Japan Watch

BoJ preview: Trick or tweak?

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Economics
Japan

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The Bank of Japan's next monetary policy meeting is scheduled for 30-31 October. According to Bloomberg's BoJ policy survey (conducted 18-23 October), only 18% of BoJ watchers expect the BoJ to adjust or scrap Yield Curve Control (YCC) at next week's meeting, though 40% say they would not rule out the risk.

Indeed, we had previously expected the BoJ's next move to be in Dec '23 – Apr '24 (base case Jan '24 MPM), when we looked for the central bank to end NIRP and remove (or greatly loosen) yield curve control (see BoJ Watch: Inching closer to normalization, 21 September 2023). However, we think changes in the external environment necessitate that the BoJ conduct another pre-emptive adjustment of yield curve control, in order to prevent the risk of another unwanted 1) re-acceleration in balance sheet expansion as it tries to contain the upward pressure in JGB yields; and 2) depreciation of the yen.

In our base case, we now see better than even odds that the BoJ will adjust yield curve control (YCC) again at this meeting. Though the exact manner of the adjustment is uncertain, if the BoJ were to move next week, we expect the central bank to raise the rate for its unlimited daily fixed rate operations to 1.5%, from the current 1% (see Exhibit 8 in the Strategy section for scenarios and market implications). That said, we expect the BoJ to frame the adjustment as another precautionary move and underscore that it stands ready to contain the pace of rise in yields, perhaps even strengthening its bond market operations in the near term.

Revisiting the logic for the 28 Jul YCC adjustments

Only three months ago, the BoJ announced a pre-emptive adjustment of YCC by raising the effective ceiling of the 10yr target to 1.0%, from 0.5% previously (see Japan Macro Watch, 29 July 2023).

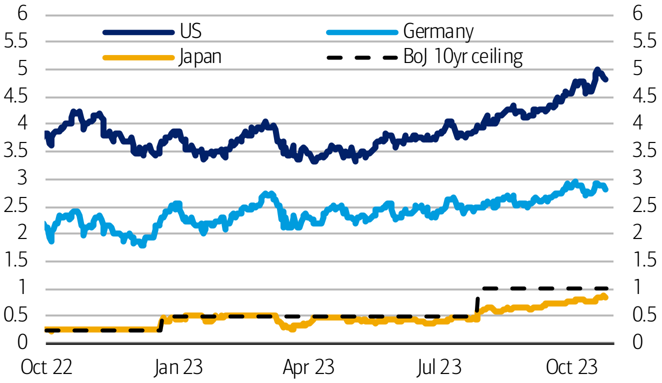
In justifying the change, the BoJ cited the risk of further upside surprises in domestic inflation momentum, arguing that attempting to control nominal yields rigidly in such a scenario would result in an 1) unwanted strengthening of monetary easing via a decline in real interest rates, and 2) side effects, such as a deterioration in bond market functioning and "volatility in other financial markets."

However, Governor Ueda was careful to portray the move as a "pre-emptive," adjustment, stressing in his press conference that the BoJ 1) would still be looking to control the pace of increase in yields between 0.5 and 1.0%, and that the central bank 2) did not foresee the 10yr yield rising to 1%, but that it raised the cap "just in case."

YCC under pressure once again

Since the 28 July YCC adjustment, global bond markets have continued to sell-off, with 10yr UST yields touching 5% at one point (+100bp vs. end-July) (Exhibit 1). While the "precautionary" expansion of the JGB 10yr target ceiling has given the long-end wiggle room to drift higher, with 10yr JGB yields trading at 0.86% as of this writing, the central bank's margin of safety is diminishing (Exhibit 2). (continued)

Exhibit 1: 10yr sovereign yields (%)
Long-end yields have been moving higher globally, led by the United States



Source: BofA Global Research, Bloomberg

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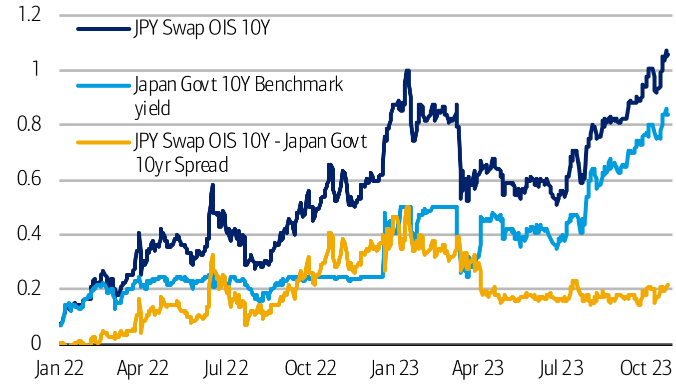
Exhibit 2: JPY Govt 10Y Benchmark yield and JPY Swap OIS 10Y
Dislocation in swap spreads not as severe as in late '22 - early '23 as Jul YCC adjustment bought wiggle room for cash JGB yields to rise



Source: BofA Global Research, Bloomberg

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What makes the recent rise in JGB yields tricky for the BoJ to address is that, whereas July's YCC adjustments could be justified by pointing to the notable improvement in underlying inflation since the December 2022 tweaks, with only three months of data since July, the improvement in inflation and inflation expectations since the last YCC tweak has been more limited (Exhibit 7).

