Daiwa Securities

Daiwa's View

FICC Research Dept

Consensus forming for BOJ's QT; anticipate yield curve flattening pressure

- "Bond Market Group" meeting minutes include opinion BOJ should lower its monthly JGB purchase amount to about Y3.0tn
- In that case, BOJ's holdings of JGBs would decline to Y523tn (48% of all JGBs outstanding) in two years
- Strong impact on medium- to long-term zone within JGB maturity structure; to act as yield curve flattening factor

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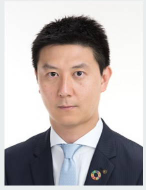


Consensus regarding QT by BOJ

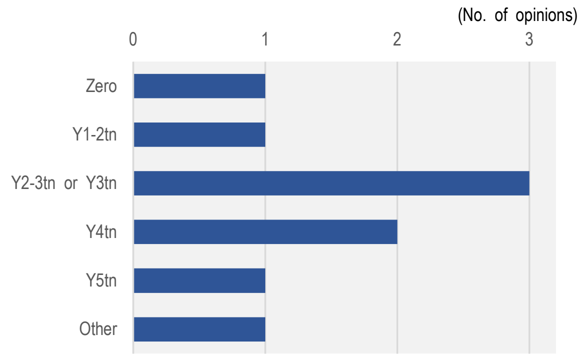
At the Monetary Policy Meeting (MPM) on 30-31 July, the BOJ is set to announce a plan to reduce its JGB purchases over the next one to two years. Based on the minutes of the 20th round of the "Bond Market Group" meetings (released on 19 Jul) and news reports about the upcoming MPM, a consensus is forming that monthly purchases will be reduced to around Y3tn over two years. In this report, we simulate the changes that would take place in the amount/share of the BOJ's JGB holdings if QT (quantitative tightening) were conducted in line with this consensus, and examine the impact on the maturity composition and the yield curve.

Point of reference is for monthly purchases to be reduced to around Y3tn

The most common opinions in the minutes were that monthly purchases should be reduced to around Y2-3tn or around Y3tn. Reasons given included (1) comparisons with cases of QT by overseas central banks, (2) the levels prior to the introduction of Quantitative and Qualitative Monetary Easing (QQE), and (3) prioritizing a recovery in market functioning. There were also two responses that monthly purchases should be reduced to around Y4tn. The reason for this relatively small reduction was uncertainty regarding the purchasing needs of private-sector banks with regard to JGB supply/demand conditions and the IRRBB. Of the nine opinions, we excluded one that did not propose specific figures, and, averaging the eight opinions (incl. those shown in a range) resulted in a reduction of monthly purchases to Y2.9tn.

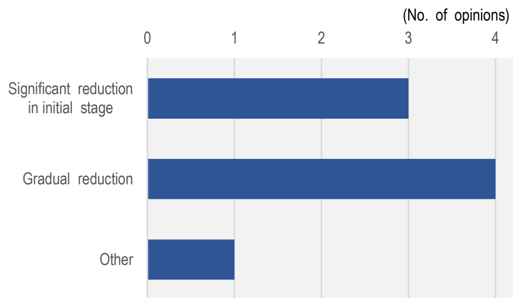
Furthermore, a Bloomberg article on the 22nd reported (based on sources in the know) that the BOJ did not intend for its reduction in JGB purchases to surprise the market, and recognized that the point of reference in the market was a reduction in monthly purchases to around Y3tn in two years. Therefore, we can say that a reduction to around Y3tn in two years is a guideline.

Chart 1: Opinions Regarding the Scale of Reductions (monthly purchases)



Source: BOJ; compiled by Daiwa.

Chart 2: Opinions Regarding Pace of Reductions



Source: BOJ; compiled by Daiwa.

