

Minutes of the Meeting of JGB Market Special Participants  
(72nd Round)

- Date: Friday, September 22, 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 in the October-December 2017 quarter**

▶ The Financial Bureau gave the following explanation about the issuance amount of Inflation-Indexed Bonds in the October-December 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 amounts in the October-December 2017 quarter.

▪ For the July - September 2017 quarter, as shown on page 3, we conducted the auction for the issuance amount of ¥400 billion in August, and Buy-back Auctions in the amount of ¥20 billion in the same month. Page 4 shows that the August auction continued to successfully end, showing the bid-to-cover ratio of 3.19. The Bank of Japan (BOJ)'s Outright Purchase on September 19, the bid-to-cover ratio had declined while the Average Successful Bid Rate/Yield Spread were also positive among Buy-back Auctions and the BOJ's Outright Purchase showed generally successful results as shown on page 5. However, these results may have been affected by news reports of the consumption tax increase connected to the snap general election called right before them. The secondary market, page 6 shows that although BEI at one point dropped to upper 0.2%, it picked up again and is now moving around 0.4%.

▪ In such circumstances, we asked for your opinions beforehand and 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 October - December 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 October - December 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 October and of December, in the same amount as the July - September quarter.

▪ 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 October - December

quarter, the auction schedule at equal intervals, etc.

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

▪ In accordance with the proposal, we agree that it is best to continue the issuance amount of ¥400 billion while conducting Buy-back Auctions on even-numbered months in the amount of ¥20 billion. The reversal of BEI's downward trend has alleviated the worries of the investors, and as there are no more bonds being issued within this year after the October auction, it is expected that the supply-demand situation will slowly improve. We think that maintaining current conditions while continuing to issue bonds into the market by a supportive manner will contribute to the growth of the market.

▪ We agree to the proposal. The current issuance amount, the amount of Buy-back Auctions, and the amount of BOJ's Outright Purchase has maintained a good balance with the demand of investors. As the market is functioning with the BEI fluctuating due to not only supply-demand but also external environments, we think that the current balance should be maintained for the time being. In addition, we recognize that the issuance amount of ¥400 billion is sufficient to secure a minimum market size.

▪ We agree to the proposal. As BEI has been continuously stable, and also for the development of the market, we would like to maintain the issuance amount of ¥400 billion. Furthermore, regarding Buy-back, we should consider a monthly Buy-back in case the supply-demand loses its balance in the future.

▪ We agree to the proposal. There has been a demand in the past 1-2 weeks and the liquidity has also risen. The balance has been clearly maintained due to the current issuance amount of ¥400 billion, as well as the ¥20 billion purchased through Buy-back held every other month.

▪ We agree to the proposal. The market has maintained a basically good balance with the current issuance amount and Buy-back amount. The recent fluctuation in prices was caused by factors explained by the debt management office.

## **2. Liquidity Enhancement Auctions for the October - December 2017 quarter**

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

▪ Regarding the Liquidity Enhancement Auctions, as shown on page 9, the FY2017 JGB Issuance Plan stipulated that an annual amount of ¥10.8 trillion would be issued, and that "based on discussions with market participants, the issuance amount for each zone 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 October - December quarter.

- As shown on page 10, in the July - September quarter we made additional issues for those that lacked liquidity and reexamined the issuance amount for each zone in light of the purpose of Liquidity Enhancement Auctions, which aim for the maintenance and enhancement of liquidity with JGB markets. More specifically, for the 1 - 5 - remaining - year zone, we increased ¥100 billion for the per-auction amount and issued the ¥300 billion in July and September. In addition, for the 5 - 15.5 - remaining - year zone, a monthly amount of ¥550 billion was issued as was done previously, and for the 15.5 - 39 - remaining - year zone, we decreased ¥100 billion for the per-auction amount and issued ¥400 billion in August.

- Page 11 onwards show the results of recent Liquidity Enhancement Auctions. Each zone was generally stable.

- When we heard opinions under these conditions about the Liquidity Enhancement Auctions for the October - December quarter from the JGB Market Special Participants in advance, and there were many opinions that maintaining the current issuance amount is appropriate.

- In view of such a situation, page 14 shows that for the October - December quarter, we have an idea of issuing the same amount for each zone as the July - September quarter, which involves ¥300 billion in November for the 1 - 5 - remaining - year zone, ¥550 billion each month for the 5 - 15.5 - remaining - year zone, and ¥400 billion in October and December for the 15.5 - 39 - remaining - year zone.

