Daiwa's View

Initial thoughts on "BOJ Finances and Estimates for the Future" from perspective of strategist

- BOJ releases latest simulations for its balance sheet, financial position, and currency confidence (points of interest for market)
- Mundane conclusions, but detailed terminal rate, long-term/short-term yield spread settings that form premise of simulation are noteworthy
- Adding current terminal rate assumed by market to long-term/short-term yield spread of +0.25 to +0.75ppt, expect 10yr JGB yield range of 1.0% to 1.5% for now

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Release of "BOJ Finances and Estimates for the Future" research paper

On 26 December, the BOJ released its "BOJ Finances and Estimates for the Future" research paper (Bank of Japan Review Series, 2024-J-15). This issue is a topic of great interest among market participants in terms of "currency confidence" and the BOJ's balance sheet. Of course, we will leave comprehensive discussions of the BOJ's finances to economists and we will leave currency confidence under a fiat money system, as well as its impact on foreign exchange markets, to currency strategists. That said, a decline in currency confidence is a factor that can lead to unwanted inflation and rising JGB yields, so it is something that a bond strategists cannot ignore. Furthermore, there were also some other assumptions in this paper that could not be overlooked, so we will provide some of our initial thoughts on this research paper.

Mundane conclusions (largely unchanged)

First, the conclusions derived from this BOJ research paper are largely the same as those that have been repeatedly communicated by the Bank. In other words, "Under a fiat money system, confidence in the currency is not directly ensured by the assets held by the central bank or its financial soundness. Therefore, even if the central bank temporarily posts losses or has negative equity, this does not impede its ability to conduct monetary policy. That said, if the central bank's financial risks become a matter of undue attention and give rise to unnecessary confusion over monetary policy, there is a risk that this could lead to a decline in its credibility. In other words, this research paper was not created to provide any new conclusions, but rather to simulate the future of the BOJ's finances in order to improve communication, based on an awareness of the problem with "gaining a wide range of understanding from people regarding central bank finances and monetary policy conduct" in order to avoid "unnecessary confusion."

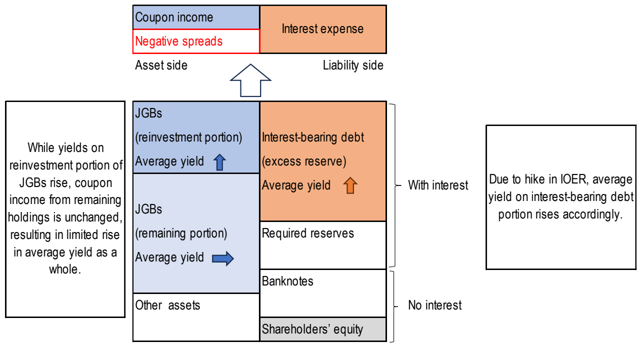
◆ **Bank of Japan Review Serie: "BOJ Finances and Estimates for the Future" (26 Dec 2024)**

・Under a fiat money system, confidence in the currency is not directly ensured by the assets held by the central bank or its financial soundness, but by the appropriate conduct of monetary policy with the aim of achieving price stability.

・The structure of central bank finances thus ensures profits from a somewhat long-term perspective. Even with our estimates, there is a possibility of a temporary deficit occurring if more stringent assumptions are made. However, we confirmed that the Bank would eventually recover its earnings, as it would not post losses. Even if it did post losses, the interest payments would decrease as the current account (excess reserves), which is a liability, decreases, and the interest income would increase as JGBs held by the Bank are sequentially replaced by JGBs with higher yields. Central banks can also provide their own means of payment and settlement. Therefore, even if the central bank temporarily posts losses or has negative equity, this does not impede its ability to conduct monetary policy.

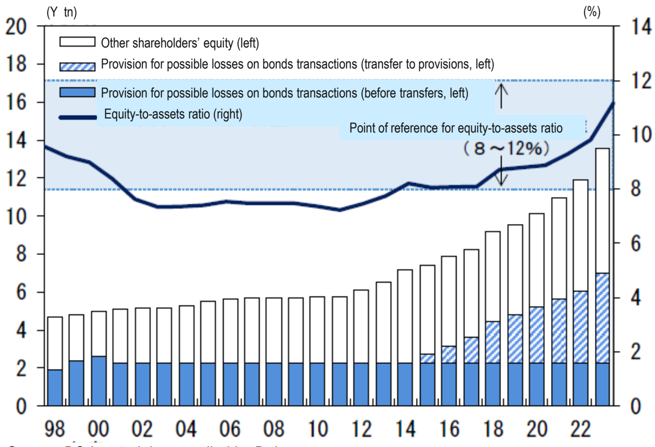
・That said, this does not imply that the central bank can run up unlimited losses and negative equity. If financial risks surrounding a central bank attract attention and cause unnecessary confusion over monetary policy, there is a risk that this could lead to a decline in confidence.

