Daiwa's View

Balance sheet expansion approaching a turning point

➢ Decision on whether to extend COVID-19 operations could cause disruption

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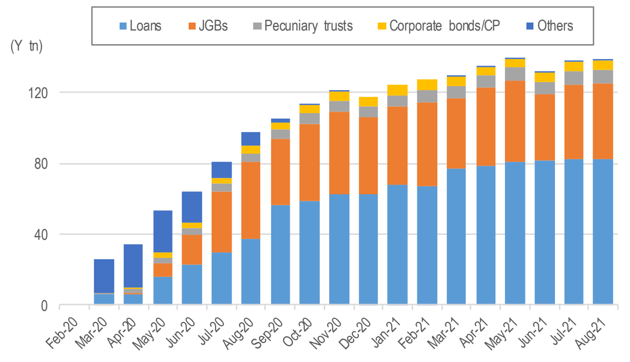
Discussion about tapering is moving forward in Europe and the US. Ahead of this, the BOJ has moderately slowed the pace of asset purchases since the assessment meeting in March. The biggest issue with the balance sheet policy is how to deal with the Special Funds-Supplying Operations to Facilitate Corporate Financing regarding the Novel Coronavirus (hereinafter referred to as COVID-19 operations). Depending on the situation with COVID-19 infections, it may serve as a factor for market turmoil towards year-end.

In the US, Fed Chair Jerome Powell confirmed the start of tapering within the year at the Jackson Hole conference. In Europe, as well, ECB officials' comments regarding slowing the pace of PEPP spending are becoming noticeable ahead of the Governing Council meeting to be held on the 9th. Due to expanded QE to address the pandemic, both the Fed and ECB have seen their balance sheets expand substantially compared to figures at end-February 2020—from \$4.20tn to \$8.38tn (nearly double) at the Fed and from €4.69tn to €8.19tn (up 1.75-fold) at the ECB. Despite strong concerns about the Delta variant, the economy is steadily recovering. Therefore, the monetary policy stage is changing due to concerns about prolonged inflation and issues of financial stability, such as spiking real estate prices.

Factors Behind Balance Sheet Expansion at BOJ Since Feb 2020
(asset side)

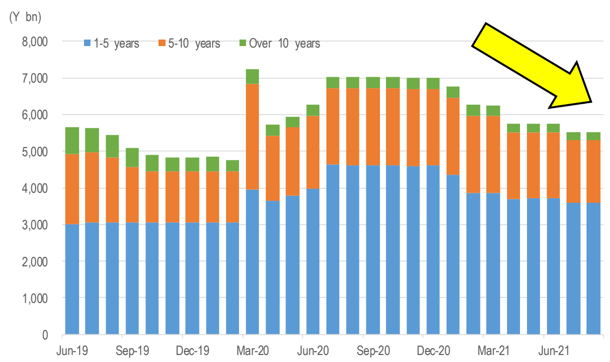


Source: BOJ; compiled by Daiwa Securities.

Since March 2020, the BOJ has also been conducting powerful monetary easing via (1) the special program to support corporate financing, (2) supply of funds in yen and foreign currencies, and (3) purchases of ETFs and J-REITs. Under QE programs in Europe and the US, balance sheets have expanded mainly via purchases of assets such as government bonds. On the other hand, of the Y140tn increase in the BOJ's total assets since February 2020, Y83tn has come from loans, including those through COVID-19 operations, followed by Y43tn in JGBs, Y7.2tn in pecuniary trusts, and Y5.6tn in CP and corporate bonds. Balance sheet expansion has been characterized by back financing of loans and purchases of risk assets.

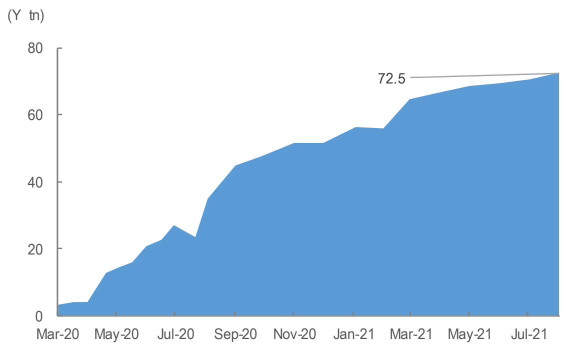
Since the March assessment meeting, tapering has been proceeding in real terms. Operations of ETF purchases have been quite limited—since April, purchases have been conducted only for two business days, with the purchase amount totaling around Y140bn. Regarding JGBs with over one year to maturity, the monthly purchase amount has now decreased to Y5.5tn vs. about Y7tn in FY20. With respect to corporate bonds as well, the monthly purchase amount since April has been Y200bn vs. Y500bn in FY20.

Amount of JGBs Purchased by BOJ (JGBs with over one year to maturity)



Source: BOJ; compiled by Daiwa Securities.

Outstanding Amount of Loans Through COVID-19 Operations



Source: BOJ; compiled by Daiwa Securities.

Loans through COVID-19 operations, the main cause of balance sheet expansion, are continuing to increase, and have recently reached Y75tn. However, the special program itself (incl. purchases of corporate bonds and CP) is a time-limited measure that only lasts until March 2022. The decision about whether it will be extended is likely to be made around year-end.[1] However, if it were not extended, the impact would be enormous. In short, the balance sheet would shrink sharply over the six months starting April 2022, which could have an impact on the risk premium from the price of assets, such as stocks. COVID-19 operations are designed to include measures to mitigate side effects while giving financial institutions incentives to lend money, such as the provision of interest under the Interest Scheme to Promote Lending and inclusion of twice as much as the amounts outstanding of related loans in the macro add-on balances. Therefore, there is concern about the impact on the financial system. Moreover, this may serve as a factor for higher yields in the form of weaker demand for investment in collateral bonds. At this point, I think it is very likely that COVID-19 operations will be extended. However, if Japan's economy recovers more than expected due to progress with vaccinations from autumn onwards, we would like to keep a close eye on this as a factor that could cause a disturbance at year-end, when the Fed is expected to start tapering.

[1] Thus far, the special program has been extended three times, with each decision to extend having been made at monetary policy meetings held approximately three months before the program's expiration.

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