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Daiwa's View

FICC Research Dept

Did 13 May reduction in JGB purchases signal change in monetary policy stance?

- Need to look at both "offensive" and "defensive" aspects of BOJ moves (like game of chess)
- 13 May reduction in JGB purchases likely in line with schedule; along with considering yen depreciation, another probable aim was to dispel overly dovish impression at Apr meeting
- While unpredictable, still too early to conclude that BOJ's policy stance (= interest rate hike logic, passive approach to B/S) has changed to hawkish/active at this point

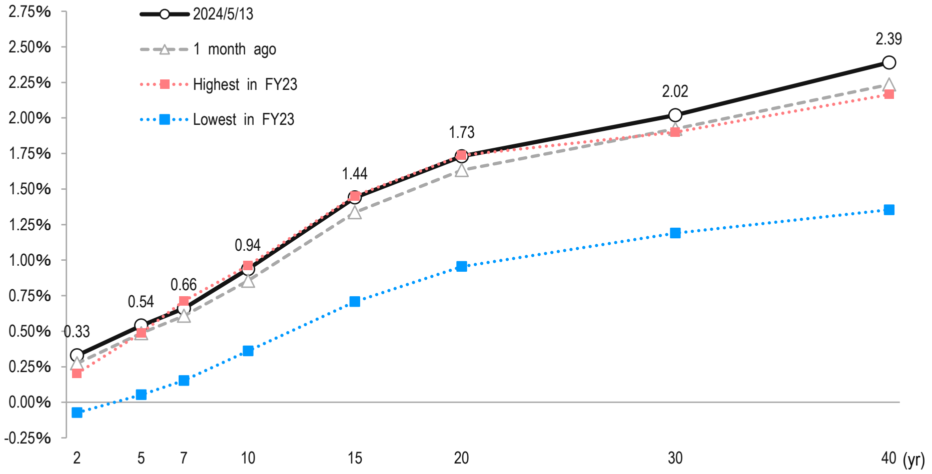
Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd

Reduction in JGB purchases

At the 13 May "rinban" regular JGB purchase operations, the BOJ reduced its purchases of JGBs in the 5~10-year zone from Y475.0bn to Y425.0bn. Despite deep-rooted expectations for a reduction among market participants, many had anticipated that the BOJ would not reduce its purchases at this time as the JGB yield absolute levels have remained elevated since the start of the year. As such, the 13 May reduction was seen as a modest surprise. Following that action, the yield on the 2-year JGB rose 1.5bp to 0.33%, that on the 5-year JGB rose 2.0bp to 0.54%, that on the 10-year JGB rose 3.5bp to 0.94%, that on the 20-year JGB rose 3.5bp to 1.73%, and that on the 30-year JGB rose 2.5bp to 2.02%. Yields on the 2-year, 5-year, 30-year, and 40-year JGBs topped their FY23 highs, while those for the 7-year, 10-year, and 20-year JGBs also moved closer to their FY23 highs. As many have asked us about the implications of these developments, we will briefly discuss them in this report.

JGB Yield Curve (Conventional yield basis, Bloomberg generic)



Source: Bloomberg; compiled by Daiwa

Change in policy stance to address rapid yen depreciation?

The simplest (superficial) interpretation of this reduction in JGB purchases would be that "BOJ changed its policy stance to address rapid yen depreciation." The BOJ certainly has an incentive to make the market think that this is its intention at this time. Indeed, the government is clearly concerned about the negative effects of a rapidly depreciating yen. An irregular meeting between Prime Minister Fumio Kishida and BOJ Governor Kazuo Ueda was held on 7 May. Then on 8 May, Ueda delivered a speech stressing that his concerns about yen depreciation have increased.

The BOJ's April "Summary of Opinions" (released on 9 May) also left a strong impression that the Monetary Policy Board is filled with hawkish opinions about interest rate paths and operations. Under the current conditions in which actual foreign exchange market intervention appears to have been executed, it is important for the market to perceive that there is good communication between the government and the BOJ and that there are no significant differences in terms of direction.