Of course, the BoJ could choose to stand pat, taking a chance that October 23rd marked the peak in US long-end yields in this cycle. It could then wait a few more months for early newsflow on the FY24 spring wage negotiations and other domestic inflation data allow the central bank to declare the achievement of its 2% price stability target, making way for revisions to NIRP and YCC.

However, we think this is a risky strategy. There is a nearly two- month gap between the 30-31 October policy meeting and the BoJ's next MPM, on 18-19 December—a long time to wait in the event of a renewed sell-off in global duration. Moreover, we expect domestic data to remain hawkish over the next few months, further boosting the market's expectations of early policy normalization.

In our view, the turn in the BoJ's communications since September suggest that the central bank has already begun laying the groundwork for an eventual end to negative interest policy (NIRP) (see BoJ Watch: Could the BoJ end NIRP in 2023?, 11 September 2023). However, the BoJ's ability to communicate its thinking around its intention for front-end normalization will be constrained if 10yr JGB yields continue to press against the 1% ceiling, as further hints on policy changes risk putting pressure on yields.

The main pushback to the case for additional YCC tweaks at the October MPM is that it risks exacerbating the sell-off in global bonds. While this is a risk, we think the BoJ will address this by strengthening its bond market operations in the near term (including immediately following next week's policy meeting) by using unscheduled bond-buying operations and funds-supplying operations against pooled collateral to contain the rise in yields.

Media reports suggest October MPM is "live"

Early media reports ahead of the MPM blackout period (starting Thursday 26 October), also suggest that there is an active debate within the central bank over the need for further YCC adjustments, with the Nikkei Shimbun (10/21), Reuters (10/23), Bloomberg (10/24) and Yomiuri (10/25) all pointing to the possibility of tweaks at the upcoming meeting (Exhibit 3). We see the following common themes:

1. All four articles imply that the BoJ is discussing the possibility of further tweaks to yield curve control (YCC) at the next policy meeting, on 30-31 October.

2. They also suggest that the BoJ sees the rise in overseas interest rates, particularly US Treasuries, as the main driver of the rise in domestic JGB yields.

3. Related to this, the consensus within the central bank is that, while there has been continued progress with Japan's underlying inflation momentum, the achievement of the 2% price stability target is not yet in sight, making major policy revisions, such as an end to NIRP or YCC removal, unlikely at next week's meeting.

4. If changes to YCC are to be made at the 31 October MPM, the BoJ would consider a variety of options, including 1) simply raising the rate for daily fixed rate operations from the current 1%; 2) scrapping the 0.5% reference point, and/or 3) adjusting how the bank conducts policy on a daily basis.

5. However, the reports all stress that discussions over the need for further YCC adjustments are on-going, and that there isn't yet a clear consensus on the board for the immediate necessity of policy changes.

Exhibit 3: Select media reports ahead of the 30-31 October BoJ MPM
Media reports suggest budding debate within the BoJ over the need for further YCC adjustments amidst the rise in long-term interest rates

	Source	Headline
21-Oct	Nikkei Shimbun*	"BoJ considers revising interest rate policy as long-term interest rates approach 1% 'cap'"
23-Oct	Reuters (English edition)	"Rising yields may pressure BOJ to consider raising newly set cap"
24-Oct	Bloomberg	"BoJ's Decision on Yield Curve Control Set to Go Down to the Wire"
25-Oct	Yomiuri Shimbun*	"BoJ to assess rise in long-term interest rates; to maintain easing measures at the 30-31 MPM

Source: BofA Global Research, Nikkei Shimbun, Reuters, Bloomberg, Yomiuri Shimbun;
*English title of the Nikkei and Yomiuri articles are BofA's

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Recent newsflow point to strong start for FY24 *Shunto*

As discussed earlier, we have expected the BoJ's next move to an end to NIRP and yield curve control in December 2023 – October 2024, with the January MPM being our base case. By then, we think the Bank of Japan will have sufficient data to argue that the achievement of sustained and stable 2% inflation is in sight.

