Japan Viewpoint

YCC removal dovish if BoJ keeps current monthly JGB purchases

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BoJ's policy normalization – focus on balance sheet policy

We expect the BoJ to declare its 2% price stability target "in sight," end NIRP, and the overall framework of YCC in either the March or April MPM. Our base case has been the April, but recent newsflow point to an increasing probability that the move comes at the central bank's next policy meeting, on 18-19 March. Given that investors have fully priced in NIRP removal by April, the BoJ's decisions around its balance sheet policy, particularly its purchases of JGBs, are a bigger source of potential volatility for markets. In this report we discuss our view on the BoJ's management of its bond purchases "post-NIRP," and market implications.

YCC vs Quantity: normalization options

Following the exit from NIRP, the BoJ largely has three options for how it communicates its JGB purchase guidelines: 1) Transition to "soft YCC", with continued focused on the level of yields; 2) Flow target with guidelines for monthly JGB purchase quantities; 3) Stock target focusing on the balance of JGB holdings. As indicated by media reports, our base case is that the BoJ moves to a flow target, initially establishing a monthly guideline for JGB purchases of around JPY6trn/month, in line with the current purchase pace of JPY5.9trn/mo. Since this is slightly above the average pace of expected redemptions for the BoJ's JGB holdings in FY24 (JPY5.6trn/mo), it implies that the size of the BoJ balance sheet will remain largely flat for now. The BoJ is unlikely to shift the target purchase pace and officially announce QT before its second hike to 0.25% (base case = Oct 2024).

Market implications

We think investors would do well to look at the detail of potential policy changes. Keeping YCC and removing the floor for purchase quantities (established by the overshooting commitment to expanding monetary base) would actually be hawkish as the BoJ can reduce the pace of JGB buying to drive yields higher. In contrast, a decision to scrap YCC may be initially perceived as hawkish by markets. However, if the BoJ communicates to the market that the pace of its JGB purchases will remain largely unchanged from current levels, as we expect under our base case, the JGB market would stabilize as markets price out the risk of quantitative tightening (QT) in the near term.

Flow target of JPY6tn monthly JGB purchases = dovish

If it chooses flow target of JPY6tn/month, the 10yr JGB yield may stabilize around 0.75% (0.7-0.80% range), and USD/JPY's decline would be limited to 145. We focus on the BoJ's guidance on rate hikes and balance sheet policy. If guidance is also dovish, it increases the risk of a further rise in USD/JPY and high pressure economy as the market would expect continued tight supply/demand balance in the JGB market and indicates the board's dovishness. Coupled with accelerating structural outflows from Japan, the lack of reductions to the BoJ's bond purchases in 2024 raises the risk of USD/JPY rising to 160 by 2025. The risk against our base case is therefore an earlier start of QT in 2H24 (vs 2025).

QT: Quantitative tightening

NIRP: Negative interest rate policy

MPM: Monetary policy meeting

BoJ: Bank of Japan

YCC: Yield curve control

QE: Quantitative easing

JGB Japanese government bond

QQE: Quantitative and qualitative easing

Refer to important disclosures on page 10 to 12.
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Timestamp: 12 March 2024 11:03AM EDT

No cut to JGB purchases = risk of BoJ seen too dovish

On March 8, Jiji press reported the following, without naming a source:

(1) The BoJ is considering scrapping yield curve control in favor of a new "quantitative" policy framework that will show the outlook for the central bank's upcoming bond buying amounts;

(2) The transition to the new framework would be delivered alongside the exit from negative interest rate policy (NIRP), as early as the 18-19 March MPM;

(3) For the time being, the guideline for monthly bond purchases would be based on the current pace, which is slightly less than JPY6tn

(4) While the commitment to maintain the current pace of bond purchases is designed to prevent a rapid rise in JGB yields associated with the exit from NIRP and transition to policy normalization, it is also intended to improve bond market functioning by allowing further fluctuations in yield

5) That said, in the event of a sudden rise in yields, the BoJ would respond nimbly, i.e. by increasing its JGB purchases.

