Daiwa's View

FICC Research Dept

What has, will, and won't return to pre-QQE levels

- 10yr JGB yield, swap spreads on way back to pre-QQE levels
- If all sectors' JGB holdings also set to rebound to pre-QQE scale, BOJ's "sizeable" cuts could shrink its holdings by around Y200tn
- Due to various irreversible changes over past 12 years (such as regulatory changes), precipitate reductions entail a risk; caution needed until floating-rate bond issuance, other systemic elements in place

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

Daiwa Securities Co. Ltd

At its 14 June monetary policy meeting (MPM), the BOJ opted to "reduce its purchase amount of Japanese government bonds (JGBs) to ensure that long-term interest rates will be formed more freely in financial markets". It will set specific targets for reductions over the next 1-2 years at the upcoming July MPM.

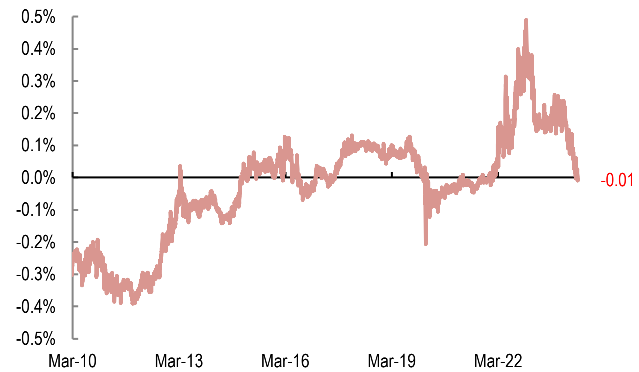
BOJ Governor Kazuo Ueda and Deputy Governor Shinichi Uchida have already stated that the planned cuts will be "sizeable". In this report, we discuss the key points in conceptualizing what "sizeable" means, and take a brief look at the aspects of the JGB landscape that have already returned to their pre-QQE state, those that are set to do so in future, and those that will not. We intend to discuss the numbers in detail in a separate report.

Some things already back to pre-QQE state
We think the starting point (benchmark) for gauging what the BOJ means by "sizeable" is a return to the state of affairs prior to its launch of qualitative and quantitative easing (QQE). A variety of data points including the 10yr JGB yield, 10yr swap spread, and 10yr breakeven inflation rate have indeed returned to near pre-QQE levels, or are on their way there (e.g., back to historical averages). That being the case, our next task is to consider the BOJ's JGB holdings, which are now at their highest since the advent of QQE.

10yr JGB Yield

Source: Bloomberg; compiled by Daiwa.

10yr Swap Spread

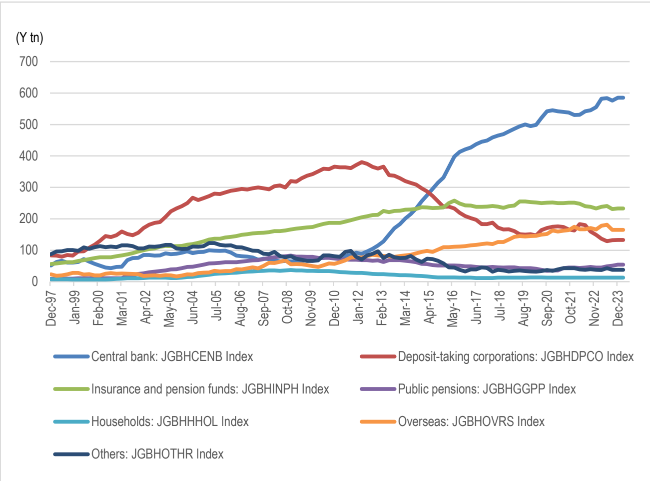


Source: Bloomberg; compiled by Daiwa.

What will return to pre-QQE state

We use BOJ Flow of Funds data to gauge trends in JGB holdings in seven sectors: the central bank, deposit-taking corporations, insurers and pension funds, public pensions, households, overseas investors, and other entities (aggregate for T-bills and JGBs/FILP bonds). A comparison of holdings for these sectors versus March 2012, which is roughly when deposit-taking corporations' holdings peaked, shows that the central bank's holdings increased by around Y500tn between March 2012 (Y89tn) and December 2023 (Y585tn). However, there were no signs of a sharp decline in holdings in the five sectors other than deposit-taking corporations, where they fell by around Y250tn, from Y380tn in March 2012 to Y133tn in December 2023. This implies the transfer of around Y200tn in JGB holdings from the BOJ to deposit-taking corporations as part of a return to (near) pre-QQE levels.

JGB Holdings by Sector (aggregate for T-bills, JGBs/FILP bonds)



Source: Bloomberg; compiled by Daiwa.

