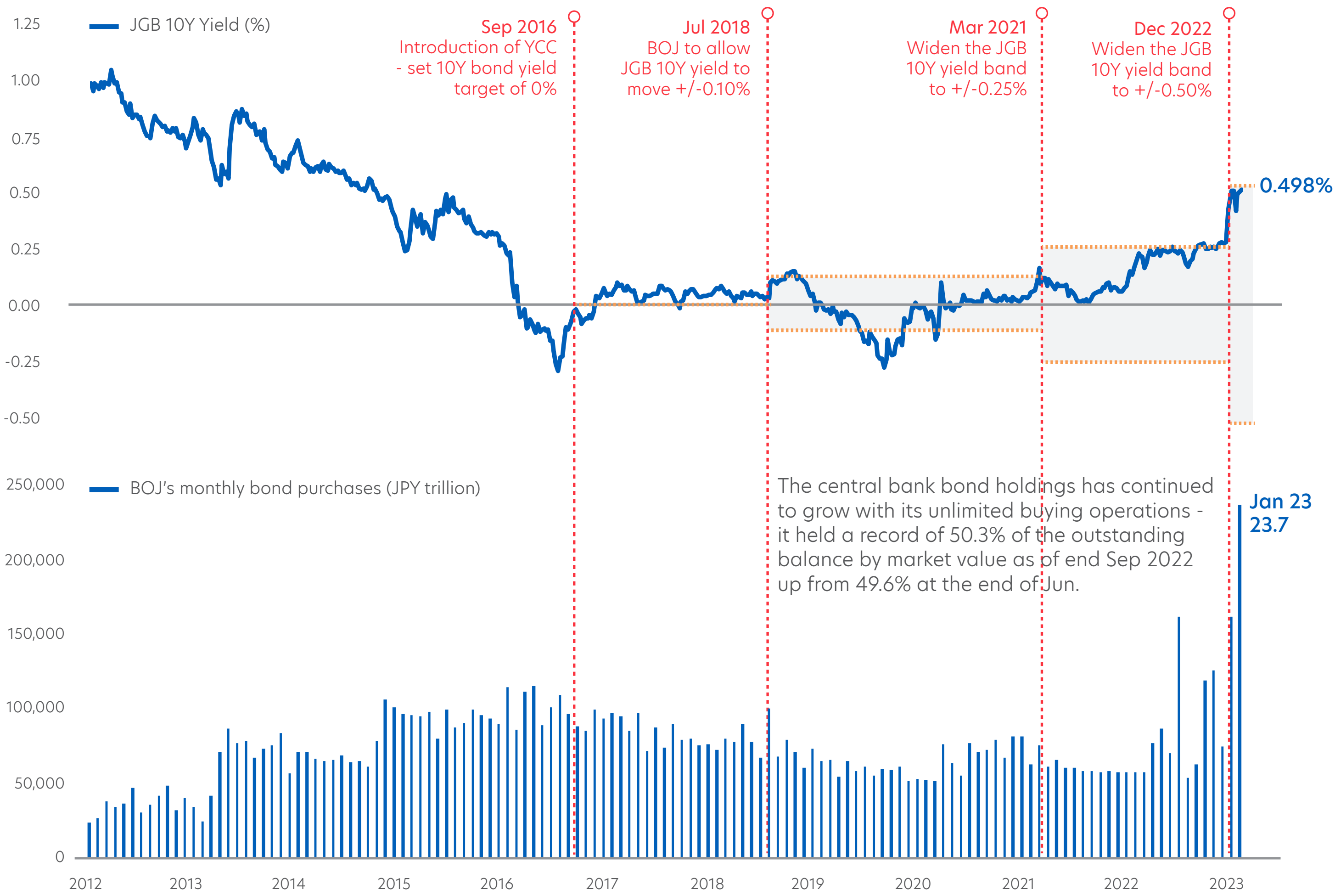
Potential Risks Arising From **BOJ's Yield Curve Control**

BOJ's Increasing Dilemma

BOJ first introduced the YCC in Sep 2016 to keep the 10Y JGB bond yield around 0%. In Mar 2021 the central bank raised the target band to +/-0.25% and lately to +/-0.50% in Dec 2022. BOJ concerns has been to fight deflation and keeping the long term interest rates low.

