Daiwa's View

Increasing news about shift to "quantity"

- Surprise during time of first rate hike in 17 years has potential to cause troublesome issues

FICC Research Dept

Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Kenji Yamamoto
81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd

Yesterday, there were news reports saying that the BOJ would provide guidelines regarding the pace of JGB purchases after the yield curve control (YCC) policy was ended. The news was based on information from those in the know following last weekend's news saying that the BOJ was mulling over replacing YCC with a new "quantitative" monetary policy framework in which the size of future JGB purchases would be indicated in advance, as a means to facilitate the normalization of monetary easing. In the lead up to next week's March Monetary Policy Meeting (MPM), there appears to be increasing news about a return to a quantitative target.

Since news regarding "quantity" increased at the end of last week, the JGB yield curve has been posting bear steepening. Looking at last Thursday's and yesterday's JGB yield curves shows that yields in the short-term and intermediate zones have been largely flat (2yr: 0.20→0.20%, 5yr: 0.38→0.38%). On the other hand, yields in the long-term and superlong zones rose substantially (10yr: 0.73→0.77% (+4bp), 20yr: 1.47→1.54% (+7bp), 30yr: 1.77→1.86%(+6bp). "Quantitative" policy has an impact on longer-term yields (term premiums). Therefore, if recent news were to have delivered a hawkish surprise with regard to market participants' awareness regarding "quantity," movements towards bear steepening would be appropriate.

That said, what was the surprise for market participants? As I touched on in our 11 March report, the BOJ was in a situation to consider shifting from the YCC policy to a quantitative target as one option. This was indicated in the IMF's Article IV talks with Japan in 2023. Furthermore, in his 8 February speech, BOJ Deputy Governor Shinichi Uchida stated that, as the (YCC) framework was a form of quantitative easing implemented through government bond purchases, simply terminating it was not the end of the story, sending a signal about a shift from the YCC to a quantitative target, without dealing with the issue of timing. It is hard to imagine that yen bond market participants, who had already digested this kind of information, would see a shift from YCC to quantity as a thunderbolt.

The surprise was the timing, not the option

However, the JGB yield curve did post steepening, as mentioned above, so there must have been a surprise of some sort. I speculate that the surprise was caused by the timing, not the option itself of a return to "quantity." Partly because Governor Ueda and Deputy Governor Uchida have repeated remarks of "so as not to create discontinuity," not a few people probably assumed that the possibility of simultaneous elimination would be low.

◆ **Deputy Governor Shinichi Uchida (8 Feb 2024)**

Another question involves the possible revision to the yield curve control framework. As this framework is a form of quantitative easing (QE) implemented through government bond purchases, simply terminating it is not the end of the story. Regardless of whether the framework will be terminated or be continued in some way, the Bank must consider how to proceed with subsequent Japanese government bond (JGB) purchases and how to maintain the stability of markets during that process. In this sense, the conduct of yield curve control and subsequent JGB purchases are part of a continuing process. Under the current framework, the amount of these purchases is determined endogenously by targeting the level of interest rates. If the Bank terminates or changes this framework, it will consider the best way to indicate how it will conduct JGB purchases, taking account of market conditions at that point in time and forecasting developments down the road. Of course, if the Bank does revise the framework, it will incline more toward letting interest rates be determined by the market. In doing so, however, it will take careful measures so as not to create discontinuity before and after the revision, and will make sure that the amount of JGB purchases will not change significantly and interest rates will not rise rapidly.

This surprise has the potential to cause troublesome issues. This is because, although the BOJ appears to want to implement the first policy interest rate hike in 17 years while avoiding causing disturbance as much as possible, if it implements a rate hike at the March or April MPM alongside a surprising decision on quantity, it might create doubts and concerns that the BOJ could be more hawkish than expected.

Looking back on remarks by Governor Kazuo Ueda since he took office, he has repeatedly made straightforward comments admitting the side effects of the YCC (decline in market functioning). If this new issue were to lead people to feel that the BOJ head, Governor Ueda, had finally revealed "hawkishness" that had been hidden thus far, it would cause commotion.

Of course, Deputy Governor Shinichi Uchida stated in his 8 February speech that "it is hard to imagine a path in which it would then keep raising the interest rate rapidly." With regard to the shift to a quantitative target that has been reported in the news recently, some news leaks said that the quantity would be adjusted mainly at the current level of slightly below Y6tn/month for the time being. Therefore, the brakes would be applied to a certain degree. That said, if this were to cause doubts and concerns regarding how long was meant by "for the time being," such concerns could lead to rapid expansion of term premiums.

Confirming the 10-year JGB term premium, we found that it has now expanded to 0.39%, from 0.35% at end-February. It hit a peak at 0.70% in October 2023, when the US long-term yield temporarily reached 5%. During the period from the Global Financial Crisis until the introduction of extraordinary easing, the average was 0.64%. If the term premium were to rise rapidly towards 0.60-0.70% in the lead up to the March MPM, it would provide a good opportunity to buy on dips in terms of a historical comparison, as well.

JGB Term Premium

Source: MOF; compiled by Daiwa.

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