Summary of Discussion at Financial Markets Panel
(Forty-second Meeting)

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Topic	Environment for BOJ monetary policy and outlook for “normalization”
Date	August 8, 2017 (6:00pm – 8:30pm)
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Key Discussion Topics

1. **Environment for BOJ monetary policy**
2. **Outlook for normalization of BOJ monetary policy**
3. **Costs and benefits of QQE**

1. Environment for BOJ monetary policy

Inoue (Organizer):

・In light of our last discussion, we would like to discuss the longer-term implications of the monetary policy environment for Japan, including a discussion of the BOJ’s “comprehensive assessment.” Factors that need to be considered include the relationship between inflation and the potential growth rate and between inflation and the output gap, the possibility of external shocks, and the resilience of Japan’s economy to such shocks. And since the BOJ is effectively partly responsible for the nation’s debt management policy, the mix of monetary and fiscal policy and measures to ensure financial system stability are also worth discussing.

・The current environment for monetary policy is noted in the reference materials. While the latest Outlook Report offers bullish forecasts of the output gap, the BOJ’s inflation projections have not improved. In fact, a majority of Policy Board members are focused on the downside risks to prices. There have clearly been improvements in the output gap, with both Cabinet Office and BOJ estimates now in positive territory. Labor market conditions are fairly tight even after stripping out the effect of the labor participation rate, and the unemployment rate is actually below the level indicative of full employment. But inasmuch as the Phillips curve has taken on a pronounced flatness, inflationary pressures are unlikely to emerge without substantial additional improvements in the output gap.

・A wide gap exists between the baseline case and the “economic revival” scenario in the Cabinet Office’s medium-term economic and fiscal forecasts. In the base-case scenario, Japan’s real GDP grows by less than 1% a year in the medium to longer run, and inflation hovers around 1%. This would make “normalization” impossible under the framework of Quantitative and Qualitative Easing (QQE). The Japan Center for Economic Research’s ESP Forecast, which compiles the projections of private-sector economists, points to a similar conclusion.

Ishikawa (Secretariat):

・According to the IMF’s forecasts for overseas economies, the global economy will continue to grow at a rate of about 3% a year, but growth in key countries and regions such as the US, the Euro Area, and China is expected to slow modestly, which may imply a gradual decline in external demand for Japan.

・A simple estimate of household inflation expectations based on the Cabinet Office’s Consumer Confidence Survey (“Price expectations a year ahead”) suggests that expectations rose to around 3% in 2014 before commencing a gradual decline that has taken them down to about 2% today. The percentage of households projecting inflation of 2% or more has fallen from 70% to less than 40%, and a growing number expect prices to rise by 0-2% or to stay flat. Corporate inflation expectations have also declined gradually and are now hovering around 1%.

・In its April *Financial System Report*, the BOJ noted three points to watch regarding financial stability. The first was the pick-up in financial intermediary activity in the real estate market. The BOJ noted that while the real estate market as a whole is not particularly overheated, investment amounts are increasing across a wider range of districts, and there is a risk of excessive declines in risk premia and overly bullish rent forecasts. The second point concerned financial institutions’ resilience to stress. The BOJ said financial institutions have solid capital bases on the whole, but the levels of net profit and equity capital remaining after stress tests vary substantially. Third, the BOJ cited financial institutions’ declining earnings power. It argued that at a time when the demand for financial services is declining—partly because of demographic factors—the competition-fragility view, which holds that competition between banks will increase their fragility, is particularly applicable to regional financial institutions. It also noted the risk that excessive risk-taking by financial institutions could impair financial stability at a time of shrinking loan-to-deposit spreads. I suspect this decline in earnings power will also weigh on the real economy by weakening banks’ ability to function as financial intermediaries.

Inoue (Organizer):

・Today we would like to consider the outlook for BOJ policy under this longer-term external environment. Such discussions often incorporate the word “normalization” in their title, following the practice in the US, but this term implies that some previous state was “normal” and involves a value judgment that it is desirable to return to that earlier state of affairs. But once an economy has undergone structural changes due to a financial crisis or other major shock, it may not necessarily be optimal to return to that earlier state. In that sense, it might be preferable to use a more neutral expression, but here we will use “normalization” for the sake of convenience.