Right now, JGB 10Y bond yield has been lifted to around 0.5% and the central bank spent a record JPY 23.7 trillion in Jan 2023 alone to prevent yields from rising past the cap. Inflation is now at 4% - double the BOJ explicit target of 2% but its largely driven by external factors. Should the central bank continue to opt for incremental widening of the target band or abandoned the YCC completely? In this report, we take a look at the implications of both options and our thoughts on how it will likely develop.



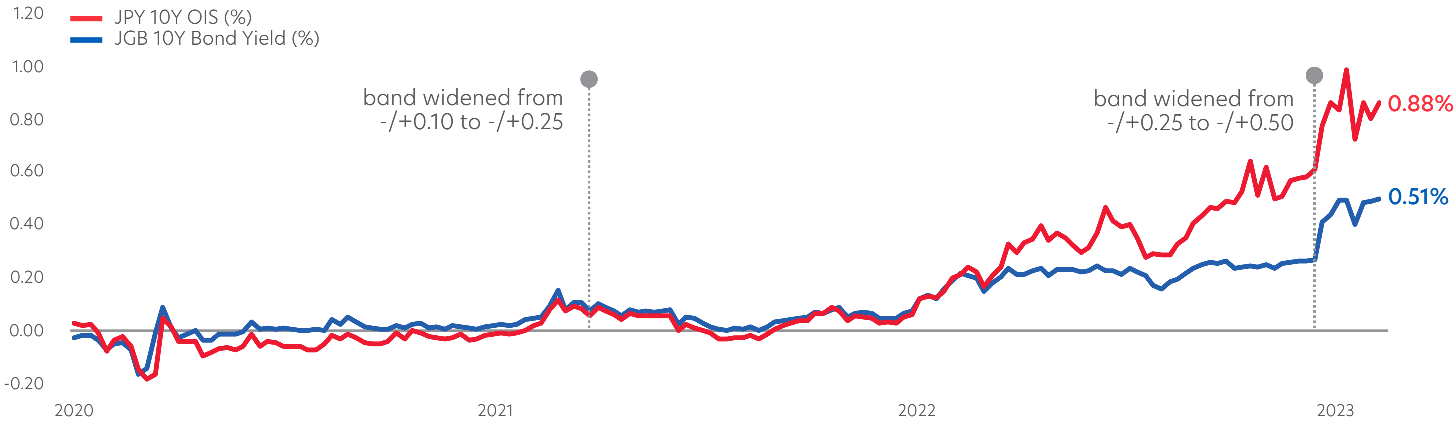
Source: BOJ, Bloomberg, Global Economics & Markets Research

BOJ - Bank of Japan
YCC - Yield Curve Control
JGB - Japan Government Bond

What Are BOJ Tools & Options?

Widening of the yield target band

In Dec 2022, BOJ surprised the markets with its tweak to the YCC. The experience after the widening of the 10Y JGB target band from +/- 0.25% to +/- 0.50% was not ideal. It did not managed to remove market distortions caused by its bond buying operation. Longer term implied rates immediately jumped towards 1.00% for 10Y JGB. This suggests that market is either not confident that BOJ is able to cap 10Y JGB yields at 0.50% or that market believes that a further widening is possible in the months ahead.



