

Minutes of the Meeting of JGB Market Special Participants
(71st Round)

- Date: Wednesday, June 28, 2017 (4:00 p.m. to 4:55 p.m.)
- Place: Special Conference Room 3, Ministry of Finance
- Gist of the Proceedings

1. Issuance amount of Inflation-Indexed Bonds Issued in the July–September 2017 quarter

▶ The Financial Bureau gave the following explanation about the issuance amount of Inflation-Indexed Bonds in the Jul-September 2017 quarter:

▪ As regards Inflation-Indexed Bonds the JGB Issuance Plan for FY2017 says on page 2 that “the debt management office flexibly adjust issuance amounts taking into consideration opinions exchanged with JGB market participants, the market environment and investment demands” for making four issuances in the year by the per-issuance amount of ¥400 billion. Therefore, today we would like to hear your opinions about the issuance amount in the July-September 2017 quarter.

▪ For the April-June 2017 quarter, as shown on page 3, we conducted the auction for the issuance amount of ¥400 billion in April, and Buy-back Auctions in the amount of ¥20 billion in April and in June, respectively. The April auction, as shown on page 4, saw a bid-to-cover ratio increase of 3.63 times, reaching its high level over the last three and half years. Page 5 shows that the Buy-back Auctions and the Bank of Japan (BOJ)’s Outright Purchase also had a somewhat higher bid-to-cover ratio during this period as well, but the results are generally successful.

As for the secondary market, displayed on page 6, declines in global inflation expectations have led the BEI to sit in the middle of the 0.4% range.

▪ At the hearing prior to this meeting, we found that many of you are concerned about the continuing limited expansion of the investor base for Inflation-Indexed Bonds, therefore being of the opinion that the debt management office should desirably maintain for the July – September quarter the current issuance amounts of Inflation-Indexed Bonds and of Buy-back Auctions.

▪ In view of such a situation, as shown on page 7, we are considering issuing Inflation-Indexed Bonds in the July - September quarter in the amount of ¥400 billion and

carrying out Buy-back Auctions in the amount of ¥20 billion in the even-numbered month of August, in the same amount as the April - June quarter.

- We believe the development of the market for Inflation-Indexed Bonds is an important issue related to the Debt Management Policy. Therefore, we would like to hear your opinions, on the direction of our policy related to the issuance amounts in the July - September quarter.

- As explained last year, issuance auctions for Inflation-Indexed Bonds are changing to a format of inputting a bidding price without regard to the indexation coefficient from August 28 of this year. However, the next auction is planned for August 3, so please bear in mind that auction will use the existing bidding method.

▶ Summarized below are the views and opinions expressed by the attendees:

- We agree to the proposal. It is good to maintain current amount management because supply and demand of Inflation-Indexed Bonds are balanced and so BEI is mostly stable, after being present amounts of issuance and buy-backs as well as BOJ purchases. Although BEI has been on a downward trend over the last half-year, we believe this is a reflection of a global reduction in expected inflation and cheaper crude oil rather than a demand/supply factor. On the contrary, if market prices did not move by such fundamentals, overseas investors might regard them as a product that is solely driven by demand/supply, which would lead to a departure of overseas investors. Within the current situation, where BEI seems to fluctuate upside and downside due to changes of fundamentals, it is preferable to maintain the current amount of both issuance and buy-backs.

- We agree to the proposal. I actually feel that the balance of supply and demand has stabilized after the present issuance amount been set. Therefore, I request to maintain current states.

- We agree to the proposal. Though the supply and demand condition is improving, the variety of domestic investors are not expanded. Therefore, it cannot be said that demand/supply have improved enough to be able to increase the issuance amount. In addition, until we can confirm stable growth in the Inflation-Indexed Bonds market, the market will require a support for improving supply and demand as well as enhancing liquidity of them, so I request buy-back auction to be continued.

- We agree to the proposal. Global circumstances surrounding Inflation-Index Bonds have been headwind for it over the past few months. Moreover, there have not been seen new expansions in the variety of investor. On the other hand, we recommend to preserve current issuance amounts and buy-back auctions because we would like the debt management office to retain their commitment of improving Inflation-Index Bonds market.

