28 March 2023

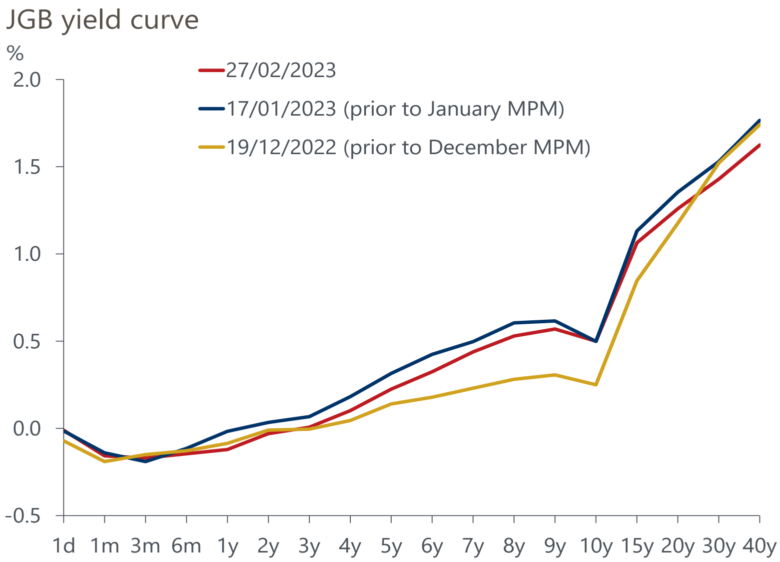
Research Briefing | Japan

The catch-22 for the BoJ as it wrestles with yields

- **The Bank of Japan enhanced its funds-supplying operations in January, after widening the tolerance band for 10-year JGB yields in December. The January actions are aimed at bringing down yields while avoiding further direct JGB purchases, but long-term JGB yields are staying stubbornly high, and market liquidity has not recovered. Maintaining the Yield Curve Control (YCC) policy is more costly now than ever.**
- **Since the December meeting, speculation of further yield hikes has increased. The 10-year JGB yield has been staying close to the new cap, and a kink in the yield curve remains. With the BoJ aggressively purchasing the JGBs, all on-the-run 10-year JGBs have effectively been absorbed from the market. Money market rates imply the shortage of JGBs is severe.**
- **To improve market liquidity, the BoJ is conducting securities lending daily, and raising its bid amount since late-December. Ironically, part of the bonds provided by this lending are used to construct short-sell positions in JGBs, resulting in further upward pressure on yields. To avoid such use, the BoJ has announced an increase in its fee. Given the new fee will be applied to all borrowers, this action is likely to limit liquidity provision.**
- **The BoJ's January decision lowered both the JGB and swap rates considerably. The operation came with solid demands from financial institutions, at least for now. However, its impact on the market has been limited except for the initial reaction.**
- **The slight improvement in the JGB market functioning has raised the possibility that the bank will be forced to re-expand the target for the long-term yield in the not too-distant future. It will help the new governor to buy time to conduct a comprehensive review of the policy framework.**

Yields on 10-year JGB have been around the upper band of the new target range introduced [in December 2022], after dropping temporarily following the bank's [January meeting], and a kink in the JGB yield curve remains (**Chart 1**). Despite the BoJ's actions, the market liquidity and its functioning are still deteriorated.

Chart 1: A kink in the JGB yield curve remains



Source: Oxford Economics/Haver Analytics

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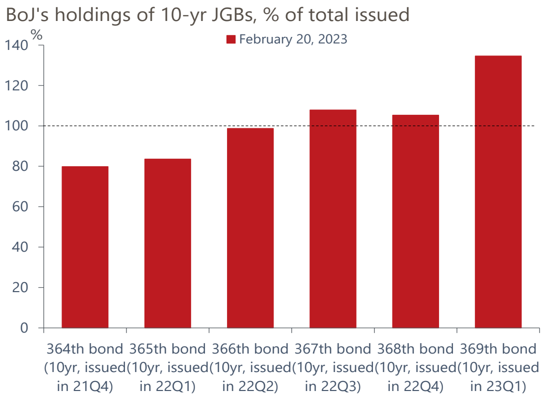
JGB liquidity has dried up with BoJ's massive purchases

Liquidity in the JGB market has been low. The BoJ raised its monthly JGB purchase target from ¥7.3 trillion to ¥9.0 trillion in December, which was largely overshadowed by its decision to expand the tolerance band for 10-year JGBs to +/-0.50% from +/-0.25%. The bank's JGB purchases in January was at the fastest pace in its history, exceeding ¥20 trillion in a single month for the first time. As a result, the bank has absorbed more than 100% of all three on-the-run 10-year government bonds, leading to significant deterioration in market liquidity (**Chart 2**).

