Asset Management One

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Speculation of Revision to the Bank of Japan's Yield Curve Control and Japan's Long-Term Interest Rates

16 June 2023

- Whilst upward pressure on U.S. long-term interest rates extends to Japan's long-term interest rates, they remain below the upper limit of the permissible fluctuation range of 0.5% amid speculations of prolonged monetary easing by the Bank of Japan (BoJ).
- Considering the domestic price trends, expectations of revision to the yield curve control (YCC) policy persist, and pressure for interest rate increases will intensify in the future.
- Even if YCC is revised or abolished, we do not anticipate a significant rise in Japan's long-term interest rates due to factors such as the BoJ's large holdings of long-term government bonds and the unlikely scenario of U.S. long-term interest rates rising significantly above 4%. The possibility of domestic investors returning to yen denominated bonds is also expected to provide support to the market.

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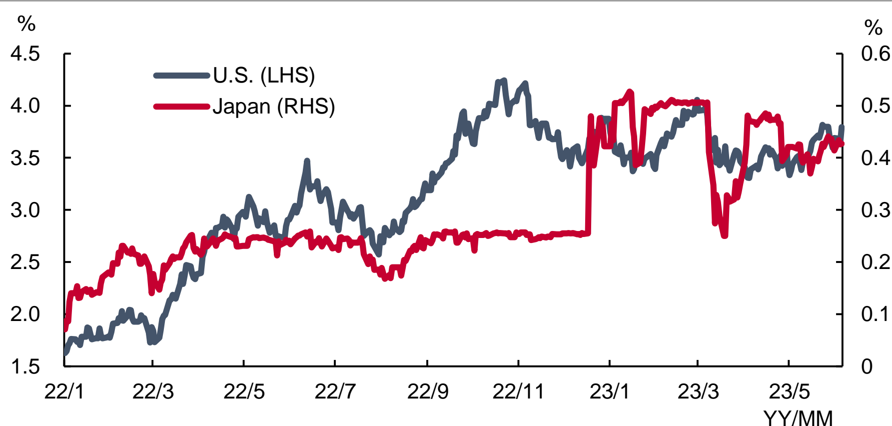
After declining following the collapse of a U.S. bank in March, U.S. long-term interest rates, represented by 10-year treasury yields, had been trading within a narrow range. Although U.S. interest rates declined from time to time due to the easing of concerns regarding the U.S. debt ceiling issue and cautious statements from senior Federal Reserve officials regarding additional rate hikes, upward pressure on interest rates persists due to better-than-expected employment data and expectations of prolonged monetary tightening.

Regarding Japan's long-term interest rates, there was a growing expectation of protracted monetary easing following the BoJ's monetary policy decision meeting in April. In mid-May, the rates temporarily dropped below 0.4%. However, the decline has slowed down recently in response to rising U.S. long-term interest rates. The interest rate level itself remains below the upper limit of the BoJ's permissible fluctuation range of 0.5% (Figure 1).

"Upward pressure on U.S. long-term interest rates whilst the speculation of prolonged monetary easing by the BoJ dominates Japan's long-term interest rates"

Figure 1: Long-term Interest Rates in U.S. and Japan (10y)

