Abridged translation

Daiwa Securities

Daiwa's View

IMF recommendations for greater YCC flexibility

- Recommendations include (1) widen 10-year JGB yield target band and/or raise 10-year JGB yield target, (2) shorten yield curve target maturity, (3) shift from JGB yield target to quantity target for JGB purchases

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

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◆ IMF recommends further flexibility for 10-year JGB yield target

On 26 January, the International Monetary Fund released its statement on the conclusion of its 2023 Article IV talks with Japan, which cover macro, comprehensive, and long-term consulting. As previously reported, the IMF has in the past recommended shifting the yield curve control (YCC) target to a shorter maturity and suspending quantitative guidance. In terms of monetary policy, this year's Article IV talks stated that "an overall accommodative monetary policy stance remains appropriate," but added that "given the two-sided risks to inflation, more flexibility in long-term yields would help to avoid abrupt changes later." The IMF recommended that the BOJ consider the following specific options to allow further flexibility and higher in long-term yields: (1) widen the trading band for the 10-year JGB yield target and/or raise the 10-year JGB yield target, (2) shorten the YCC target maturity, and (3) shift from a JGB yield target to a quantity target for JGB purchases.

Japan: Staff Concluding Statement of the 2023 Article IV Mission (26 Jan 2023)

In this context, the BoJ could consider the following options to allow further flexibility and increases in long-term yields: widening the 10-year target band and/or raising the 10-year target, shortening the yield curve target, or shifting from a JGB yield target to a quantity target of JGB purchases. The BoJ would need to carefully assess the pros and cons of each strategy. For instance, widening the 10-year band around the yield target would entail a minor adjustment to the current YCC framework, however the fluctuation range will have to be wide enough for market forces to play a leading role. On the other hand, moving to a quantity-based approach instead would not entail defending a particular yield level and the side-effects that come with it, however the quantity of BoJ's JGB purchases would need to be state-contingent and adjusted if yields moved up too rapidly. Lastly, moving to a shorter-term yield target would help ensure that the short-term yields (which matters more for real activity) continue to stay low until the 2 percent target is durably achieved, but the BoJ may face similar costly side-effects that come with targeting a particular yield level.

◆ Widen trading band → shorten YCC target maturity → return to quantity-based approach

In past recommendations for YCC framework adjustments, "shorten the YCC target maturity" had been the very first option mentioned. However, the latest recommendations were listed in the order of "widen trading band and/or raise 10-year target → shorten YCC target maturity → return to quantity-based approach." This ordering may not necessarily be IMF's intended order of priority, but it seems very reasonable to us considering that our main scenario for the next BOJ policy revision is "eliminate (or gut) YCC" and our sub-scenario is "shorten the YCC target maturity."

Also, we have the impression that this year's recommendations include more references to "quantity-based approaches" in contrast to the past. This likely reflects a growing awareness of the problems with balance sheet control.

One of the primary risks when adopting a yield targeting strategy is that the central bank's balance sheet may become a dependent variable and its volatility could increase. In this regard, the BOJ's decision at its January Monetary Policy Meeting to enhance its pooled-collateral operations is a measure more suited to the current conditions, as opposed to its fixed-rate purchase operations, in that this new measure does not increase the amount of JGBs held on the BOJ's balance sheet. Nevertheless, it should be noted that this does not mean that all balance sheet control problems are resolved. Yield target level adjustments in response to changes in macroeconomic conditions, as well as operational skill, are two different dimensions and setting unsustainable yield levels could cause the balance sheet to swell. This is not a matter that can be resolved in terms of operational means, but is a side effect inherent in the yield targeting strategy itself.

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