Summary of Discussion at Financial Markets Panel
(Thirty-seventh Meeting)

May 20, 2016

Topic: Policy Issues for the central banks in US and Eurozone

Date: March 14, 2016 (1:30pm – 2:00pm)

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Key Discussion Points

1. **Lead comments and rejoinders (US)**
2. **Survey results and free discussion (US)**
3. **Lead comments and rejoinders (Eurozone)**
4. **Survey results and free discussion (Eurozone)**

Summary of Comments

1. Lead comments and rejoinders (US)

Inoue (Moderator):

・We will discuss current economic and financial conditions in the US and the Eurozone along with central bank policy, touching on the points brought up in the keynote addresses. Although I have already asked panelists in advance to cover certain points, we will take a flexible approach today and have a period of free discussion.

Mr. Kato:

・I would like to focus my comments on FRB's monetary policy. After the global financial crisis in 2007-08, central banks in some countries and areas—including New Zealand, Australia and Europe—quickly began raising interest rates, but were subsequently forced to cut rates. In contrast, the FRB was very patient, waiting until share prices had exceeded the pre-crisis peak by about 30% before moving to raise rates. While some are concerned about rate hikes amid a mature economic cycle, the mainstream view at the FRB is that it is now acceptable to raise rates since it waited for so long.

・The FRB is closely watching employment and wages, and a key leading indicator of the latter is the job leavers ratio. Since US employers typically do not raise base pay, employees must move from one company to another to earn higher wages. The job leavers ratio has risen markedly in recent months, and the trend is upward even if there are fluctuations along the way. I therefore suspect FRB officials are not pessimistic on the subject of wage inflation.

・The annual rate of change in core PCE, the FRB's preferred measure of inflation, has now climbed above 1.5%. The various inflation indicators compiled by the regional Feds are also accelerating, and even if they do not point to an imminent overheating of price pressures, I think the dominant view at the FRB is that it would be inappropriate to leave the policy rate at or around zero. Core CPI inflation recently broke above 2%. While the goods component of this index continues to fall on annual basis, the prices of rent and other services are accelerating. I suspect this may be due in part to the wage trends noted earlier.

・FOMC members' median forecast as shown in the committee's December "dot chart" implied four rate hikes a year. The market, viewed through the lens of federal funds futures, is taking a much more guarded view of the situation. While FOMC members are likely to revise down the expected number of rate hikes per year when they meet in March, the wage and price conditions noted above suggest the FOMC will not be as cautious as market participants are. Attention will also focus on the number of rate increases expected in 2017. If the FOMC simply wants to delay the start of rate rises it will probably opt for four hikes in 2017, while doves may seek a continuation of the cautious pace of 2016 and hawks may want more rate increases in order to make up for lost time.

・The problem for the FRB is that communications regarding its forecasts for the pace of future rate hikes are not functioning

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properly. The market's tendency to focus on the FOMC's median forecasts makes it difficult for the FRB to flexibly adjust policy in response to changes in the financial and economic environment. Rate hike expectations also have an impact on economic activity via a stronger dollar, and the effective dollar rate has increased appreciably in both nominal and real terms. The FRB wants to share the uncertainty of its forecasts with the market and is now considering the use of fan charts as one means of achieving this. However, these will not be ready in time for the March FOMC meeting, and in any case adopting them now risks destabilizing the market since the lower end of the chart would include negative interest rates.

・Draining current account balances (excess reserves) is another important aspect of the normalization of monetary policy. Last January the New York Fed presented its forecasts for the decline in current account balances if the FRB were to discontinue the reinvestment of principal payments. Since the reinvestment policy is still in place today, the envisioned path of decline will be delayed by another year or so. In any event, the FRB will have to raise rates at a time when huge amounts of excess reserves remain in the system. Moreover, as noted by Mr. Yamasaki, more restrictive financial regulation has led to the interruption of capital flows despite the ample reserves. For example, banks have sought to keep their end-of-month risk assets in check by avoiding uncollateralized funding, and as a result the federal funds rate has a clearly expressed tendency to fall sharply at the end of each month. In reaction, repo rates tend to surge higher at the end of every quarter.