Source: Bloomberg, Global Economics & Markets Research

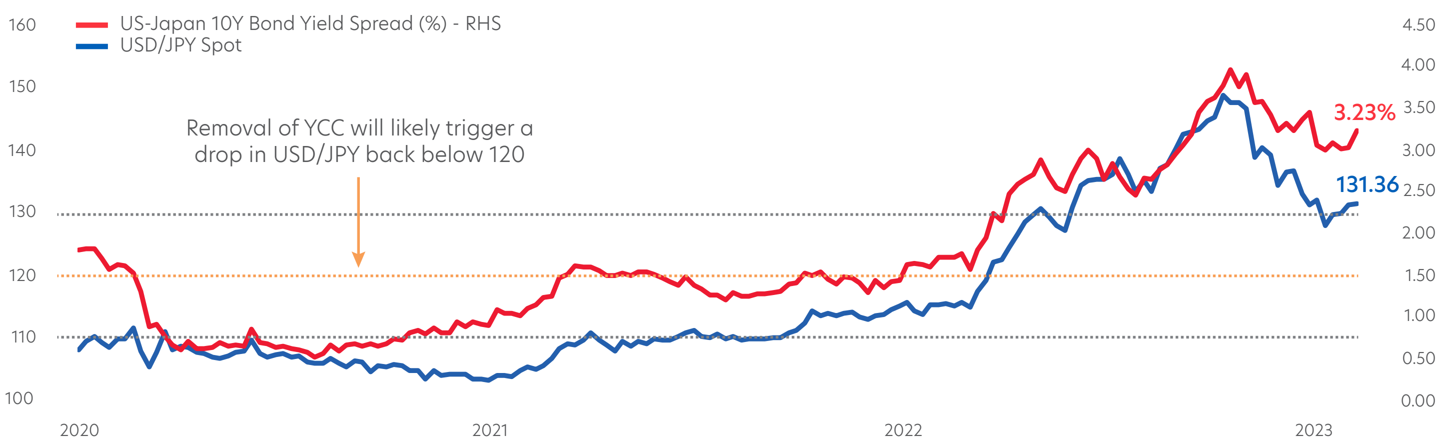
BOJ will continue to be in a position to be challenged and questioned by financial markets should it opt for incremental widening of target band since it no longer serve the intention of keeping long-term rates low. As the uncertainty continues, and the market grows increasingly skeptical of the BOJ, longer term implied JPY rates may well rise further and the USD/JPY will on balance start to strengthen. On comparison, the rise in JPY rates and strength in the USD/JPY will be less volatile and more manageable than the complete removal of the YCC (please see next section).

Scrapping of the YCC

A complete removal of YCC would imply that BOJ will allow longer term JGB yields, particularly the 10Y JGB yield to rise alongside market forces and in line with developing inflation and growth dynamics. Upon the removal of YCC, it is likely that BOJ may still need to engage in targeted bond buying operations in order to limit excessive yield volatility.

BOJ is the only central bank in the Developed Market (DM) space to hold yields near zero, while other DM central banks have hiked significantly. US Federal Funds Rate has already risen to an upper bound of 4.75%, while even European Central Bank's Refinancing Rate has also risen to 3.00%.

The ensuring rise in longer term JGB yield will significantly close the rate differential gap between the JPY and other key DM currencies, thereby triggering a renewed USD/JPY strength. It is likely that for a start, USD/JPY will plunge in a knee jerk reaction below the psychological 120 level.



Source: Bloomberg, Global Economics & Markets Research

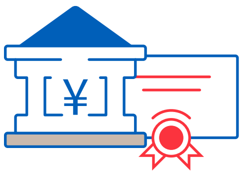
The renewed JPY strength, coupled with rising onshore yield will led to an unwinding of the JPY carry trade. This is the most unpredictable and potentially disruptive implication.

Renewed JPY strength

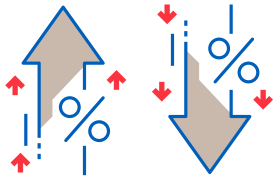
Result in knee jerk reaction in USDJPY below 120 level

Rise in JGB yields

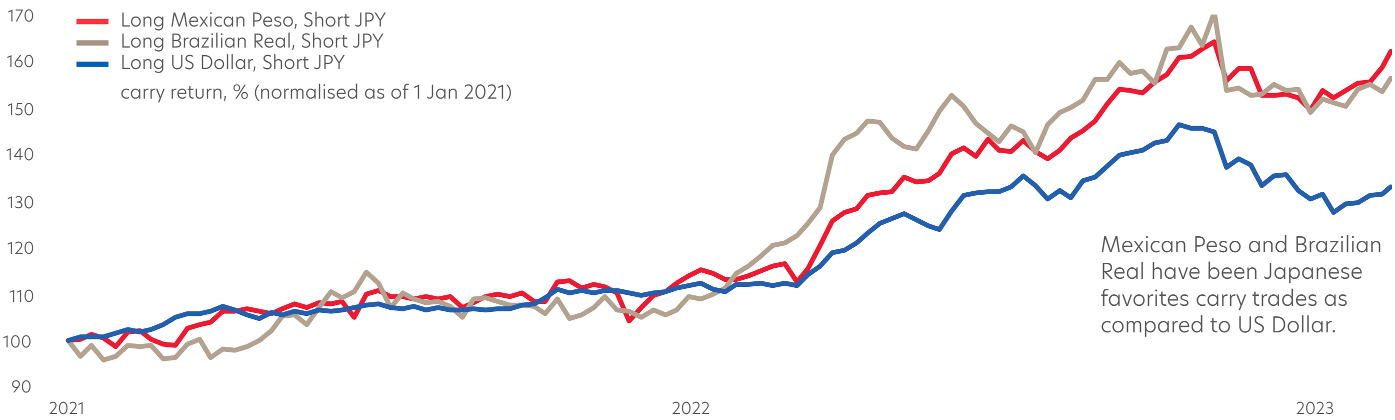
Result in more bond purchase operation to limit yield volatility



