

Daiwa's View

FICC Research Dept.

BOJ's quantitative tightening and optimal balance sheet debate

- BOJ's holdings of JGBs to decrease from Y250tn to just over Y100tn in 10 years
- QT suspension debate in US and Japan's case

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Continued flattening of JGB yield curve in Tokyo market

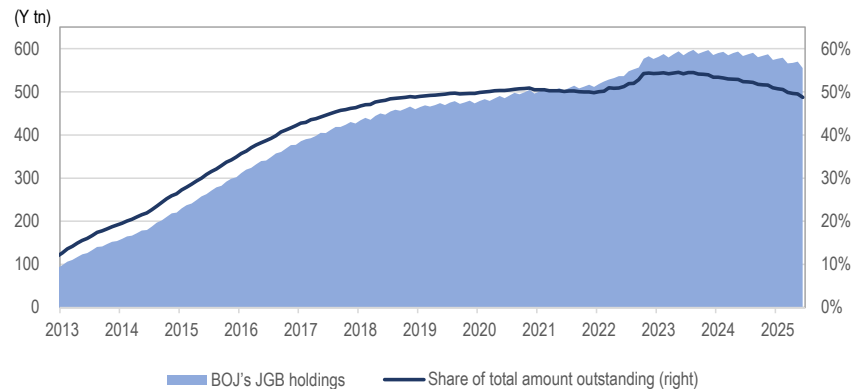
On 20 October, JGB yields on the Tokyo market rose by 4~5bp across medium- to long-term maturities, while 20-year and 30-year JGBs closed nearly unchanged. As such, bear-flattening of the yield curve deepened. If the so-called "Takaichi trade" points to fiscal concerns stemming from delayed rate hikes and aggressive fiscal policy, the underlying pattern should be steepening. As such, this price movement was somewhat unexpected. The factors contributing to this flattening include (1) agreement between the LDP and Japan Innovation Party to form a new coalition, which helped to dispel uncertainties following the surprise result at the 4 October LDP presidential election (won by Takaichi) and Komeito's decision to leave the ruling coalition and (2) increased expectations for a BOJ rate hike, which had been thought to be on hold. Indeed, the probability of the BOJ hiking rates within this year (as factored in by the market), which had briefly fallen below 50%, has since recovered to around 65%. The Takaichi Cabinet is expected to be formed today. Attention will then turn to (1) ministerial appointments, including the finance minister, and (2) BOJ's messaging regarding its next rate hike.

This report focuses on the BOJ's balance sheet policy amid such conditions. The BOJ has been conducting quantitative tightening (QT) since last summer. The amount of JGBs held through QT impacts JGB yields via the stock effect. Our aim is to derive implications for the optimal current account deposit amounts while simulating the amount of JGBs held by the BOJ.

BOJ holdings of JGBs decreased by Y35tn in the first year since QT began

The BOJ began reducing its JGB purchases, known as quantitative tightening (QT), at its July 2024 Monetary Policy Meeting (MPM). Prior to this, the Bank had been purchasing JGBs at a monthly pace of approximately Y5.7tn. It announced plans to reduce this by Y400bn per quarter, aiming to reach the monthly purchase amount of Y2.9tn by March 2026. Also, an interim assessment of QT was conducted at the June 2025 MPM. For FY26, the pace for reducing purchases will be halved from Y400bn to Y200bn per quarter, with the monthly purchase amount set to decrease to Y2.1tn in March 2027.

