

Minutes of the Fourth Round of the "Bond Market Group" Meetings

1. Outline

- | | | |
|-----------|--------------------------------------|-----------------------|
| (1) Date | Commercial banks group (22 firms) | December 6 at 4:00 pm |
| | Securities firms group (24 firms) | December 6 at 5:30 pm |
| | Buy-side group (20 firms) | December 7 at 4:00 pm |
| (2) Place | The Head Office of the Bank of Japan | |

(3) Participants

- Persons in charge of bond market issues in financial institutions, participating in the "Bond Market Survey"
- Director-General of the Financial Markets Department, Head of Coordination and Market Analysis Division, Head of Market Operations Division, Head of Market Infrastructure Division

2. Introduction by the Bank of Japan

- The Bank explained to each group (1) the results of the "Bond Market Survey," (2) liquidity in the JGB market, and (3) recent developments in the financial markets and market operations.

3. Views provided by participants

- The Bank exchanged views with participants on the above topics. Views provided by participants are as follows.

Japanese bond market after the introduction of "QQE with Yield Curve Control"

- There is a sense of reassurance among investors as volatility in the Japanese bond market has declined as a result of yield curve control and the 10-year JGB yields have recently turned positive.
- One reason for the DI of Japanese bond market functioning in the November

2016 Bond Market Survey becoming less negative can be pointed out to be an improvement of the investment environment for long-term JGBs after the introduction of yield curve control as the yield curve has steepened moderately.

- Investors have recently been able to trade with a sense of ease, thanks to tighter bid-ask spreads as a result of low volatility. However, the yield level is still extremely low and there are concerns that if such condition persists for a long period of time, investors may gradually leave the market.
- When we look at trading volumes in the Japanese bond market, it is still hard to argue that the trading in the market is active. The current situation in the market is one in which only certain liquidity indices, such as bid-ask spreads, have improved under limited trading.
- The profitability of transactions in the Japanese bond market seems to have declined after the introduction of yield curve control as volatility has been dampened and expectations for higher yields in the future prevail.
- Some used to make profits from transactions that took advantage of market volatility. But such transactions cannot be made these days as market volatility declined after the introduction of yield curve control.
- In the current Japanese bond market, many investors tend to take the same investment actions. Normally, transactions among investors with different market views create liquidity in the market, but that is not the situation in the market these days.
- The price discovery function of the Japanese bond market has clearly declined since the introduction of yield curve control. It is becoming difficult to draw market participants' prospects on economic activity and prices from the movement of interest rates.
- Investors' interest in JGBs seems to be decreasing due to the dampened market volatility after the introduction of yield curve control, as well as to the low yield level caused by the negative interest rate policy.

Impacts of rising overseas interest rates

- Amid rising overseas interest rates since the U.S. presidential election, the Japanese bond market nowadays seems to be returning to its healthy state, as investors' future expectations of interest rates have started to vary.

- The rise of domestic interest rates is limited and volatility is low, even with the overseas interest rates rising. This can be attributed to market participants' prospect of interest rates being implicitly formed within a limited range under yield curve control.
- Domestic interest rates have remained stable amid the worldwide upward pressure on interest rates since the U.S. presidential election. It seems as if upward pressure on interest rates is accumulating like "magma" in the Japanese bond market.
- When we think of future developments of the Japanese bond market, trends in overseas financial and capital markets, especially whether the rise of interest rates will continue, are the points to watch.

The Bank's Operations

- The fixed-rate purchase operation conducted on November 17 is considered a strong manifestation by the Bank to control the entire yield curve. To achieve the 10-year JGB yield target, it is important to control the short- to mid-term JGB yields, mainly 2-year and 5-year JGB yields. It seems that the fixed-rate purchase operation was effective.
- As an operational response to a rise in interest rates, increasing the amount of JGB purchases was considered to come first and then if necessary fixed-rate purchase operations would come in addition. However, by looking at the Bank's response on November 17, it is now understood that fixed-rate purchase operations, which have the advantage of being flexible and speedy, would be used first if the pace of interest rates rise is fast.
- We are paying attention to when and how market operations will be conducted if super-long-term JGB yields continue to rise in the future.
- While yield curve control is currently suppressing a rise of domestic interest rates, we are concerned about a possible sudden rise of interest rates' volatility under such a framework.
- Even though it depends on future developments in economic activity and prices as well as financial conditions, a time will likely come when the Bank considers changing the interest rate target. Since those changes will have large impacts on bond portfolios of financial institutions, we would like to ask the

Bank to have proper communication with market participants at such times.

Impacts of financial regulations

- It seems that some securities firms have come to be less active in market-making using balance sheets due to financial regulations.
- Financial regulations do not seem to have large impacts on trading in the Japanese bond market at present, but there is a concern that complete implementation of various financial regulations in the future may lead to lower liquidity in the market.
- Under the continued low interest rate environment, we are concerned that the regulation of interest rate risk in the banking book may lead to an even lower incentive for banks to invest in JGBs, depending on the manner in which it is applied in Japan.
- It is necessary to extend the duration of assets in line with liabilities if we consider the economic value-based risk management. The problem is that extending the duration of assets would significantly lower the profits, as assets with long durations have extremely low yields at present.

Environment surrounding foreign currency funding

- It is becoming more difficult for Japanese financial institutions to fund foreign currencies due to impacts of some regulations.
- We are concerned about whether the dollar funding cost will remain at high levels for a period of time.