GENERALI INVESTMENTS

Market Commentary

March 19, 2021

Macro & Market Research, Generali Insurance Asset Management S.p.A. SGR

BoJ policy review introduces additional interest rate flexibility

- **The Bank of Japan (BoJ) maintained its yield curve control policy with the short-term and 10y JGB targets of -0.1% and 0%.**
- **The policy review basically brings three new decisions:**
    - **The BoJ will introduce an "Interest Scheme to Promote Lending" which enables the bank to cut interest rates while mitigating its negative side effects.**
    - **It widens the band in which 10y-JGB yields can fluctuate from 20 bps to 25 bps.**
    - **The bank will purchase ETFs and J-REITs only when necessary with an upper annual limit of JPY 12 tr resp. JPY 180 bn.**
- **The new measures look to add more flexibility to the BoJ policy options but we consider the hurdles for a fundamental change in interest rate policy still as substantial.**

After a two-days monetary policy meeting, the BoJ announced today its interest decision and the results of the deliberations on its policy review. Regarding the interest decision, the BoJ maintained its yield curve control approach with the short-term and 10y JGB targets of -0.1% resp. 0%.

The policy review had long been announced and provoked a lot of market speculations beforehand. The BoJ intended to make its monetary policy "*further effective*" and "*more sustainable*". Thus, the policy review was expected to tackle some fundamental problems within the current approach. Basically, the yield curve control policy looks a bit stuck. Due to the flatness of the yield curve, and the negative interest at the short end of the curve especially smaller, regional banks claim that their margins are threatened to an extent jeopardising their existence. Thus, the BoE considers its room for manoeuvre to be limited by these side effects on the financial sector and the transmission channels. Moreover, trade in 10y JGB is very much restricted due to the fixing of the long-term interest rate. At the same time, markets complained that stock prices are artificially driven up by the BoE buying targets.

To tackle these issues, the BoJ introduced several measures:

1. The Bank will establish an "Interest Scheme to Promote Lending". The BoJ explicitly mentioned that the scheme will be set up "*with a view to enabling the Bank to cut short- and long-term interest rates nimbly while considering the impact on the functioning of financial intermediation".* Under this scheme, the BoJ will pay additional interest to financial institutions' current account balances (held at the BoJ). These balances correspond to the outstanding amount of funds that have been provided through the BoJ's various fund-provisioning measures to promote financial institutions' lending. Moreover, the applied interest rates will be linked to the short-term policy rate. The eligible fund-provisioning measures and the incentives will be categorized into three groups as specified in the table (Source: BoJ: Further Effective and Sustainable Monetary Easing, March 19, 2021):

	Applied interest rate (incentive)	Eligible fund-provisioning measure
Category I	0.2%	➢ Special Funds-Supplying Operations to Facilitate Financing in Response to COVID-19, when funds are provided against loans made by financial institutions on their own
Category II	0.1%	➢ Special Funds-Supplying Operations to Facilitate Financing in Response to COVID-19, when funds are provided against loans other than those for Category I and against private debt pledged as collateral
Category III	0%	➢ Loan Support Program ➢ Funds-Supplying Operation to Support Financial Institutions in Disaster Areas

Finally, "*the applied interest rate for Category II will be the absolute (sic!) value of the short-term policy interest rate, and a higher rate will be applied for Category I and a lower rate for Category III*". Consequently, if the BoJ cut its short-term policy rate to -0.2, current account balances from Category II would receive an interest rate of +0.2%.

In sum, the BoJ intends to get more room for manoeuvre in its policy rates by compensating the effects on its special fund supplying operations. This begs the question whether the measures will be enough to shield the financial sector from the impact of even more negative yields? First market views were out, centring on the fact that a cut in the BoJ short-term rate would lead to downward pressure on all interest rates. Thus, compensation would only be partial, limited to the special fund supplying operations. And more fundamentally, the success of the negative interest rate policy on Japan's inflation has been rather mixed so far. While details still need to be clarified, it looks that the hurdle for the BoJ to go much deeper into negative interest rate territory is still rather high.

2. In contrast to this rather complicated scheme, the BoJ will only allow a very small widening of the band in which 10y JGB yields can fluctuate. It was increased by 5 bps to +/-0.25%. That is unlikely to revitalise the market much. Previously, during a Diet testimony, Governor Kuroda had denied press reports about a widening to 30 bps, so that the eventual outcome may represent a compromise within the BoJ. Moreover, the BoJ will – as before – not apply the band rigidly.

3. Thirdly, the Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) now only when necessary. Instead of buying at a set pace, the BOJ will step in when markets destabilise. Thus, the bank removed its annual ETF buying target of JPY 6 tr and replaced it with upper limits of about JPY 12 tr and about JPY 180 bn (J-REITs). Moreover, ETF buying will now be contained to the broader Topix-linked ETFs, which had a limited negative impact on the Nikkei 225 today (-1.4%).

All in, the new measures look to add more flexibility to the BoJ policy options but we consider the hurdles for a fundamental change in interest rate policy still as substantial.

Author:
Christoph Siepmann
Christoph.siepmann@generali-invest.com