【Fixed Income Commentary - Monetary Policy Navigator】

Anticipated BoJ explanation for winding down YCC

(original Japanese report issued on May 18, 2023)

Key points

- How would BoJ explain a decision to dismantle YCC in Oct-Dec 2023?
- Possible explanation would be the Bank concluding that it 1) had made "sufficient" progress on achieving the price target or 2) needs to address side effects of policy
- We think it would cite both factors and portray itself as "nimbly responding to developments in economic activity and prices as well as financial conditions"

How would BoJ explain decision to wind down YCC?

We revised our BoJ monetary policy scenario in the May 8 issue of *Japan Economic & Financial Weekly* ("Revised scenarios for monetary policy and JGB yields"). Until then, our main scenario had called for the Bank to wind down the policy of yield curve control (YCC) as early as the June Policy Board meeting, but we have pushed back that forecast to Oct-Dec 2023. Our decision took into account the results of the April 27-28 Board meeting, the Outlook Report that was released at the same time, and the dovish tone of Governor Kazuo Ueda's remarks at his post-meeting press conference. How might the BoJ explain its decision if it chooses to discontinue YCC in Oct-Dec 2023? Below we summarize our views on this question and present our forecasts.

We think BoJ would offer two main explanations

Broadly speaking, we envision two likely explanations for a decision to end YCC. The first would be that there was now less need to continue using the unprecedented tool of YCC since a stable and sustained achievement of the 2% inflation target was within sight. The second would be that the side effects of leaving YCC in place had intensified, or were expected to intensify, and the BoJ had therefore decided that this was the right time to wind down the policy.

1) Conditions specified in policy guidelines have been achieved

Winding down the policy based on the first explanation -- that there is less need to continue YCC since a stable and sustained achievement of the 2% inflation target is within sight -- would be in line with the policy guidelines already presented by the BoJ. Table 1 shows the policy guidelines revealed at the April Policy Board meeting. Regarding YCC, the Bank pledged to "continue with Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner." If the Board decides that YYC is "no longer necessary" to maintain the target, we think the next step would be to discuss an exit.

Table1: Policy guidelines presented by Ueda BoJ at April Policy Board meeting

Policy stance	
Newly added	With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.
Continuation of YCC	The Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner.
Inflation-overshoot commitment	It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all item less fresh food) exceeds 2 percent and stays above the target in a stable manner.
Clause of "will not hesitate"	The Bank will continue to maintain stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary

"Forward guidance for policy rates" deleted

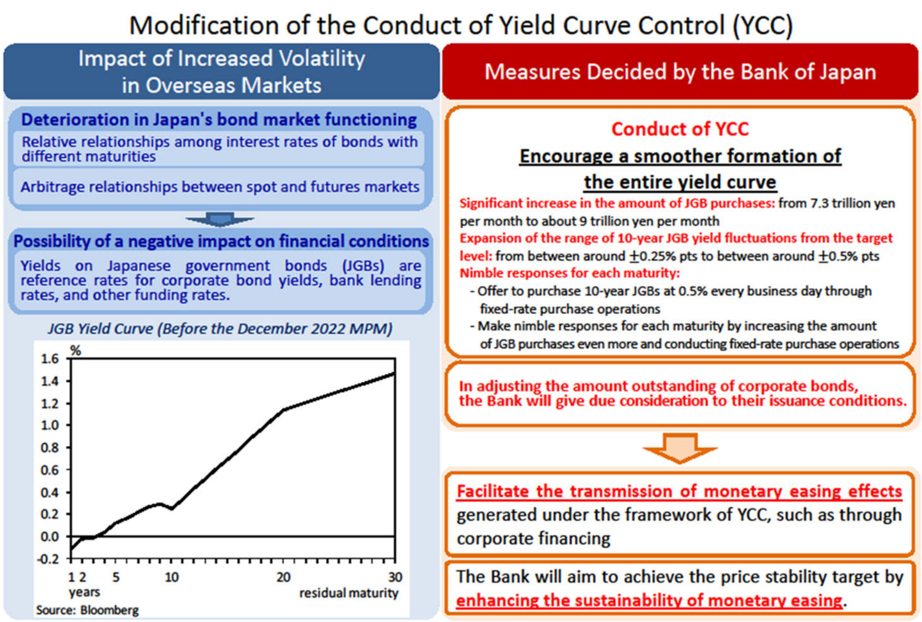
For the time being, while closely monitoring the impact of COVID-19, the Bank will support financing, mainly of firms, and maintain stability in financial markets, and will not hesitate to take additional easing measures if necessary; it also expects short- and long-term policy interest rates to remain at their present or lower levels.

Source: MUMSS, from BoJ

2) Side effects of policy need to be addressed

The other possible explanation -- that the side effects of continuing YCC have intensified, or are expected to intensify, and the Bank has therefore decided that this is the right time to wind down the policy -- is basically the same reason cited for revising YCC at the December 2022 Policy Board meeting. At that meeting, the BoJ opted to widen the trading band for the 10-year JGB yield to around ±0.50% (from around ±0.25%) because of the "deteriorated functioning of bond markets," uncoupling the decision from its assessment of economic activity and prices (Graph 1). If JGB market functioning were to worsen again, or if other side effects were to become more prominent, or if either of these outcomes was anticipated, we think the Bank would consider revising or discontinuing YCC.

