

Daiwa's View

FICC Research Dept

BOJ holds “Bond Market Group” meeting (Day 1), releases explanatory materials from Financial Markets Department

- BOJ released “Responses to Opinion Inquiries” and “Examples of Specific Opinions” to share opinions received at meeting
- Left impression that many opinions were covered in published materials; no particular consensus was formed
- BOJ officials expected to make final decision on proposed JGB purchasing reductions, focusing on these proposals, while monitoring balance between predictability and flexibility



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Day 1 of the BOJ's “Bond Market Group” meeting with a commercial banks group and a securities firms group was held on 9 July and explanatory materials from the Financial Markets Department were released. The Bank plans to meet with the buy-side group on Day 2 (10 July). This “Bond Market Group” meeting is usually held every six months, inviting those in charge of bond market issues within financial institutions, including those who participate in the BOJ's “Bond Market Survey” and other surveys. This 20th meeting was called and held at an irregular time as the BOJ now wants to hear opinions regarding its JGB purchase operations going forward.

The materials released on 9 July included specific “pre-meeting inquiries” submitted to the meeting participants, as well as “Responses to Opinion Inquiries” and “Examples of Specific Opinions.” After providing an overview of the contents in the disclosed materials, we would like to briefly discuss our personal impressions and observations.

◆ Explanatory materials from Financial Markets Department at BOJ's “Bond Market Group” meeting (9 Jul 2024)

Pre-meeting inquiries

(1) Range and pace for JGB purchase reductions

- Please share with us your opinions on the range and pace for specific JGB purchase reductions.

(2) How to indicate guidance for reducing JGB purchases

- Currently, the BOJ indicates its JGB purchasing amounts for monthly flows using a range format (¥5.0~7.0tn) in the “Quarterly Schedule of Outright Purchases of Japanese Government Bonds” provided by the Financial Markets Department. From the perspective of ensuring an appropriate balance between predictability and flexibility when reducing JGB purchases in the future, we would like to hear your opinions on the period covered by the reduction plan and how to indicate the purchasing amounts (What is the purchase amount range?)

(3) How to proceed with reductions by remaining maturity

- The Financial Markets Department provides the monthly purchasing amounts by remaining maturity in the “Quarterly Schedule of Outright Purchases of Japanese Government Bonds.” Please share with us your opinions on how to proceed with reductions by remaining maturity.

(4) Others

- If you have any opinions on issues other than the above (1) through (3), please share them with us.

Eventual reduction range: JGB purchasing amount of less than Y4.0tn in two years

◆ Explanatory materials from Financial Markets Department at BOJ's "Bond Market Group" meeting (9 Jul 2024) Responses to Opinion Inquiries (JGB purchase reduction range)

- Received a wide range of opinions on the eventual reduction range within the reduction plan period, including (1) "Eventually, purchases should be zero," (2) "Purchases should be set at about Y2.0~3.0tn per month," and (3) "Monthly purchases of about Y4.0tn should continue," as well as more qualitative opinions that did not refer to any specific reduction ranges.

There was a wide range of opinions regarding the eventual reduction range and no particular consensus was formed. However, according to the numerical suggestions provided in the materials, the smallest suggestion was for zero monthly purchases, the next was for about Y2.0~3.0tn per month (reduction of Y3.0~4.0tn), and the largest was for about Y4.0tn per month (reduction of about Y2.0tn). As might be expected, there were no overly dovish proposals such as JGB purchases of Y5.0tn per month after two years (Y1.0tn reduction range).

The "Examples of Specific Opinions" included various "should" arguments. Indeed, there were many well-founded "should" arguments such as (1) "Should indicate a path to zero JGB purchases," (2) "Should return to some form of JGB purchases to supply growth currency," (3) "Should consider examples of quantitative tightening among overseas central banks," and (4) "Should consider range and pace of reductions based on volatility and JGB issuance amounts by maturity."