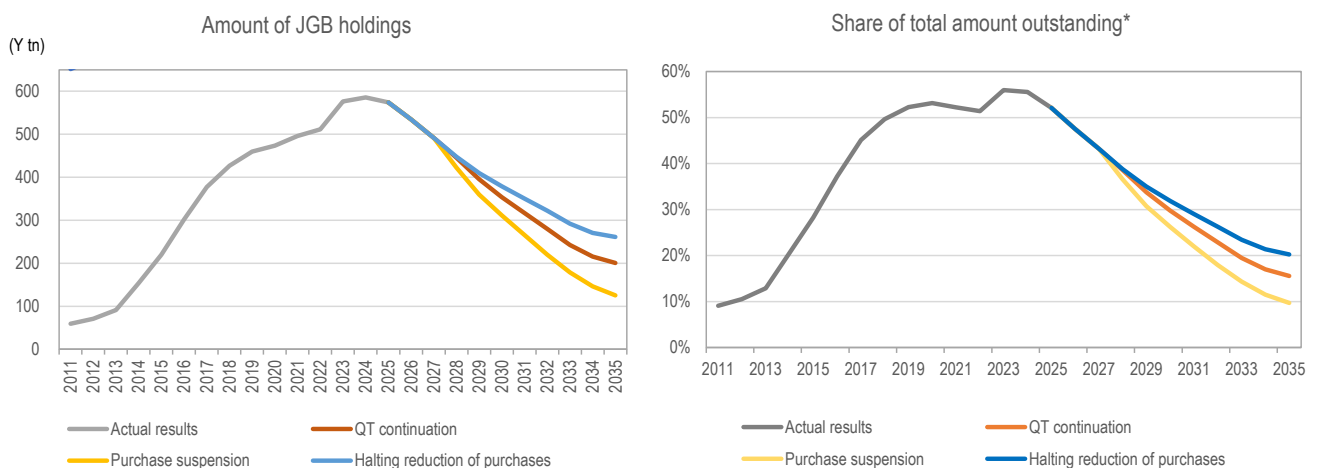
When confirming the actual amount of JGBs held by the BOJ, as of September 2025, the amount stood at Y555tn (representing 48.7% of total issued amount), a slight decrease of roughly Y35tn from the Y590tn (53.0%) recorded in July 2024 when QT started. If reductions proceed as planned, the amount is expected to decrease to Y535tn at the end of March 2026 and Y492tn at the end of March 2027. The total reduction from the start of QT will be approximately Y100tn.

Chart 1: BOJ's JGB Holdings and Share of Total Amount Outstanding


Source: BOJ; compiled by Daiwa.

QT simulations

JGB purchase amounts for FY27 and beyond remain undetermined. Therefore, we simulated the BOJ's holdings under the three scenarios of: (1) QT continuation scenario: After quarterly reductions of Y200bn each in FY27 and FY28, purchases of Y1.1tn per month continue from FY29, representing a somewhat extreme example, (2) Purchase suspension scenario: Suspension of purchases from FY27 onwards, and (3) Halting reduction of purchases scenario: Continue purchases of Y2.1tn from FY27 onwards. Simulating the BOJ's holdings under these three scenarios shows that at the end of FY27, the amounts would be (1) Y445tn, (2) Y422tn, and (3) Y448tn, respectively. Here, there are no significant differences. However, at the end of FY30, the amounts would be (1) Y317tn, (2) Y266tn, and (3) Y350tn, respectively. Furthermore, at the end of FY34, they would be (1) Y201tn, (2) Y125tn, and (3) Y261tn, respectively¹. The projected range for the BOJ's holdings of JGBs approximately 10 years from now is expected to be around a maximum of Y250tn and a minimum of just over Y100tn.

Chart 2: QT Simulations


Source: BOJ, Cabinet Office; compiled by Daiwa.

*Denominator used for calculating the share is outstanding government debt from Cabinet Office's medium-to-long-term projections.

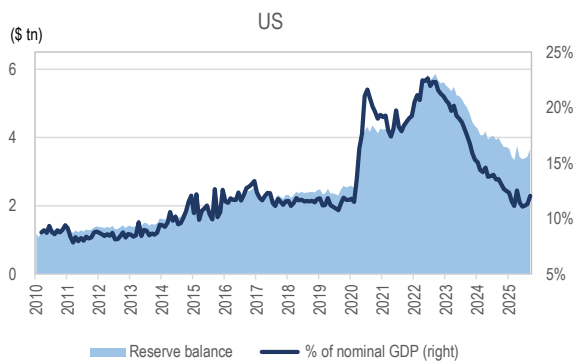
¹ The simulation results have not significantly changed since before the interim assessment. For details, refer to [Daiwa Memorandum: Simulations of QT by BOJ \(18 Apr 2025\)](#).

QT debate in US and situation in Japan

In the US, Fed Chairman Powell suggested ending balance sheet reductions during his 14 October speech, increasing the likelihood that QT will be halted after the start of 2026. Against this backdrop, the reduction in balance sheet size has led to a decrease in liabilities, particularly a decline in reserves. This has made it easier for short-term interest rates like SOFR to rise relative to the IOER. Furthermore, considering that the reserve balance-to-GDP ratio was around 7% during the sharp rise for short-term yields in the money market under QT in 2019, a balance-to-GDP ratio of around 8% to 9% is regarded as the target. The fact that this level has been approached also serves as an argument for halting QT.