Jiji's report, which we view as credible, raises the likelihood that yield curve control will be scrapped at the time of its policy overhaul and replaced with a directive focusing on the flow of its monthly JGB purchases, which is likely to be set at "around JPY6trn."

The market has shown a hawkish reaction to the reports, with the 10yr JGB yield rising to 0.77% from 0.73% over the weekend. However, the lack of a cut to the BoJ's monthly purchases would keep supply/demand balance in the JGB market tight and would have dovish implications for the rates/FX market in 2024.

Unless accompanied by hawkish guidance on further rate hikes (which is not our base case), or signals that the JPY6trn may be reduced further in due course, the BoJ's upcoming exit from NIRP/YCC may be interpreted as a "dovish hike," limiting the rise in long-end yields and making the current rally in the yen short-lived.

Below, we discuss our views on the BoJ's policy, focusing on its balance sheet policy and draw market implications.

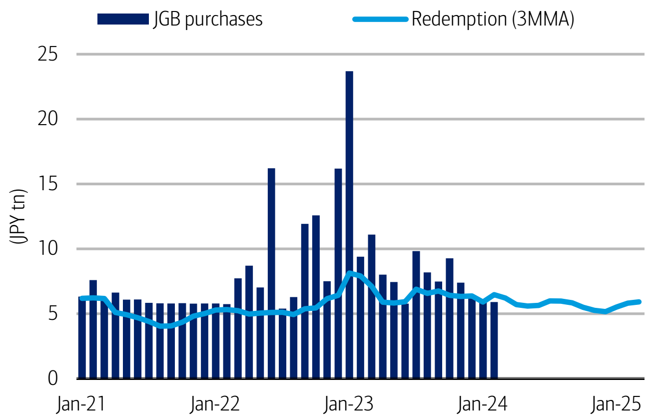
Lingering uncertainties around balance sheet policy

While the markets' focus has thus far been focused been on the timing and likelihood of NIRP removal, the BoJ has indicated that upcoming policy changes would likely involve a fairly comprehensive overhaul of its current large-scale easing program (BoJ Watch: Jan MPM Summary of Opinions: further signals for Mar/Apr policy change, 31 January 2024).

This would include potential revisions to the overall framework of yield curve control, as well as the 2% inflation overshooting commitment, which obliges the BoJ to continue expanding the monetary base, until its price stability target is durably achieved.

Repeated adjustments to the YCC de facto ceiling for the 10yr JGB yield have allowed the central bank to gradually reduce its monthly JGB purchases, to JPY 5.9trn as of February. This is slightly above the average pace of redemptions on the central bank's JGB holdings, which we estimate at JPY5.6trn in FY24 (Exhibit 1). Therefore, further reductions to the BoJ's bond purchase pace would imply a reduction of the BoJ's balance sheet.

Exhibit 1: BoJ's JGB buying (monthly) vs redemption (3mma)
BoJ still buys around as much as amount of redemption in its JGB portfolio



Source: BoJ, Bloomberg, BofA Global Research

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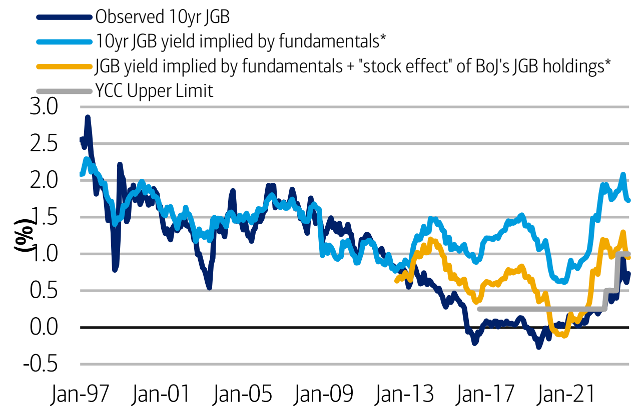
Exhibit 2: BofA's 10yr JGB yield "fair value" analysis
10yr JGB yield has room to rise if BoJ QT



Source: BoJ, MIC, MHLW, Bloomberg, BofA Global Research
*Inputs of "fundamentals": PCV (core CPI, active job openings-to-applicants ratio), 10yr UST yield
Liquid Insight: BoJ could act if 10yr JGB yield hits 75bp 09 August 2023

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We expect the 2% overshooting commitment to be abolished
We expect the 2% inflation overshooting commitment to be abolished when the BoJ exits NIRP (BoJ Watch: Jan MPM Summary of Opinions: further signals for Mar/Apr policy change, 31 January 2024). Though this would, in theory, allow the BoJ to reduce its JGB purchases further, resulting in QT, the BoJ has indicated that changes to its bond purchases would be made with a view to avoiding "discontinuities" in policy and the markets.