Mr. Oshima:

・I would like to comment on the situation in the US from the perspective of someone who watches the markets from a bank perspective. As for the relationship between FOMC forecasts and market views noted by Mr. Kato, the median forecasts in the dot charts were largely consistent with the numbers being priced in by fed funds futures over the last two years or so. After former Chairman Bernanke signaled in May–June 2013 that the FRB was preparing to taper the QE, the market's view converged on that outcome. But a relatively wide gap then opened up between the two, and the market began to ask whether the 3.5% neutral rate of interest indicated by FOMC members was realistic in light of changes in the global economy and the potential growth rate of the US. This divergence in views has been one of the causes of market instability, and the question of how this gap is to be filled will have critical implications for forecasts of future rate hikes. While the "dot charts" initially functioned well as a tool for forward guidance, the side effects of these charts have recently become increasingly evident.

・Factors other than monetary policy with the potential to influence interest rates include divergences in national fundamentals and economic policy along with trends in asset prices and financial regulation. However, not all of these factors are pushing in the same direction. There is also a growing influence from a variety of issues that were not well understood historically, including the global decline in labor productivity, geopolitical risk, structural problems in Europe's economy and financial sector, and China's economy. Parts of the US economy—including the housing market and auto sales—are extremely strong, and inflation appears to be accelerating, but that has not led to improvements in the potential growth rate.

・As central banks maintain policies intended to depress long-term interest rates, banks' net interest margin continues to trend lower in both Japan and the US. Japan has also begun administering the powerful monetary drug of negative interest rates. In response to the low interest rate environment in the US, banks are increasing their held-to-maturity investments in mortgage bonds, while their holdings of available-for-sale securities have not grown substantially. Unrealized gains or losses on the latter impact directly on bank capital, and amid today's high market volatility banks apparently prefer to lock in longer-term spreads. Meanwhile, there is little momentum behind lending growth. Although there is substantial borrowing demand, banks are being hobbled by balance sheet constraints under tougher financial regulation.

・The velocity of money continues to decline as money supply growth has been modest at best despite the huge amounts of liquidity supplied by the G10 central banks (and not just the BOJ, the FRB and the ECB). It is difficult for the authorities to lift economic growth rates with velocity at such low levels. From a broader standpoint, financial assets have been growing since before Lehman's collapse, opening up a widening rift with the real economy. The key questions here are how to reduce that gap and whether or not financial assets will destabilize the real economy in the meantime.

・The map of global government bond yields prepared by Mizuho Research Institute's Takata shows the continuous proliferation of negative yields. While Japanese government bonds used to be located near the middle of the chart, now they are the second lowest in the world after Switzerland. In contrast, US Treasury securities remain attractive for their high credit ratings and high yields. Inasmuch as the countries offering higher yields also have questionable fundamentals, conditions will remain conducive to inflows of funds to the US bond market. From the standpoint of the

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US authorities, further declines in interest rates could create excesses in light of the fundamentals, while increases in rates have the potential to trigger dollar appreciation or destabilization in overseas markets. It is a fine balance.

Inoue (Moderator):

・Does anyone else have anything to say about the US?

Mr. Takata:

・The divergence between the FRB's forecasts for the path of rate hikes and the market's view is a crucial point. I suspect the gap is attributable to the fact that today's world can no longer be understood using empirical rules of thumb alone. The tightening phases experienced by Ms. Yellen and other policymakers since the 1970s typically consisted of about 400bp in rate hikes. That the "neutral rate" indicated on the current "dot chart" shows a similar forecast for the current cycle suggests that many FOMC members expect the current series of rate hikes will largely echo past tightening phases. However, the developed economy government bond yields shown on my yield map are lower than at any time in human history. Only US Treasury securities continue to offer both high credit ratings and positive yields, and they have become the buoy towards which struggling global investors are swimming. It is therefore difficult to say just how far the dollar might rise if US interest rates were to rise. Pushing ahead with rate hikes based on a traditional approach under such unusual conditions is, at the very least, a departure from the reality of current economic and financial conditions.