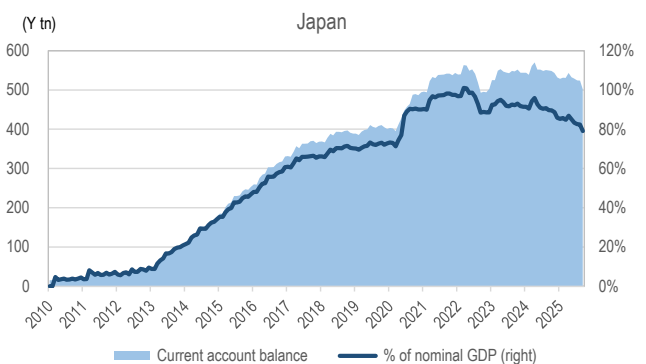
What can be determined by applying such cases to Japan? As of end-September, the BOJ's current account balance stood at ¥502tn, equivalent to 79% of Japan's nominal GDP. Even if this is reduced to 10% of GDP, that would amount to ¥64tn, a significant gap from the current figure. Also, at the start of the large-scale easing in 2013, the current accounts-to-GDP was 13%. The figure is ¥82tn when applying this to the current GDP.

Chart 3: Fed Reserve Balance, % of Nominal GDP



Source: Bloomberg; compiled by Daiwa.

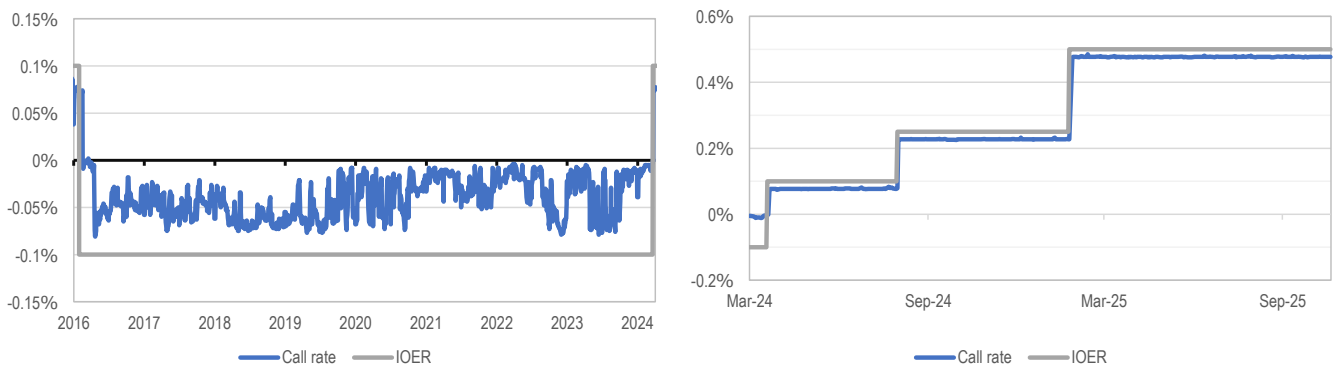
Chart 4: BOJ Current Account Balance, % of Nominal GDP



Source: Bloomberg; compiled by Daiwa.

Also, examining the IOER and call rates reveals that during the period from January 2016 to March 2024, when negative interest rates were in effect, the call rate consistently traded stably between the -0.1% applied to current account balances and the 0.0% applied to macro add-on balance. Generally speaking, there have been no instances where the call rate has risen significantly more than the IOER, even after the rate hike in 2024.

Chart 5: Call Rate and IOER in Japan.



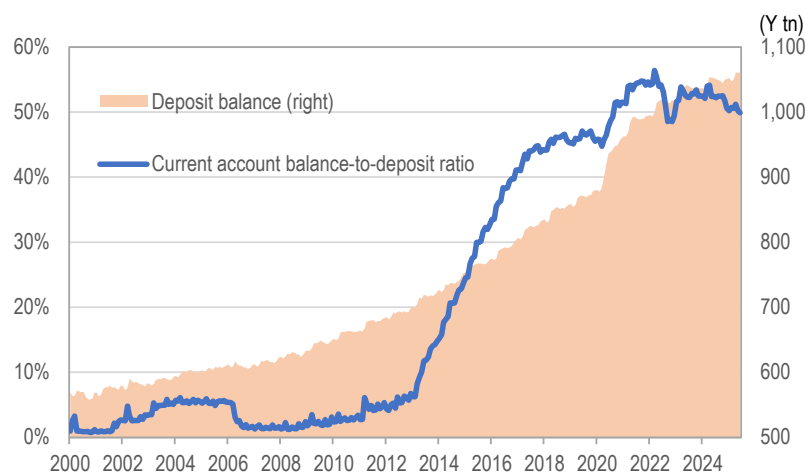
Source: Bloomberg; compiled by Daiwa.