Leading to an unwinding of the JPY carry trade



Given that JPY rates were previously near zero, many investors have been funding their global investments with short JPY funding. This JPY funding will no longer be attractive should JPY strengthen and JPY rates rise. Should enough unwinding of the JPY carry trade emerge, this might trigger a new round of global market volatility and pressure global risk assets.



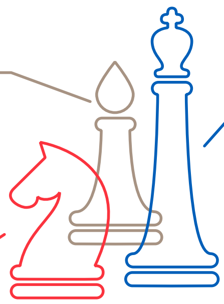
Source: Bloomberg, Global Economics & Markets Research

It remains highly uncertain as to the size of this JPY carry trade and the potential volatility this might trigger. Ultimately, further JPY strength will also lead to Japanese investors finally deciding to pullback their funds globally and invest in Japan instead.

Other possibilities

2% inflation target - set by the BOJ and the government in 2013 to fight deflation - likely a review if this target is still relevant given that core inflation is at 4% now but factors driving it are seen as transient

End negative rate - this requires a scenario where rising prices and higher wages provide household with more purchasing power

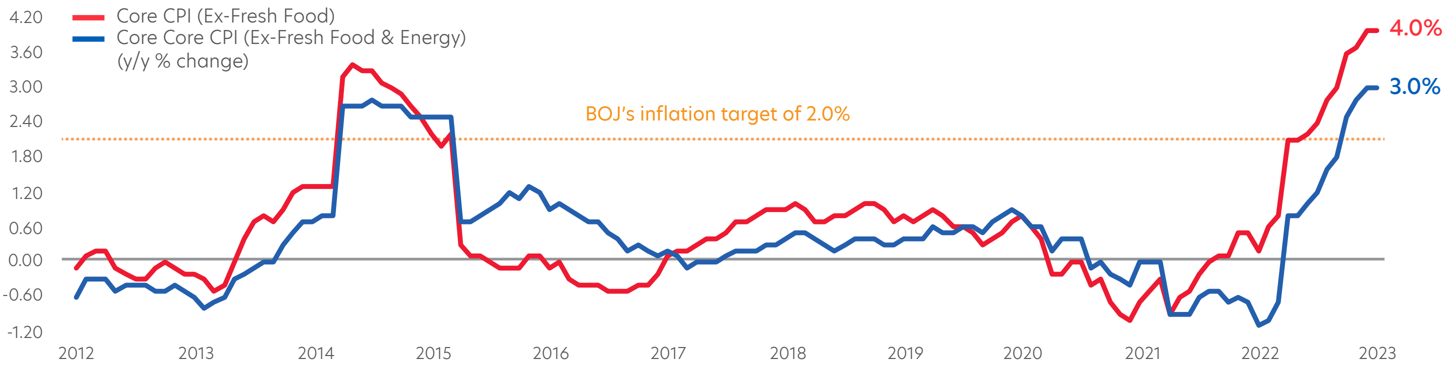


Tweak its forward guidance on interest rates - a neutral view will signal the possibility of raising rates gradually once the economy condition improves

What Are BOJ Challenges?

CPI inflation has risen to multi-decade high

Headline CPI inflation rose to 41-year high in Dec 2022 - price developments were driven largely by higher import costs, supply chain constraints and global increase in raw material and energy prices – pushed higher by the pandemic and the war in Ukraine. But ultimately, the factors will be transitory for Japan CPI price inflation unless it is accompanied by wage growth.