For example, in his speech in February, vice governor Uchida said the YCC framework is "a form of quantitative easing (QE) implemented through JGB purchases" so "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 JGB purchases and how to maintain the stability of markets during that process."

Uchida's comments imply that, even if the BoJ formally ends the yield curve control framework at the time of its policy overhaul, it is highly unlikely to abruptly stop buying JGBs, given its outsized influence on the JGB markets. But there are lingering uncertainties as to how quickly it will reduce its purchases. Given that the BoJ's cumulative JGB buying has likely contained the level of the yields by a significant margin (Exhibit 2), its decisions around its balance sheet policy, particularly its purchases of JGBs, are a bigger source of potential volatility for markets.

YCC vs Quantity: normalization options

Following the exit from NIRP, the BoJ largely has three options for how it determines, communicates its directive for JGB purchases.

1) Transition to "soft YCC": Though the BoJ may formally end its overall framework for QQE+YCC, as part of declaring its 2% price stability target "in sight," it could choose to retain a "reference yield" for the 10yr JGB yield. For example, it could retain "1%" or slightly higher level, as a soft ceiling for the 10yr JGB yield. The pace of bond purchases would then be determined endogenously by market conditions.

2) Flow target: In this scenario, the BoJ would abandon a price target for bonds and establish guidelines for JGB purchases focusing on the quantity of monthly purchases, which stood at around JPY5.9trn/month as of Feb '24.

3) Stock target: This scenario would also see the BoJ return to guidelines focusing on the balance of JGB holdings, which stood at around JPY597trn as of Feb 2024.

Note that prior to the introduction of YCC, in September 2016, the BoJ's policy directive committed the central bank to "purchase JGBs so that their amount outstanding will increase at an annual pace of about JPY80trn."

Jiji's report suggests if the BoJ removes YCC and moves to a quantity target, it would opt for guidelines focusing on the flow of purchases, not the stock of JGB holdings.

Base case: flow target, with no immediate QT

Our base case is that the BoJ moves to a flow target, establishing a monthly guideline for gross JGB purchases. Removing YCC and moving to a flow target can simply the policy framework and avoid the risk of YCC, but the hurdle for QT would increase (on pros/cons of each policy, see: Pros/Cons of YCC vs flow target).

Following the Jiji report, the monthly guideline is likely to be JPY6tn, around the current purchase pace of JPY5.9tn if the BoJ is to choose the flow target. Given that this is around the pace of expected redemptions in FY24 (JPY5.6tn), our forecast assumes that the size of the BoJ's JGB holdings will remain largely unchanged in 2024.

As the BoJ would be careful to not send an overly hawkish signal as it conducts policy exit, the BoJ is unlikely to lower the target purchase pace before its second hike, which we expect in 4Q24. This is consistent with our expectation that quantitative tightening (QT) would be delayed until 2025.

Risk of an earlier QT

However, uncertainty remains high, including how the BoJ communities its future steps on rate hikes and balance sheet. The BoJ stressing it could reduce the JPY6tn guideline if conditions allow would lead the market to price in the risk of an early start of QT. The BoJ signaling some scope for deviation from the JPY6tn guideline – i.e. Ueda says JPY6tn only a guideline, not a hard target and they will manage it flexibly– could also make the market expect stealth QT – further reductions in JGB purchases.

On a dovish direction, the BoJ scrapping YCC but retaining unlimited fixed rate bond buying operations as a backstop in the JGB market would be a dovish surprise.

We think the risk against our base case is an earlier start of gradual QT in 2H24, considering net benefits QT would bring and the risk of USD/JPY overshooting on depressed domestic yields (see: Risk/benefits of quantitative tightening).