・Issues to be discussed regarding the outlook for monetary policy normalization include the sequence to be followed and the question of what policy tools should be utilized after normalization. As for the former, the US and Europe, which started the normalization process before Japan, have opted to end quantitative easing first, then raise policy rates, and finally reduce the size of their balance sheets. To the extent that quantitative easing was an emergency measure taken when the policy rate encountered the zero nominal bound, it makes sense to end it as soon as the emergency is over, and the central banks may also be watching the changing balance of benefits and side effects brought about by the policy. As for rate hikes, both the FRB and the ECB seek to restore the policy rate to its traditional role as the primary policy tool because its effects are predictable and it is operationally easy to use.

・In the Euro Area, however, the existence of a Negative-Interest-Rate Policy (NIRP) complicates the discussion. The prevailing view in the market is that the ECB will commence raising rates as soon as it finishes winding down quantitative easing. However, many market participants are also of the view that NIRP will be revised before quantitative easing is brought to an end. Banks’ loan-to-deposit spreads continue to shrink in the Euro Area, and the findings of the ECB’s Lending Survey suggest there are limits to how far financial institutions can cope by raising fees. As such, I think banks are becoming increasingly unhappy with NIRP, and we need to consider the possibility that this will affect the sequence of the normalization process.

・In Japan, the direct costs of NIRP for financial institutions have been relatively stable over time. Distortions among short-term rates have diminished, partly because the BOJ has curbed its purchases of T-Bills over time, and the balance of uncollateralized call loans has recovered to some extent. Still, a number of risks remain, including the fact that more than three-fourths of all lending is being conducted at rates of less than 1%, and the continued decline in loan-to-deposit spreads is depressing financial institutions’ profitability and undermining their ability to serve as financial intermediaries.

・When forecasting the outlook for the BOJ's normalization process, we need to take into account the fact that since last year's comprehensive assessment the main policy tool has become the policy rate (which includes the 10-year JGB yield as well as the traditional short-term policy rate). The BOJ's current purchases of JGBs are below the amount needed to increase its holdings by ¥80trn a year, and Governor Kuroda himself has argued that the size of the bond purchases is an "endogenous variable" under the Yield Curve Control (YCC). But inasmuch as the central bank has adopted a framework under which it reviews YCC targets at each Monetary Policy Meeting, the sequencing of the normalization process will also become an issue in light of this flexibility. The BOJ has expressed the view that the appropriateness of target yields under YCC should be based on the natural rate of interest and the equilibrium yield curve. Then, as the natural rate of interest rises, the BOJ has the option of either adjusting its targets (which have become more accommodative) to maintain the same level of easing or allowing them to remain unchanged and thereby creating more accommodative financial conditions. Meanwhile, some are skeptical about the use of the natural rate of interest and the equilibrium yield curve in the actual conduct of monetary policy inasmuch as estimates can vary significantly depending on what method is used.

・If the BOJ is to achieve its inflation target under YCC, the sustainability of YCC is also important. Even after the adoption of YCC, there have been periods—such as Nov-Dec 2016 and Feb-Mar 2017—when the 10-year JGB yield came under upward pressure due to overseas factors. However, the BOJ responded to these pressures with fixed-rate purchase operations and other powerful measures to keep interest rates in check. This suggests the BOJ does not intend to change its target for the 10-year JGB yield under YCC unless prompted to do so by improved domestic fundamentals. I would like to ask why the BOJ is able to control the 10-year yield, a question that is often raised in the west.

Mr. Egawa:

・I do not think it is possible for the central bank's balance sheet to remain as large as nominal GDP on a semi-permanent basis. Some may disagree, but I think normalization is necessary.

Inoue (Organizer):

・What is the biggest problem with the current state of affairs?

Mr. Egawa:

・In the four years since QQE was launched, all that has happened is that current account deposits at the BOJ have increased dramatically—they have not been utilized in a meaningful way. The argument that this policy cannot be discontinued even though its benefits have yet to be confirmed is highly problematic, in my view. Many of the functions of the JGB market have deteriorated significantly under this policy. For example, credit market pricing now uses absolute yields instead of adding a spread to JGB yields, as was the traditional practice.

Mr. Takata:

・Of Japan's five rate-hike phases, after 1970's the objective of the fourth, which began in 2000, was more to normalize monetary policy than to keep inflationary pressures in check. This time, however, the BOJ has not talked about "normalization." It is also interesting to note that all five times, Japan followed the US and Europe in raising rates, and the global economy considerably slowed soon after it began tightening. If the US economy were to stagnate, prompting the FRB to cut rates, the BOJ might be forced to postpone its own rate hikes until the next rate-hike phase for the US and Europe came around. As such, developments in the US economy, the "frontrunner" of the business cycle, are extremely important for Japan.

