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IKIGAI FOR MRS. WATANABE: BOJ'S STRUCTURAL SHIFT FROM ULTRA LOOSE MONETARY POLICY BRACING FOR POST KURODA DAYS…AND….THE PERIOD OF $ STRENGTHENING IS ALMOST OVER…GOOD FOR GLOBAL MARKETS

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Bank of Japan continued to pull out surprises. Interestingly Japan, resurrecting from the rumbles of post WWII, has often taken the world by surprise with shattering concepts in engineering ranging from automobiles to heavy industries to robotics (the idea of ATM is believed to have come from vending machines deployed in 1964 Tokyo Olympic games!). **The concept of carry trade in USD/JPY was probably communized by persistent hordes of Japanese housewives (commonly referred to as Mrs. Watanabe)** in the 80s and raged through the 'lost decades' of 90s and 2000s in search of better yields, of late in search of Ikigai and good fortune as population ages.

The Bank of Japan's overwhelming presence in the JGB market where it's the biggest buyer under its curve control policy has exacerbated liquidity issues and led to a deterioration in market functioning. Further continuance of accommodative stance along with high inflation implies there are no buyers in bonds and markets are prone to speculative attack. Yields on Japanese government bonds (JGBs) are reference rates for corporate bond yields, bank lending rates, and other funding rates and if there are no buyers this could have a negative impact on financial conditions such as issuance conditions for corporate bonds.

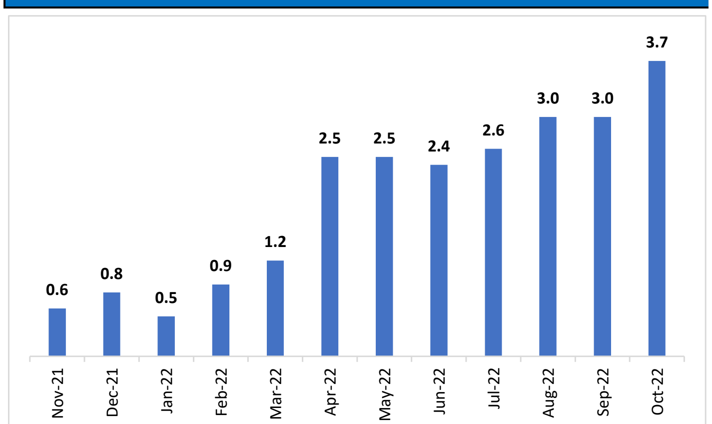
To correct this, BOJ will offer to purchase 10-year JGBs at 0.5 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted. The Bank expects that the measures will facilitate the transmission of monetary easing effects generated under the framework of yield curve control, such as through corporate financing. BoJ had of late accelerated its government bond purchases, topping 50% of total bonds share, pinning down the long term interest rates, but creating distortions in the bond market. Markets have often fretted over BoJ's mounting unrealized losses in billions of dollar as widening gap between local and offshore monetary policies has helped in pushing yields higher, while prices have been driven southwards. The increase in yield corridor on 20th December in a 'surprise move' was a natural step since independent predictions from mid-year itself show that paper losses (unrealized) would exceed the central bank's capital base itself should the yield on 10-year papers alone rise to 0.65%.

The shift in the BOJ's stance on YCC had its obvious fallouts. The yen appreciated to four-month high. The price of gold also moved in tandem with dollar. On 20 Dec, the dollar plunged as much as 4% against the yen, its largest daily percentage fall since 1998. The USD, however, rebounded and the pair hovers around 132 as on date. The current situation where most of the principal currency central banks are in tightening mode, BOJ's accommodative stance will make international capital more volatile. **Interestingly, the dollar appreciation, going by historical trends, has almost peaked out and it is likely that dollar will start to weaken further from here onwards. This could have important implications of global terms of trade of Japan, with USA and China taking divergent approaches in reorienting global supply lines, even as banks/financial stocks gained on higher interest rate expectations amidst a market rout.**

BANK OF JAPAN (BOJ) SURPRISES MARKETS WITH ITS POLICY TWEAK

- BoJ stunned markets around the world after an unexpected policy tweak on December 20. BoJ decided to modify the conduct of yield curve control (YCC) in order to improve market functioning and encourage a smoother formation of the entire yield curve, while maintaining accommodative financial conditions. It would allow yields on 10-year government bonds to move up or down within 50 basis points around its zero percent target, wider than the previous 25-point band. The policy stance largely remains accommodative with step-up of asset purchase programme.
- The BoJ will apply a negative interest rate of minus 0.1 % to the Policy-Rate. The Bank will purchase a necessary amount of JGBs without setting an upper limit so that 10-year JGB yields will remain at around zero percent.
- BOJ significantly increased the amount of JGB purchases from 7.3 trillion yen to about 9 trillion yen.

