CAPITAL ECONOMICS

GLOBAL MARKETS UPDATE

How abandoning Yield Curve Control would affect JGBs

- **We think the yield of 10-year Japanese Government Bonds (JGBs) would rise to at least 1% if the Bank of Japan (BoJ) decided to abandon Yield Curve Control (YCC), which could conceivably happen as soon as tomorrow. But we wouldn't be surprised if it ended this year below that level.**
- Following the BoJ's unexpected decision on 20th December to widen its tolerance band for the yield of 10-year JGBs by 25bp to 0%±50bp, that yield has spent the past week testing the new ceiling. The BoJ has so far defended the target by purchasing large amounts of JGBs. But we expect it to throw in the towel soon, and abandon the target entirely. Our best guess is that this will happen in April, but it could be this week.
- **If the BoJ abandoned YCC tomorrow, we think the yield of 10-year JGBs would rise significantly more than it has already, for three key reasons.**
- **The first reason is that it ought to remove the remaining "kink" in the yield curve, all else equal.** One way of estimating the potential effect on the 10-year yield is by looking at interest rates elsewhere along the JGB curve. If we estimate a smoothed yield curve, based on the yield of JGBs of maturities from 1 to 6 and 15 to 30 years, the implied 10-year yield is ~0.9%. This is about 40bp above its level now. (See Charts 1 & 2.) That's similar to the Japanese 10-year OIS rate, which isn't directly affected by YCC. (See Chart 3.)
- **The second reason is that we suspect it would prompt investors to reassess the prospects for Japanese conventional monetary policy.** After all, when the Bank tweaked the YCC band in December, near-term OIS-implied policy rates jumped by ~25bp. Admittedly, those implied rates have since fallen back somewhat. (See Chart 4.) But we wouldn't be surprised if they rebounded to an even higher level in the immediate aftermath of a decision to abandon YCC.
- **The third reason is the level of yields elsewhere in the world, to the extent that high-grade government bonds can be considered substitutes for one another once hedged into a common currency.** We will look at this in more detail in a separate *Update* on our *Asset Allocation Service*.
- **We doubt, however, that the second and third reasons would continue to exert additional upward pressure on the 10-year JGB yield for very long.**
- As far as conventional monetary policy is concerned, we anticipate that there would be a strong signal from the authorities that there were no implications for short-term rates. We think the threshold for hikes is much higher than for the abandonment of YCC and that, with inflation looking set to decline before long, it won't be met in any case. That said, the timing of the abandonment of YCC could be important. Investors' view of the prospects for short-term rates could well be different if YCC were abandoned under a more hawkish BoJ Governor (which seems possible) later this year than under the incumbent.
- And when it comes to high-grade government bonds elsewhere, our view is that 10-year yields will continue to *fall* a bit in general, bearing down on the 10-year JGB yield.
- The upshot is that while **we wouldn't be surprised if the 10-year JGB yield rose well above 1% if YCC were abandoned this week, we anticipate that it would subsequently fall back towards, or perhaps even below, that level by the end of 2023**. We intend to revisit our current forecast of 0.4% in due course.

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Chart 1: Yield Curve Of Japan Government Bonds as of 13th January 2023 (%)

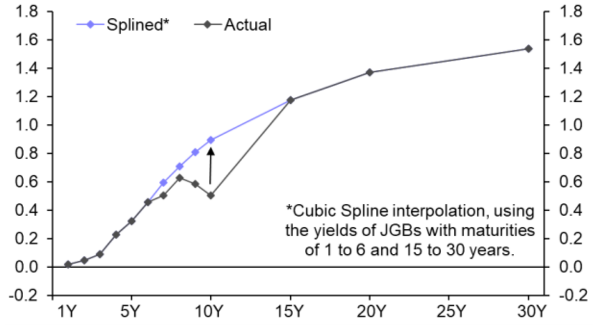


Chart 2: Yield Of 10-Year Japan Government Bonds (%)

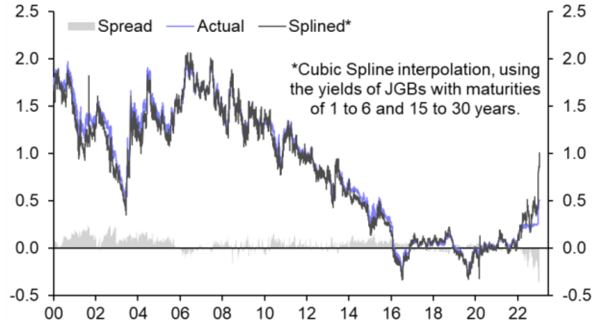


Chart 3: Yield Of 10-Year Japan Government Bonds and 10-year OIS Rate (%)

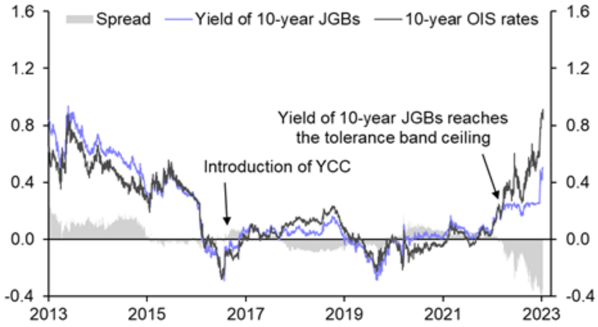
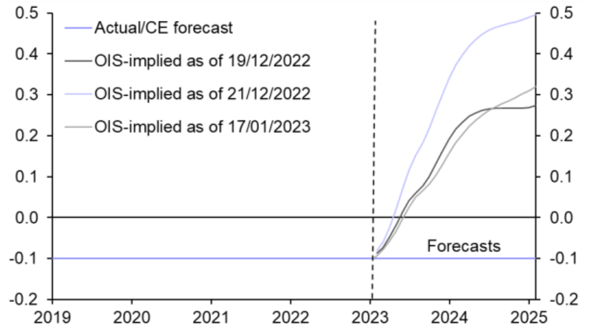


Chart 4: Policy Rates (%)



Sources: Refinitiv, Bloomberg, Capital Economics

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