Inoue (Organizer):

・Is it possible that in past rate-hike phases, such as in 2000 and 2006, the fact that Japan was the only major economy engaged in unconventional monetary policy at a time of relative strength overseas was what prompted the strong desire to return to a "normal" world, as defined by western economies? This time, however, the external environment is very different: the US and European economies are not particularly robust, and both continue to suffer from structural problems.

Mr. Takata:

・In 2000 and 2006, Japan was the only country suffering from balance sheet problems, but today the US and Europe are in the same boat.

Ms. Suda:

・The uncertainty characterizing long-term trends for banknote demand makes it difficult to carry out *a priori* discussions of how large the central bank's balance sheet should be. In that sense as well, I think "normalization" should be understood to mean not a return to some original state but rather a shift in direction from an abnormal state of affairs to more normal conditions. The BOJ also needs to communicate carefully to the market the asymmetry inherent in easing and normalization along with its intention to focus on market functions in the post-normalization conduct of monetary policy. When the Central Bank Research Committee discussed revisions to the Bank of Japan Act in late 1990's, the importance of achieving a proper balance between the benefits and costs of monetary accommodation was discussed, but recently there has been little talk about the costs of these policies.

Mr. Fukuda:

・The hurdle for monetary policy in 2006 was lower than it is today: Then, the goal was to keep inflation sustainably at 0% or higher. In light of recent price trends, I think it will be difficult to engage in a serious discussion of "normalization" without a fundamental rethink of the 2% target.

Mr. Takata:

・The BOJ has set itself a high hurdle of 2% inflation in spite of the fact that Japan's economy has the weakest momentum of any major economy, with a declining natural rate of interest. The gap between the BOJ's target and the economic reality will persist barring a tremendous pick-up in the economy's metabolism or a reduction in the level of inflation being targeted.

Ms. Suda:

・The BOJ's commitment to reach the 2% target and "[maintain] that target in a stable manner" also serves as a constraint on policy administration. The "hurdle" noted by Mr. Takata would be substantially lower if the BOJ had set itself a target *range* of, say, 1% to 3%. The absence of a concrete definition for "in a stable manner" also makes it more difficult to envision an exit from quantitative easing. And inasmuch as the BOJ has pledged to "achieve" the 2% target, it has lost the option of switching policy because of potential risks and costs at a time when inflation is moving closer to—but has not yet reached—2%.

Mr. Oshima:

・For market participants, it is important to be able to envision to some extent the path to an exit from monetary accommodation. In that sense, the FRB has skillfully managed its dialogue with the market. When there are problems with this dialogue, volatility increases and leveraged investors find themselves forced to sell assets, resulting in substantial price corrections.

・One side effect of powerful monetary accommodation in the financial markets is an increase in passive investments, which entails a build-up of funds over which supervisory authorities have relatively little control. Another is the sort of overpricing of assets currently seen in US credit and corporate bond markets. There is a substantial risk of a correction in asset prices, including stocks and real estate, and there are fears that such a correction could have a serious impact on the financial system. Meanwhile, macro policies designed to stabilize the financial system cannot be deployed until the risk emerges, and there is also the question of how to deal with the media. Additionally, inasmuch as market participants take the overpricing of assets as a given in their actions, a sudden return to fair value could have severe implications for the market.

Mr. Egawa:

・Of particular concern is the impact such a correction could have on government and corporate bonds. The absolute level of yield spreads in Japan has been low enough for long enough that income during a phase of rising rates would not be sufficient to offset the resulting capital losses.

Inoue (Organizer):

・A central bank seeking to normalize monetary policy needs to engage in communications to ensure that market participants understand the direction of policy and the level of inflation being targeted. At the same time, it needs to make appropriate statements about financial risks and resilience.

Mr. Oshima:

・I think the greatest concern for Japan's financial system is the decline in financial institutions' profitability.

Mr. Tokushima:

・Institutions responsible for investing long-term funds are also exhausted. Market participants that have fixed target returns and have depended on JGBs as the centerpiece of their portfolios no longer have anywhere to go. In this sense, I think a continuation of the current low-growth, low-return environment would be more dangerous than the potential impact of a surge in long-term interest rates due to expectations of policy normalization.