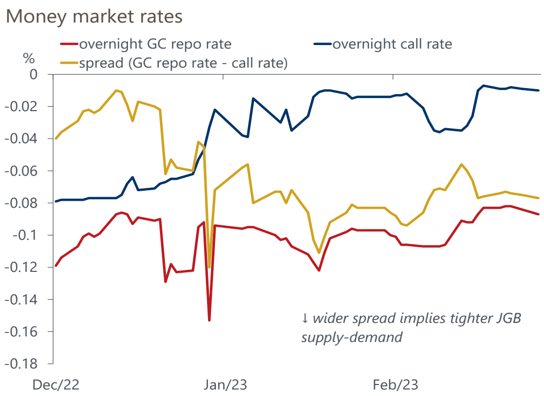
Chart 2: BoJ holds more than 100% of all on-the-run 10-year JGBs



Source: Oxford Economics/MoF/BoJ

Limited JGB liquidity is also confirmed in the money market. The spread between the uncollateralized overnight call rate and the general collateral (GC) repo rate has widened recently, suggesting that JGB collaterals are in short supply (**Chart 3**).

Chart 3: Money market rates suggest tight supply-demand condition in JGBs

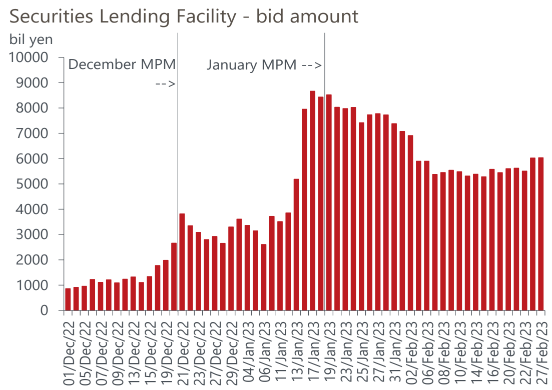


Source: Oxford Economics/Haver Analytics/JSDA

BoJ's security lending resulted in increased JGB short positions

The BoJ is taking steps to mitigate the negative impact on market liquidity from its JGB purchases, via a means to provide bonds they hold temporarily – the securities lending facility (SLF). Its daily bid amount doubled in mid-January and continued to stay elevated (**Chart 4**). The market relies on the bonds provided through SLF for transactions more and more.

Chart 4: Increased usage in SLF

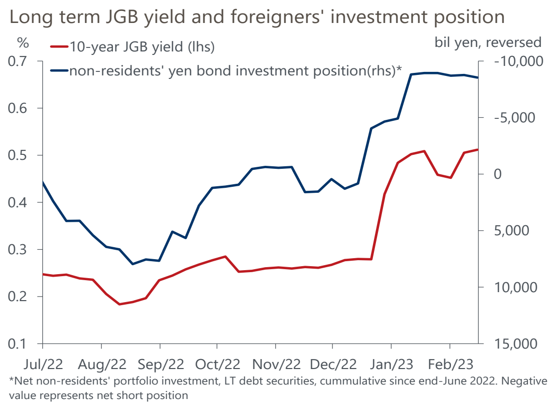


Source: Oxford Economics/BoJ

Meanwhile, selling pressure on JGBs, particularly those from non-Japanese investors has not abated, resulting in further upward pressure on yields (**Chart 5**). Ironically, part of the bonds provided by the SLF are used to short-sell JGBs with its low fee.

To avoid such use, the BoJ announced an increase in the fee for lending on-the-run 10-year JGBs. Given that new fee will be applied to all borrowers, this action is likely to result in limiting liquidity provisions.