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

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

- We agree to the proposal. The two Liquidity Enhancement Auctions held this week had acceptable results, which shows us that the issuance amount for each zone as well as the recent supply and demand environment are generally well-balanced. Although some issues of the short - to - medium - term zone had a short supply which caused the interest rate to fall during late August to early September, looking back, this shows the successful result of deciding to increase the issuance amount for the 1 - 5 - remaining - year zone based on discussions held at the previous meeting. Regarding the October-December quarter, we think it is best to maintain the current issuance amount.

- We agree to the proposal. As there continues to be a vigorous demand in the 5 - 15.5 - remaining - year zone, we request a monthly issuance amount of ¥550 billion as was done in the July - September quarter. Regarding the 1-5 - remaining - year zone and the 15.5 - 39 - remaining - year zone, as the amount was already changed in the July - September quarter and the auctions results were satisfactory, we think that maintaining current conditions would be best.

- We agree to the proposal. We think that issuing bonds in a stable and continuous manner will add depth to the liquidity. The issuance amount must be changed in a flexible manner in response to the market environment, taking into consideration the immediate effect, as well as the effect it will have in the next quarter and the next half year. In that sense, since a review of the issuance amount for each zone was conducted just recently, we would like to maintain current conditions in this quarter.

- We agree to the proposal. In cases where a large purchase is made by investors in the short - to -medium - term zone when the supply and demand balance is tight, this makes it hard to fix a price and a smooth market making becomes difficult. To be honest, although we want to increase the issuance amount as ¥300 billion for the 1 - 5 - remaining - year zone is still not enough to improve supply and demand, investors may object if this results in decreasing the issuance amount for the super long-term zone. Therefore, although we may request an increase of the issuance amount for the 1 - 5 - remaining - year zone in the future when the decline in liquidity becomes a matter of concern, if it continues as the current conditions, the proposal is a satisfactory compromise concerning balance.

- We agree to the proposal. With the issuance amount for this fiscal year already decided, we think it is most ideal to maintain current conditions when considering the balance among the issuance amount for each zone. However, in terms of market making, we think that the supply and demand for some issues is tight in the 1 - 5 - remaining - year zone. Although the supply and demand balance of the 1 - 5 - remaining - year zone has recently improved somewhat, we think the issuance amount of ¥300 billion in alternate months is insufficient. From the next fiscal year onwards, we would like to decrease the current issuance amount of 2-Year Bonds and increase the Liquidity Enhancement Auctions for the 1 - 5 - remaining - year zone.

- We basically have no objection to the proposal. However, although it is very likely that the current issuance amount will continue, there is a demand in the 15.5 - 39 - remaining - year zone as well. Of course, as we are very well aware that there is a demand in the 1 - 5 - remaining - year zone, we want the debt management office to consider the market environment of each zones and respond in a flexible manner.

- We propose ¥100 billion increase to the per-auction amount for the 1 - 5 - remaining - year zone and ¥100 billion reduction to the per-auction for the 15.5 - 39 - remaining - year zone. When comparing short - to - medium - term zone and super long-term zone, the difference of supply and demand is clear especially regarding outstanding bonds. The 40-Year Bonds increased this fiscal year has caused a steepening pressure on the yield curve as well as the weakening of supply and demand in the super long-term zone. In order to correct this situation, we think that it is necessary to increase the issuance amount in the medium-term zone and decrease the issuance amount in the super long-term zone.

- Liquidity Enhancement Auctions are held with the Reference Statistical Prices for OTC Bond Transactions of the Japan Securities Dealers Association as a reference. The Reference Statistical Prices for OTC Bond Transactions do not calculate the issues with less than 5 reported companies, and there was one case like this in the Inflation-Indexed

Bonds in late August. In addition, especially in foreign affiliated securities companies, it is becoming difficult to make such reports externally. For example, how will the debt management office respond in case the Reference Statistical Prices for OTC Bond Transactions has not been calculated even though the Liquidity Enhancement Auctions has been scheduled?

(In response, the Financial Bureau gave the following answer: “in such a case, we will hold the auction using the Reference Statistical Prices for OTC Bond Transactions from the previous business day. Although we are currently using this arrangement, if necessary, we will consider how to handle matters in the future by consulting the BOJ.”)

### **3. Latest JGB market situation and outlook for future**

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

- Although the yield curve control policy was implemented, going through a trial-and-error process within the market, with the fluctuation of purchase operation amounts as well as several fixed-rate purchase operations implemented by the BOJ, the market has become able to correspond well with the passing of time. We are now able to fully understand that targets set by the BOJ make an impact, whether it is 10 Year Bonds in the future, or even 20, 30, or 40 Year Bonds ahead in the super long-term zone. Although we are not expecting a major market fluctuation any time soon, as the impact of financial policies on the market is great, there is a possibility that volatility will increase to some extent with the appointment of the Governor of the BOJ held next year.

