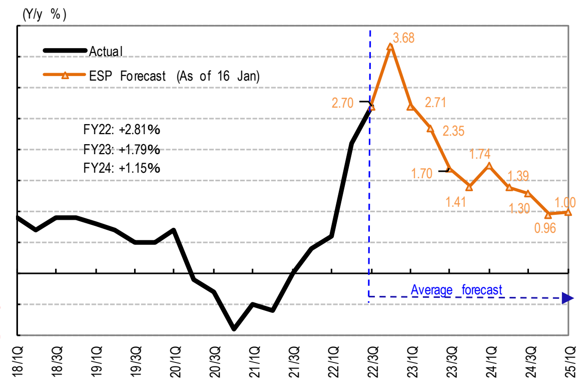
Source: BOJ; compiled by Daiwa Securities.
Note: Shaded areas indicate recessions.

Chart 4: Japan's Growth Rate Forecasts



Source: Cabinet Office, Japan Center for Economic Research; compiled by Daiwa Securities.

Chart 5: Japan's Core CPI Forecasts



Source: Ministry of Internal Affairs and Communications, Japan Center for Economic Research; compiled by Daiwa Securities.

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