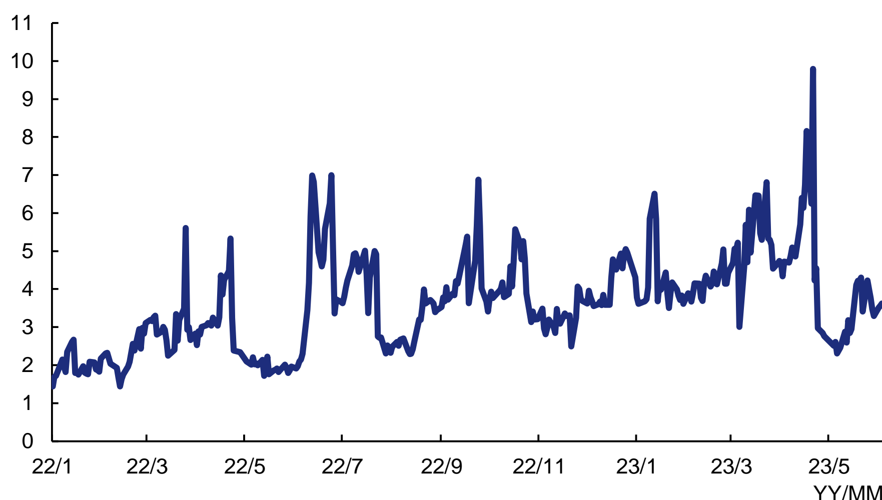


Source: Bloomberg
Period: Daily data from 3 January 2022 to 7 June 2023

The S&P/JPX JGB VIX Index, which represents the expected volatility of Japanese government bonds (JGBs), experienced a significant increase prior to the BoJ's monetary policy decision in April. This was due to heightened concerns that under the new leadership led by Governor Ueda, the bank would normalise monetary policy earlier than expected. However, during the meeting, the bank decided to maintain the current monetary policy and expressed its commitment to patiently continue monetary easing while nimbly responding to developments in economic activity and prices to achieve the 2% inflation target in a sustainable and stable manner, accompanied by wage increases, dispelling speculations of early policy revisions and leading to a decrease in volatility (Figure 2).

"Volatility of JGBs has stabilised"

Figure 2: JGB VIX Index



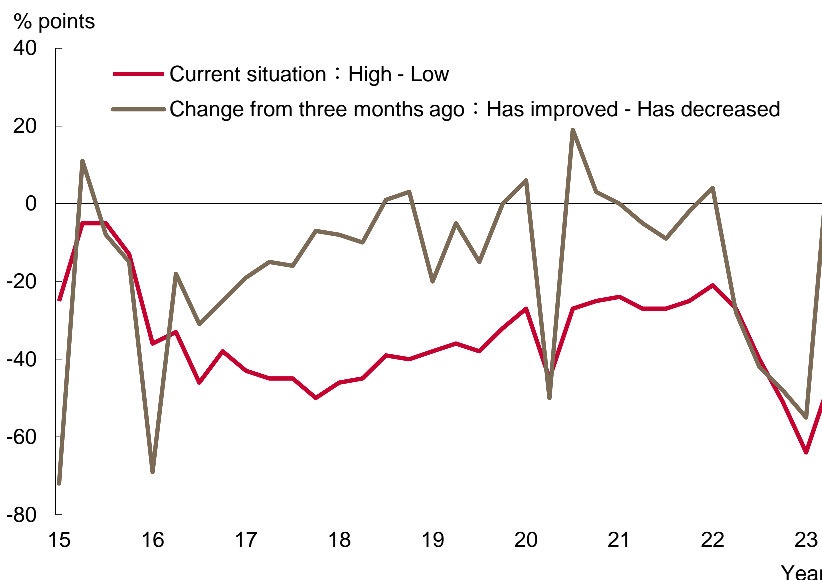
Source: Bloomberg
Period: Daily data from 5 January 2022 to 7 June 2023

Turning our attention to the current domestic prices, there is an upward trend, particularly in food prices. In April, the consumer price index (excluding fresh food and energy) increased by 4.1% year-on-year, and up from the 3.8% increase in March, reaching historically high levels. The pass-through of rising import costs to consumers continues. The central bank expects the impact of price pass-through to diminish, leading to a narrowing of the positive margin for future domestic prices. However, considering the current price trend, it is likely that the inflation outlook for the fiscal year 2023 will be revised upward in the July outlook report, which could potentially lead to a renewed speculation of policy normalisation. Furthermore, in the April meeting, the language suggesting a possibility of interest rate cuts, which was present until March, was removed, indicating the preservation of policy flexibility. While the volatility has stabilised, outlook remains uncertain.

