

Focal Point

Will the Bank of Japan drop its Yield Curve Control policy soon?

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Our Focal Point series explores topical issues on macro, markets and investment

- The ongoing monetary expansion of the Bank of Japan (BoJ) has become a strong outlier internationally, sparking worries of forthcoming market turmoil if recovering inflation forces BoJ into an abrupt exit from its yield curve control (YCC). However, we deem this not very likely.
- While energy prices and depreciation of the yen will lift inflation rate to about 4% yoy by the turn of the year this supply shock does not trigger a sustainable, virtuous wage-price cycle the central bank is aiming at. But it will likely be sufficient for the BoJ to begin adjusting its policy stance cautiously over the course of 2023.
- Short- and medium-dated Japanese government bond yields are seen to track the monetary policy steps upwards. By contrast, very long-dated bond yields are being pulled down by the global yield environment, triggering a flattening of the very long end of the curve. The yen will benefit from a declining yield gap vs. the US.

Japan's monetary policy has become a strong outlier in the international context. While all major central banks rushed to tighten policy to prevent inflation from becoming entrenched, the BoJ has stuck to its ultra-loose Yield Curve Control (YCC) policy with a Policy-Balance rate at -0.1% and the 10-year Japanese Government Bond (JGB) yield target at "around" 0% incl. a band of +/- 25bp to reflate its economy. To guarantee this yield, the BoJ offers fixed-rate purchases of 10y JGBs at 0.25% "[without setting an upper limit](#)".

Markets have tested the BoJ's resolve several times as the yen (JPY) plummeted on the rising US/Japan yield differential. Some market participants see a shift in the BoJ's policy stance as inevitable and worry it will elicit massive turbulences and contagion to other markets. Such fears are not far-fetched as the end of the Swiss franc-euro peg in 2015, or the sudden collapse of the Australian yield curve

control in 2021 have shown. However, we see good reasons why the BoJ is currently sticking to its policy but also identify key signposts that could change her mind.

The BoJ's current YCC stance

Spectacular market turbulences often involve central banks abruptly changing their preferences, either resulting from dilemma situations, or (like recently the Fed or ECB) sudden revisions in its outlook. The BoJ is confronted first with the weakness of the yen which results in imported inflation on top of high energy prices, and secondly its commitment to YCC which implies giving up the control of money supply (and potentially inflation). For the time being, the BoJ has communicated the hierarchy of its goals. First, it accepts the depreciation of the yen, and the flexible exchange guarantees independence against FX influence on money

supply. Moreover, institutionally the BoJ only acts as an agent for FX interventions, which are financed from a reserve fund of US\$ 1.3 tn owned and administered by the Ministry of Finance. Second, the BoJ – at least for now – prioritises yield control over money supply, not only rejecting the need for tightening but maintaining the view that an easy policy stance is warranted. Thus, speculative attacks building on these mechanisms are not overly likely to succeed in the near term. Moreover, the recent yen appreciation mitigated the risks of such attacks.

Growth of BoJ balance sheet and asset purchasing



Source: Datastream, GIAM calculations

However, the BoJ might be driven out of her currently rather “independent” position, if it were to see the need to regain control over money supply to (potentially) contain inflation and inflation expectations. This would imply giving up YCC. It would also amount to the BoJ to judge that the risks of the Japanese economy falling back into “lowflation” or even deflation had diminished significantly. Under Governor Kuroda, whose second term expires in early April, the BoJ has focussed on influencing the expectations channel to break the “deflationary mindset”. The BoJ monetary policy has been meant to induce a virtuous cycle in which its expansionary stance creates higher inflation expectations, resulting in higher wages, sponsoring higher demand, and enabling firms to increase prices. The target is to reach an inflation level of about 2% on a sustained basis. The BoJ also introduced a form of price level targeting, pledging to allow inflation overshoots to make up for previous shortfalls. Monetary policy has not been very successful in driving inflation higher.

