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Daiwa's View

BOJ Review rebuts the narrative that QT is driving the rise in long-term interest rates

- The principal drivers of the rise in long-term interest rates are not the reduction in JGB purchases, but changes in inflation expectations and the policy environment

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On 4 August, Jiji Press reported that, when Prime Minister Sanae Takaichi met with BOJ Governor Kazuo Ueda on 22 May, she asked the BOJ to purchase JGBs as necessary to curb the rise in long-term interest rates. The prime minister reportedly stated, "I would like the BOJ to understand the Cabinet's initiatives and conduct monetary policy appropriately," and called on the BOJ, which was reducing its JGB purchases, to take "appropriate measures to ensure market stability." Governor Ueda was reported to have replied, "We need to consider the market's reaction," while adding, "We will respond if anything happens."

According to government officials, the prime minister's strong interest in JGB purchases reflected her expansionary fiscal policy, including defense spending and crisis-management investment. It has also been reported that, when the supplementary budget was being compiled in May, the government temporarily considered whether it could "use the BOJ to secure funding." Following the meeting, the Prime Minister's Office reportedly handed Governor Ueda a summary of the prime minister's remarks and asked him to read it aloud to the press. Government representatives repeated remarks to the same effect at the BOJ's June Monetary Policy Meeting (MPM).

The narrative that QT was driving the rise in long-term interest rates gains traction within the administration

Prime Minister Takaichi's request did not emerge suddenly. When long-term interest rates rose sharply in May, the view that "the BOJ's QT is destabilizing the bond market" spread among those close to the administration. According to the *Nikkei*, the 10-year JGB yield temporarily rose to 2.8% in May, its highest level in approximately 30 years. While some attributed the rise to fiscal concerns and inflation expectations, Mr. Nagahama of the Daiichi Life Research Institute cited JGB supply/demand factors associated with the BOJ's QT, presenting this as the view of "market participants."

Together with former BOJ Deputy Governor Masazumi Wakatabe, Mr. Nagahama serves as a private-sector member of the Council on Economic and Fiscal Policy. At the Council's May meeting, the private-sector members submitted a document stating that they "expect appropriate monetary policy to be conducted with due consideration also given to developments in the supply of and demand for various types of funds in the market." Mr. Aida and others serve on the Japan Growth Strategy Council overseen by Minister of State for Economic and Fiscal Policy Minoru Kiuchi, and Mr. Aida was also reported to have argued that the rise in long-term interest rates was attributable to supply/demand factors.

The argument that had taken shape around the administration was that the rise in long-term interest rates reflected the BOJ's reduction in JGB purchases, and that the rise should therefore be curbed by slowing QT or increasing JGB purchases. Prime Minister Takaichi's request for JGB purchases can also be viewed as an extension of this line of argument.

A shared goal, but different views on how to achieve it

The BOJ and the Prime Minister's Office agreed that neither wanted long-term interest rates to rise. According to the *Nikkei*, following the 22 May meeting, a government official recalled that "the BOJ and the Prime Minister's Office shared the goal of not wanting long-term interest rates to rise," but admitted that "they could not agree on the means."

This remark succinctly illustrates the difference in views between the Prime Minister's Office and the BOJ. The Prime Minister's Office regarded deteriorating JGB supply/demand conditions and the BOJ's QT as factors behind the rise in long-term interest rates. It therefore considered halting the reduction in JGB purchases or increasing purchases as necessary to be potential measures for curbing the rise in long-term interest rates.

The BOJ, however, offered a different explanation. In the minutes of the June MPM released yesterday, a few members expressed the recognition that "raising the policy interest rate with the aim of achieving price stability would lead to stabilizing long-term interest rates, taking into account that the recent rise in long-term interest rates was mainly attributable to heightened concerns over inflation due to factors such as the effects of the situation in the Middle East."

The BOJ's logic does not attribute the rise in long-term interest rates solely to JGB supply and demand. If inflation concerns and a rise in the underlying rate of inflation are pushing up the term premium, then containing concerns about future inflation through timely and appropriate interest rate hikes would ultimately also help stabilize long-term interest rates. The BOJ's position is that the remedy for rising long-term interest rates is not JGB purchases, but rather monetary policy normalization. Many market participants would probably agree with this view.