Meanwhile, some participants pointed out that Japanese banks have limited needs for bond purchases considering IRRBB (interest rate risk in the banking book) restrictions and other factors. Some participants also said, "It is acceptable to temporarily reduce the amount up to about Y5.0tn and then consider further reductions while monitoring the supply/demand conditions for JGBs and other factors."

In our opinion, the extent to which banks will have excess holding capacity (= degree of reduction to reach point of relying on arbitrage investors to bid on JGBs) after the introduction of Basel III is unknown. It seems to us that a step-by-step approach that moves closer to the ideal purchasing reduction amount without creating unintended yield spikes is appropriate. In any case, we were left with the impression that the necessary issues have generally been stated and the final decisions will be made by BOJ officials while monitoring the balance between predictability and flexibility.

Pace of reduction: In stages?

◆ Explanatory materials from Financial Markets Department at BOJ's "Bond Market Group" meeting (9 Jul 2024) Responses to Opinion Inquiries (JGB purchase reduction pace)

- Regarding the pace of JGB purchasing reductions, we mainly received such opinions as (1) "Should promptly reduce purchases by a certain amount," (2) "Should promptly reduce a certain amount followed by gradual reductions in stages," and (3) "Should gradually reduce purchases over a period of about two years."

A wide range of opinions regarding the pace of reduction were cited. These opinions included (1) "Promptly reduce by a certain amount," (2) "Promptly reduce by a certain amount followed by gradual reductions in stages," and (3) "Reduce gradually over a period of about two years." Here again, no particular consensus was formed (intentionally?).

Again, in our opinion, there are some unknowns as to how much holding capacity banks will have after the introduction of Basel III (= degree of reduction to reach point of relying on arbitrage investors to bid on JGBs). In terms of the pace of reduction, a phased approach that allows for some flexibility while increasing predictability seems appropriate.

Japan now has a golden opportunity to finally achieve an underlying inflation rate of 2%. At this juncture, Japan should avoid nipping that opportunity in the bud via unintended tightening of financial conditions brought about by a sharp rise in long-term interest rates. The disadvantages of taking excessive risk for the reduced pace of JGB purchases are

likely to outweigh the advantages, as there is little evidence that higher interest rates driven by term premiums deter yen depreciation.

How to indicate guidance for reducing JGB purchases: Continue or elimination range approach?

◆ Explanatory materials from Financial Markets Department at BOJ's "Bond Market Group" meeting (9 Jul 2024) Responses to Opinion Inquiries (How to indicate guidance for reducing JGB purchases)

- Regarding the guidance for JGB purchasing reductions, we received both a "Continuation of the range method is appropriate" opinion and a "Should use fixed amounts, not ranges" opinion.

Regarding guidance for the reduction of JGB purchases, the following two proposals were presented: (1) "It is appropriate to continue the range method as in the past" and (2) "Fixed amounts is the best way forward."

If the BOJ wants to make gradual progress with respect to predictability, it could achieve some success by narrowing the JGB purchasing range while still presenting a range, as it did in the past. Another major advantage of this approach is that the Bank has accumulated know-how in this area through its past operations. That said, in the event that the JGB purchasing amount becomes stuck at the upper or lower end of a narrowing range, we could easily envision a situation in which speculation among market participants increases, volatility rises, and liquidity declines in anticipation of the BOJ's intentions.

If the BOJ wants to move forward in terms of predictability, eliminating JGB purchasing amount ranges could be ideal. Of course, some degree of flexibility is probably an essential requirement, so some sort of mechanism will have to be devised separately to allow for such flexibility. Ultimately, this seems to come down to how much faith the BOJ has in the JGB market. If we take a serious look at the decline in market functionality caused by the yield curve control (YCC) policy, a gradualist approach may be appropriate here as well. However, there will be a prolonged period of time when speculation about BOJ operations will impact market functioning.