Mechanism of Negative Spreads



Source: BOJ materials; compiled by Daiwa.

Balance of Shareholders' Equity



Source: BOJ materials; compiled by Daiwa.
Note: Other shareholders' equity includes legal reserve.

Focus on assumptions

This time, a number of important assumptions were made regarding the estimates. Of course, this is clear from the research paper's annotation that read "Major central banks overseas, such as the US Federal Reserve, also make estimates based on the interest rate forecasts incorporated into market interest rates and the results of market participant surveys." These premises are not the official view held by the BOJ, but it is still important for market participants to recognize what assumptions (premises) were used to make the estimates.

What caught our eye was ① on page 5, which said there is the assumption that short-term yields will move in line with the implied forward rate in the OIS market and that long-term yields will move in line with the implied forward rate calculated from the JGB yield curve (as of end-Sep 2024). Also, as a premise for an additional scenario, a range of estimated values was shown assuming that (a) short-term yields will be 1.0%-2.0% over the next few years and (b) the long-term/short-term yield spread in that case will be +0.25 to +0.75ppt.

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・In addition to the market interest rate incorporated into the policy rate forecast, the range of estimated values for the cases (a) short-term interest rate is between 1.0% and 2.0% over the next few years and (b) long-term/short-term yield spread in this case is +0.25 to +0.75ppt, will also be provided.

Long-term/short-term yield spread: +0.25 to +0.75ppt

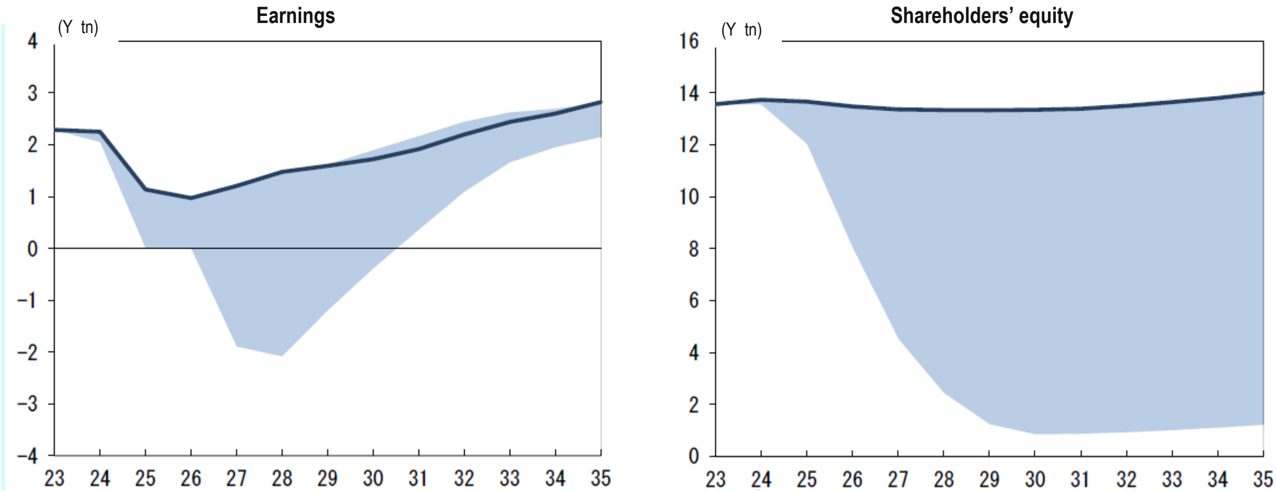
Of course, when discussing the terminal level of interest rate hikes, we cannot overlook the premise of the terminal level, but we will leave the discussion of that point to economists. In this report we want to focus on assumption (b) regarding the long-term/short-term yield spread. This is because we can forecast the near-term range of the long-term yield by using assumption (b) and the current market consensus for the terminal rate.

If we use this assumed range, which we generally see as reasonable (but leaves the impression of being a bit tight), when the BOJ raises its target to "0.5%," the median 10-year JGB yield is around 1% (0.75-1.25%), for example. If the target is raised to "0.75%," which is often considered to be a terminal level by a relatively many market participants, the estimated median for 10-year JGB yield would be around 1.25% (1.0-1.5%). Once the target is raised to "1%," which is viewed as a terminal level by certain market participants, the estimated median for the 10-year JGB yield would be 1.5% (1.25-1.75%).