◆ **Minutes of June BOJ Monetary Policy Meeting (5 Aug 2026)**

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The government called for a halt to QT

The government, however, explored a different response. According to the *Nikkei*, the idea of halting the reduction in JGB purchases gained traction within the administration. As the June meeting approached and it became known that the BOJ intended to raise interest rates, Minister of State for Economic and Fiscal Policy Kiuchi reportedly told those around him, "If they are going to raise interest rates, we will get what we can in return," indicating that he clearly expected a "concession" in return.

In fact, at the June meeting, a Cabinet Office representative stated that, "Regarding the purchase of JGBs, it is necessary for the Bank to examine the macroeconomic impact of the reduction in the size of its balance sheet and to take appropriate action for market stability."

◆ **Minutes of June BOJ Monetary Policy Meeting (5 Aug 2026): Cabinet Office Representative**

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As a result, while raising the policy interest rate to 1%, the BOJ decided to halt further reductions in JGB purchases from April 2027 and continue purchasing approximately Y2tn per month. Some government officials have suggested that "the prime minister's side appears to have understood the revision of the purchase plan as having been made in exchange for permitting the interest rate hike" (Jiji Press).

Risk of being perceived as fiscal financing

Within the BOJ, however, there was strong concern about such an interpretation. According to the minutes of the June meeting, Board Member Tamura argued that "the Bank should allow long-term interest rates to be determined by the market and its participants." He also warned that "if the intention behind the Bank's JGB purchases was perceived by the market as fiscal financing or as an attempt to lower long-term interest rates, this could lead to bias in the market and undermine the credibility of the Bank."

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- The member noted that the purpose of the Bank's past large-scale JGB purchases was monetary easing, and there was no need for such purchases under the current circumstances. The member then expressed the recognition that no disruptions had occurred in the JGB markets, and there was no reason at all to halt the reduction of the purchase amount. Furthermore, the member added that, if the intention behind the Bank's JGB purchases was perceived by the market as fiscal financing or as an attempt to lower long-term interest rates, this could lead to bias in the market and undermine the credibility of the Bank.

With regard to halting the reduction in JGB purchases, several members also stated that "it is necessary to clearly explain that the Bank's aim is not to support government financing." Another member stated that, although it was necessary to support stability in the markets, it should be made clear that the Bank would discuss the specific pace of its JGB purchases from the viewpoint of avoiding sudden movements in the markets following the termination of large-scale monetary easing, and that the Bank did not aim at controlling long-term interest rates or the yield curve.

Views supporting continued interest rate hikes were also prominent at the meeting. Several members argued that financial conditions were expected to remain accommodative after the policy interest rate hike at this meeting. These members continued that, therefore, if economic activity and prices developed in line with its outlook, the Bank should maintain its stance to continue to raise the policy interest rate. Another member argued that the policy rate should be moved closer to the neutral rate at a pace of "with intervals of a few months."

◆ **Minutes of June BOJ Monetary Policy Meeting (5 Aug 2026)**

- Some members expressed the recognition that it was necessary to explain clearly that a halt of the reduction of the JGB purchase amount was a measure aimed at preventing the JGB markets from becoming unstable so that economic activity would not be adversely affected and the Bank's aim was not to support government financing.
- In addition, one member expressed the view that, although it was necessary to support stability in the markets, it should be made clear that the Bank would discuss the specific pace of its JGB purchases from the viewpoint of avoiding sudden movements in the markets following the termination of large-scale monetary easing, and that the Bank did not aim at controlling long-term interest rates or the yield curve.

Message of the BOJ Review

Shortly after these developments, the BOJ Review titled "Impact of the Bank of Japan's Reductions in JGB Purchases on the JGB Markets"[1] was released. The Review's message is quite clear. The argument that the recent rise in long-term interest rates is attributable to the BOJ's QT, namely its reduction in JGB purchases, is not supported. This is effectively the Review's conclusion. The fact that the authors are identified not by individual name but as the BOJ's Monetary Affairs Department and Financial Markets Department further reinforces the significance of this message.

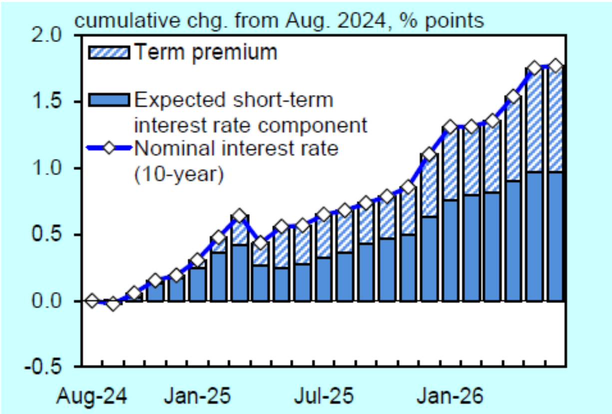
At the outset, the Review explicitly states that "the recent rise in long-term interest rates has been driven, to a certain extent, by fundamental factors such as the rise in the underlying inflation."