How to proceed with reductions by remaining maturity: No consensus

◆ Explanatory materials from Financial Markets Department at BOJ's "Bond Market Group" meeting (9 Jul 2024) Responses to Opinion Inquiries (How to proceed with reductions by remaining maturity)

- As for how to proceed with JGB purchasing reductions by remaining maturity, we received opinions that consider supply/demand conditions for each zone, such as (1) "Amount should be reduced mainly in the short- and medium-term zones," (2) "Priority should be given to the medium- to long-term zones," (3) "Priority should be given to reducing purchases in the zone up to the 10-year JGB" and (4) "Priority should be given to reductions in the super long-term zone." In addition to those opinions, we received opinions such as **"Should be reworked to realize a market-neutral purchasing approach."**

In terms of how to best proceed with JGB purchasing reductions by remaining maturity, opinions were cited based on the supply/demand conditions for each zone, such as (1) "Amount should be reduced mainly in the short- and medium-term zones" and (2) "Priority should be given to the medium- to long-term zones." No real consensus was seen in the materials released by the BOJ. Still, a different opinion that read, "Should be reworked to realize market-neutral buying" caught our attention.

We also believe that this "market-neutral buying approach" is ideal from the perspective of restoring market functioning and independent price formation. This is also the approach to purchasing adopted by the Federal Reserve Bank of New York (NY Fed). In the "February 2022 FAQs," the Fed indicated a relatively neutral purchasing policy for securities that it entrusts to the market so as to limit the impact of their operations on normal market functioning. If this means "reducing JGB purchase amount to ensure that long-term interest rates would be formed more freely," then this NY Fed policy of market engagement seems worth considering with respect to the BOJ as well.

◆ **NY Fed FAQs: Treasury Purchases (11 Feb 2022)**

What Treasury securities will the Desk purchase?

In general, the Desk seeks to operate in a manner that is **relatively neutral to the securities available for purchase and in a way that limits the potential for operations to affect normal market functioning**, unless otherwise appropriate for efficient and effective implementation under the directive. As such, purchases of Treasury securities are conducted **across a range of maturities and security types in rough proportion to the universe of Treasury securities outstanding**. Purchases may be conducted in nominal coupon securities, bills, Treasury Inflation-Protected Securities (TIPS), and Floating Rate Notes (FRNs).

Of course, the BOJ is probably well aware of the benefits of the NY Fed's market engagement policy (emphasis on market functioning). Meanwhile, the US and Japanese government bond markets differ in terms of investor diversity, market depth, and trust in the market (liquidity). In light of these differences, it is possible that, at least until now, the shortest route to idealism (as in the case of the NY Fed) has not always been the correct one for the BOJ. However, when the BOJ is biased in terms of remaining maturities with respect to the balance of JGBs it leaves in the market, the market inevitably takes into account the speculation (underlying circumstances) that led to that bias. If such central bank speculation (bias) can be overlooked, the market's price discovery function will become easier to manifest.

Others: Liquidity of CTD issues, etc.

◆ **Explanatory materials from Financial Markets Department at BOJ's "Bond Market Group" meeting (9 Jul 2024)**

Responses to Opinion Inquiries (Others)

- Other opinions included those from the perspective of restoring liquidity, the method of classifying remaining maturities, and how to indicate JGB purchase policies other than purchase flows.

Finally, other opinions on various points were also received. At the top of the list were hopes related to JGB sales for issues where JGB purchases have been large in the past and for which the BOJ holds a large percentage of outstanding JGBs, as well as hopes related to liquidity of CTD issues. It is well known that the percentages of outstanding JGBs held by the BOJ are skewed from issue to issue. The damage in terms of liquidity is maximized when bonds for which the BOJ holds a large percentage of the outstanding amount become CTD issues.

Meanwhile, if the BOJ were to take steps to sell JGBs on the market, speculation regarding issue selection and timing would impact market price trends and negatively impact market functioning. If JGBs for which the BOJ holds a large percentage of the outstanding issuance become depleted and overvalued, then there should be the desire to purchase them at higher prices (lower yields) in liquidity enhancement auctions. Thus, another possible route is to request the expansion of liquidity enhancement auctions with increased ingenuity. The latter could satisfy the market, the BOJ, and the government (JGB issuance with low procurement costs).

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