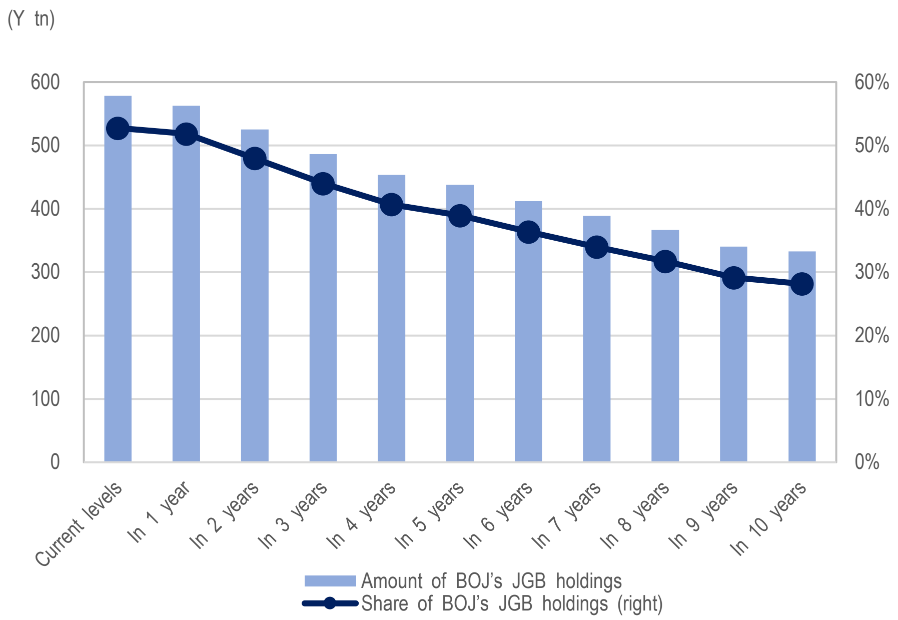
The pace of reductions is likely to be gradual

The opinions in the minutes regarding the pace of the reductions were divided into (1) recommending significant reductions from the beginning and (2) recommending gradual reductions. Reasons given for the former included the view that there would be a quick recovery in market functioning, and that an excessive rise in interest rates would be unlikely to occur even if the BOJ initially reduced its purchases of JGBs by a significant amount. Meanwhile, regarding the latter opinion (for gradual reductions), several comments were made regarding depository financial institutions, particularly regional financial institutions. Also, in the BOJ's April *Financial System Report*, a major theme was the large exposure to interest rate risk at regional financial institutions as compared to major banks. One could say that the actual pace of the reduction in JGB purchases will depend on the evaluation of the overall financial system, including regional financial institutions. Given the comment in the above-mentioned Bloomberg article that the BOJ did not intend to surprise the market, we think the BOJ is likely to decide on something closer to a gradual reduction, rather than the alternative.

Simulations of amount/share of BOJ's JGB holdings

In our previous report, we simulated the amount/share of the BOJ's JGB holdings as well as the amount/share of JGBs absorbed by the market over the next ten years based on three scenarios[1]. Here, we update the simulations in line with the consensus that monthly purchases will be reduced gradually to around Y3tn over two years. Specifically, Chart 3 shows the amount/share of the BOJ's JGB holdings if monthly purchases were reduced from the current Y5.7tn to Y4.5tn (-Y1.2tn) in the first year, to Y3tn (-Y2.7tn) in the second year, and maintained at Y3tn from then on. In this scenario, the amount of the BOJ's JGB holdings is estimated to fall to Y523tn (-Y53tn vs. current holdings) in two years, and its share of JGB holdings is estimated to fall from the current 53% to 48% (down 5 percentage points). If the BOJ continues monthly purchases at Y3tn (Y36tn/year) from the third year onwards, the amount of its JGB holdings is estimated to decrease to Y438tn (-Y141tn) in five years and Y333tn (-Y245tn) in ten years, and its share of JGB holdings is estimated to fall to 39% in five years and 28% in ten years.

Chart 3: Simulation Results ~ Amount/Share of BOJ's JGB Holdings



Source: BOJ, MOF's disclosed materials; compiled by Daiwa.

[1] For details regarding the assumptions made for simulations, refer to our *Daiwa Memorandum* "Simulations of QT by BOJ" (3 Jul 2024) (only available in Japanese).