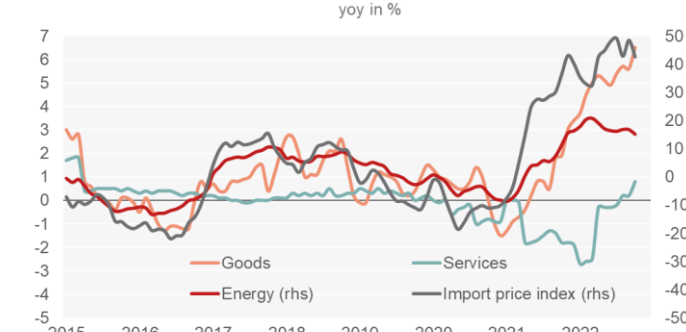
Inflation to rise but only limitedly in global comparison

Nevertheless, rising energy prices and the depreciation of the yen have pushed up Japan’s CPI inflation to 3.7% yoy in October, marking the highest reading since February 1982. The traditional core-core inflation (ex food and energy) rose to 1.5% yoy while the BoJ’s alternative definition ex fresh (!) food and energy rose by 2.5% yoy. The main drivers of inflation continue to be energy (15.2% yoy) and food. The

yen depreciation drove up import prices by more than 40% yoy. While that raises headline inflation, the terms-of-trade shock to real income curbs domestic demand. Overall, the reason for the still relatively low core-core inflation is the services sector, where inflation increased to just 0.8% yoy.

Looking ahead, the government moved to limit the (energy) price pressures via fiscal policy, which could suppress core (ex food) CPI by 1.2 pp. The BoJ estimates that a 10% depreciation of the nominal effective yen exchange rate would boost annual core-core CPI by about 0.5 pp after six quarters. This implies an impact of currently about 0.8 pp. Upside surprises could still result from delayed FX effects but given that our 2023 YE target of JPY/USD 130 implies a stronger exchange rate, the impact should recede and even reverse over time. We expect inflation to peak at around 4% yoy at the turn of the year, resulting in an average of 2.5% for 2022, 2.8% in 2023 and 1.3% in 2024. No measure of core inflation is immune to the exchange rate impact. Thus, traditional core-core inflation could rise to more than 3% early next year, but the annual average is expected to fall back to just 0.5% in 2024. In sum, with the current policy stance the BoJ would tolerate inflation above target in the near term (albeit at a tiny level in international comparison), but will that prompt her into action, abruptly or otherwise?

Japan: Consumer and Import Prices



Source: Datastream, GIAM calculations

BoJ is likely able to respond calmly

Governor Kuroda dismissed current inflation – independently whether it is headline or core inflation – as of the “wrong kind” as its key drivers (energy prices, imported inflation) result mainly from a supply side shock, which will reduce household’s income and thus is no basis for the much wanted “virtuous” wage-price cycle. Moreover, previous experience suggests that the economy quickly returns to lowflation, once the energy price impulse is over. Thus, the BoJ’s hopes focus on spring wage negotiations. Gov. Kuroda has pointed out that a wage rise of around 3% would be commensurate with an inflation rate of 2%, provided this rise would be excluding seniority-driven pay increases. However,

while a number of about 3% by spring looks realistic, excluding the seniority-driven part only results in wage hikes close to 1%, i.e. in the range of productivity increases. In any case, a one-off wage increase would not do the trick. Only if a trend for steady wage growth could be confirmed, that would give the next BoJ governor room to modify YCC. The BoJ itself is sceptical concerning its latest (fiscal year) inflation forecast.

Longer-term monetary policy outlook

Given the above discussion, the BoJ is likely to well look through the current inflation spike. However, Kuroda's recent remarks that *"if the achievement of our 2% inflation target comes into sight, making yield curve control more flexible could become an option"*, were widely interpreted as preparing already the field for his successor. Currently, Deputy Governor Masayoshi Amamiya and former deputy Hiroshi Nakaso are given the highest chances. Both have been closely involved in current policy setting. Any new governor would want to review¹ the Kuroda term, but this does not necessarily imply a more fundamental shift near-term. Although risks remain, we see a sudden policy shift as rather less likely but find the highest probability in a gradual shifting away from the current stance while a stronger domestic global/China downturn could prevent action within 2023. In terms of policy sequence, we expect first a successive increase of the 10yr target band, followed by a shortening of the YCC to five years, and as the last move, a switch from NIRP to ZIRP (when the output gap shows stronger signs of closing). The BoJ stressed that its action will be data-driven but we consider a widening of the band to 0.5% in summer 2023 as likely. There was also talk, that "cosmetics" could even come before the end of the Kuroda term. A gradual approach is also warranted as to coordinate with the government, given the negative impact on the government debt service and financing needs (IMF estimates debt at 263,9% of GDP for 2022).