Japan CPI Inflation (% YoY)



Source: SBI Research

- The Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) as necessary with upper limits of about 12 trillion yen and about 180 billion yen, respectively, on annual paces of increase in their amounts outstanding

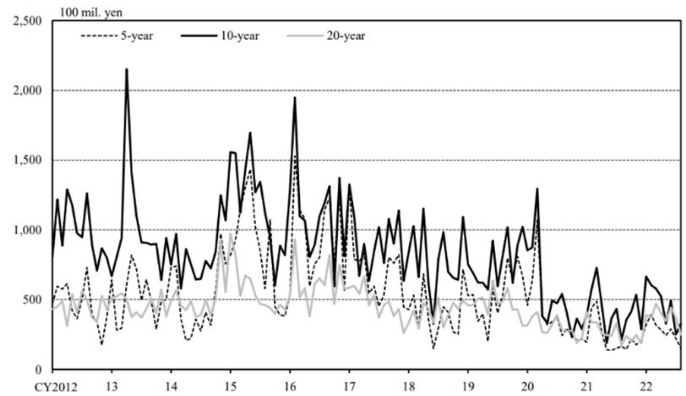
FORWARD GUIDANCE

- BOJ communicated that it 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.
- BOJ will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.
- On the price front, the year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has been at around 3.5 percent due to rises in prices of such items as energy, food, and durable goods. Meanwhile, inflation expectations have risen.
- Thus, it may appear premature to conclude that BOJ will exit the monetary policy accommodation and raise interest rates in future. The concerns on financial stability and monetary policy transmission appear to influence the decision which impact the long end of the yen yield curve. The short end of the curve has seen no change, rather increase in JGB purchases from 7.3 trillion yen to about 9 trillion yen.

ISSUES IN JAPANESE CORPORATE BOND MARKETS

- The Bank of Japan's overwhelming presence in the JGB market where it's the biggest buyer under its curve control policy has exacerbated liquidity issues and led to a deterioration in market functioning.
- With rise in interest rates in overseas markets such as the US and EU, the BOJ's position has drained the liquidity from the domestic bond markets. Further continuance of accommodative stance along with high inflation implies there are no buyers in bonds and markets are prone to speculative attack.
- Since yields on Japanese government bonds (JGBs) are reference rates for corporate bond yields, bank lending rates, and other funding rates. If these market conditions persist, this could have a negative impact on financial conditions such as issuance conditions for corporate bonds.
- Banks/Financial shares have gained, buoyed by interest rate rise hopes, though Nikkei 225 and TOPIX nosedived.

Daily Transaction Volume of On-the-run Bonds by Maturity



Source: BOJ: Liquidity Indicators in the JGB Markets

- To correct this, BOJ will offer to purchase 10-year JGBs at 0.5 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted.
- The Bank expects that the measures will facilitate the transmission of monetary easing effects generated under the framework of yield curve control, such as through corporate financing.
- The Bank will purchase CP and corporate bonds at about the same pace as prior to the novel coronavirus (COVID-19) pandemic, so that their amounts outstanding will gradually return to pre-pandemic levels, namely, about 2 trillion yen for CP and about 3 trillion yen for corporate bonds.

THE RACE FOR BOJ GOVERNOR: WHO GETS C-SUITE

- The neo-baroque BoJ building in Nihonbashi, Chuo, Tokyo, designed by Tatsuno Kingo in 1896 ironically sits on the site of a former gold mint (the Kinza) and (not so coincidentally) near the better known Ginza district, whose name translates to "silver mint". A pertinent question that has kept the Japanese, and inter-linked overseas markets, on the tenterhooks of late is who succeeds Haruhiko Kuroda as the new governor next spring (Kuroda is slated to retire in April'23 after a decade steering the Japanese economy through a set of guiding principles markets colloquially referred to as *Kurodanomics* under strong, long tutelage of first Shinzo Abe, and later Yoshihide Suga briefly and now with Fumio Kishida in a not so frictionless manner as repeated rumours of 'shortening' Kuroda's tenure had to be countered by Kishida, eager to **adding wage growth as a new monetary policy goal**.