Market implications

Near term: Keeping YCC hawkish, flow target of JPY6tn dovish

We think investors would do well to look at the detail of potential policy changes. The market's reaction to a removal of YCC may be initially hawkish. However, if the BoJ communicates to the market that it would maintain the pace of bond buying in case of flow target policy, the JGB market would stabilize as it expects stable bond buying by the BoJ in the near term (see: Pros/Cons of YCC vs flow target).

Keeping YCC but removing the floor for purchase quantities (established by the overshooting commitment to expanding monetary base) would actually be hawkish as the BoJ can reduce the pace of JGB buying to drive yields higher.

Given positioning, there is a scope for USD/JPY's sell-off (see: FX Watch: Japan BoP: yen's spring rally 08 March 2024). If it scraps YCC and establishes a new guideline for flow JGB purchases at JPY6tn/month, as the Jiji report implies, the 10yr JGB yield may stabilize around 0.75% (0.7-0.80% range), and USD/JPY's decline would be limited to 145. If the BoJ retains YCC while scrapping the 2% overshooting commitment for the monetary base, we think the 10yr JGB yield can rise to 0.9-1.0% in the near-term and USD/JPY fall to 143-145.

Risk of uncomfortable rise in USD/JPY, risk of an earlier QT

Coupled with structural outflows from Japan and a resilient US economy (see: FX Watch: Japan BoP: yen's spring rally 08 March 2024), the lack of reductions to the BoJ's bond purchases throughout 2024 raises the risk of USD/JPY rising to 160 by 2025, potentially leading to a further rise in inflation expectations amidst a high-pressure economy.

With strong momentum in the spring wage negotiations and the risk of tight JGB demand/supply balance driving USD/JPY higher, the risk against our base case is therefore an earlier start of gradual QT in 2H24 (vs 2025).

Exhibit 7: Expected market reaction to BoJ's potential policy choice upon normalization

YCC to be hawkish, flow target to be dovish if JPY6tn in the near-term

	YCC (1% soft upper limit plus/minus 50bp allowance range)	Flow target (BoJ to keep the current pace of JGB buying with a bias to reduce over time)
Short-term implications	Hawkish as BoJ seen to reduce JGB purchases to let yields rise *10yr JGB to rise to 0.9% *USD/JPY to fall to 143-145	Less hawkish as BoJ unlikely to significantly reduce JGB buying immediately *10yr JGB stabilizes around 0.75% *USD/JPY's fall limited to 145

Source: BofA Global Research

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Appendix

Risk/benefits of quantitative tightening

We discuss benefits and risk QT could bring. There are benefits that QT would bring, which could make the BoJ consider QT if conditions allow in coming months/quarters as it proceeds with policy normalization.

- **Improved bond market functioning**: After starting QQE in April 2013, the BoJ has been buying at least 43% of gross JGB issuance every month (Exhibit 3). As the BoJ has crowded out private investors from the market, measures of JGB market functioning have deteriorated (Exhibit 4). One of the opinions expressed at the December 2023 BoJ workshop conducting a "Broad-Perspective Review Of Monetary Policy" was that BoJ JGB holdings in excess of 70% of outstanding issuance reduces market trading volume. BoJ purchases of 5-10yr JGBs in January were equivalent to about 70% of new issuance during the month (see: Japan Rates Watch: Policy revision expectations rising but BoJ unlikely to reduce Rinban ops 08 February 2024).

- **Correct JGB's "overvaluation"**: The BoJ's significant JGB buying has lowered the 10yr JGB yield well below the level implied by fundamentals (currently 1.7%, Exhibit 2). Depressed JGB yields have caused USD/JPY to rise as the US-Japan real interest rate spreads have widened to the highest level since 2007. As the risk of inflation relative to the risk of deflation has been rising, scaling back bond purchases could help bring policy back to an appropriate level by reducing the overvaluation of JGBs.

- **Create room for monetary easing in the future**: The size of the BoJ's balance sheet has risen to above 120% of Japan's GDP, by far the biggest among major central banks, creating outsized excess JPY liquidity (Exhibit 5). QT could help normalize the size of the BoJ's balance sheet and JPY's liquidity, and create room for monetary easing in the future.

