JAPAN PREVIEW: Yields, ETF Buying – BOJ Set to Add Flexibility

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By Yuki Masujima (Economist)

(Bloomberg Economics) -- The Bank of Japan may adjust the way it manages the 10-year JGB yield and conducts ETF and REIT purchases in order to make its monetary stimulus more sustainable for a longer period, in our view. The aim would be to make its yield curve control policy more flexible, and give itself more leeway to reduce asset purchases when market conditions allow.

We expect Governor Haruhiko Kuroda to convey the most consequential changes in fresh guidance at his press conference on Friday, when he explains the results of the months-long review of the policy framework.

* The basic elements of yield-curve control will probably remain unchanged, with the short-term rate anchored at -0.1% and the BOJ aiming to keep the 10-year JGB yield around 0% -- while allowing fluctuations depending on economic and price developments.
* We expect Kuroda to renew the commitment to the 10-year yield range of +/-0.2 ppt around 0%, but -- importantly -- also indicate that temporary moves beyond the range would be acceptable, as long as the effects of monetary easing aren’t disrupted and the yield curve is consistent with economic activity, prices, and financial conditions.
* In operational terms, this may mean the BOJ will conduct its JGB purchases with more flexibility -- changing the frequency of the operations and the menu of its purchases, depending on market conditions.
* This would help improve the functioning of the Japanese government bond market in terms of price discovery and liquidity -- increasing policy sustainability.

BOJ Continues to Control Yield Curve

The BOJ is likely to give itself more room for maneuver on its ETF and REIT purchases. Any changes would probably be conveyed through tweaks to guidance and footnotes.

* The effect would be to allow the BOJ to reduce or stop buying ETFs and REITs when markets are hitting highs and step up

purchases when markets are crashing.
* Under smooth market conditions, the pace of buying could be substantially lower than previously.

Economy Set to Contract in 1Q, CPI in Deflation

Steps to contain the coronavirus continue to weigh on the economy, with a state of emergency that was called in early January slated to remain in place in the Tokyo region until March 21. The service sector is taking the heaviest hit. But stronger exports, combined with mild yen declines, are supporting the manufacturing sector.

On balance, the economy is poised for a deep contraction in 1Q. Our GDP tracker points to a drop of more than 5% (quarter-on-quarter, annualized), based on January's data, after an 11.7% expansion in 4Q. We expect a rebound in 2Q after the emergency is lifted, and see the economy registering growth of 2.5% in 2021.

Financial conditions are broadly supportive, with equity prices buoyant and a steepening yield curve conducive to bank lending. Consumer price inflation remains anemic. We estimate the core consumer price index fell 0.4% year on year in February, a seventh straight month of declines and far from the BOJ's 2% inflation target.
Attaining 2% inflation will take considerable time. A challenge ahead for the BOJ will be to transition policy from a focus on emergency support for the corporate sector to more sustainable and effective stimulus in a post-Covid environment.

BOJ Board Almost Is United in Support for Japan Inc.

* BOJ officials have sent the mixed signals on yield management. Governor Kuroda said it's neither necessary nor appropriate to expand the target band for the 10-year JGB yield. But Deputy Governor Masayoshi Amamiya said it's fine for the yield to move in a wider range as long as it doesn't damage the effects of monetary easing.
* In our view, the comments aren't necessarily contradictory -- assuming they were referring to two different environments: crisis fighting during Covid (Kuroda) and post-Covid stimulus

(Amamiya).
* What's more, a lot probably depends on the backdrop. The 10-year JGB yield taking a fast run at the 0.2% upper end of the range could cause concern as it may put upward pressure on the yen -- a negative for growth and inflation. Circumstances such as the current ones -- with higher U.S. yields lifting the dollar (weakening the yen) -- are more benign, and would likely be of less concern to the BOJ.

Slowing ETF, REIT Purchases

* The two officials were more consistent in messaging on ETF purchases -- more flexibility is needed to deal with both financial instability and negative side effects.
* Local media have reported that the BOJ is likely to eliminate its guideline of buying 6 trillion yen of ETFs annually but keep the 12 trillion yen annual cap.
* The BOJ has been including a footnote in its policy statements that specifies guidelines for its annual asset purchases -- about 6 trillion yen for ETFs and about 90 billion yen for REITs. That footnote will probably be dropped in future statements.

To contact the economist on this analysis:
Yuki Masujima (Economist) in Tokyo at ymasujima@bloomberg.net
To contact the editor responsible for this analysis:
Arran Scott at ascott101@bloomberg.net

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