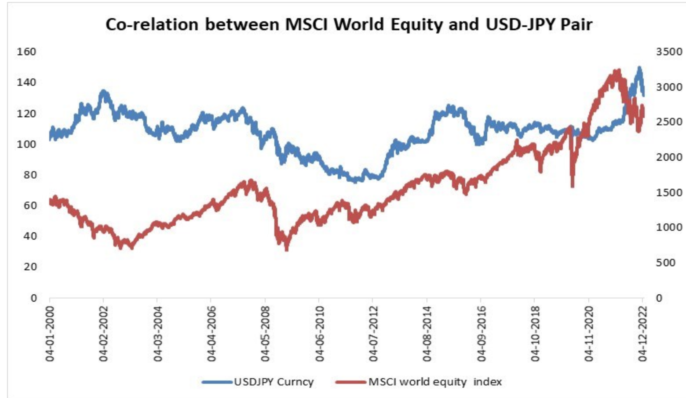
Current BoJ Deputy Governor Masayoshi Amamiya, a dovish central banker with more than four decades inside BoJ and known internally as "Mr. BoJ" is the front runner at the moment as various market polls have exhibited. Also, his predecessor Hiroshi Nakaso is considered a strong contender to succeed *Kuradonomics* from among a hefty group of competing contenders when the hot seat opens this spring, with various challenges before local, as also global economy, getting more visible to BoJ. Going by the latest tweak in YCC (Yield Control Curve) and the knee-jerk reaction from markets, BoJ's natural path could be to abandon the negative interest rate policy next spring onwards, more in tandem with the need to enhance the JGB market functioning. This gels well with Kuroda's repeated stance in the press conference that the shift is not a rate hike, but more intended to enhance bond market functionality.

HAS THE YEN LOST ITS SHEEN AS A SAFE HEAVEN CURRENCY (AND, WHAT IT MEANS FOR THE JAPANESE ECONOMY THROUGH THE UNFOLDING DECADE)

The might of Japan, resurrecting from the rumbles of post WWII, took the western world by surprise as the tiny Asian island nation showed novel, often competition shattering concepts in engineering (duly infused with its unique cultural identity), ranging from automobiles to heavy industries to robotics (the idea of ATM is believed to have come from vending machines deployed in 1964 Tokyo Olympic games!). The rising clout of Japan ,with the tag of second largest economy, also fuelled another financial master stroke, that of carry trade in USD/JPY which was probably communized by persistent hordes of Japanese housewives (commonly referred to as Mrs. Watanabe that still rings true) in the 80s and raged through the 'lost decades' of 90s and 2000s in search of better yields to tide over the limited investment avenues available at home front. The falling yen, and the interest rate differential between the two partner nations fuelled the carry trade largely.

JPY has traditionally been a safe currency asset, its positive co-relation with MSCI World equity index remaining strong even in the early, tumultuous days of pandemic (0.35). However, with the start of the war early this year and the growing divergence between the BoJ and other major Central Banks, in particular the Fed, has ensured the Yen losing its turf as a preferred safe heaven currency (for good, we believe), duly assisted with seemingly durable structural shifts in the terms of trade between Japan and other major economies.

Waning Position of USDJPY as a Safe Heaven Currency



Source: SBI Research

Higher Imports, losing Exports share

Japan Imports by Category (CY 2021)	Value ($Bn)
Mineral fuels, oils, distillation products	154.73
Electrical, electronic equipment	113.41
Machinery, nuclear reactors, boilers	71.16
Pharmaceutical products	37.29
Ores slag and ash	34.47
Optical, photo, technical, medical apparatus	28.24
Pearls, precious stones, metals, coins	24.11
Vehicles other than railway, tramway	23.08
Plastics	17.37
Organic chemicals	16.78

A robust trade surplus should be a natural vector, underpinning a safe heaven currency status – balancing and nourishing a natural demand for such currency in times of crisis. Apparently, JPY appears to have lost that strength or backing from trade as its trade deficit appears to be growing with rising import bill, accentuated by energy and commodity prices hike post the long war and uncertain headwinds on exports front as its competitive advantages in automobiles seems to be losing steam with the emergence of new names like BYD in EVs. An aging population, with growth rate expected to falter in 2023 (1.6% by IMF estimates) and inflation running much above the central Bank's mandate leaves little room to manoeuvre for the policy makers but BoJ, under Kuroda, has succeeded in keeping the ultra loose policy stance, allowing the domestic currency to depreciate to decadal lows that benefitted the exports but brought to the fore the fissures present in the socio-economic fabric of the country, which is likely to cede its third largest economy tag in favour of another worthy suitor from Asia, i.e. India by end-2027.