- We agree to the proposal. Considering a current situation of not expanding investor base and a future development of Inflation-Index Bonds market, the issuance amount is recommendable to remain current situation. As of Buy-back auction, it is good to conduct once at this July-September quarter, however, if the balance of demand and supply broke down in the future, it is better to reexamine the Buy-back auction plan: purchasing ¥20 billion each month.

2. Liquidity Enhancement Auctions for the July - September 2017 quarter

▶ The Financial Bureau provided the following explanations regarding the Liquidity Enhancement Auctions for the July - September 2017 quarter:

- Regarding the Liquidity Enhancement Auctions, the FY2017 JGB Issuance Plan aims to issue ¥10.8 trillion annually, as shown on page 9, with ¥1.2 trillion for the 1 - 5 - remaining - year zone, ¥6.6 trillion for the 5 - 15.5 - remaining - year zone, and ¥3 trillion for the 15.5 - 39 - remaining - year zone, and that ultimately “based on discussions with market participants, the issuance amount would be adjusted flexibly manner in response to the market environment and investment demands”.

Today, we request you to discuss the issuance amount for each zone in the July - September quarter.

- As shown on page 10, and in accordance with the targets displayed in the JGB Issuance Plan, in the April - June quarter we issued JGBs ¥200 billion in May for the 1 - 5 - remaining - year zone, and ¥550 billion in each month for the 5 - 15.5 - remaining - year zone, and ¥500 billion in April and June for the 15.5 - 39 - remaining - year zone.

- Page 11 shows the results of the recent Liquidity Enhancement Auctions. Aside from the continued high rate of bit-to cover ratios for the 1 - 5 - remaining - year zone, the other zones were generally stable.

- When we heard opinions under these conditions about the Liquidity Enhancement Auctions for the July - September quarter from the JGB Market Special Participants in advance, there were many requests to increase the amount for the 1 - 5 - remaining - year zone and decrease amount for the 15.5 - 39 - remaining - year zone, as supply and demand is constrained and the market make-up is difficult for many issues, particularly for the 1 - 5 - remaining - year zone.

- Liquidity Enhancement Auctions are to issue JGBs for which liquidity shortfall, and aim for the maintenance and enhancement of liquidity with JGB markets. In that sense, adjusting the issuance amount can be considered very important so that JGB Market Special Participants actually responsible for the market make-up will be able to smoothly commit to the market make-up.

- Therefore, as shown on page 12, we have an idea of issuing ¥300 billion in July and September for the 1 - 5 - remaining - year zone, ¥550 billion each month for the 5 - 15.5 - remaining - year zone, and ¥400 billion in August for the 15.5 - 39 - remaining - year zone.

- In addition, as indicated from page 13 onward, we are reconsidering the selection rule for target issuances in Liquidity Enhancement Auctions from the July - September quarter onward. Under the current rules, current issuances as of the first day of the month of the auction were removed from the bidding targets, so, for example, in the Liquidity Enhancement Auction in March for the 1 - 5 - remaining - year zone, the 130th of 5 - Year Bonds, which had tight supply and demand, was removed from the bidding targets.

- Moving forward, we are thinking that we would like to end the issuing of new bonds on the first day of the month of the auction and that we would like to include issuances that could not be issued outside of the Liquidity Enhancement Auctions as subjects in the Liquidity Enhancement Auctions, even if they are current issuances.

- Based on today's discussion, we will decide the issuance amount for each zone of the Liquidity Enhancement Auctions in the July - September quarter, and so we would like to ask for opinions.

- ▶ The following opinions were given, in addition to having no objection to the proposal regarding the Liquidity Enhancement Auctions for the July - September 2017 quarter.

- We agree to the proposal. What to prioritize is a decision as there are merits and demerits

for each combination of issuance amounts for each zone. Since maintaining JGB market functions is being an issue, we are mostly concerned that smooth operation of the market-making for the 1 - 5 - remaining - year zone are becoming difficult. When we have a customer's order, we are considering to avoid the situation that we can not provide the pricing due to limited availability in the market. Therefore, it is desirable to increase the amount for the 1 - 5 - remaining - year zone. As of the 15.5 - 39 - remaining - year zone, although it seems that there is constant demand from investors, watching the most recent data of sales trends, it is not as if demand is so high that dropping from ¥500 billion to ¥400 billion will cause a shortage.