According to the latest bond market survey conducted in May, the current index of the Market Functionality Perception Diffusion Index improved significantly to -46, a notable improvement of +18 points compared to the previous survey's record low of -64 in February. It also showed improvement compared to the November 2022 survey of -51 conducted just before the BoJ decided to expand the permissible fluctuation range of long-term interest rates in December last year (Figure 3).

"The functionality of the bond market has improved, but speculations around the revision of YCC persist"

Figure 3: Bond Market Survey
Degree of Bond Market Functioning Diffusion Index



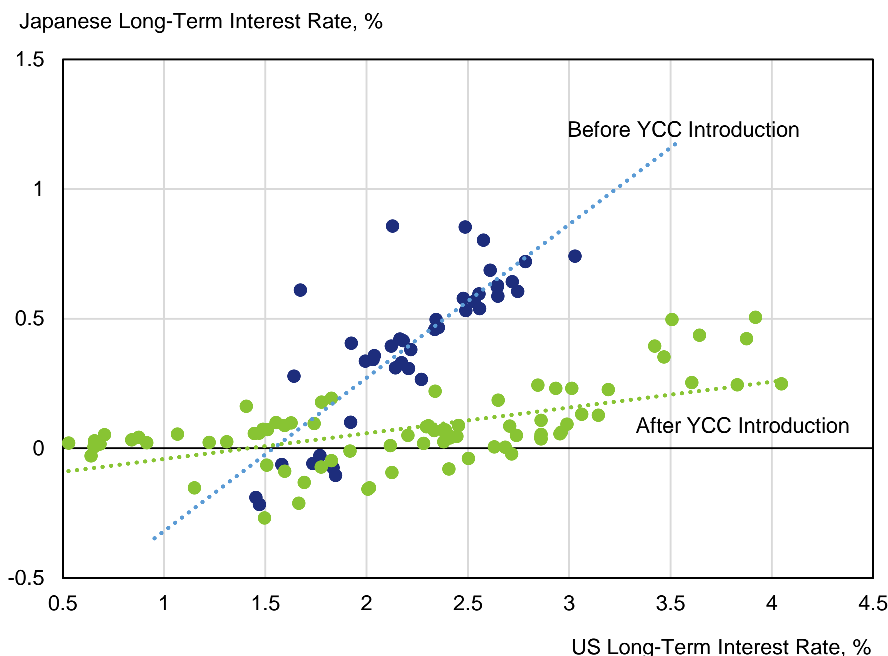
Source: BoJ
Period: Quarterly data from February 2015 to May 2023
Note: The survey is conducted in February, May, August, and November each year.

Based on these results, we expect that the perceived need for further YCC revisions by the BoJ to enhance market functionality has temporarily diminished. However, when examining individual judgement items, the Diffusion Index for the number of trading counterparts in the current index continued to decline from the previous survey, indicating a persisting deterioration in the aspect. Furthermore, the current level of the Market Functionality Perception Diffusion Index still remains significantly distant from the levels seen in the May 2022 survey (-27), before the sharp decline in the summer of last year, suggesting that the resolution of market functionality decline has not been achieved. Governor Ueda has mentioned that while continuing monetary easing, if there are changes in the balance of effects and side effects, YCC revisions could be possible. However, YCC is a difficult measure to communicate to the market in advance. In the domestic bond market, we expect there will be increased upward pressure on interest rates due to speculation surrounding the revision or abolition of YCC.

"Limited upside in interest rates due to revision or abolition of YCC"

The relationship between long-term interest rates in the United States and Japan, or the extent to which U.S. rates affect Japanese rates, has decreased since the introduction of YCC (Figure 4). If YCC is revised or abolished, the relationship between the two will increase. Nevertheless, considering the downward pressure on interest rates resulting from the BoJ's holdings of JGBs, it is unlikely that the relationship will return to the levels observed before the introduction of YCC.

Figure 4: The Relationship Between Long-term Interest Rates in U.S. and Japan



Source: Bloomberg
Period: Monthly data from April 2013 to 7 May 2023
Before YCC Introduction : from April 2013 to August 2016
After YCC Introduction : from September 2016 to May 2023
Note: The dotted line shows the trend.