The missing ingredient in the BoJ's declaration of sustained and stable 2% inflation has been confidence in the outlook for FY24 wages. On this front, recent newsflow has been positive: on 19 October, Japan's Umbrella Union Rengo announced that it would seek total pay hikes of "more than 5%" (including a 3% increase in base salaries), a stronger stance compared to its previous demand of "around 5%."

More importantly, several big corporates have recently announced large pay hikes of 7%. In the case of the FY23 *Shunto*, large corporates began announcing their intentions around pay hikes as early as December. But the fact that the cycle kicked off two months earlier, in October, underscores the fact that the norms around wage-setting are changing. It also increases the likelihood that the BoJ will not have to wait until mid-2024 to make a preliminary assessment on the sustainability of wage growth.

Elsewhere, the results of the September Bank of Japan Tankan also pointed to continued progress towards sustained and stable 2% inflation: business sentiment among large non-manufacturers improved to the highest level in 32 years, while medium term (5yr) inflation expectations remained firm (see Japan Watch: BoJ Tankan (Sep): Domestic resilience points to self-sustaining inflation cycle, 2 October 2023).

Outlook report: Further upward revisions to FY23 and FY24 inflation

Even if we are wrong and the BoJ decides to stand pat next week, we think further policy revisions are a matter of time.

Exhibit 4: BoJ policy board median CPI forecasts

We expect another round of upward revisions to the BoJ's inflation projections, though FY25 should continue to fall short of 2%

Avg% Yr	CPI ex fresh food				CPI ex food & energy			
	BoJ (Jul)	BoJ (Oct)* *expected	BBG (11 Oct)	BofA (29 Sep)	BoJ (Jul)	BoJ (Oct)* *expected	BBG (11 Oct)	BofA (29 Sep)
CY								
23	-	-	3.0	3.1	-	-	3.9	3.9
24	-	-	2.0	3.2	-	-	2.1	2.6
25	-	-	1.4	1.8	-	-	1.6	2.1
FY								
23	2.5	3.0	2.7	3.0	3.2	3.7	3.8	3.9
24	1.9	2.0	1.9	2.8	1.7	1.8	1.8	2.3
25	1.6	1.7	1.4	1.7	1.8	1.9	1.7	2.0

Source: BoJ, Bloomberg, BofA Global Research
*Figures are BoFA forecasts of BoJ's October projections

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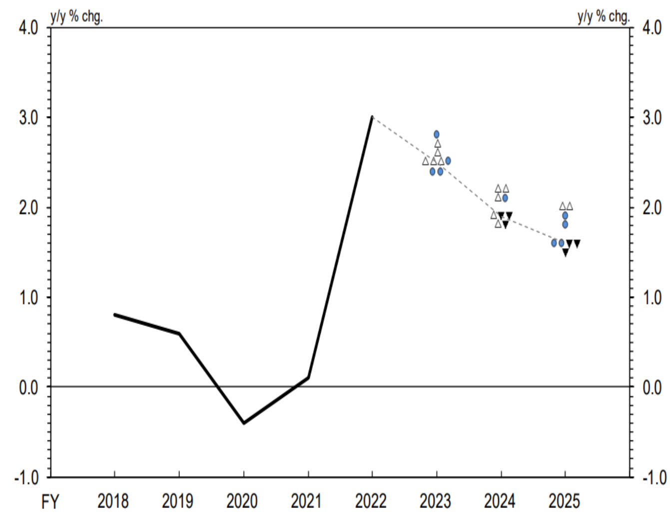
Exhibit 5: BoJ policy board members' forecasts and risk assessment for CPI ex fresh food (July Outlook Report)

The majority of policy board members saw Japan-style core inflation falling short of 2% by FY25, with three seeing risks tilted to the downside.



Source: Bank of Japan

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Indeed, the upcoming Outlook Report should show the central bank moving another step closer in declaring victory on its 2% price stability target.

Media reports have already suggested that the BoJ board will be looking to deliver another round of upward revisions to its FY23 and FY24 Japan-style core (CPI ex fresh food) projections (Exhibit 4). Despite a large (0.7ppt) revision in July, the BoJ's average FY23 projection of 2.5%YoY falls well short of our and consensus estimates of 3.0% and 2.7%, respectively. Though there are some uncertainties around individual policy board members' assumptions around the timing for the phasing out of government energy subsidies, we expect an upward revision to around 3% in the October Outlook Report. Meanwhile, we expect a small upward revision for the FY24 figure, to +2.0%.