We also agree to reconsider the selection rule for target issues. We have no problem with an increase in the target issues.

- We agree to the proposal. We see many issues with significant shorts for the 1 - 5 - remaining - year zone, and there are also issues with continuing high repo rates. Additionally, even within the BOJ's Securities Lending Facility operation, strong needs is shown for a long term depending on the issues. I believe that the correct method of resolving this situation would normally be via market participants' self-supporting endeavors, but, on the other hand, if this situation continues for a while, it will have a negative impact on healthy growth in the market. Therefore, the increase for the 1 - 5 - remaining - year zone is important in the sense that it will expand the variety of investors by resolving an unstable market situation.

We also agree to reconsider the selection rule for target issues. It is based on the needs of a broad range of investors, and I think that it contributes to market growth.

- We agree to the proposal. Short positions are growing for certain issues for the 1 - 5 - remaining - year zone, and distortions in supply and demand can be seen in some issues. However, while a degree of investor demand is certainly apparent in the super long-term zone, the movements of final investors like life insurance companies are limited, and if ¥500 billion continues to be the issuance amount for the 15.5 - 39 - remaining - year zone, there is a possibility that the burden on securities companies who sell it will be slightly larger.

We fully agree to reconsider the selection rule for target issues.

- We agree to the proposal. The trends of super long-term zone is that the interest rates are trending upwards because of less demand of life insurance companies and demand is concentrating on current issues. However, the yield curve is distorted for the 1 - 5 - remaining - year zone, so it is preferable to follow the suggestion to resolve this problem.

- We agree to the proposal. Supply and demand in the medium-term zone was extremely tight for a period. I believe that it has somewhat relieved now, but there are few opportunities to sell, and short-positions potentially remain. As it will take a little more time to resolve these short-positions, an increase in the amount for the 1 - 5 - remaining - year zone is welcome.

We also agree to reconsider the selection rule for target issues.

- Basically, we agree to the proposal. As a result of listening to the opinions of the JGB Market Special Participants that there are many people asking for an increase in the amount for the 1 - 5 - remaining - year zone, I believe this plan is an adjustment of the issuance amount in response to the market situation.

However, with market functions significantly impaired due to the excessive decrease in the level of volatility, since the super long-term zone has a comparatively fluctuations, I wonder if its issuance amount decreased, the price movement will be lost because of tightness of supply and demand. Without moderate volatility, I feel that there is a risk of market participants gradually decreasing. Of course, since no plan will satisfy all needs, I agree to the proposal for the July - September quarter, but I ask you to revisit the issuance amounts for each zone once the medium-term zone's pricing structure has returned to normal.

We also agree to reconsider the selection rule for target issues. There is nothing better than many target issues, and it is an extremely helpful proposal.

- We understand the proposal to increase the amount for the relevant zones since supply and demand continue to be tight for a portion of issues in the medium-term zone.

Additionally, expanding the target issues means the expansion of the options for auction participants, so I fully agree to reconsider the selection rule for target issues.

- We agree to the proposal for the July - September quarter. There are no short positions that stand out for the 15.5 - 39 - remaining - year zone, and in terms of supplementing liquidity, we consider that there is more continuing demand for the 1 - 5 and 5 - 15.5 - remaining - year zone.

As for reviewing the selection rule for target issues, considering the current environment for supply and demand, I would like to welcome an expansion of target issues.

3. Shortening of Settlement Cycle related to the coupon-bearing issues (5-30 year

issues) in massive JGB redemption months and the monthly 2-year issue

▶ The Financial Bureau provided the following explanation regarding the shortening of settlement cycle related to the coupon-bearing issues (5-30 year issues) in massive JGB redemption months and the monthly 2-year issue

▪ As explained during the previous meeting, we have been looking into shortening of settlement cycle in order to reduce the settlement risk in the coupon-bearing issues (5-30 year issues) in massive JGB redemption months (March / June / September / December) and the monthly 2-year issue, for which the period from auction to issuance is long.