Short-term interest rates and current account volume mechanisms

Short-term interest rates, such as the call rate, are determined by the supply-demand relationship between commercial banks' demand for liquidity and the central bank's supply of current accounts. Salido and Vissing-Jorgensen (2023)², prominent in the field of academic research, estimated the reserves function of banks in the US, presenting standard ratios of 7%, 11%, and 13.5% vs GDP. Similarly, in Afonso, Giannone, La Spada, and Williams (2025)³, which includes John C. Williams (president and chief executive officer of Federal Reserve Bank of New York) as an author, the shape of the demand function for commercial bank reserves is estimated. The reserve amounts relative to total bank assets is presented as guides of 12% to 13%. In other words, in the US, it has become possible to identify the critical point at which reserves shift from "ample" to "scarce" due to spikes in short-term interest rates. However, in Japan, the BOJ's balance sheet remains large and the supply of current accounts continues to be extremely abundant, making it difficult to grasp the appropriate level of current accounts.

The demand for current accounts at commercial banks is generally considered to be a function of the total deposits held by the banking sector. Banks seek to hold a certain amount of their deposits in the most liquid form (central bank current accounts) in order to prepare for withdrawals. The total deposits in Japan's banking sector currently stands at ¥1,056tn, with current accounts accounting for approximately 50%. When initiating large-scale monetary easing in March 2013, this accounted for approximately 10%. Converting that into current deposit levels, current accounts would come to ¥105.6tn.

Chart 6: BOJ Current Account Balance-to-Deposit Ratio



Source: BOJ; compiled by Daiwa.

Changing liquidity demands among banks

Several issues exist regarding demand for current accounts within the banking sector. The paper "Liquidity Dependence and the Waxing and Waning of Central Bank Balance Sheets," written by Acharya, Chauhan, Rajan (former Governor of Reserve Bank of India, currently Professor of Finance at the University of Chicago) and Stefen (2024)⁴ points out that the liability structure weakened and short-term markets became more prone to tightening due to (1) the shortening of the duration for private bank deposits during the quantitative easing period when liquidity was supplied in large quantities and (2) increased contractual commitments, such as commitment lines. The BIS (2025)⁵ also points out that liquidity regulations introduced in the mid-2010s under

² David Lopez-Salido and Annette Vissing-Jorgensen (2023). Reserve Demand, Interest Rate Control, and Quantitative Tightening.

³ Gara Afonso, Domenico Giannone, Gabriele La Spada and Williams (2025). Scarce Abundant, or Ample? A Time-Varying Model of the Reserve Demand Curve. NY FED STAFF REPORTS.

⁴ Acharya, Chauhan, Rajan and Stefen (2024). [Liquidity Dependence and the Waxing and Waning of Central Bank Balance Sheets](#). NBER.

⁵ [BIS Quarterly Review, September 2025](#). Monetary policy operational frameworks – a new taxonomy.

Basel III, particularly the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements, increased demand for reserves among regulated banks.

Summary

Considering the above points, the optimal level of current accounts at the BOJ should be set at least at around Y100tn. Over time, while reducing its balance sheet and taking the abovementioned changes into account, the Bank will seek to determine the optimal value. At the June 2025 MPM, where the interim QT report was presented and a decision was made to slow the pace of QT from FY26, the necessity of discussing the optimal balance sheet size from a long-term perspective was debated. The QT landing spot will likely be a main theme in the next interim report due out in June 2026. Central bank holdings of government bonds impact yields via their stock effect. We want to carefully monitor future discussions.

Summary of Opinions at BOJ MPM (16-17 Jun 2025)

- The Bank can proceed more cautiously with the reduction of the JGB purchase amount on a flow basis in fiscal 2026, when the Bank will enter the next phase of the reduction process toward reaching the final level of the purchase amount. In addition, the Bank should consider what would be the optimal size of its balance sheet, from both the asset and liability sides.
- Excess reserves seem to be at abundant levels. It is therefore necessary for the Bank to proceed steadily with the reduction of its purchase amount of JGBs, and thereby normalize its balance sheet.
- Regarding the reduction of its purchase amount of JGBs, the Bank needs to consider how to set the final level of the purchase amount from a long-term perspective, along with the future course of the reduction in the size of its balance sheet.

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