Actually, the Mundell-Fleming model, which is the open economy version of the macroeconomic model (IS-LM analysis), also shows that independent monetary easing and exchange rate intervention (≈ pseudo fixed market) are incompatible and likely to lead to capital outflows. On 16 October 2023, Vice Minister of Finance Masato Kanda stated that in the event of severe yen depreciation Japan would, "Stop capital outflows by raising interest rates or counter excessive volatility with currency intervention" (albeit he said this as a generalization). We believe that this statement was made more with an awareness of the "trilemma" of international finance, rather than pressure the BOJ.

However, the BOJ's moves are thought out ahead of time, like a game of chess, and usually have both "offensive" and "defensive" aspects. Even if the total is somewhat hawkish in itself, interpreting this latest JGB purchasing measure from only one of the two direction is not good. In addition to the easy-to-understand hawkish aspect of the reduced JGB purchases, we think it is also important to determine whether the dovish aspect (or at least an aspect that is not too hawkish) also has some validity.

Was JGB purchasing reduction as scheduled?

The most recent one-time reduction in the JGB purchasing amount was Y50.0bn, or Y200bn on a monthly basis (Y50bn reduction x 4 times/month). While this is of course within the scope of a "certain allowance (for example, around Y1.0~2.0tn)," the BOJ can, at its own discretion, flexibly determine adjustments according to market conditions. The reduction range this time was extremely narrow compared to this allowance. The fact that JGB issuance amount (calendar-based market issuance) was reduced from Y2.7tn/month in FY23 to Y2.6tn/month (down Y100bn/month) at the beginning of FY24 is also a factor that may weaken the hawkish interpretation of this JGB purchasing reduction. Even if the JGB purchasing amount is reduced by Y200bn/month in the current round of operations, the net deterioration in supply and demand would come to a Y100bn/month decrease, considering that the issuance amount is also reduced by Y100bn. If divided into four operations, this measure will have only a minimal net supply-demand impact of a Y25bn/month decline (compared to March).

Furthermore, we can probably take into account that of JGBs to be redeemed in FY24 (approximately Y110tn), the portion held by the BOJ is approximately Y68tn (monthly average of Y5.7tn). Since the total regular purchasing operation offer in April 2024 was Y5.91tn for all maturities, including the inflation-indexed JGBs, and the amount of the operation in May will come to around Y5.7tn (assuming operation after this reduction is to leave amount unchanged). Due to this reduction JGBs purchases, the amounts of JGBs to be redeemed and to be reinvested are even.

Is BOJ trying to dispel overly dovish perception?

Bluntly speaking, from the start, almost all experts that we know had assumed that even this level of reduction would take place over the span of time until the end of June. The reduction in JGB purchasing operations this time can be interpreted as a carefully planned on-schedule action rather than a change in the BOJ's stance in response to rapid yen depreciation. As for the timing, this seems reasonable if we consider the possibility of extreme swings for US Treasury yields and the dollar/yen (≈ intervention) when April US CPI is released on 15 May.

Of course, one of the reasons why this timing was chosen was undoubtedly weak-yen considerations. If anything, the BOJ aims to correct the perception left by the April policy bord meeting, specifically by arbitrarily cutting out the overly dovish aspects, including in terms of the impact of yen depreciation on underlying inflation. This may be due in part to the fact that 13 May was the best time to launch the scheduled amount reduction to Y5.7tn/month.

Going forward, we cannot predict changes in the future depending on the exchange rate and price situation (in this regard, left to the US and the Fed). Still, isn't the BOJ maintaining the conventional logic of considering additional rate hikes as the certainty (confidence) of achieving 2% underlying inflation increases? Of course, a greater awareness of the weak-yen impacts on underlying inflation will probably hasten the timing of the rate hike somewhat. However, it would be premature to find strong policy implications in the 13 May JGB purchasing reductions and jump to the conclusion that the BOJ's stance (= logic of raising interest rates, passive B/S stance not as an active monetary policy tool) has shifted to a full-fledged hawkish and active direction at this point. That said, it is too early to conclude that the BOJ has made a full-fledged shift to a more hawkish and active stance.

◆ **BOJ Policy Board member Asahi Noguchi (18 Apr 2024)**

One thing I would like to emphasize is that the BOJ's policy change will basically entail raising the short-term interest rate, which is basically the traditional measure. So, even if the balance sheet is reduced, that will have little policy meaning in itself. I think it is clear that there is little policy significance in shrinking the balance sheet.

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