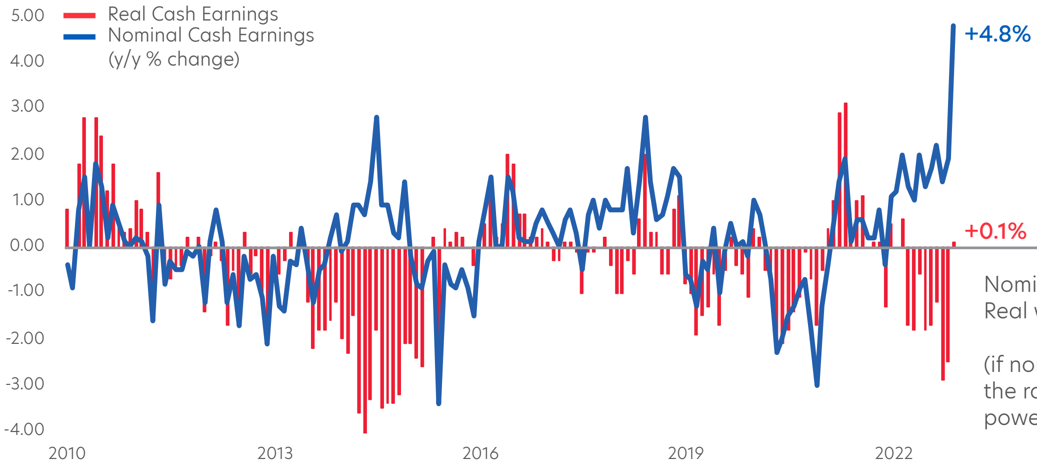


Source: Bloomberg, Global Economics & Markets Research

Stagnant real wage growth

One of the key reasons for BOJ's maintaining its ultra-easy monetary policy is that Japan's price situation is different from that in US and Europe, as these economies are seeing wages increases while wage growth has been lacking in Japan. BOJ Governor Kuroda previously indicated Japan needs a 3% real wage growth to meet the 2% inflation target.

Labor cash earnings unexpectedly jumped to 4.8% y/y in Dec 2022 from 1.9%, the fastest pace in nearly 26 years, while real cash earnings grew positively for the first time since Feb 2022. However, the strong wage gains in Dec was attributed to the one-off winter bonus and real earnings while positive, it was barely so.



Despite the year-end wage surge, consumer sentiment remained weak as real household spending declined deeper in Dec 2022.

Nominal wage - wages paid by employer
Real wage - wages adjusted for inflation

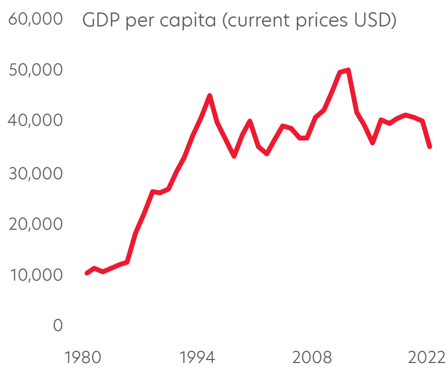
(if nominal wage increases slower than the rate of inflation, then purchasing power will decline)

Source: Bloomberg, Global Economics & Markets Research

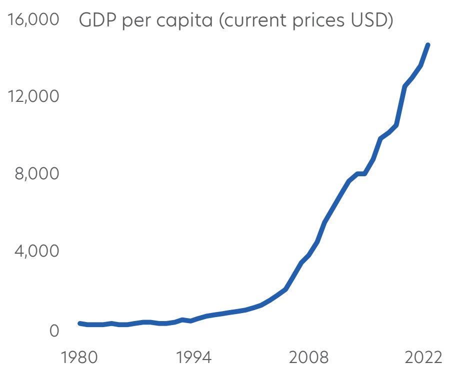
Little improvement in productivity

Japan's GDP per capita has stagnated over the years.

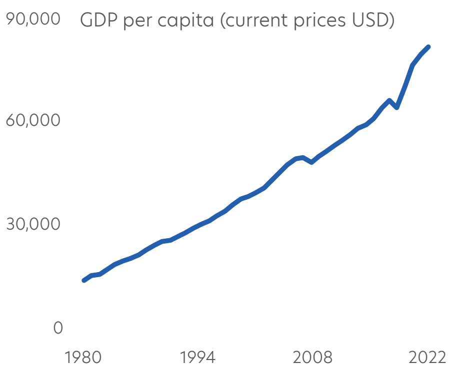
Japan



China



United States



Source: IMF, Global Economics & Markets Research

How We Think It Will Develop

Factors affecting the outcome

Shunto's Outcome

One of the key elements affecting the policy development will be the outcome of Shunto. Some major Japanese companies and organisations such as Keidaren, Rengo and other trade unions have openly supported PM Kishida's call to raise wages strongly.