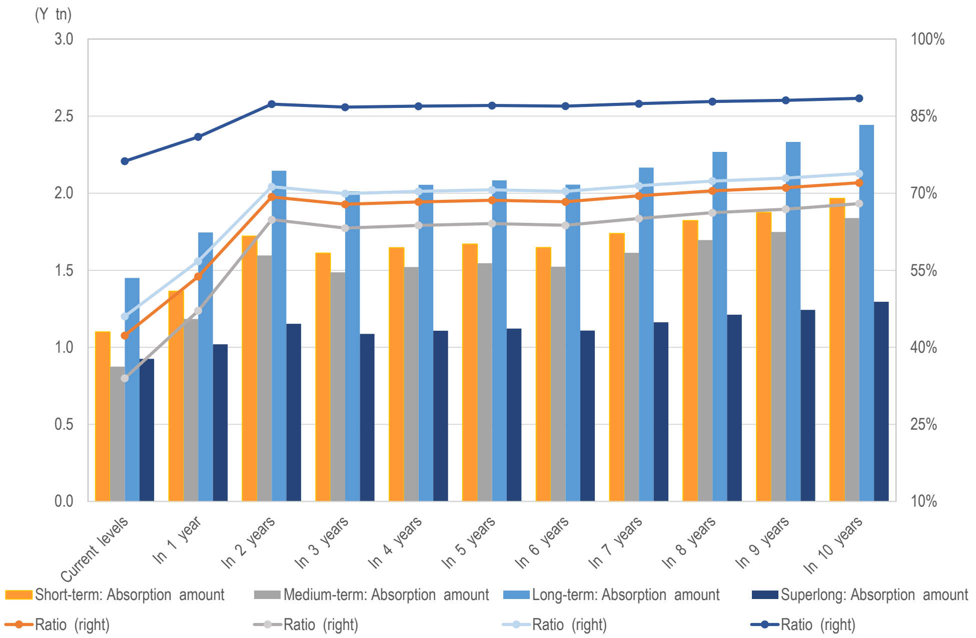
Focus on maturity structure when purchasing JGBs

With an image of the BOJ's reduction range for its JGB purchases starting to take shape, the discussion will likely shift to a breakdown of the JGBs to be purchased by maturity. The minutes for the "Bond Market Group" meetings provided examples of various opinions pertaining to the BOJ's purchasing policies by maturity. Still, many of the meeting participants called for JGB purchasing reductions, mainly in the medium- to long-term zone. Some pointed to buying demand from banks and overseas investors, while some held the opinion that a focus on medium- to long-term JGB purchases should be reconsidered from the standpoint of market neutrality.

Simulation of market absorption amounts/ratios under uniform reduction scenario

The above simulation is based on a premise (uniform reduction scenario) that the breakdown of the Y5.7tn monthly purchases of JGBs by maturity is constant (around 30% each for short-term, medium-term, and long-term JGBs and around 10% for super-long-term JGBs). In that case, the monthly market absorption amount (JGB issuance amount – BOJ purchases) and ratio (market absorption amount / JGB issuance amount) for each maturity zone are as shown in Chart 4. Even though the market absorption ratio for super-long-term JGBs, which is currently around 75%, will rise to 87% after two years, the absolute amount will increase only by about Y200bn per month (from the current Y0.9tn) to about Y1.1tn. Meanwhile, the long-term zone's market absorption ratio will increase from 46% to 70% in two years and the amount absorbed will increase from Y1.5tn to Y2.2tn (up Y0.7tn). Also, the medium-term zone's market absorption amount will increase from Y0.9tn to Y1.6tn (up Y0.7tn), and the ratio will rise significantly from 34% to 65%.