・We have begun discussions with the BOJ regarding the level of super-long JGB yields. The appropriate level for super-long yields as derived from the equilibrium yield curve under YCC has increased slightly, but is still very low. Some nonfinancial companies are happy with the status quo because they can issue 20- and 30-year debt at low rates, but there are few places for them to invest the money. In that sense, our government may be the only entity that benefits from the current regime of low super-long bond yields.

Mr. Kitamura:

・If long-term interest rates in the US and Europe were to rise in response to a normalization of monetary policy, would institutional investors in Japan buy more foreign bonds?

Mr. Tokushima:

・There are some restrictions including capital adequacy regulations on life insurers that prevent an unlimited shift into foreign bonds, but I think other investors like pension funds could start buying more.

Mr. Kitamura:

・In that case, it would not do for Japan to be the only country with low government bond yields.

Mr. Tokushima:

・If the percentage of JGBs owned by institutional investors is high—as is currently the case—JGB yields could be kept low for the most cases even if those investors shifted funds into foreign bonds. But a discontinuation of the BOJ's purchases of JGBs could place upward pressure on long-term JGB yields.

Mr. Takata:

・I think Governor Kuroda's real intention is to encourage a transition away from deflationary sentiment under bubble-like conditions by emphasizing the policy rate differential with the US and Europe and thereby pushing the yen lower and stocks higher.

Mr. Fukuda:

・Even if that is true, I still think the BOJ needs to examine the effectiveness of its approach. The weaker yen has boosted earnings at exporters and share prices have risen, but higher import prices have reduced incomes in dollar terms. Nor has there been any change in consumers' deflationary mindset.

Mr. Kitamura:

・In the conduct of economic policy, I think there is a limit—perhaps five years?—to how long you can stick with one mechanism. If it doesn't work by then, policymakers need to adopt a different approach.

Inoue (Organizer):

・I also think it is unfortunate that the "comprehensive assessment" was carried out at somewhat strange time and that there has not been enough discussion with market participants.

Mr. Fukuda:

・The analysis presented in the comprehensive assessment focused on the channel of real interest rates in spite of the fact that QQE's greatest impact on the real economy was via the cheaper yen.

Mr. Takata:

・I suspect the BOJ feels that the third "arrow" of Abenomics ("growth strategies," i.e., structural reforms) must be effective in order for it to meet its inflation target. While tighter labor market conditions have boosted investment in labor-saving equipment and prompted a pick-up in wage inflation, there is little momentum behind structural reforms on the whole.

Mr. Tokushima:

・The unemployment rate has declined, and labor market conditions appear to have tightened. However, the annual increases in social security burdens including employee pension premiums have neutralized the modest gains in wages, having prevented household disposable income from rising. Other factors helping to keep households' propensity to consume depressed include concerns about retirement and the increase in non-regular employment. I do not think the Japanese economy will improve without a solution to the structural problems plaguing the labor market.

Mr. Watanabe:

・Empirical analysis of the export function suggests that export volume has grown less sensitive to the exchange rate in recent years and more sensitive to the global economy. Consequently, we cannot expect a weaker yen to provide the same boost to exports and the economy that it once did.

Ms. Suda:

・There is in fact a growing tendency for businesses to set export prices based on overseas prices, but the impact of QQE has been the cheaper yen. However, there are limitations to a policy that seeks to guide the yen sharply lower by keeping domestic interest rates in check and thereby widening the interest rate differential with other countries. Incidentally, some think the BOJ's fixed-rate purchase operations at the same cut-off rate were intended to guide the yen lower, but it may be that the main objective of these operations was to defuse speculation that Japan was ready to follow the US and Europe in tightening policy at a time when those countries were discussing the normalization of monetary policy.

Inoue (Organizer):

・If the market has confidence in YCC, BOJ will be able to control the 10-year JGB yield without buying that many JGBs.

Mr. Tokushima:

・Inasmuch as the BOJ already holds more than 40% of outstanding JGB issuance, it is difficult to envision the 10-year JGB yield jumping higher on a modest reduction in the rate of its purchases. In that sense, the BOJ's commitment and its dialogue with the market have probably been quite effective.