・Another concern is that Chair Yellen and other members of the FOMC's mainstream faction are describing the current rate hike cycle as a "normalization" of interest rates. This is similar to the situation in Japan in 2000 when the BOJ wound down its zero-interest-rate policy. In short, the central bank is trying to argue that monetary policy remains accommodative even though it is raising rates. I have referred to this as the "Hayamification" of Chair Yellen (after then-BOJ Governor Hayami). While it is understandable that a central bank would use this rationale, I cannot help but question whether there is really a need to raise rates. When the FRB hiked rates last December, the ISM index was below 50 and there were few concerns about an acceleration of inflation. Ordinarily the role of a rate hike is to snuff out the flames of excessive economic or price growth. Did the FRB realize that extinguishing the flame in the US would do the same for the entire global economy? I think a non-traditional approach was probably called for here.

Mr. Egawa:

・US monetary policy is conducted basically for the sake of the US economy and other economic regions where the dollar is used. Since the US dollar is a reserve currency, US Treasury securities are held by many investors outside the US. The concern is that if the FRB is the only major central bank to hike rates and the ECB and the BOJ adopt more accommodative policies, capital flows will concentrate in the US. That said, it is not so easy for Japanese investors, at least, to expand their investments in US Treasury securities since the elevated cost of dollar funding (via USD/JPY basis swap spreads) and the corresponding cost of currency hedging prevents them from earning a reasonable spread. The current elevation of basis cost, which should be determined by the difference between short-term rates, is due largely to the fact that more restrictive financial regulation has placed new constraints on interbank lending. Additionally, if expectations for higher US interest rates emerge, investors will have to take a cautious approach towards US bonds if they hope to avoid potential capital losses. For Japanese investors, who use a currency that is not pegged to the US dollar, it is not particularly easy to hold Treasury securities and other US dollar investments at the current time.

2. Survey and free discussion (US)

Inoue (Moderator):

・I would now like to ask the audience today to complete a brief survey. The first question concerns the number of times the FRB will raise rates in 2016. About half of you answered "two" and a third, "one." The next most common reply was "zero," with about 15% of replies, while only 2% saw the FRB raising rates three times or more this year. The second question concerns the justification for hiking rates. Answers 1 and 2 were employment and inflation, the twin components of the FRB's "dual mandate." Answer 3 was to prevent financial "excess" due to a continuation of low interest rates, something also emphasized by Fed Vice Chairman Fischer. Answer 4 was included to capture all other factors. The most common reply was inflation, with 43% of all responses, but the prevention of excess garnered an unexpectedly high one third of all responses. Employment came in at a surprisingly low 13%.

Mr. Kato:

・The quandary for the FRB is that it cannot openly present its rationale for normalizing the policy rate and proceed to hike rates. The FRB was the first to carry out QE and as a result the US economy was the first to recover, in part because the dollar fell against other currencies. When Japan and the Eurozone subsequently implemented their own versions of QE, which led to declines in the value of EUR and JPY, the FRB had to tolerate those currency moves. And at a time when the emerging economies are not recovering, the FRB cannot raise rates as

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quickly as it would like because of concerns about the economic impact of a strong dollar. The fact that the official statement from the latest meeting of G20 finance ministers and central bank governors included a warning against excessive reliance on monetary policy probably reflects the fact that the US would suffer if the Eurozone and Japan were to push ahead with further accommodation. It will therefore become increasingly difficult to achieve international coordination under these conditions.

・It will probably take until 2023 for the FRB to "normalize" the level of excess reserves, and between now and then there are likely to be business cycles. The argument could be made that the "new normal" will involve conducting monetary policy at a time of massive excess reserves. The concern, however, is that excessive risk-taking will spread if more market participants start to expect excess liquidity will remain in the system for an extended period of time. Justifying rate hikes in this sort of environment will be very difficult for the FRB.

Mr. Oshima:

・I expect the FOMC will leave policy on hold when it meets in March, but I answered "two times" to Question 1. The FRB will be careful to avoid triggering instability in global financial markets, but I project it will raise rates in line with the fundamentals once the markets regain their composure and a recovery path emerges for the global economy. In other words, "two times" represents FOMC members' current scenario. "Zero time" is also a possibility depending on future developments.

・With so many excess reserves in the system, it remains to be seen whether the FRB can actually wait for inflation to climb above 2%. The FRB's normalization strategy, which involves raising interest rates while the liquidity remains in the system, is a reflection of its emphasis on financial stability. If rate hikes continue, therefore, I think the FRB may deepen its dialogue with market participants regarding the normalization strategy in light of conditions in global financial markets and US fundamentals.

