Daiwa Securities

Daiwa's View

BOJ January policy meeting not uneventful

- Are enhanced pooled collateral operations a Japanese version of LTRO?

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.

Are enhanced pooled collateral operations a Japanese version of LTRO?

Interest Rate on Loans Based on Fixed-rate Method Under Funds-Supplying Operations Against Pooled Collateral

Interest rate on loans
0% per annum (Temporary Rules regarding Funds-Supplying Operations against Pooled Collateral)
The Bank shall determine the interest rate of each loan in order to encourage the formation of a yield curve that is consistent with the guideline for market operations, taking into account market prices of Japanese government bonds for each maturity

Source: BOJ; compiled by Daiwa Securities.

BOJ January policy meeting not uneventful

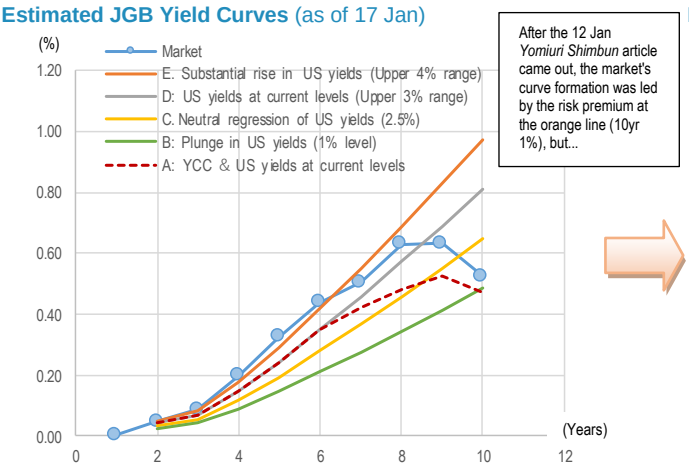
At its January Monetary Policy Meeting yesterday, the BOJ held fast to its 0% ±0.5% 10yr yield target. It also announced a modification to the loan rate for its fixed-rate funds-supplying operations against pooled collateral, adding this sentence: "The Bank shall determine the interest rate of each loan in order to encourage the formation of a yield curve that is consistent with the guideline for market operations, taking into account market prices of Japanese government bonds for each maturity. Regarding the variable-rate method, as well, existing restrictions, such as the loan duration of up to one year, were removed. As such, several measures were announced. (See this report for a comprehensive review of the meeting.)

Media reports prior to the policy meeting showed the consensus view was that the BOJ would not announce further YCC changes at this meeting. These reports included a 6 Jan Bloomberg article quoting an official saying that "there is no urgency to make further changes at this time" and a quote in a 12 Jan article in the *Yomiuri Shimbun* saying "we will look closely at whether changes to JGB purchase amounts can correct market distortions and will make additional changes to policy if necessary." We also had forecast that the BOJ would stand pat. Thus it seems that the BOJ's decision was what the market was expecting. Amid rising uncertainty following the surprise YCC change at the December policy meeting, there were also many market participants who expected the BOJ to widen the trading band or eliminate YCC altogether, and consequently JGB yields declined sharply, by 3.5bp to 0.005% for the 2yr, 9bp to 0.23% for the 5yr, and 8.5bp to 0.415% for the 10yr (see next page).

As evidenced by the major role played in stabilizing the euro zone crisis in 2011-2012 when former ECB President Mario Draghi proposed the 3yr Long-Term Refinancing Operations (LTRO), if used skillfully the pooled collateral operations can provide a "double backstop," a very powerful tool. Because this eases financial conditions by providing funds to the private sector, it affects the products that are most advantageous for the private sector's financial institutions, which is an important point. This is expected to put some downward yield pressure on off-the-run JGBs and other bonds that are eligible for collateral (such as municipal bonds), which are not the target of fixed-rate purchase operations, and even swaps if collateralized (swaps rank right behind JGBs in importance as a benchmark for corporate bonds). In achieving the policy intention of smooth yield curve formation and the transmission of monetary easing to corporate finance, pooled collateral operations look to be a more appropriate tool for current conditions than fixed-rate purchase operations are.