- **Reduce the amount of payments of interests on excess reserves to banks**: When the BoJ exits NIRP, it would start paying net positive interests on excess reserve. QT could reduce the size of excess reserves and the amount of interest paid to banks. While slipping into negative income or negative equity should not, in theory, constrain the BoJ's ability to implement monetary policy, ballooning interest rate payments could become a political and social issue (see Impact of potential BoJ rate hikes (part 3): Effect on BoJ finances, 10 October 2023).

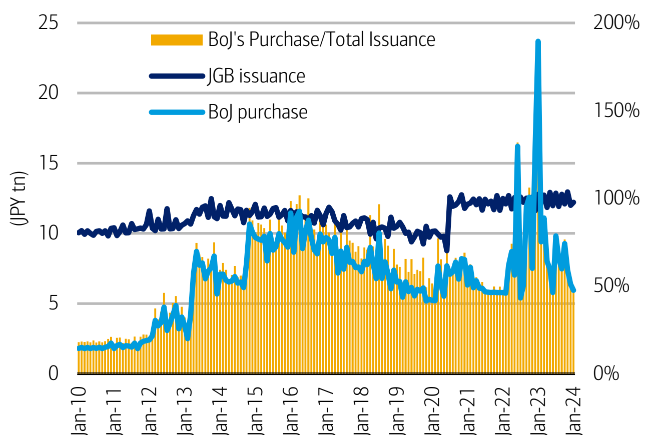
Risks associated with QT

However, potential risks associated with QT could make the BoJ cautious in proceeding with QT, judging from its cautious and gradual approach to policy normalization to date:

- **Destabilization of the bond market**: As the BoJ scales back bond buying, the bond market, which has been under significant influence of the BoJ, could destabilize.
- **Unintended tightening signal**: QT could also send stronger policy tightening signal to the market. The BoJ's recent communications imply it wants to maintain certain level of policy accommodation after it exits NIRP.
- **Unrealized losses in the BoJ's JGB portfolio**: QT could drive JGB yields higher, which could lead to unrealized losses in the BoJ's JGB portfolio (see: Japan Watch: Impact of potential BoJ rate hikes (part 3): Effect on BoJ finances 10 October 2023). Although the BoJ does not mark to market its JGB holdings, as noted above, the deterioration of the BoJ's balance sheet could become a political issue and, at worst, lower the market and public's trust in the yen.

The upshot is that the BoJ's QT may not start right away and would be gradual even if it starts to reap these benefits of QT while avoiding the risks. Rapid explicit QT would be seen risky by the BoJ, as it could destabilize the bond market and send a policy tightening signal to the market when the BoJ's confidence level for sustainable 2% inflation is still not high enough to justify aggressive policy tightening.

Exhibit 4: BoJ's monthly JGB purchases vs gross JGB issuance
BoJ still buying about 50% of the total JGB issuance per month



Source: MoF, BoJ, BofA Global Research

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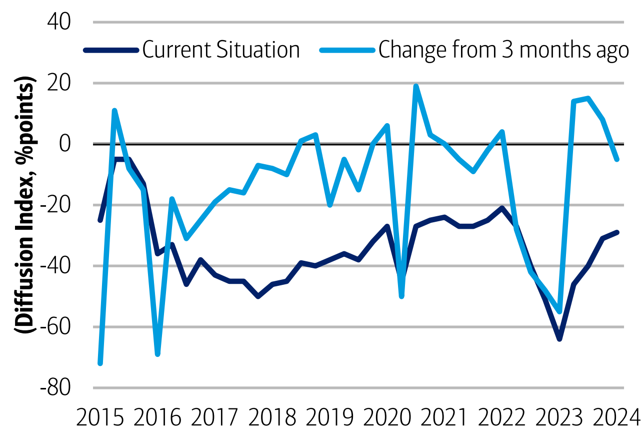
Exhibit 5: Measures of the degree of bond market functioning (BoJ's Bond Market Survey; latest = Feb 2024)
Scope for a recovery in bond market functioning