Since this issue is a problem that could have a significant impact on the systems of the market participants, we have listened carefully to opinions from many areas as conducting a survey with the assistance of the Japan Securities Dealers Association. And now we have summarized our proposal as explained on page 17.

▪ First, we are considering enacting the plan at the same time as the T+1 change in the secondary market planned for May 1, 2018.

Therefore, the coupon-bearing issues (5-30 year issues) in massive JGB redemption months will be implemented in June 2018, and the monthly 2-year issue will be from May 2018.

▪ Additionally, in terms of how this will be implemented, the first step is that the coupon-bearing issues (5-30 year issues) in massive JGB redemption months will be no longer be issued on the 20th day (or next business day, if that day should be on the weekend) of the auction month, regardless of auction date. Instead, this will change to T+1. In accordance, this means that the issuance amount for the massive redemption months of March, June, September, and December will be redeemed in the same month as prior-month and two-months-prior bonds, and that we will extend the redemption date by three months from the amount issued in the following month (April, July, October, and January) and issue new bonds. This is a result of hearing from many participants in the market that issuing new bonds at T+1 for the interest payments and redemptions undertaken in March, June, September, and December would require large-scale revisions of the system in relation to initial interest payments.

▪ Second, the monthly 2-year issue are currently issued on the 15th day of the following month, regardless of the date of the auction, but the issuance date will now be the 1st day of the month following the auction. Additionally, the dates for interest payments and

redemption will be changed to the 1st as well. This is to prevent the confusion that may arise from simply converting 2-year issue auctioned at the end of the month to a T+1 structure, which could result in the bond being issued either within the same month or in the following month, depending on the date of the auction. As such, we retained following-month issuance while attempting to shorten the settlement period as much as possible.

- We would like to make a final decision regarding this issue based on the discussion today, and so we would like to ask for your opinions once more.

- As we have already explained, in line with changing to T+1 for issuing government bonds, we are changing the timetable for auctions. The changes to the timetable announced in November of last year are reproduced on page 26, so please check it.

- ▶ The following is a summary of opinions expressed by the attendees:

- We agree to the proposal. The burden of dealing with the system prior to converting the JGB liquidity market to T+1 was large, so we hoped for implementation from May 2018 and has informed the Financial Bureau. I would like to appreciate for setting an implementation period that takes the circumstances of us into consideration.

- We agree to the proposal. The coupon-bearing issues in massive JGB redemption months had a time lag before issuance, which was causing price distortions to occur, so we look forward to the conversion to T + 1 making pricing smooth. The 2-year issue is the same. Because the Financial Bureau was kind enough to confirm for us in advance, it seems that we will be able to proceed with handling it smoothly, including our back office.

- We agree to the proposal. As a secondary effect, we can take a more aggressive stance than before for bidding in massive JGB redemption months auctions. In other words, at the end of the fiscal year, based on internal rules and with our balance sheet being very restrictive, the current method of extending redemption dates by 3 months from March, June, September, and December issuances makes it difficult to bundle short positions on existing, issued bonds with long positions on newly issued bonds at the end of the quarter under the current method. Now, by changing to the method that extends the redemption date by three months from the issued amounts in April, July, October, and January, these issues are considerably mitigated, and it will be easier to bid.

- We agree to the proposal. If it is implemented along with the planned conversion to T+1 in May 2018, then market participants will have sufficient time.
- We agree to the proposal. The Financial Bureau conducted thorough investigations ahead of this issue. Based on that, we believe that smoothest implementation method is proposed.

4. Latest JGB market situation and its future outlook

▶ The following is a summary of opinions expressed by the attendees:

- In the bond market, the BOJ's yield curve controls are fundamentally effective, and it seems that there will be limited movement for the time being. In fact, the summary of the agenda of the Monetary Policy Decision Meeting in March shows that many members have recognized that it is not appropriate to raise the BOJ's long-term interest rate control target due to the rise in interest rates overseas, so unless we see achievement of the 2% target for price stabilization, the situation is unlikely to change.

