December 21, 2017
Financial Markets Department
Bank of Japan

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

1. Outline

(1) Date	Commercial banks group (24 firms)	December 6 at 4:00 pm
	Securities firms group (25 firms)	December 6 at 5:30 pm
	Buy-side group (22 firms)	December 7 at 4:45 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. The Bank also explained that it would consider introducing new liquidity indicators of the JGB market.

3. Views provided by participants

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

<u>Recent Japanese bond market and its outlook</u>

- ➢ More than a year has passed since the introduction of yield curve control. During this time, yield curve control has been functioning steadily, and yen yields have been stable even when overseas interest rates fluctuated.

- Recently, due to the flattening of the U.S. yield curve and an increase in the cost of currency hedging, investment in foreign bonds is less profitable. This has led to fund inflows to the JGB market.
- Bond market volatility remains at a low level. For some market participants, this may make it easy to invest in JGBs. On the other hand, those such as securities firms which mainly earn profits by trading may view this situation as adverse.
- Although the bond market is stable and is giving off a sense of reassurance, it has become more difficult to form efficient portfolios. This is because bond prices, which in theory should be inversely correlated with stock prices, show little response even in a situation where stock prices fluctuate significantly.
- In regards to the outlook for the bond market, it will be highly susceptible to the Bank's monetary policy, given that there is no other major market material to be considered. As the term of office of both the governor and the deputy governors will expire next year, we are paying close attention to the possibility and the timing of policy changes and what will trigger market participants to start factoring them into their market decisions.
- The yield curve has been controlled smoothly since the last meeting. This is partly because overseas interest rates have not risen significantly during this time. We suppose that the feasibility of yield curve control will be challenged when strong upward pressure on interest rates is generated by overseas factors.

<u>Functioning and liquidity of the Japanese bond market</u>

- In the current bond market, there is a sense of ease in making investment decisions as yen yields are highly predictable against the backdrop of the Bank's close communication with market participants and highly transparent market operations.
- However, it should be also noted that, as time has elapsed since the introduction of yield curve control, market participants have come to take the shrunken market size into consideration and limit the trading size per transaction so that they can execute their transactions smoothly.
- Under the persistent low yield and low volatility environment, both the number of market participants and transaction volume are decreasing.

- Although objective indicators and survey results on bond market functioning and liquidity show various views, a feeling gained through actually conducting transactions is that market functioning and liquidity are clearly declining.
- Market liquidity is seemingly high as the bid-ask spread is tight and the number of best-ask orders is sufficient. However, this is merely a result of the low volatility brought about by yield curve control.
- It has become especially difficult to conduct transactions of off-the-run issues because of the increasing share of the Bank's holdings. Recently, the market has occasionally fallen into an unprecedented situation in which neither an offer nor a bid is submitted.
- Under this circumstance, there are concerns about whether the market will function if investors sell a vast amount of off-the-run issues. Market participants have no choice but to reduce the trade size of off-the-run issues as the repo market is not functioning very effectively either.
- The price discovery function of the bond market seems to be deteriorated. Many market participants have come to pay little attention to economic indicators and fundamentals, and hence yen yields react almost only to the Bank's operations.
- Under the recent low yield and low volatility environment, JGBs are unattractive as an investment option. Therefore, we are shifting resources including human resources from domestic to overseas markets, from bonds to credit products, and so forth.
- If the current market environment persists for a long period of time, there will be a large number of market participants, especially those who have started their careers recently, who have never seen the JGB market being volatile. In this sense, there are concerns about whether market-making can be conducted properly when interest rates start rising in the future.
- There are concerns that, once the number and the skill of market participants decline to certain levels, it might take time for bond market functioning to recover even after the "exit."
- It would be appreciated if the Bank could keep monitoring liquidity of the JGB market from multiple angles and introduce various liquidity indicators.

The Bank's operations

- There is a sense of reassurance about the Bank's operations. They are conducted with close attention paid to the market.
- There may be no need for the Bank to continue purchasing T-bills in a situation where their supply and demand conditions are tight due to overseas demand and domestic collateral needs.
- If the government is going to reduce the amount of JGB issues for the next fiscal year, we would like the Bank to decrease the amount of JGB purchases as well.
- We suppose that the Bank should start decreasing the amount of JGB purchases under current favorable market conditions in order to prepare for the smooth transition to the "exit" in the future.
- In order to improve the liquidity of off-the-run issues, the Bank may consider market operations in which it supplies off-the-run issues to the market and purchases on-the-run issues.

Initiatives to shorten the settlement cycle of JGBs to T+1

- In regards to shortening the settlement cycle of JGBs to T+1, preparations are steadily advancing in terms of operational arrangements and system developments.
- All participants have completed previous running tests without problems. While we are slightly concerned about whether transactions at late hours will be conducted without delay after shortening the settlement cycle of JGBs to T+1, we will prepare sufficiently through the next year's running test which targets various market participants.
- We care about how repo market liquidity will change after shortening the settlement cycle of JGBs to T+1 in May 2018.