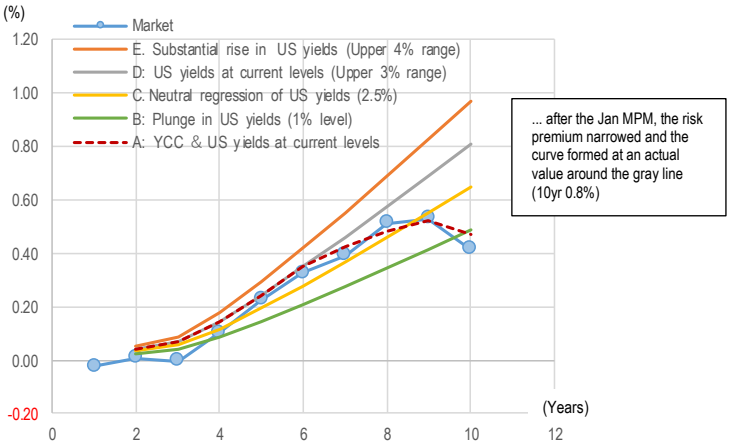
Although there was a significant decline in JGB yields yesterday, the risk premium that widened significantly after the *Yomiuri Shimbun* article came out only partially narrowed back (see next page). This newest enhancement of operations could also be seen as preparing ahead of time a tool capable of controlling any actions automatically triggered by the next widening of the trading band or elimination of YCC. Even if there is a rapid stabilization of the 5yr and under zone, where the pooled collateral operations apply, there will still be worries over future monetary policy and market tensions related to the 10yr zone are unlikely to be completely eliminated.

Estimated JGB Yield Curves (as of 17 Jan)



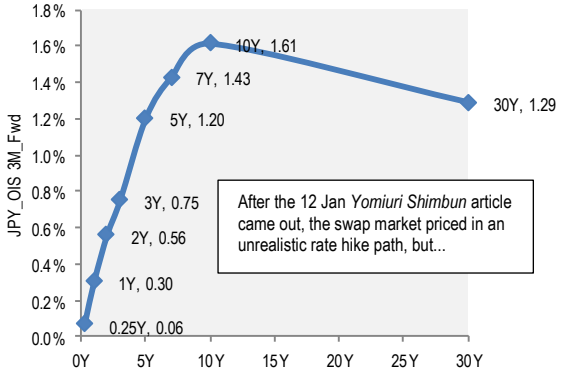
Source: Bloomberg; compiled by Daiwa Securities.

Estimated JGB Yield Curves (as of 18 Jan)



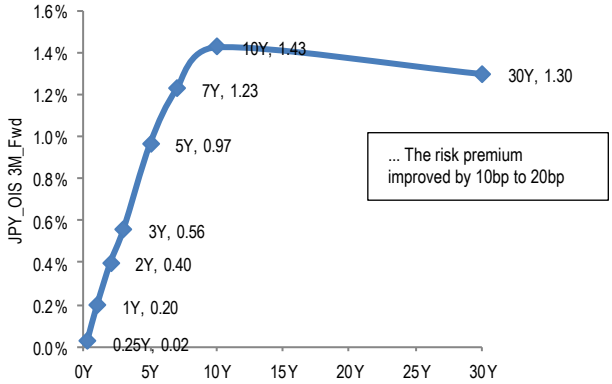
Source: Bloomberg; compiled by Daiwa Securities.

JPY Swap OIS 3M Forward Yield (as of 13 Jan)



Source: Bloomberg; compiled by Daiwa Securities.

JPY Swap OIS 3M Forward Yield (as of 18 Jan)



Source: Bloomberg; compiled by Daiwa Securities.

That the BOJ decision followed previous media reports appears to have made predictions of monetary policy from the next meeting more reassuring. It is important that the January *Outlook Report* forecast the FY24 core CPI at 1.8% and the core core at 1.6%, both below the 2% target (this was a surprise, with previous reports having noted the possibility of the core CPI being above 2%), which signaled the BOJ's intent not to abolish YCC before the next *Outlook Report* comes out at the April policy meeting. It is of course possible that the inflation outlook will be revised to over 2% in the April *Outlook Report*, and although that certainly does not bind the next BOJ president, scheduled to take over in April, to a particular policy (which means there will be continued speculation that YCC will be eliminated/revised), if that speculation cools during the rest of Mr. Kuroda's term, this would put slight pressure to calm the risk premium, which is still widening.

Additionally, on Monday of next week, a new auction method (meaning not a fixed rate) will be used for the 5yr zone through pooled collateral operations. Reports thus far indicate that many market participants are skeptical about how effective that will be, but to the extent that prior expectations are low, if the operations wind up being effective it could further rein in the risk premium. To repeat, because the pooled collateral operations will affect the entire JPY bond market as well as swaps, there is a risk of underestimating the policy effects when looking only at its impacts on the JGB market. We note that when former ECB President Draghi announced the 3yr LTRO in 2011-2012, there were virtually no market participants who predicted that it would have as much of a spread narrowing effect on Italian government bonds as it did.

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