Matters of concern are the following 2 points: the decline of liquidity due to the yield curve control policy and the damage to the pricing function of JGBs. Regarding the decline in liquidity, it is difficult to specifically indicate the decline numerically. However, when the BOJ purchases a large volume of JGBs, if there is a huge amount of supply in the market, is it not unsound to think that there is no problem with the decline in liquidity because it is all purchased by the BOJ? Concerning the pricing function, although there used to be a function that increase the yield when there was talk about fiscal expansion, there is no such function in the current market. As such a situation prolongs, the gap between the current price and the actual price continues to expand. Therefore, there is continuous concern over whether it is appropriate to overlook such a situation.

- We are paying attention to how the market will change after the appointment of the Governor of the BOJ which will be held next year. While there are concerns about whether the burden on the monetary system will be too much or that the yield control policy may be prolonged, in the long run, as the term for the Governor of the BOJ is 5 years, we may have to think of an exit strategy during that time. The BOJ requires the assistance of commercial banks towards the end of the monetary easing, and without this assistance, there is a possibility that the JGB market will fall apart. In that sense, we think that the next Governor of the BOJ should have a long-term perspective towards maintaining market functions and firmly stabilizing the monetary system while also achieving price targets.

Regarding the decline of liquidity and market functions, although it is difficult to describe numerically, improvements have not necessarily been made, which is evident

through survey results of the market participants. Even if there is no index to indicate the decline of liquidity, we think it is necessary to keep looking at various numbers and indexes.

- We do not think that there will be any major changes in the market within the span of 1 or 2 years. However, as the government is currently in a position to provide funding at a cheaper interest rate than before, we want the government to actively use this opportunity to promote fiscal soundness, equip the market environment and enable it to be able to cope in case financial policies are normalized, as well as to consider the composition of the balance of JGB for every term.

While it is difficult for financial institutions to make a profit in the yen interest rate market, in recent years, many are finding a way to make profit in foreign-currency businesses. Under such circumstances, the creditworthiness as the sovereign of Japan is important. Although we should see the consumption tax increase in a positive light, when thinking of the expansion of social security costs in the future while the achievement of a primary balance surplus is uncertain, the downgrade risk of JGB is considerably high from a medium - to - long - term perspective. While Chinese government bonds were downgraded yesterday, if JGB is downgraded significantly in the future, foreign-currency businesses of financial institutions will be cut off. Therefore, we should not let up on conducting fiscal consolidation.

- With the decline in volatility as well as the reduction of JGBs circulating within the market under the yield curve control policy, a number of issues have become evident from the standpoint of a market maker.

The first issue is the downward trend in trading volume of market participants. If supply-demand becomes extremely tight due to the lack of JGBs circulating within the market, the repo market will also become considerably tight, causing an increase in repo costs. This results in a cost increase concerning the balance sheets of dealers, and transaction costs for investors will also increase due to these transaction costs. In addition to the market volatility being extremely low, the increase in transaction costs as well as returns not matching the costs for investors have resulted in a decrease in trading volume. Moreover, lack of liquidity was presented as the deciding factor for the recent reinvestment deferment of JGBs as well as a balance reduction by the European sovereign wealth fund. Although the situation is not critical as such movements are not advancing at an accelerating rate, many red flags have appeared in various places.

The second issue is the decline in the signal function of the market. Under normal conditions, the market transmits various signs regarding fiscal discipline, economic peaks and troughs, as well as the economic outlook. However, the signal function of the market has declined along with its volatility. Although it is desirable that financial authorities and issuing authorities make policy decisions based on market signals, there is a bigger risk of making an error in policy decisions due to the decline in the signal function of the market.

- From the position of a market maker, the decline in liquidity has made an impression. As the environment has made it especially difficult to correspond to the large-scale demands of investors, in order to increase liquidity of JGBs, we have asked the BOJ to improve convenience of the Securities Lending Facilities of JGBs.

Regarding the outlook of interest rates, while most market participants do not expect

current conditions to change as the yield curve control policy has become highly effective within the market, it will be hard to see any movement, whether good or bad, for some time. On the other hand, while it is assumed that the current financial policy will be long-lasting, prices will fluctuate if an event that overrides such assumptions occurs. We are focusing on 2 events that may have such an impact: the general election, which will be held soon, and the appointment of the Governor of the BOJ, which will be held next year.

- Transactions on a scale of 10-20 billion yen have been smooth as bid/offer prices have not changed. On the other hand, large-scale transactions on a scale of 100-200 billion yen are facing difficulties.

Concerning the future outlook, we assume that the yield curve control policy will basically continue, and while we also assume that the downward trend of volatility will continue, we will pay attention to the general election as well as geopolitical risks associated with North Korea.