Deposit-taking Corporations' JGB Holdings

Source: Bloomberg; compiled by Daiwa.

What will not return to pre-QQE state (irreversible changes over past 12 years)

Naturally, several major structural changes have occurred since 2012. It would be simplistic to expect deposit-taking corporations' holdings to rebound to pre-QQE levels without taking these changes into account. Specifically, we focus on the following two changes.

1. Basel III (change in regulatory environment)

The 2007-2009 global financial crisis (GFC) exposed the failure of regulation under Basel II (distorted incentives) and drove the creation of Basel III. However (per Atsushi Miyauchi, author of footnoted book[1]), post-GFC reforms to the financial system failed to adequately consider micro-level incentives. Also, while regulations based on Basel III had not been implemented when the BOJ launched QQE, a variety of regulations that followed the spirit of Basel III, including interest rate risk in the banking book (IRRBB) and leverage ratio regulations, have been adopted. These regulations may have created new distortions that limited deposit-taking corporations' freedom at the micro level. Central banks' QE may have obscured these deficiencies (weaknesses) in Basel III, and we would watch the risk that quantitative tightening (QT) could bring them into sharp relief.

We think all JGB market participants will recall the comments (warning) from Hiroyuki Seki, then-Managing Executive Officer of MUFG Bank, in a June 2023 Study Group on Government Debt Management. Materials released at the time, which are still available on the internet, include a simulation showing that around 30% of the BOJ's Y555tn in JGB holdings as of December 2022 is a point of reference for purchases by deposit-taking

[1] 1. For details, see "An Economic Study of the Financial Crisis and Basel Rules: Risk Perspectives on the Financial System" (in Japanese), Atsushi Miyauchi, Keiso Shobo, 2015.

corporations. This simulation suggests that any rebound in their holdings will be capped at around Y166tn (Y555tn x 0.3), and we would not expect them to restore the Y250tn decline in these holdings since the start of QQE (at least in the same form). In other words, given the different regulatory environment that is now in place, an attempt to simply return Y250tn in interest-bearing JGBs to deposit-taking corporations without taking regulatory changes into account could trigger a jump in long-term yields.

2. Ample-reserve system (change in rate-control practices)
As of 2012, central banks' QE was still positioned as an unconventional tool. However, more banks began buying sovereign bonds and other risk assets as they faced an inability to lower interest rates further, and QE is now seen as part of their standard toolkit[2]. This led central banks including the Fed and BOJ to adopt a methodology (the "ample-reserve system") predicated on the existence of ample reserves, which paid a set rate of interest on excess reserves and enabled the central bank to keep short-term market interest rates within a set range by encouraging arbitrage by financial institutions. The use of interest on excess reserves (IOER) to control short-term interest rates represented a drastic and revolutionary change in the techniques used to control financial markets (described as an "egg of Columbus", i.e. a seemingly impossible task that becomes easy once understood, by ex-BOJ deputy governor Masayoshi Amamiya). It freed central banks from a key previous constraint: the assumption that when exiting monetary easing, they needed to absorb all excess funds before embarking on operations to raise short-term interest rates. It instead became essential for central banks to leave ample excess reserves on their balance sheet to facilitate the control of short-term rates via IOER.

This suggests the following two broad conclusions.

- The BOJ's use of the word "sizeable" implies that it will shrink its balance sheet by at least Y100tn, far above the cumulative Y48tn reduction over two years (assuming a Y2tn reduction in monthly purchases) that the market seems to expect.
- However, the constraints we discussed in point 1 signal the major risk from a precipitate move to reduce holdings by more than Y150tn without responding to regulatory changes such as Basel III IRRBB rules, for example by issuing floating-rate bonds.

Given that it will likely take nearly two years to implement legal and systemic reforms relating to the issuance and purchase of floating-rate bonds to ease regulatory constraints on deposit-taking corporations, we think a full-scale recovery in their JGB holdings is unlikely in the next 1-2 years. If we are correct, we think one plausible scenario would be for the BOJ to initially scale back its outright purchase (*Rinban*) operations by just Y1tn-2tn, followed by a cut of Y3tn (Y4tn if possible) if it deems that market trends and progress with systemic changes permit, thereby shrinking its holdings at a faster pace. We would view sustained reductions of Y5tn/Y6tn as excessive, in that they could focus attention on the risk of the BOJ becoming unable to maintain the excess reserves required under the ample reserve system we discussed under point 2.

[2] "The Formation of Japanese Long-Term Interest Rates During Large-Scale JGB Purchases", BOJ, 2024 (Japanese only as of the writing of this report).