Graph 1: BoJ revises YCC in Dec 2022, citing "deteriorated functioning of bond markets"



Source: BoJ

At April meeting, BoJ saw little need to revise YCC from either perspective

At the April 27-28 Policy Board meeting, the first held under Governor Ueda, the BoJ opted to leave policy on hold after deciding that the conditions surrounding YCC did not correspond to either of the explanations noted above. In the Outlook Report, the Bank projected core CPI inflation of 1.8% in FY23, 2.0% in FY24, and 1.6% in FY25 (Table 2). Notably, it forecast the rate of inflation would slow to less than 2% in FY25. It also made a cautious assessment of the balance of risks, noting that "risks to prices are skewed to the upside for fiscal 2023 but are skewed to the downside for fiscal 2025." With regard to the side effects of YCC, Governor Ueda said at his press conference that “the modest downswing in domestic interest rates prompted by the decline in overseas rates starting in March has been useful in reducing the side effects of YCC." He noted that "the widening of the trading band in December and the more flexible deployment of the SLF have also helped to form a smoother yield curve." While acknowledging that "side effects have not disappeared completely," he expressed the view that existing conditions did not warrant any immediate new response.

Table 2: Inflation projections and risk assessment in April Outlook Report

(%, the median forecast, the forecast ranges of the majority members are in parentheses)

	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
FY23	1.8 < 1.7 ~ 2.0 >	2.5 < 2.7 ~ 2.7 >
FY24	2.0 < 1.8 ~ 2.1 >	1.7 < 1.5 ~ 1.8 >
FY25	1.6 < 1.6 ~ 1.9 >	1.8 < 1.8 ~ 2.0 >

Risk balance

Risks to prices are skewed to the upside for fiscal 2023 but are skewed to the downside for fiscal 2025.

Source: MUMSS, from BoJ

Anticipated BoJ explanation for winding down YCC

If the BoJ decides to wind down YCC in Oct-Dec 2023, we expect it will offer both of the explanations noted above. We have the following expectations with regard to the first.

We project that at the July Policy Board meeting the BoJ will raise its inflation forecast for FY23 to 2.0% or higher (up from 1.8% in April)[1] and reiterate its April forecast for inflation of around 2.0% in FY24. However, we think it will leave its projection for FY25 unchanged at around 1.6%. At the October Board meeting, we see it leaving its projections for FY23 and FY24 largely unchanged while modestly raising its forecast for FY25. We think the BoJ will conclude that despite "extremely high uncertainties for Japan’s economy," prices "continue their upward trend towards achieving the 2% inflation target in a sustainable and stable manner," in light of the recovery in domestic demand and companies' positive price- and wage-setting behavior. We also expect the Bank will forecast that "the output gap is likely to turn positive and continue to expand moderately."

We think the BoJ will then decide to wind down YCC to ensure flexibility for future monetary policy and reduce the side effects associated with the extended period of

[1] In the May edition of the ESP Forecast Survey, private-sector economists projected a core CPI inflation rate of 2.31% in FY23 (up from 2.15% in the April survey) and 1.47% in FY24 (up from 1.43%).

YCC. In this regard, it is likely to argue that 1) side effects such as the impairment of market functioning due to prolonged yield curve control have not completely disappeared; 2) the costs of implementing YCC will grow as the BoJ gets closer to achieving the price target since the side effects of this policy will increase along with inflation expectations; and 3) monetary accommodation has a relatively large impact in the short- and medium-term sectors, as noted in the Bank's "comprehensive assessment" in September 2016.

YCC framework becomes more costly to maintain as goal approaches

As for the second argument, Governor Ueda said in his press conference on April 28 that "the policy of YCC is such that side effects emerge once the economy enters a phase of rising inflation expectations" (Table 3). Experience has shown that it becomes difficult to continue YCC once inflation gets close to the target level, and that doing so produces increasing side effects, such as the need to purchase massive quantities of government bonds. In other words, once it becomes more likely that the Bank will succeed in "[achieving] the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases," the side effects of continuing YCC will become more pronounced. These may include distortions in the yield curve and reduced liquidity in the JGB market due to larger central bank bond purchases. As inflation accelerates, the contracting spreads at financial institutions caused by the prolonged period of low interest rates are also likely to become a bigger issue. In this way, the first and second explanations noted above are effectively two sides of the same coin.

Table 3: Comments on YCC at Governor Ueda's April 28 press conference

> YCC does not have a strong accommodative effect while the underlying trend of prices is weak. Once the underlying trend of inflation picks up a little, inflation expectations also rise, and actions to suppress nominal interest rates serve to lower real interest rates, which are equal to nominal rates less the expected inflation rate, thereby enhancing the effect of easing on the economy. <u>However, this phase is also conducive to the emergence of side effects.</u> I think we have been in such a phase since last year, and at the risk of repeating myself I hope to closely monitor the situation while carrying out a detailed analysis of the effects and side effects of YCC.

Note: Emphasis by MUMSS.
Source: MUMSS, from BoJ.

Summary

In conclusion, we expect the BoJ will decide to exit from (wind down) YCC to avoid anticipated side effects from increased likelihood of "[achieving] the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases." When it does so, we think it will emphasize that it is "nimbly responding to developments in economic activity and prices as well as financial conditions," as noted in the policy guidelines presented at the April Policy Board meeting. Incidentally, we expect the Bank will not yet be certain of "[achieving] the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases" in Oct-Dec this year, and that it will therefore leave the negative-interest-rate policy in place and continue buying JGBs.

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9:30 JST, May 18, 2023

Appendix A

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