Source: BoJ, BofA Global Research

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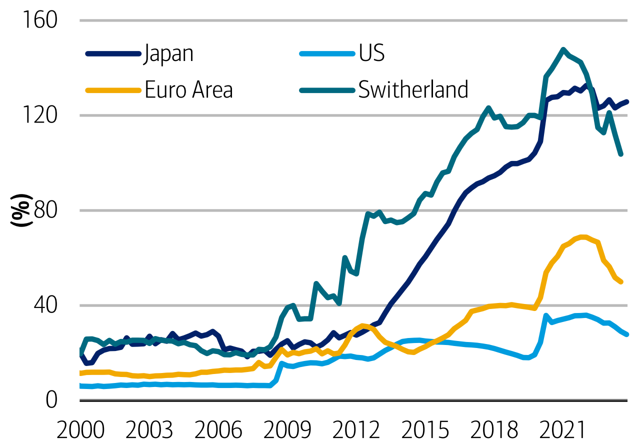
Exhibit 6: Central banks' balance sheets as % of nominal GDP
BoJ's BS exceeds 120% of nominal GDP



Source: BofA Global Research, Bloomberg

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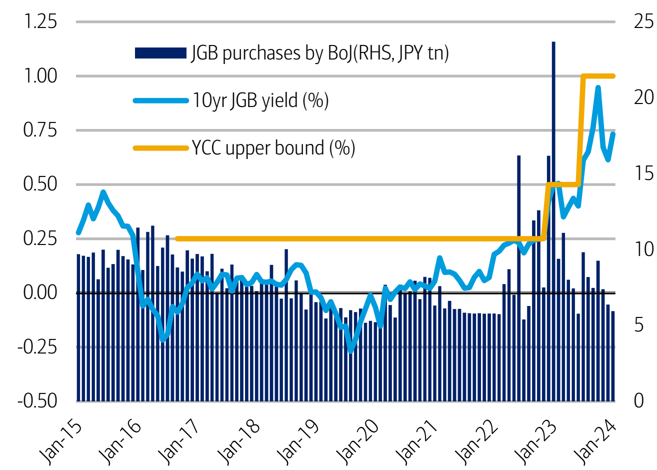
Exhibit 7: 10yr JGB yield, YCC and JGB purchases by the BoJ
BoJ increased its JGB purchases to defend the YCC



Source: BoJ, Bloomberg, BofA Global Research

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Pros/Cons of YCC vs flow target

YCC: Best option today for stealth QT but risk of YCC attack

- **Procyclical** – YCC's biggest trait is its procyclicality. The presumption is that the BoJ would want to contain the impact of external shocks on the JGB market. It is easier for the BoJ to reduce JGB buying when foreign rates are stable or falling, while it may have to increase JGB buying when foreign rates are rising.

- **Today's environment = stealth QT possible** – Given the Fed's easing bias and the BoJ's willingness to let yields rise, the BoJ can reduce JGB buying to drive yields higher without explicit QT policy.

- **Ultimately, can contain yield level** – Another benefit of YCC is that the BoJ can ultimately justify containing the JGB yields buy increased JGB purchases. This may be seen attractive to policymakers given Japan's high level of public debt outstanding and the BoJ's huge JGB holdings (though the BoJ does not have to mark-to-market).

- **Risk of YCC attack = unwanted rise in BS, higher FX vol** – However, if US rates rise, the market may attack YCC and the BoJ may have to defend it by increased JGB buying as it did in 2022 and 2023, leading to an unwanted balance sheet expansion by the BoJ (Exhibit 6) and another volatile rise in USD/JPY.

- **Arbitrariness of yield target** – Another issue is the arbitrariness of the yield target. The BoJ's choice for the "reference" price for the 10yr JGB yield should, in theory, be based on its assumptions regarding Japan's neutral rate. However, we think the central bank is reluctant to present a view on r* at this point, given the inherent difficulties involved in its measurement as well as the fact that Japan's inflation regime is still in a transitional state. Without a proper debate on the neutral rate, the yield target can be seen arbitrary and too subjective by the market.

