Japan Watch

Nikkei reports "BoJ to discuss YCC tweak to allow rates over 0.5%" – quick take

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Economics
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What happened?

The Nikkei Shimbun reported in an article published 2am that the BoJ "will discuss a proposed amendment to its short- land long-term interest rates operations under yield curve control (YCC)," without citing attribution (quotes are our translation of the Japanese original, unless otherwise noted). The key line then follows: "A proposal has emerged to leave the upper limit of the 10yr JGB permissible trading range unchanged at 0.5%, but to allow yields to exceed 0.5% to a certain extent, depending on market developments" (「長期金利の操作の上限は0.5%のまま据え置くものの、市場動向に応じて0.5%を一定程度超えることも容認する案が浮上している。」). It adds that the change would be "aimed at making the management of YCC—which suppresses interest rates through massive purchases of government bonds—more flexible and soften market distortions."

Our initial thoughts:

Per our BoJ preview (see BoJ preview: Are we there yet?, 27 July 2023), we have been expecting no change in the BoJ's key policy settings at today's policy meeting, though we noted that views on the board regarding the need for YCC adjustments was becoming more split: according to the Summary of Opinions of the 16 June MPM, at least one board member suggesting that "a revision to the treatment of yield curve control should be discussed at an early stage," with a view to 1) limiting the risk of excess volatility at the time of an exit; 2) improving market functioning; and 3) enabling a smoother dialogue with market participants.

Given the high profile nature of the Nikkei article (the 2am "evening scoop" features prominently on the front page of today's morning print edition) we think the facts stated in the article are credible, and that indeed some form of proposed amendment will be discussed at today's MPM. We also think that the board may ultimately agree to some kind of change in language around the current policy directive on yield curve control, specifically the directive "1) b) Conduct of Yield Curve Control" (see reference at the end of this report).

However, we caution there are still many uncertainties around how far the adjustments will go. In our view, there is a risk that the actual contents of the changes could be limited to minor operational tweaks and end up being a "disappointment" for those looking for a proper hawkish turn by the BoJ. Questions include:

1) What part of the policy directive will the BoJ change?

Based on the tone of the Nikkei article, it seems highly likely that the BoJ will leave unchanged its current directive to maintain NIRP and the long-rate target of "around zero %". It also seems likely to continue referencing a 0.5% ceiling for its band around the 10yr JGB yield, although it may loosen the language slightly to "around +/-50bp." This makes it likely that the board's discussions around the YCC revisions will focus on current language on the "Conduct of Yield Curve Control." (continued)

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Specifically, given the mention of "flexibilization" of market operations, the most likely outcome—if any—is a scrapping of the board's promise to conduct unlimited fixed rate bond-buying operations on every business day, which was introduced in April 2022 and strengthened the central bank's rigid control of bond markets.

2) How will the BoJ define and implement the new (more flexible) threshold for intervention?

As Nikkei reported, the new proposal would "allow yields to exceed 0.5% 'to a certain extent'…'depending on market developments'" (emphasis ours).

This points to two considerations for intervention.

A "a certain extent" refers to the level of yields. Coupled with the likely retention of the current 0.5% 10yr yield ceiling, it suggests that the BoJ will continue to draw a line in the sand to limit the rise in yields beyond a certain threshold (i.e. – it will not condone a rise in yields to 1%, no matter how gradual). However, it remains to be seen how much of a deviation the BoJ would allow (i.e. 0.6%? 0.7%? 0.75%?) and how the BoJ communicates this (for example, via the publication of a reference range for yields).

In the extreme, the BoJ quietly allows the "0.5%" 10yr ceiling to go the way of the Kuroda-era "JPY80trn net JGB asset purchase target," which remained in writing until April 2020 but was de facto abolished following the transition to Yield Curve Control, in September 2016.

However, this is likely to encounter strong opposition from the "doves" on the board, who likely see the need to maintain low interest rate levels given the fragility of the recovery in growth and underlying inflation. A large backup in yields, no matter how gradual, would also run counter to Governor Ueda's remarks expressing a lack in confidence in the sustainability of 2% inflation over the medium term at this stage (see BoJ preview: Are we there yet?, 27 July 2023).

The other criteria for intervention ("depending on market developments"), seems to be referring to the extent of 1) market volatility and 2) global rate environment (i.e. a backup in global bond yields would see the BoJ intervening more aggressively). However, this also leaves room for a lot of discretion.

3) What is the BoJ's main aim and will they succeed?

Admittedly, it seems that injecting greater "uncertainty" into the thresholds for BoJ long rate control is precisely the aim of the reported amendments.

In doing so, it seems the BoJ wants to achieve three goals:

1) Make it more costly to engage in speculative attacks (shorting) of JGBs, by making the trigger for intervention more unpredictable, while condoning a "healthy" rise in volatility and yields to some extent;

2) In the process, ultimately reduce the amount of net JGB purchases from current levels and prevent the balance sheet from expanding faster

3) Discourage one-sided bets on yen depreciation

On the third point, we find it notable that the Nikkei article cites the persistence of cost-push inflation driven by higher import prices as a backdrop for the proposed amendment, stating that "there is also a growing sense of caution about rising prices resulting from the weak yen." It notes that "making interest rate operations more elastic could result in a narrowing of the interest rate differential and halt the yen's weakening trend."

However, if the main aim behind the operational tweaks is 2) reduction of JGB purchases, it remains uncertain whether the BoJ will be successful. Depending on how the operational amendments are implemented, the increased uncertainty could end up forcing the BoJ to buy more JGBs.

We will follow with updated thoughts following the MPM decision (expected any time after 11:30am JST) and Governor Ueda's press conference (scheduled 3:30pm JST).

Reference: Directive for Yield Curve Control (June MPM)

(1) Yield curve control

a) The Bank decided to set the following guideline for market operations for the intermeeting period.

The short-term policy interest rate: The Bank will apply a negative interest rate of minus 0.1 percent to the Policy-Rate Balances in current accounts held by financial institutions at the Bank.

The long-term interest rate: The Bank will purchase a necessary amount of Japanese government bonds (JGBs) without setting an upper limit so that 10-year JGB yields will remain at around zero percent.

b) Conduct of yield curve control

The Bank will continue to allow 10-year JGB yields to fluctuate in the range of around plus and minus 0.5 percentage points from the target level, and will offer to purchase 10-year JGBs at 0.5 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted. In order to encourage the formation of a yield curve that is consistent with the above guideline for market operations, the Bank will continue with large-scale JGB purchases and make nimble responses for each maturity by increasing the amount of JGB purchases and conducting fixed-rate purchase operations.

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