Chart 4: Simulation Results ~ Market Absorption Amount/Ratio by Maturity (uniform reduction amounts, monthly basis)

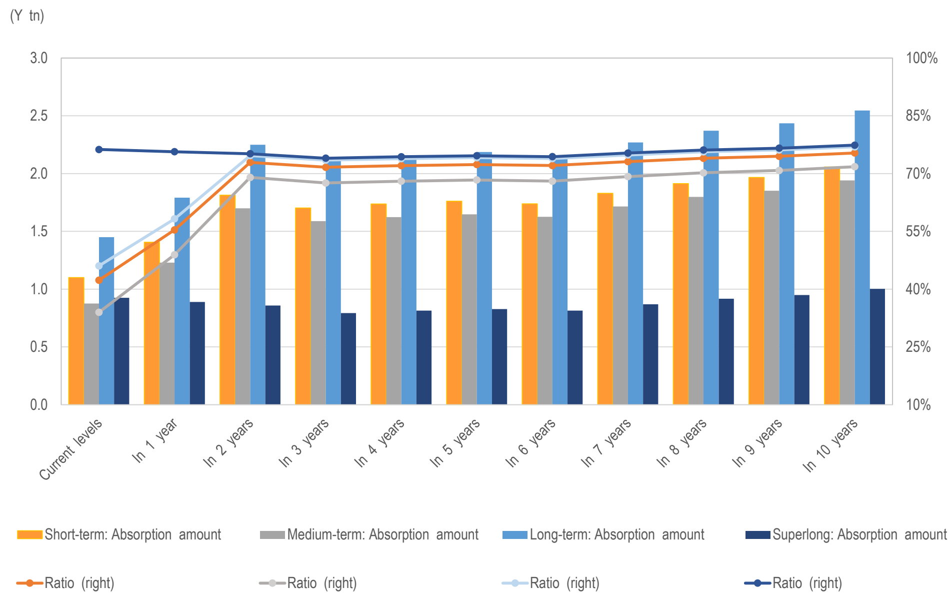


Source: BOJ, MOF's disclosed materials; compiled by Daiwa.

Short-, medium-, and long-term reduction scenarios

Based on opinions from the "Bond Market Group" meetings, we want to examine the impact of the reduction in JGB purchases by the BOJ, focusing on short-, medium-, and long-term JGBs. Here, we assume the case in which only short-, medium-, and long-term JGB purchases are reduced uniformly (short-, medium-, and long-term reduction scenario), with the super-long-term JGB purchase amount unchanged (at Y0.6tn per month). The results are shown in Chart 5. In this case, even though the monthly absorption amount would increase to Y2.3tn for long-term JGBs and Y1.7tn for medium-term JGBs in two years, the difference vs the uniform reduction scenario would only be about Y0.1tn per month. Meanwhile, turning to the market absorption ratios, after the second year the scenario calls for each maturity to converge generally between 70% and 75%, approaching market-neutral purchases.

Chart 5: Simulation Results: ~ Market Absorption Amount/Ratio by Maturity (short-, medium-, and long-term JGB reductions, monthly basis)



Source: BOJ, MOF's disclosed materials; compiled by Daiwa.

BOJ's QT to exert flattening pressure on JGB yield curve

Based on the above analysis, we now want to discuss market impacts. Unless the BOJ is willing to reduce its purchases of super-long-term JGBs, the largest impact will be in the medium-term zone, followed by the long-term zone, regardless of whether purchases are reduced uniformly for each maturity or reduced mainly for the medium- to long-term zone. Accordingly, the start of QT is likely to exert flattening pressure on the JGB yield curve. However, the above analysis requires some caveats in terms of its premise. First, the maturity structure for JGB issuance is assumed to be constant at the current ratios for the purpose of the simulation. However, from the perspective of optimal debt management policy, the issuance maturities could be flexibly changed depending on yield levels and investor demand. Also, in the future the BOJ may prefer to hold short- to medium-term JGBs rather than super-long-term JGBs, to realize the optimal balance sheet. In that case, we would expect steepening of the JGB yield curve due to reduced purchase of super-long-term JGBs. However, the above factors are medium- to long-term themes to some degree and the BOJ's start of QT is likely to impact the JGB yield curve in the form of flattening pressure.

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