Chart 5: Foreign investors are tilted toward short positions



Source: Oxford Economics/Haver Analytics/MoF

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YCC prolonged with enhanced funds-supplying operations?

The BoJ decided to enhance its funds-supplying operations at its January meeting. The bank now provides low-rate longer term loans. Since the meeting, they have conducted the operation three times at a maturity of 5 years, resulting in injecting ¥3 trillion to financial institutions in total (**Table 1**). The average interest rate, according to auction results, has been 0.12% to 0.15%, which is lower than the 5-year JGB yield. Bid-to-cover ratios of 3.0 to 3.3 is higher than previous similar operations with shorter maturities.

Table 1: Results of funds-supplying operations since Jan-2023

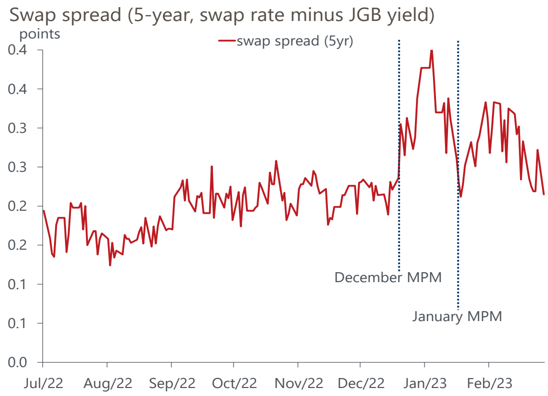
Operation results of Funds-Supplying Operation, since Jan-2023						
offer date	maturity	amounts offered (100mil)	competitive bid	successful bid	bid to cover ratio	interest rate (average)
04-Jan	2 years	10,000	58,267	10,016	5.8	0.000
05-Jan	2 years	20,000	51,717	20,014	2.6	0.000
06-Jan	2 years	20,000	40,721	20,011	2.0	0.000
10-Jan	2 weeks	-	1,359	1,359		0.000
12-Jan	2 years	20,000	37,006	20,008	1.8	0.000
13-Jan	2 years	20,000	22,162	20,009	1.1	0.000
18-Jan	2 years	10,000	1,163	1,163	1.0	0.000
23-Jan	5 years	10,000	31,290	10,003	3.1	0.145
24-Jan	2 weeks	-	5,770	5,770		0.000
31-Jan	5 years	10,000	32,639	10,004	3.3	0.142
14-Feb	5 years	10,000	30,318	10,004	3.0	0.121

Source: Oxford Economics / Bank of Japan

Source: Oxford Economics/BoJ

The goal of this operation is to put downward pressure in the 'belly zone (around a five-year duration)' JGB yields, as is the case with other operations. The main feature of this operation is that the BoJ influences market yields indirectly by supplying term-funding to banks, instead of purchasing JGBs directly. By doing so, they expect to lower the swap rate along with the JGB yields, while avoiding additional asset purchases. Indeed, after the announcement, the 5-year swap rate dropped faster than the same maturity JGB yield, leading to tightening in the swap spread to a one-month low (**Chart 6**). The effect of its announcement was firmly as the BoJ intended.

Chart 6: Swap spread tightened only temporarily after January MPM



Source: Oxford Economics/Haver Analytics

However, the impact of the actual operations on the interest rates have been unclear. At the least, the footprints on JGB yields and swap rates from three operations conducted so far seem to have been negligible. Looking ahead, it's unlikely that this operation will further reduce interest rates from this point, even if the term fundings keep going smoothly. Moreover, given that financial institutions are facing constraints from capital regulations and the availability of eligible collateral, we think that demand for this operation will gradually lower over time.

The BoJ is facing difficulty more than ever

The increase in the SLF fee symbolically illustrates the catch-22 situation that the BoJ increasingly finds itself in – a need for additional measure to fight the upward pressure in the yield curve, while the functioning of the market seems to be deteriorating.

We see a rising possibility that the BoJ will be forced to re-expand the target rate for the long-term yield in the not-too-distant future. It will give the new BoJ governor the job of conducting a comprehensive review of the overall monetary easing framework after succeeding Governor Kuroda in April. Given recent developments, we don't exclude the possibility that the decision will come earlier – Friday next week – though the chances are slim.