A decomposition of the rise in long-term interest rates shows that the expected short-term interest rate component and the term premium each contributed roughly half of the increase. However, the contribution from the former is attributed to changes in the outlook for the policy interest rate against the backdrop of a rise in the underlying rate of inflation and higher inflation expectations. In other words, the BOJ's position is not that "the rise in long-term interest rates is attributable to QT," but that it reflects more firmly established inflation and expectations of policy rate hikes.

[1] BOJ Monetary Affairs Department / Financial Markets Department (2026). "Impact of the Bank of Japan's Reductions in JGB Purchases on the JGB Markets."

The Review also presents the BOJ's own estimates, indicating that the diminishing stock effect resulting from the reduction in JGB purchases can explain only around 10bp of the rise, and that even the combined stock and flow effects can explain only approximately 25bp. The BOJ's assessment is that QT has had an impact, but cannot be regarded as the principal driver of the recent rise in long-term interest rates.

Decomposition of Long-Term Yields into Factors



Notes: 1. Data are as of end-June 2026.
2. Estimates based on the term structure model in Imakubo and Nakajima (2015).
Sources: Bank of Japan; Bloomberg; Consensus Economics Inc., "Consensus Forecasts."

Source: Reprinted from BOJ Monetary Affairs Department / Financial Markets Department (2026). "Impact of the Bank of Japan's Reductions in JGB Purchases on the JGB Markets."

Market functioning is actually improving

Another major theme of the Review is the improvement in market functioning. The BOJ highlights the increased availability of newly issued JGBs in the secondary market, improved liquidity in the market for off-the-run issues, the correction of distortions in the yield curve, and the restoration of the market's price discovery function. The Review states that "the JGB markets are regaining the price-discovery function they are originally expected to perform." In other words, the BOJ's assessment is that the reduction in purchases is not damaging the market, but is instead promoting its normalization.

The Review also illustrates the relationship between economic indicators and JGB futures prices. During the period of large-scale monetary easing, the bond market's response was limited even when economic indicators exceeded market expectations. Following the normalization of monetary policy, however, a clear tendency has emerged for bond prices to decline and interest rates to rise when strong economic indicators are released. The BOJ regards this change as evidence that the JGB markets are gradually regaining the price-discovery function they are originally expected to perform.

The BOJ is therefore presenting an assessment that is effectively the opposite of the view expressed among those close to the Takaichi administration that "QT is destabilizing the market." Throughout the Review, the BOJ conveys its assessment that the reduction in JGB purchases is improving market functioning and allowing information on the economy and prices to be reflected more directly in long-term interest rates.

Between June 2024 and March 2026, banks increased their JGB holdings by Y36tn, pension funds by Y20tn, overseas investors by Y27tn, and households by Y6tn. The Review's assessment is that the market is gradually transitioning to a more diverse investor base beyond the BOJ. It also notes, however, that portfolio adjustments take time, which is one of the reasons for halting further reductions in purchases from April 2027.

◆ **Minutes of June BOJ Monetary Policy Meeting (5 Aug 2026)**

- Some members expressed the recognition that there was no reason to change the plan, as the majority of market participants had supported maintaining it even amid a rise in long-term interest rates, and also in view of prioritizing the predictability of the Bank's JGB purchases.

This review has made the BOJ's assessment quite clear. The recent rise in long-term interest rates reflects to a considerable degree changes in fundamentals, including a rise in the underlying rate of inflation and higher inflation expectations, while the impact of QT has been limited. The reduction in purchases is facilitating the normalization of market functioning, and the JGB market is gradually transitioning to a more diverse investor base beyond the BOJ.

Based on this assessment, there is no need for the BOJ to increase its JGB purchases merely because long-term interest rates have risen. Rather, from the BOJ's perspective, timely and appropriate interest rate hikes aimed at containing inflation concerns are the policy response that will help stabilize long-term interest rates. Indeed, at the June meeting, a few members stated that "raising the policy interest rate with the aim of achieving price stability would lead to stabilizing long-term interest rates."