Mr. Takata:

・My answer for the number of rate hikes in 2016 was "zero," but I think the more common response of "two" is also a possibility. It would be embarrassing for the FRB to raise interest rates only once, and if the economy subsequently weakens, a single hike would leave the central bank open to the criticism that it should not have raised rates at all. Additionally, the current economic expansion in the US will not last forever, and I suspect the FRB wants to give itself room to cut rates in response to the next recession. FRB officials may fear that unless they take advantage of every opportunity to raise rates now, they will be forced to rely on negative interest rates during the next downturn. But raising rates for this kind of reason is a very risky proposition for the markets.

Mr. Egawa:

・I predicted two rate hikes in 2016 because I thought it would be difficult for the FRB to push ahead with numerous increases at a time of continued "risk-off" sentiment and concerns about the emerging economies.

・Bank lending rates are extremely low in Japan, and many blame monetary accommodation for the pressure on banks' lending spreads. Similar arguments can be heard in the US, although the absolute level of earnings there is much higher than in Japan. The net interest margin in Japan, for example, is zero or negative, while in the US it is substantially higher. The absolute level of lending rates is less than 1% on new loans in Japan, whereas in the US banks are lending new money at rates of more than 3%. It is interesting that banks' behavior is so different in the two countries when the monetary environments are so similar.

3. Lead comments and rejoinders (Eurozone)

Inoue (Moderator):

・Now I would like to move on to the Eurozone.

Mr. Takata:

・Low inflation is also behind the adoption of negative interest rates policy (NIRP) in the Eurozone and northern Europe. That said, Eurozone growth rates are expected to be in the respectable range of 1.0% to 1.5%. What are policymakers so worried about if the region does not suffer from the low growth and deflation that characterizes Japan? I suspect it is structural problems, and particularly the question of how to address imbalances within the Eurozone. Under a common currency, large gaps in competitiveness are bound to emerge between countries like Germany and Greece. Similar disparities exist within Japan between, say, Tokyo and rural areas. That the yield spreads in Tokyo do not differ significantly from those elsewhere in the country is due to the central government's use of fiscal policy (including transfers to local governments) to level the playing field. The Eurozone has no mechanism for fiscal transfers and demanded extreme fiscal austerity from countries with weak fiscal structures. As a result, the so-called PIIGS began reporting balance of payments surpluses, in part because of improved competitiveness owing to a weak-EUR policy.

・My map of global yields shows that government bond yields in the PIIGS are still higher than those in Germany, but have fallen dramatically compared with a few years ago. While authorities

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succeeded in "neutralizing" the European debt crisis, they did so via tough austerity policies that put stresses on domestic demand and led to higher unemployment rates. I think the ECB adopted NIRP to boost external demand via weaker EUR. Countries in the Eurozone are now running larger current account surpluses than those in other regions. Since the 1970s it was the countries running large current account surpluses, such as Japan in the 1980s and China after the global crisis, that were asked to serve as the engines of global economic growth. Today, however, the Eurozone is pushing ahead with beggar-thy-neighbor policies in the form of fiscal austerity and NIRP (and correspondingly weak EUR). That is dragging the broader global economy into a "black hole" of deflationary pressures.

・US households moved ahead with balance sheet adjustments after the global financial crisis in 2007–08. In contrast, European banks maintained high loan-to-deposit ratios (Germany is the one exception, with a ratio of less than 100). In this sense, it faces problems similar to those of Japan during its financial crisis in the 1990s. Additionally, European banks' bad loan ratios are not only high overall but are still increasing in some countries. When it comes down to the mix of fiscal and monetary policy, fiscal policy is effectively shut out of the mix, leaving a distorted policy mix consisting of extreme monetary accommodation (including NIRP) and weak-EUR policy. Inflation remains low despite the monetary easing, but housing prices are starting to rise, and the question is how the ECB views this situation.