Moderate appreciation of Japanese yen

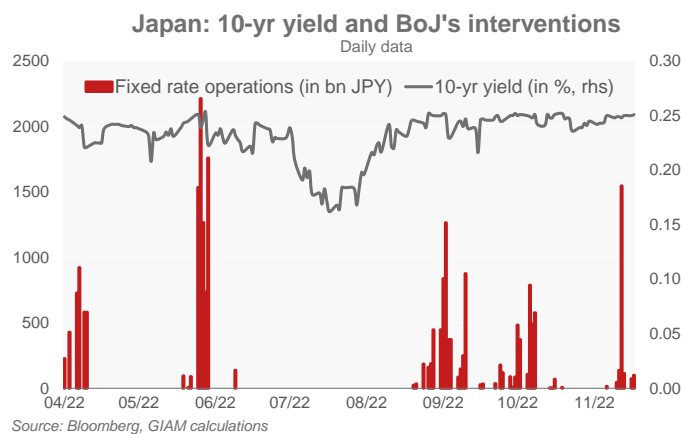
The USD/JPY has been closely tied to US yields over the past two years (corr. coefficient 0.95). It is now past its peak as US yields are headed for a moderate further decline and Japanese yields are set to rise moderately (see below). Betas from the past two years suggest that a yield spread tightening of 50 bps could translate into a 4% bounce against a broadly weaker USD. Furthermore, the yen's deep fundamental undervaluation, positioning, the BoJ's intervention threat, and likely higher FX hedging by the Government Pension Investment Fund (GPIF) point to additional JPY support, that can lower the USD/JPY to 130

¹ The Kuroda policy led to an increase in the BoJ's balance sheet to more than 130% of GDP by end Q2 2022, compared with below 40% in the US. Neverthe-

by end-2023, with the risk tilted towards even lower levels.

Flattening of the very long end of the yield curve ahead

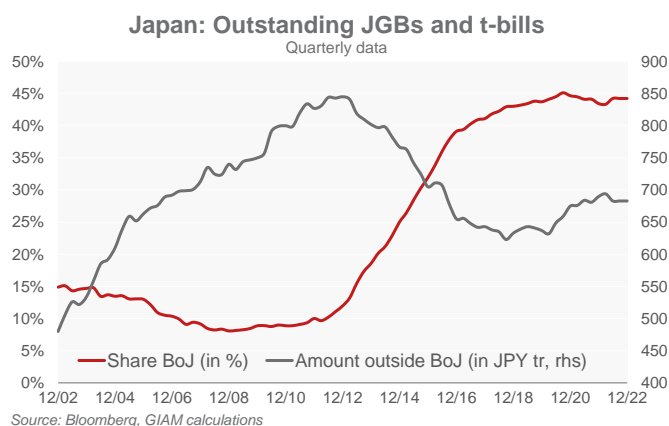
The Japanese government bond market is dominated by monetary policy interventions as the yield on the 10-year bond is anchored at 0.25%. Striking, the yields of the 8- and 9-year bonds, e.g., are slightly higher (as are the ones on longer maturities). The short end of the curve is fixed by the unchanged NIRP, leaving maturities of up to 3 years at negative yields. In surveys, market participants have pointed to worsening market functioning (however, the current situation is still better than in Q1 2020). It should be noted, however, that despite the massive interventions, the BoJ's share has not risen any further in the last two years but remains relatively stable at 45% of outstanding JGBs and t-bills as the BoJ is currently not buying the entire government bond net issuance (see chart below). The free float in absolute volumes has even increased somewhat recently. Furthermore, it is important to note that the 45% share is concentrated in shorter maturities (up to 75% for maturities ≤10 years, but only around 30% for very long-dated bonds). The yield of very long-dated bonds is influenced to a greater extent by global factors. E.g., 30-year government bonds currently yield around 1.45%. This allows Japanese investors to buy higher-yielding Japanese yen-denominated bonds.