What the market will focus on after QT

The Review clearly indicates the BOJ's view that QT is not the principal driver of the rise in long-term interest rates. However, the market's attention will not end there. In the Review, the BOJ itself cites a rise in the underlying rate of inflation, the outlook for future policy interest rates, and uncertainty surrounding fiscal and monetary policy as factors behind the rise in long-term interest rates. Put differently, the more firmly the BOJ rejects the narrative that QT is driving the rise in long-term interest rates, the more market attention is likely to shift toward inflation developments and fiscal management.

Against this backdrop, the government decided at a Cabinet meeting on 5 August to reduce the consumption tax rate on food from 8% to 1%. The market has already been highly attentive to the outlook for fiscal management and JGB supply. Furthermore, according to the *Nikkei*, a senior US government official was reported to have expressed caution regarding Japan's tax-cut policy, stating, "The choice is whether to implement tax cuts or introduce measures to curb inflation. If it were up to me, I would prioritize the latter."

In this sense, the Review is not simply an "acquittal of QT." The more the BOJ explains that QT's impact has been limited, the more strongly the market will focus on the question: "How, then, should we assess the fiscal policy and future JGB supply risks that lie behind the rise in interest rates?"

The Review is not a document that directly discusses fiscal policy. However, having attributed the rise in long-term interest rates primarily to changes in inflation and the policy environment rather than to QT, the BOJ may have made the market even more sensitive to fiscal management and the outlook for JGB supply.

Focus of the next meeting between the prime minister and BOJ governor

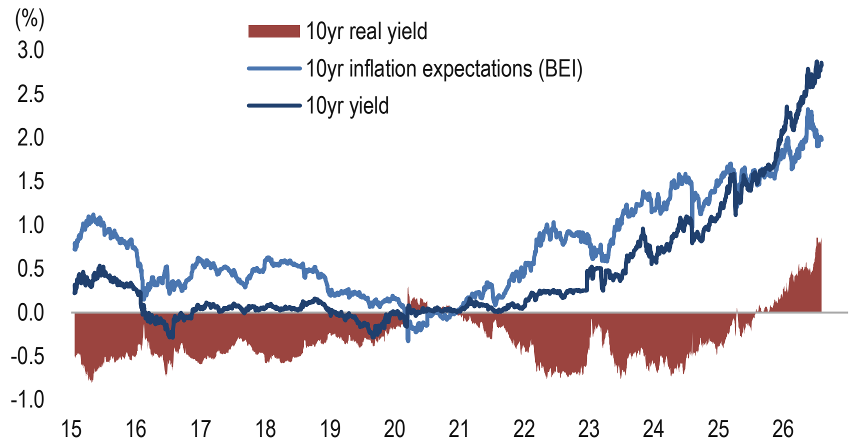
It is also noteworthy that details of the 22 May meeting were not reported until August. Meetings between the prime minister and Governor Ueda have been held at regular intervals, leading to growing market expectations that the next meeting may be approaching. Coming immediately after the coordinated foreign exchange intervention, this latest report has once again focused attention on the difference in views between the two sides regarding JGB purchases and the appropriate response to the rise in long-term interest rates.

At the 22 May meeting between the prime minister and the BOJ governor, Prime Minister Takaichi asked Governor Ueda to purchase JGBs as necessary. Long-term interest rates subsequently rose temporarily to their highest level in approximately 30 years. At the June MPM, the BOJ decided both to raise interest rates and to halt further reductions in JGB purchases from April 2027. Then, in August, the BOJ released this Review examining the impact of QT on the rise in long-term interest rates. Even so, the situation still appears to be characterized by the statement that "the two sides share the goal of not wanting long-term interest rates to rise, but they cannot agree on the means."

The BOJ Review clearly presents the BOJ's view that the argument attributing the recent rise in long-term interest rates to QT is not supported. From the BOJ's perspective, the principal drivers of the rise in long-term interest rates are changes in fundamentals, including a rise in the underlying rate of inflation and higher inflation expectations. Its position is that timely and appropriate interest rate hikes would also contribute to the stability of long-term interest rates.

Meanwhile, those close to the administration continue to attribute the rise in long-term interest rates largely to JGB supply/demand conditions and QT, and to call for the BOJ to respond through JGB purchases. The remark made by a government official after the May meeting that "the two sides share the goal, but cannot agree on the means" still hold true today. The latest BOJ Review can be regarded as the BOJ's response to that debate.

Japan: 10yr Yield, Real Yield, and BEI



Source: Bloomberg; compiled by Daiwa.

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