Mr. Egawa:

・In October 2014 the ECB decided to begin buying ABS and covered bonds. Purchases of covered bonds began immediately, and purchases of ABS commenced in November 2014. One reason why the central bank began buying ABS early on was to encourage banks to lend to small businesses. Although the ECB has been buying ABS for 16 months now, however, cumulative purchases as of end-February 2016 stood at just 18.6 billion euros, or about ¥2.4trn. This represents a mere 1.5% of outstanding euro ABS issuance (approx. 1.2 trillion euros) and only 0.6% of the central bank's total assets.

・The reason for this unimpressive results can be traced to how the securities are purchased. The ECB's guidelines require it, in principal, to acquire only the most senior tranche of such securitizations. Mezzanine tranches can also be purchased, but only if guaranteed. The senior tranches eligible for purchase by the ECB are considered safe assets that are expected to be fully repaid even in the event of higher than expected loan losses. In the case of diversified loan securitizations, the rating agencies often assign these senior tranches AAA ratings or at least ratings that are somewhat higher than the corresponding sovereigns. The credit risk is concentrated in the subordinated tranches, which remain on bank balance sheets even if the ECB buys the senior tranches and which in practice are difficult to sell to other investors. So while the central bank's purchases of ABS may make it easier for banks to raise funds, they cannot be expected to ease bank capital constraints. Addressing this problem will require the support of third parties, such as when the EIB began taking on ABS credit risk in March 2014.

・In Italy, four banks failed around the end of 2015 as the bad debt crisis deepened. The European Commission decided that plans for Italy's Interbank Deposit Protection Fund to contribute funds to the failed lenders represented a form of government assistance that undermined private-sector's fair competition. As a last resort, the Italian central bank securitized the loans held by the failed lenders and had the newly created securities guaranteed by the Ministry of Finance. This was the first instance in Italy of the use of securitization to dispose of non-performing loans utilizing government guarantee.

・As of end-February 2016 the ECB had purchased a total of 158.3 billion euros in covered bonds, placing them somewhere between ABS and government bonds in terms of the scale of buying. Covered bonds are a special type of debt security issued by financial institutions. Since they have no seniority structure and have the same characteristics as the senior tranche of an ABS, they are identical to ABS in the sense that while purchases by the ECB can make it easier for banks to raise funds, they do not reduce credit risk or ease capital constraints.

4. Survey results and free discussion (Eurozone)

Inoue:

・I would now like to conduct a survey. Question 3 concerns the expected impact of the ECB's recently announced easing measures. The central bank announced a variety of measures, but for now I would like to focus on the enhancements to NIRP and the Bank's asset purchases. A summary of the survey results shows 40% of respondents expecting little or nothing from the new measures and roughly the same percentage expecting them to have an effect only on the market. Just one fourth of respondents thought the measures would have a meaningful impact on the economic fundamentals. Question 4 asked what policy measures should receive the greatest focus in the Eurozone policy mix going forward. Possible answers included fiscal policy, monetary policy, financial system policy, and others. By far the most common reply was "fiscal policy," with 60%, followed by "measures to stabilize the financial system" and "other" with slightly more than 10%

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each and “monetary policy” with just 1%.

Mr. Oshima:

・In the leading European economies, the banking sectors in Italy, Spain and France all have loan-to-deposit ratios in excess of 100%. A reduction in bank funding costs via the ECB monetary accommodation plays a meaningful role in that sense. Italian banks are clearly adopting a less restrictive lending stance, and demand for loans in Europe's main economies— including Italy and Spain—is also picking up.

・The ECB's recent easing measures represented a “full package,” and I think two points were especially important to note. One was ECB President Draghi's remark suggesting the ECB would be hesitant to take rates further below zero. The markets seemed to view this as a slip of the tongue, but I think Mr. Draghi's comment—along with his remark suggesting that the ECB had considered (but ultimately rejected) the sort of tiered system adopted by the BOJ—can be interpreted to mean that TLTRO II, which had the impact of communicating the ECB's consideration for banks and the financial system, can be expected to ease financial system concerns and support bank credit creation at a time when Eurozone financial markets continue to suffer from segmentation. Inasmuch as the Eurozone is characterized by an extremely high reliance on bank lending, I think it was fortunate that the ECB took the view that banks are an important part of the policy transmission mechanism and therefore chose not to rely entirely on NIRP.