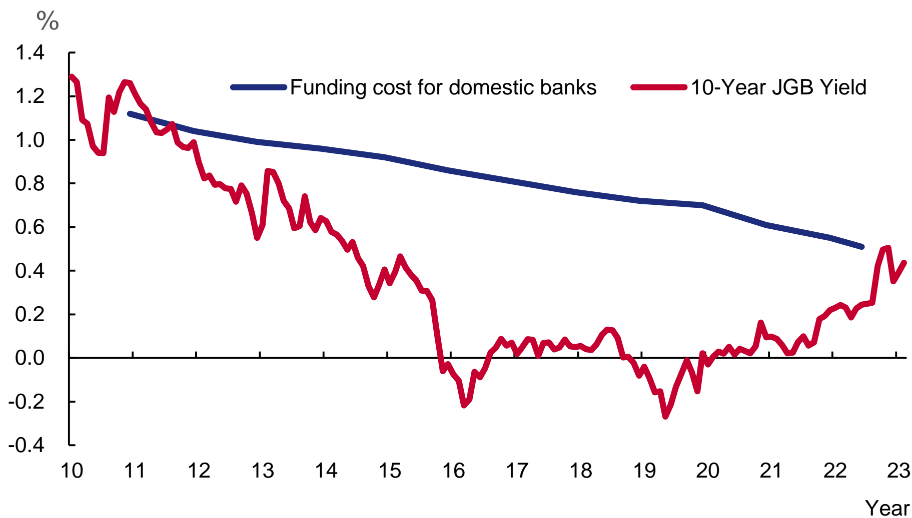
Furthermore, if there is limited room in U.S. long-term interest rates, the rise in Japanese long-term interest rates will also be limited. Regarding U.S. long-term interest rates, the Federal Reserve is anticipated to maintain a cautious stance on inflation and keep future rate hike options open, although there is a possibility of temporarily holding off on rate increases in order to assess the impact of previous rate hikes in the June FOMC meeting*. Indicators suggesting a weakening labour market demand-supply balance in the U.S. and considerations of concerns over a deteriorating U.S. economy indicate that the rate hikes by the FRB are likely to be nearing the end. Given these factors, it is difficult to envision a scenario where U.S. long-term interest rates rise significantly above 4%.

*Note: original report in Japanese language was published on 9th June 2023.

"Possibility of domestic investors returning to yen bonds"

There is a possibility of domestic investors returning to yen bonds. Currently, the domestic bond market is experiencing a favourable demand-supply environment. In the previous fiscal year, amid uncertainties surrounding the modification of the BoJ's YCC policy and the increase in overseas interest rates, the holdings of JGBs by domestic banks decreased significantly compared to the previous year. According to data from the BoJ, the holdings of JGBs by domestic banks at the end of the fiscal year 2022 amounted to 83.6 trillion yen, a decrease of 14.8 trillion yen compared to the previous year. This suggests considerable potential buying power this fiscal year. The attractiveness of investing in Japanese 10-year government bonds compared to the funding cost for domestic banks indicates the possibility of a trend of return to yen bonds (Figure 5).

Figure 5: Funding Cost for Domestic Banks and 10-Year JGB Yield



Source: Japanese Bankers Association, Bloomberg
Period: Funding cost : Annual data from 2011 to 2022, as of the end of March (2011 - 2021) and the end of September (2022)
10-Year JGB Yield : Monthly data from April 2010 to May 2023

Indeed, such development can be considered as factors that would restrain the rise in Japanese long-term interest rates, particularly in the scenario of YCC revision or abolition. If domestic investors, including domestic banks, join the trend and increase their holdings of JGBs it would create additional demand for these bonds. This increased demand would act as a mitigating force against the upward pressure on Japanese long-term interest rates. By investing in JGBs, domestic investors would effectively contribute to stabilising or even lowering the yields on these bonds, thereby influencing the overall trend of Japanese long-term interest rates.

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