A strong wage uplift from the negotiation will be a key factor leading BOJ to exit its ultra-easy policy but a disappointment at the Shunto (deemed as any increase less than 3%) will mean a longer wait for the exit.

As the Shunto outcome is not expected before the 10 Mar decision, the last meeting chaired by Kuroda as governor, only the expectations may be mentioned in the meeting but will not drive a change in 10 Mar policy meeting.

Shunto - Spring wage negotiation
Rengo - Japanese Trade Union Confederation
Keidaren - Japan Business Federation

Inflation Level

As we mentioned earlier, Japan's inflationary pressures are driven by external forces and domestic wage growth factor has been absent. While we believe it will ultimately be wage growth that will sway the central bank's decision, we note that added inflation pressures on domestic goods and (more importantly) services could come from the re-opening and influx of travelers.

Economic Growth

Our 2023 growth outlook is largely premised on broad moderation in external economies this year. We are projecting the US and European economies to enter a shallow recession this year amidst aggressive monetary policy tightening which will imply softer demand for Japan's exports. In comparison, services is expected to fare better and help anchor the domestic economic recovery. We keep to our Japan GDP growth forecast of 1.0% for 2023.

New governor new policy outlook?

In a surprise move, Japan's PM, Kishida, nominated 71-year-old Kazuo Ueda as the central bank's next governor. This was a surprise announcement as the academic (who was also a former BOJ board member from 1998 to 2005) did not feature in any central bank watchers' shortlist to replace Kuroda. The appointments (including the deputy governors) will be finalised if approved by the plenary sessions of both chambers of the Diet which is most likely to be approved as the ruling coalition holds majority in both houses of parliament.

One key factor in the consideration of potential policy change from the upcoming BOJ Governor would be that Ueda is not known as either very dovish or very hawkish in his policy view. In a article written by Ueda published on 6 Jul 2022 which was titled "Japan, Avoid Hasty Tightening", may well describe his approach towards monetary policy making under his watch.

The BOJ policy meeting on 27-28 Apr will be widely watched event given that it will be the first BOJ decision under the new governor and the outcome of the Shunto negotiation will be out by then.

While it is not easy navigating an exit from the YCC and negative interest rates, the policy has significantly impaired the function of the JGB markets and it is inevitable for the YCC to be scrapped and for the economy to revert back to market price discovery to determine the yields. That said, we believe it will be carried out at a gradual well-telegraphed pace, and not a sharp and sudden reversal. Ahead of his appointment, Kuroda may use his last meeting in Mar to tweak the YCC to provide his successor a smoother transition process.

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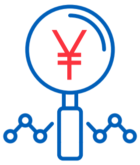
Our Base Case Forecast

Below we set out what we expect from the BOJ under the new Governor

Policy Action	When is it likely to take place?	Probability
Further widening of the yield target band to +/- 100bps	**09/10 Mar 2023:** The idea is the exiting BOJ Governor Kuroda to tweak YCC to give incoming Governor more time to assess BOJ's decade of ultra-easy monetary stimulus	50%
Adjust its forward guidance on YCC and interest rates	**Apr to Dec 2023:** A protracted period to give market guidance and time to prepare for an orderly exit of BOJ's ultra-easy monetary policy	60%
Scrapping of YCC and lifting of the negative policy rate	**Jan 2024:** We expect monetary policy normalization to begin only in early 2024 - YCC to be dropped and negative policy call rate to raise from -0.1% to 0%.	60%



USD/JPY to start drifting lower towards the low 120s as the US Fed stops its rate hike by May.

2Q23	3Q23	4Q23
128	125	122

Important dates to watch

- **~Feb to Mar** Shunto negotiations
- **24-27 Feb** Confirmation hearings for nominated officials - BOJ Gov & two deputy Governors
- **09-10 Mar** Gov Kuroda last policy meeting
- **08 Apr** Gov Kuroda's term ends
- **10-16 Apr** New governor to attend its first major int'l meeting - Spring Int'l IMF meetings
- **27-28 Apr** First BOJ meeting by the new governor

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