Of course, these ranges of the long-term/short-term yield spread are figures for when the policy interest rate is 1.0-2.0%. In general, as the policy interest rate approaches the neutral interest rate, the long-term/short-term yield spread tends to flatten out. As such, in the current phase where the policy interest rate is below 1%, the median long-term/short-term yield spread value should tend to easily reach a level somewhat higher than +0.5ppt. If we take this into account and the terminal level market forecast is accurate, then 1.0-1.5% (with a median of just over 1.25%) would be recognized as the 10-year JGB yield range for the time being. This is generally consistent with the outcome that we envision.

The current BOJ interest rate target is 0.25% and the 10-year JGB yield is approximately 1.1%, so the long-term/short-term yield spread is +0.85ppt, which exceeds the upper limit of +0.75ppt assumption in (b). This can be viewed as one piece of circumstantial evidence that the current policy interest rate is too low (and that the process of hiking rates is underway). If the long-term/short-term yield spread remains around +0.5ppt after additional rate hikes, that would probably be close to the terminal point.

Trial Calculations for Earnings and Shareholders' Equity in the Future



Source: BOJ materials; compiled by Daiwa.
Notes: (1) Solid lines show trial calculations if interest rates move in line with forecasts that are factored into the market (as of Sep 2024).
(2) Shaded areas indicate range of trial calculations if interest rates move in line with forecasts shown in the above-mentioned assumptions (a) and (b), as well as assumption for (1).

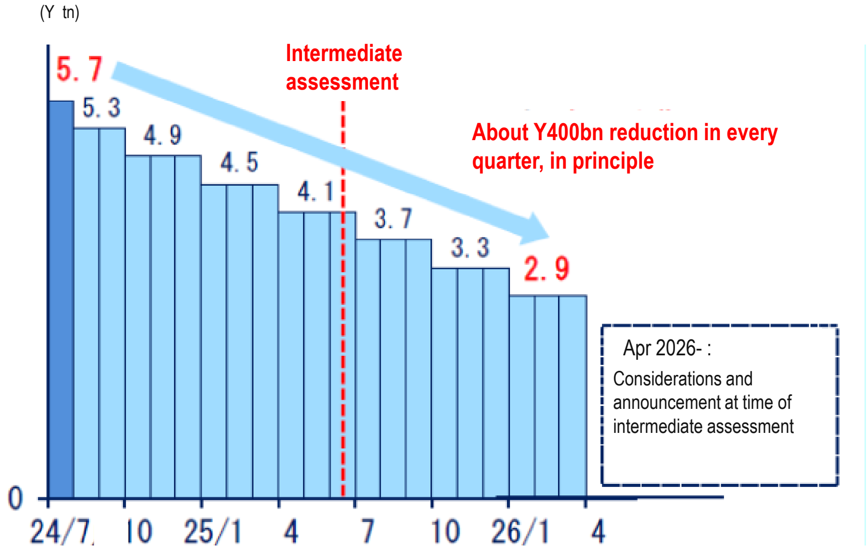
BOJ reducing monthly purchases of JGBs to Y3.0tn, then no changes

For the sake of convenience when making our balance sheet estimates, we expect that the BOJ's plan to reduce the amount of JGBs purchased each month, which was decided in July 2024, to be implemented and the monthly amount of JGB purchases to be reduced to around Y3.0tn per month between January and March 2026, with the amount remaining unchanged from April 2026.

The Bank announced that it would conduct a mid-term evaluation of the plan to reduce the amount of JGB purchases at the June 2025 Monetary Policy Meeting (MPM). At the same time, the Bank plans to reconsider its policy of purchasing JGBs after April 2026 and present the results of its deliberations. Market participants are keenly interested in this topic, but it was not included in the Bank's assumptions this time, which was somewhat disappointing. However, this does not mean that changes in the reduction pace are not being considered. Rather, it seems that the reality is that the Bank could not make assumptions that would give the market any advance knowledge of the matters to be decided at MPMs based on hearings with bond investors and other such events.

When the BOJ launched its quantitative tightening in July 2024, the top priorities were to suppress market volatility and avoid a sharp rise in term premiums. However, considering the speed of change for exchange rates and externals, June 2025, one year after the start of quantitative tightening, will be the time to start discussions, including further reductions in the purchase of JGBs. Issues surrounding the BOJ's balance sheet and the purchase of JGBs will be major JGB market themes in the first half of 2025.

Schedule for Monthly Purchase Amount of JGBs (approximate amount)



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