When considering future developments, the movements of the dollar, and especially the outcome of the FRB's monetary policy, which is the primary driver in dollar fluctuations, is important, but a decline in the US growth rate would set up the pattern for disinflation, therefore it is unclear for how long the FRB can continue to raise rates.

Additionally, the US economic recovery will enter its ninth year next month, but we see a slight decline in housing and automobile sales, which are highly sensitive to interest rates, and if the economy slows down, the FRB may stop raising interest rates. However, as these possibilities are not fully incorporated into the market, the likelihood of a weakening dollar / appreciating yen will increase. This shift may not occur for the time being, but we need to be alert.

While the purchase amount for the remaining maturities of 10 - 25 years zone within the BOJ's JGB purchases is mostly in line with the issue amount in the market, the purchase amount for the remaining maturities over-25 years zone is not even half of the amount issued in the market. Therefore, 30-year and 40-year bonds are likely to be relatively cheap. On the other hand, in the US, since the FRB aims for continuous rate increases, flattening out are likely to occur.

Although paradoxical, it is easier for overseas investors to participate in 30-year and 40-year bonds where the BOJ's controls are less effective, so assuming that the flattening of the yield curve in the US continues, surprisingly, the relative cheapness of Japan's 30-year and 40-year bonds may be corrected by these developments.

As the decline in liquidity becomes more serious, we hope that the government and the BOJ continue to think ahead about various ways to be able to respond promptly when a problem occurs in the market.

- Currently, overseas interest rates are spread high and low, but for JGB, as long as the BOJ does not change the current long-term interest rate control target, the 10-year bond rate will continue to remain near 0%. However, there is a possibility that rising global interest rates would influence the behavior of final investors like life insurance companies, therefore if investors' interest rate targets for 30-year and 40-year bonds remain high, pressure will mount to steepen them.

With regard to the medium-to-short-term zone, as the negative range of the dollar-yen basis swap shrinks, its attractiveness to foreign investors for investment is diminishing. In addition, since the BOJ's purchase amount for the same zone is also declining, domestic investor demand will need to return in the future. I think that there will be a variety of movements when the supply-demand structure changes, so I'd like to figure out the level at which supply and demand can be confirmed.

- While the idea that Japan's inflation rate is difficult to increase is becoming firmly established, the market's short-term materials are directed toward overseas monetary policy. In addition to the prediction that the FRB will formally decide to reduce its balance sheet during the July-September period, the ECB is also highly likely to issue some statements on QE policies that are only committed to through the end of the year. This is a major shift in monetary policy from the past few years, where central banks buy large amounts of government bonds globally, therefore this may potentially be the most important theme for the July-September period.

In the long term, the main theme is how the BOJ will smoothly implement purchase reductions. The fact that the BOJ purchases a large amount of government bonds with QQE means that, when considering the government and the BOJ together, the only conclusion is that debt is being brought into the short-term in a significant way, therefore this could be considered as vulnerability potentially and presently increasing should interest rates rise.

As the issuing authority, it is important to consider how to implement debt management based on these circumstances, as well as how to grow the market in the future.

- Market price movements are very limited due to the BOJ's yield curve controls. It barely reacts to indices such as overseas interest rate trends or domestic fundamentals, and with volatility being significantly suppressed; it is balanced with supply and demand alone,

reducing price fluctuation. As a result, foreign investors' interest in yen interest rates has also declined considerably, which is causing a further decline in market liquidity.

If this situation continues for too long, there is a possibility that market functions will be greatly damaged. The current market theme is surely how to make active price movements a little more possible, such as interest rates going up and down based on domestic and foreign fundamentals. Normally, with too low volatility, the return on risk comparisons would improve, making it more likely that investment in JGB would be reconsidered, but the current low levels of volatility were artificially created. As such, investors will not be able to commit to long-term investments. This may be one reason not to stimulate demand for 30-year bonds or 40-year bonds.

- Since the time that the market spends at a standstill is growing little by little, investor motivation has fallen considerably. Over-the-counter trading has been hard to execute these days, and the market's sensitivities to events are low. So, once the market starts moving, volatility could get way higher than expected.

Therefore, we believe it will be important that the situation becomes one where market participants may act based on greater variety of viewpoints.