In summary, YCC would be the best option today if the BoJ wants to reduce JGB buying / holdings through stealth QT given a stable US rates environment. If the BoJ is to target 1% initially, the current bond buying pace, which has contained the 10yr JGB yield around 0.7%, would need to be slowed down. However, YCC's defining feature is its procyclicality and thus remains vulnerable in a higher US rates environment, as we saw in 2022 and 2023.

Flow target: Autonomy on balance sheet control but higher hurdle for QT

- **BoJ can control balance sheet** – The BoJ can take back full control of its balance sheet if it shifts to a flow target on its JGB holdings and let the market decide the yield level.

- **Strong signaling impact and higher hurdle for QT/QE** – Flow target policy would have a strong signaling impact as it implies the BoJ wants to expand or reduce its balance sheet. For this reason, the hurdle for QT and QE would be higher.

- **Limited control of yield curve** – The flip side of a flow target is the lack of control over the yield curve. It can impact the yield curve by adjusting the flow target, but flexibility would be limited given the signaling impact a change in the flow target has.

A flow target may be more orthodox than YCC as it does not intend to control the yield curve and it can be countercyclical. However, the lack of a hard backstop for JGB yields and strong signaling impact would raise the hurdle for QT. If the BoJ chooses to target the monthly JGB purchase at JPY6trn as reported, demand supply/demand balance in the JGB markets would remain tight.

Exhibit 8: 3 most likely options of BoJ's policy on bond buying: policy features and pros/cons
Keeping YCC would be hawkish, removing YCC and moving to a flow target of JPY6tn/month would be dovish

	YCC	Flow target
Policy target	10yr yield (point target with allowance range)	Balance of BoJ's JGB holdings
Cyclicality	Procyclical	Countercyclical
Market control vs balance sheet control	Strong market control vs weak BS control	Weak market control vs strong BS control
Pros	Immediate stealth QT possible Controllability of yield curve	Full control of quantity Strong signaling impact
Cons	Policy's procyclicality (YCC attack risk) Arbitrariness of yield target	High hurdle for QT/QE Lack of backstop in JGB market

Source: BofA Global Research

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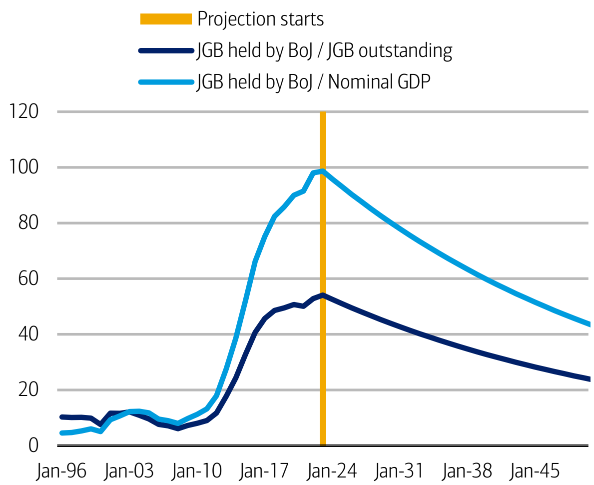
"Nominal QT" vs "real QT"

While our and market focus is on nominal QT, we think the aspect of real QT is also important from a longer-term perspective. For example, 3% nominal GDP growth would accumulate to 16% compound growth in 5 years, 34% in 10 years and 81% in 20 years (Exhibit 9). Even if the BoJ keeps the size of its JGB holdings unchanged, its share of nominal GDP and the JGBs outstanding (assuming the size of debt grows in parallel to the economy) will decline over time.

This "real QT" aspect could also exert upward pressure on yields over time as it erodes the stock effect of the BoJ's cumulative JGB purchases. However, if the BoJ is to rely on "real QT" without nominal QT, policy could remain too loose, exerting upward pressure on inflation breakeven and USD/JPY.

Exhibit 9: BoJ's JGB holdings as percentage of Japan's nominal GDP and JGB outstanding (assuming no change in JGB holdings and 3% nominal growth and JGB outstanding from 2024)

BoJ's JGB holdings will shrink relative to Japan's economy and JGB market over time if economy grows



Source: BofA Global Research, Cabinet Office, BoJ

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