Until spring 2023 (assuming an unchanged monetary policy stance) we expect the Japanese government bond market to remain on balance in rather calm waters. The current rather falling yields play into the BoJ's hand insofar as they reduce the upward pressure on yields and the monetary policy divergence between the BoJ and the Fed. With the BoJ maintaining its monetary policy stance into 2023 (see above), yields for up to 10 years should also remain around the current level. On the contrary, yields on very long-dated bonds are likely to trend downwards in line with the global

less, so far its impact on sustained inflation has been low. In fact, we see the difficulties of monetary policy much more routed in demographics than in a deflationary mindset.

downward trend. This is all the more true as the long end of the curve is supported by Japanese life insurers. Additionally, given the high hedging benefits, this market segment has also become attractive for foreign investors as adjusted for FX hedging costs EA and US government bonds struggle to exceed superlong JGB yields.



Yet further into 2023, the outlook may turn riskier. As soon as the BoJ takes the first steps towards monetary policy adjustment (see above), yields will immediately adjust upwards to the new targets. Depending on the respective measures (ZIRP, shortening of YCC to five years), it can be assumed that the yield curve will directly reflect the new monetary policy environment for up to 10 years (hence, e.g., an increase in the target band to 50 bps implies 10-year yields to adjust to 0.5% and ZIRP means the yield of short-dated bonds would rise above zero). The upward movement of 10yr OIS in recent months indicates that bond markets are expecting an adjustment. The fact that 10yr OIS has recently risen to even 0.6% also shows that further steps can be expected in the long term.

It seems worth noting that moving away from the central banks' very accommodative monetary easing could result in weakening the credibility of the BoJ's inflation targeting. This could eventually result in a downward adjustment of inflation expectations. Currently, the 5-year 5-year inflation swaps are at an extreme low of 1% by international standards. Accordingly, the combination of higher nominal yields and lower inflation expectations might trigger an increase in real yields.

Regardless of the development of short and medium-term bond yields, we consider a flattening of the very long end as the most likely scenario. Currently, 10y/30y is very steep at a level of 120 bps (the highest level since 2013) and a clear outlier in international comparison. Going forward, we see two significant developments regarding the steepness of the very long end. In the short term, the global exposure of very long-dated bonds should contribute to a **bull flattening**. As soon as the BoJ adjusts its monetary policy and in particular

raises the target band of the 10-year bond to 50 bps, the curve will flatten further (**bear flattening**). Overall, we forecast a noticeable narrowing of the 10y/30y gap to below 80 bps by the end of 2023. This circumstance makes flattening trades appear very attractive at present.

If the BoJ implements the adjustments as intended, the impact on Bunds and Treasuries should be limited. After falling over the last two years, Japan's ownership has decreased to around 4% of the outstanding stock. Based on betas this translates into a potential upward shift of up to 15 bps for 10-year core government bond yields in case of a 25 bps increase in 10-year JGB yields. However, Japan's share of some EA non-core government bond markets is more significant. E.g., Japan holds still around 12% of outstanding French OATs which implies some spread widening in case Japanese investors reduce their exposure to these markets.

If the BoJ does not successfully manage its monetary policy adjustment or Japanese underlying inflation rebounds more strongly, however, it may lead to violent market movements. This is especially true if market participants question the credibility of the new yield target after a cap increase. The associated large losses and margin calls could lead to assets being disposed of in a disorderly manner. In that case, domestic pension funds would also be affected, and contagion would occur across borders. Although we rate the probability of such a scenario as limited market participants are nevertheless advised to pay close attention to respective leading signals and, if necessary, to react at an early stage by closing positions.

IMPRINT

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