More important will be policy board members' forecasts for—and confidence in—the FY25 inflation outlook. In its July Outlook Report, the BoJ policy board's median FY25 CPI projections were unchanged at 1.6% for the Japan-style core (CPI ex fresh food) and 1.8% for the ex-energy BoJ-style core (CPI ex fresh food & energy; figures are fiscal year averages). Moreover, only two board members saw the risks around their FY25 Japan-style core inflation projections as tilted to the upside; these happened to be the only two that forecast inflation at 2% (Exhibit 5). Five out of the nine policy board members forecast FY25 Japan-style core inflation of 1.5-1.6%, with three flagging risks to the downside.

In the October Outlook Report, we expect the board's median FY25 inflation projections to be revised up a touch (i.e. by 0.1ppt), but fall slightly short of 2%. We also think the BoJ will refrain from flagging that risks to the FY25 price outlook are skewed to the "upside," as the median view on the policy board is still likely to be cautious on the outlook for medium-term inflation. Such forecasts would be consistent with the BoJ's view that 2% inflation is not yet in sight—and therefore refrain from major policy revisions, such as an end to NIRP or removal of yield curve control. However, as noted earlier, we expect the data/newsflow to prompt further revisions as early as January.

- Izumi Devalier and Takayasu Kudo, Japan Economists

FX/Rates: short JGB, not USD/JPY

As noted above, our economists' base case is for the BoJ to implement another YCC tweak at the Oct MPM, which is a close call between a hold. If the BoJ is to move at the

Oct MPM as we expect, the early timing of another YCC tweak after the one in July would be primarily due to higher US rates, which have driven the 10yr JGB yield higher above 0.85%, and the BoJ's preemptive approach to YCC although we acknowledge fundamental developments, which would also be cited as a reason for such a policy tweak.

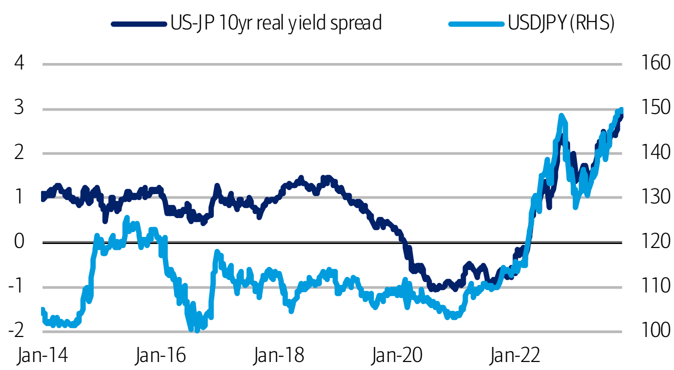
As such, our core view remains that the BoJ's measured policy normalization, especially YCC tweaks, would lead to higher yields but not to a higher JPY (see: Liquid Insight: Short JGB, not USD/JPY 12 September 2023). The BoJ is facing a difficult situation. The widening US-Japan real interest rate spread has been driving USD/JPY higher to a critical 150 level, reflecting the gap in monetary policy stance (Exhibit 6). However, Japan's BEI is still at 1.2% and more work may be needed to re-anchor Japan's inflation expectations at 2% so the BoJ would not want to send a tightening signal to the market (Exhibit 7).

Rise in yields fine for BoJ as long as it is gradual

At the end, the BoJ would likely have to remain accommodative and accept some degree of yen weakness while minimizing the side effect – excessive yen weakness, unwanted expansion of its balance sheet. The BoJ would allow a gradual rise in the long-term yields – if necessary by tweaking YCC – while it would also attempt to slow the rise in the yields by policy intervention.

While the BoJ has so far conducted funds-supplying operations against pooled collateral and unscheduled operations, the BoJ has not boosted its size of Rinban operations. We think the hurdle for changing the size of Rinban operations is high with elevated US rates volatility as (1) we think the market reaction to the change in the size is asymmetric (reduction to have bigger impact than increase); (2) a reduction would send a policy normalization signal (once they increase the size, it may be difficult to bring it down).