THE UNSURPRISING SURPRISE

Post the devastating Tsunami in March'2011, further accentuated by the Fukushima nuclear disaster, there has been a durable structural shift in the 4 trillion dollar plus, all important JGB market where the ownership pattern has gradually shifted and concentrated in BoJ, at the cost of dwindling representation from once powerful depository corporations. Despite the country having a steady flow from retail investors in financial instruments and products, further helped by inflows from investors to have a foothold in the most tech-centric economy, the sway of JGB in determining, and defending the yield has been substantial till date within the 'yield curve control' target.

BoJ has, of late, accelerated its government bond purchases, topping 50% of total bonds share, pinning down the long term interest rates, but creating distortions in the bond market too with threat of inverted yield curve looming large in select tenors. Markets have often fretted over the mounting unrealized losses in billions of dollar as widening gap between local and offshore monetary policies has helped in pushing yields higher, while prices have been driven southwards. The increase in yield corridor on 20th December in a 'surprise move' was a natural step since research firms were predicting from mid-year itself that paper losses (unrealized) would exceed the central bank's capital base itself should the yield on 10-year papers alone rise to 0.65%. JPY, after continuous fall for months against a resilient Dollar and hitting a psychological benchmark of 150 this October had reversed the trend gaining close to 10% before the MPM announcement (duly aided by DXY losing its steam). We, obviously, fail to see much of a surprise here given the fag end of Kurodanomics ready to take a beating for all the ills with the Japanese economy as the new political dispensation spearheads its search for the next occupant of the old building in Kinza, who may have to trudge along a chequered path, fighting forces beyond much control on external as also internal fronts. Another interesting play to unfold in coming years will be repricing of terms of trade as both USA and China, Japan's biggest trade partners take divergent approaches in shifting global supply lines, underpinned by the rising tensions in the Taiwan strait, which are already being mirrored in the global battles for transfer of crucial technology and services component, where Japan seems to be losing its once hallowed Midas touch as rivals from Taiwan to South Korea rise.

JGBs (Japanese Government Bonds) held by BoJ (Dec'22)

Issue	Total Issues O/S	Amount O/S (in JPY Billion)
2 YEAR JGB	24	34,833
5 YEAR JGB	21	98,363
10 YEAR JGB	43	2,52,611
20 YEAR JGB	124	1,07,521
30 YEAR JGB	76	37,542
40 YEAR JGB	15	7,810
Floating Rate JGB	48	142
Inflation-Indexed JGB	11	4548
Total O/S	JPY	~543 Tn

Source: Financial Markets Department (BoJ) / SBI Research

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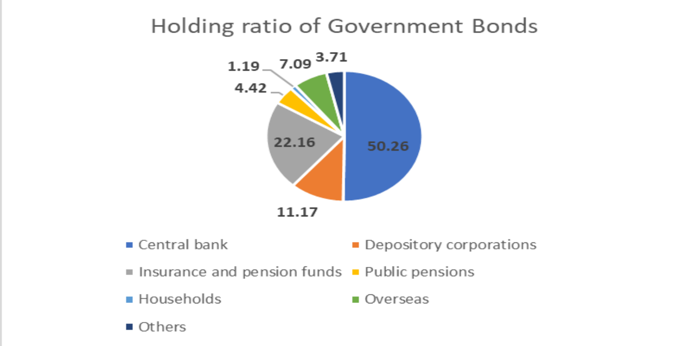

Source: Financial Markets Department (BoJ) / SBI Research

Foreign Trade Value	2017	2018	2019	2020	2021
Imports of Goods	671	749	721	635	769
Exports of Goods	698	738	706	641	756
Imports of Services	191	201	204	183	207
Exports of Services	182	189	203	156	168

Source: SBI Research (Amount in USD Billion)

OUTLOOK

- The shift in the BOJs stance on YCC had its obvious fallouts. The yen has appreciated to four-month high. The price of gold also moved in tandem with dollar.
- On 20 Dec, the dollar plunged as much as 4% against the yen, its largest daily percentage fall since 1998. The USD, however, rebounded on and is hovering around 132 as on date.
- The current situation where most of the principal currency central banks are in tightening mode, BOJ's accommodative stance will make international capital more volatile.

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