Mr. Kato:

・In spite of the bold easing measures announced, the markets responded negatively to Mr. Draghi's indication that the ECB was done cutting rates. Since then, market participants have been taking another look at the easing package. But inasmuch as EUR has not fallen against USD and given the reaction to the BOJ's announcement of NIRP in January, I suspect market participants have lost their faith in the ability of central banks to work miracles. News reports in Europe have tended to emphasize the view that the ECB's asset purchases will have little impact or will actually do more harm than good. I have no doubt that the ECB worked hard to compile the recent easing package, and as Mr. Oshima noted it will probably have some effect, but I do not expect a striking policy impact such as a full-blown resurgence of inflation expectations.

・Many in Europe are arguing that NIRP should have been introduced before QE. Not only will NIRP serve as a disincentive for banks to sell assets to the ECB, but a negative rate of interest on banks' excess reserves represents a major cost for them. Additionally, there are some 6,000 eurozone financial institutions with current accounts at the central bank, and wide variances in both their business models and the distribution of their funds means it would be difficult to adopt a tiered structure that is fair to such a broad range of institutions.

・Moreover, there are ongoing arguments in Europe over whether 2% constitutes an appropriate inflation target. The general populace would understand the need for action if measures had to be taken to slow elevated inflation rates to around 2% or to pull the economy out of deflation. However, many question why all the monetary policy measures need to be pulled out in order to raise the inflation rate from somewhere in the 0–1% range to 2%. In Sweden, for example, these efforts have fueled a housing bubble. In Germany and France as well, there are growing concerns about the long-term impact of powerful monetary easing measures. Hence there is growing attention on the matter of what constitutes an appropriate policy mix.

Inoue (Moderator):

・I would now like to accept questions from the floor.

A gentleman in the audience:

・The reference materials provided by Mr. Kato show trends in short-term interest rates. How should we view the relationship between the federal funds rate, the GC repo rate, and the tri-party repo rate? And why has the federal funds rate fallen below 0.4% when the Fed wants to guide the policy rate to around 0.5% given the December rate hike?

Mr. Kato:

・There was not much difference between the three rates you mention until 2015. The spread between the GC repo rate and the tri-party repo rate in particular has widened since then. The GC repo rate is used mainly for funding transactions between securities companies, while the tri-party repo rate is used for funding transactions between institutional investors (such as MMFs) and securities companies. As such, the disparity in short-term rates would appear to reflect differences in the creditworthiness of the participants. It may be that the tri-party repo rate has been kept in check by investors' preference for creditworthy securities companies, whereas with the GC repo rate there are cases of small securities companies using collateral to obtain funding, resulting in higher lending rates.

・It makes no sense that the unsecured federal funds rate is lower than the (Treasury-secured) repo rate, but institutions like Freddie Mac and Fannie Mae that do not receive any interest on their deposits with the FRB must park their funds somewhere, and with foreign banks able to borrow this money on the federal funds market and deposit it with the FRB at a profit, it is hard for the fed

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funds rate to rise. This diversity of market participants therefore makes it difficult for the FRB to guide the federal funds rate to the desired level. Still, inasmuch as the New York Fed was worried about its ability to continue guiding market rates after the December rate hike, I think it is probably quite satisfied with the current degree of control.

Inoue (Moderator):

・If there are no other questions, I would like to conclude this session with some closing remarks by Mr. Egawa and Mr. Takata, who we had to leave out because of time constraints.

Mr. Takata:

・The ECB had to carry out further easing at its recent meeting because it had hinted an easing at the January Governing Council meeting. And to the extent that the measures taken at last December meeting were judged insufficient by market participants, it probably needed to deliver a full package of measures this time. However, I suspect there were constraints stemming from the fact that the Governing Council meeting came immediately on the heels of the G20 meeting, and that may have led to the comment by President Draghi noted above. Additionally, as Mr. Kato pointed out, the European media and the BIS have been talking about the limits to monetary policy. In that sense, I think NIRP represent the end of Round 1 in Japan and elsewhere. The next question is how authorities in Japan, the US and Europe will address this unprecedented phenomenon of negative government bond yields.

Mr. Egawa:

・To the extent that banks play a central role in financial intermediation in both the eurozone and Japan, I think the ECB's recent policy decision and the impact thereof will be very instructive for Japan.

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