Exhibit 6: US-JP 10yr real yield spread vs USD/JPY
Rising US real yields driving USD/JPY higher



Source: BofA Global Research, Bloomberg

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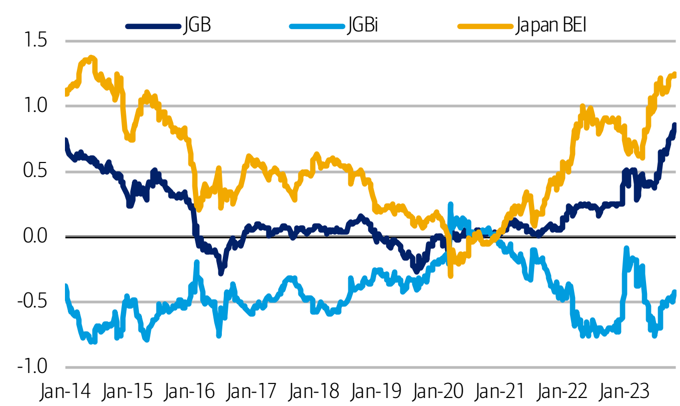
Exhibit 7: Japan 10yr: nominal (JGB), real (JGBi), BEI
BEI has risen but still distance toward 2%



Source: BofA Global Research, Bloomberg

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Scenarios (spot ref: USD/JPY 149.5, 10yr JGB yield 0.86%)

We summarize our scenarios and expected market reactions below (Exhibit 8):

- **Base case (raise the YCC ceiling by 50bp)**: The 10yr JGB yield would likely sell off immediately but the BoJ would try to contain it by strengthening policy intervention to calm the market. However, the yield would be allowed to rise gradually toward 1% by year-end, led by a rise in the real yield, and break it in 1Q24. As the BoJ would want to keep the current Rinban operations to avoid being seen hawkish, the 10-30yr JGB curve is expected to continue steepening, given the difference in its purchase size and frequency. USD/JPY may decline by 1% (148) initially but would stabilize with an upward bias given carry.

- **No change (dovish case)**: Given expectations for an eventual exit from YCC and NIRP, the market would still be incentivized to trade JGB from the short side especially if the US rates stay elevated. The 10yr JGB yield could rise toward 1% by 1Q24 and the BoJ would likely try to slow the rise by funds-supplying operations and/or unscheduled bond buying operations with strong policy intervention if the 10yr rises to 0.95%. The BoJ may end up having to buy more JGBs than monthly issuance, leading to a further deterioration in the bond market functioning and yen depreciation. The market would also combine the short JGB trade with long USD/JPY, lifting USD/JPY to 151-152, testing the MoF. The MoF may need to intervene if the US rates remain elevated.

- **Remove YCC (hawkish case)**: JGBs would be sold across the curve with the 10yr yield rising to 1% in the near term and possibly toward 1.15% by year-end with a steepening curve bias. USD/JPY would sell-off by 2-3% (145-146.5) initially but follow-through could be limited given elevated USD/JPY carry without a hawkish guidance by the BoJ. The BoJ would in principle not need to keep its excessive bond-buying operations if it ends YCC, but an immediate reduction in its JGB purchases could have a significant impact on the JGB market. The BoJ would reduce its Rinban only in a gradual pace and in the near term it may even need to strengthen operations if the bond market sells-off in an disorderly manner especially in the medium- to long-term sector. Once the market stabilizes, the BoJ may be able to reduce purchases in the superlong sector from ¥100bn each time to ¥75bn, given latent demand from Japanese life insurers.

- **Remove YCC and NIRP (hawkish tail risk)**: We expect the similar reaction to the scenario “remove YCC”, but the sell-off would be harder due to the NIRP removal and its signaling impact, especially in the medium-term sector, which may require the BoJ’s stronger intervention. Some domestic banks may reduce medium-term JGBs and shift to current account deposits. The sell-off would be more parallel across the curve relative to the YCC removal scenario. USD/JPY could sell-off by 3-5% (142-145) initially and the medium-term development would depend on the BoJ’s forward guidance. If the market assume additional hikes are limited, USD/JPY may bounce back. If the BoJ delivers hawkish guidance on additional hikes, USD/JPY may correct to 140 although we think aggressive hikes could raise the issue of Japan’s debt sustainability and can be eventually negative for JPY.

Exhibit 8: Expected JGB and USD/JPY reactions to different BoJ outcomes (spot ref: USD/JPY 149.5; 10yr JGB 0.86%)

Risk is tilted to higher JGB yields but not stronger JPY

	Hold	Base case (raise YCC ceiling from 1% to 1.5%)	YCC removal	YCC + NIRP removal
JGBs	Limited Reaction	2yr: 0.10% 5yr: 0.40% 10yr: 0.95% 30yr: 1.95%	2yr: 0.10% 5yr: 0.45% 10yr: 1.15% 30yr: 2.00%	2yr: 0.15% 5yr: 0.50% 10yr: 1.20% 30yr: 2.00%
USD/JPY	Rise to 151-152 MoF intervention risk rise	-1% (148) bounce back on USD/JPY carry	-3% - -2% (145-146.5) it may stabilize on USD/JPY carry	-5% - -3% (142-145) Medium-term depend on forward guidance

Source: BofA Global Research

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