Mr. Takata:

・There is room for further discussion of this point—the BOJ said as much in last year's "comprehensive assessment," where it noted its intention to further discuss the appropriate level for the 10-year JGB yield on a separate occasion. There needs to be a discussion of what yield curve shape would be optimal for investors and nonfinancial companies. I suspect many non-financial firms with their surplus of savings would prefer higher rates to lower ones. And inasmuch as the financial system's functions become increasingly impaired the longer that NIRP is left in place, I think the next “comprehensive assessment” needs to discuss whether the current low-interest-rate environment is truly sustainable for non-financial firms and financial institutions alike.

Inoue (Organizer):

・Even last year’s comprehensive assessment noted that the shape of the yield curve in the short- and medium-term sectors (probably out to around 2-3 years) had a comparatively large economic impact.

Mr. Tokushima:

・It is up to 5-year rates that have the greatest impact on corporate business investment.

Inoue (Organizer):

・At the same time, I think it would be hard to ensure a balanced discussion unless we also take into account the effect of fluctuations in the 10-year JGB yield on the financial system.

Mr. Tokushima:

・The yield declined after the adoption of NIRP, increasing costs further for companies with excess savings by lowering the rates used to discount their retirement benefit liabilities. I think the BOJ probably underestimated this side effect.

Mr. Fukuda

・A lower 10-year JGB yield would not boost business investment, but it does have an outsized impact on real estate.

Ms. Suda:

・A rise in interest rates today would probably have the greatest impact on residential mortgages among economic activities. Not only are interest rates low, but homebuyers in their 20s and 30s are able to buy homes without a down payment. This generation already has a low propensity to consume, and a rise in long-term interest rates would further undermine sentiment. For this reason as well, it would be preferable to start the monetary policy normalization process somewhat early and proceed slowly, raising rates in “baby steps.”

Mr. Oshima:

・When a survey asked companies whether they preferred a strong or a weak yen, most of the small and medium-sized businesses, which tend to be importers, said a strong yen was better for them. The exporters seeking a weak yen are all large companies, and they have a large weighting in equity indices and a correspondingly large impact on stock prices. It is therefore difficult to say which is better for the broader economy. If anything, it may be that *stable* exchange rates are important.

・The purchase of foreign bonds entails dollar funding costs, so I suspect that super-long-term JGBs will remain the preferred option for domestic investors unless overseas long-term rates rise significantly. It is important that the risk of foreign exchange and government bonds be backed by a healthy stability. In this sense, I think a modest rise in long-term interest rates would help improve the economy’s stability.

Mr. Tokushima:

・In a survey of market participants, many said they would actually resume buying JGBs if yields were to rise.

Mr. Kitamura:

・The job offers-to-applicants ratio is now higher than it was during the bubble, but inasmuch as exchange rates are now moving in the opposite direction, we should not declare Abenomics a success simply because the numbers look good. I am also concerned about the inflation expectation in the BOJ’s Outlook Report. Healthy policy debate is possible if the forecasts of Policy Board members are dispersed to some extent, but when all of the members indicate projections of around 2% regardless of actual developments in prices, it becomes difficult for the central bank to engage in a dialogue with market participants or to maintain their confidence.

Mr. Fukuda:

・The BOJ was once viewed as the body that provided the most accurate forecasts. Now its projections are frequently off the mark, and market participants no longer trust what it says.

Mr. Kozu:

・I think the market understands the BOJ’s decision to stick to a certain stance and takes it as inevitable. However, market participants seem to be worried at the same time that something bad could eventually happen if the BOJ maintains such stance. What we need now is a discussion to explore ways of gradually shifting monetary policy to a more stable footing.

・The BOJ needs to provide a good explanation as to why it may have been unable in six years to hit the inflation target which it originally thought achievable in two years. It would then be appropriate to reconsider its approach to the target thereafter. On the one hand, in light of a potential impact on foreign exchange rate, it is probably impossible for Japan to unilaterally change its 2% target. On the other hand, the outlook for the US economic cycle and the Chinese policy administration after the 19th Party Congress points to a growing likelihood of slowing down economic activities to some extent in key overseas economies. The question then becomes how the BOJ can communicate smoothly with the market in maintaining its 2% target.

Mr. Hosono:

・The original reason for setting the inflation target at 2% was in order to secure a “margin of safety” for the policy rate and to take into account the upward bias of the CPI. As such, I question the view that the 2% target must be maintained to prevent the yen from rising. I don’t think the current exchange rate is consistent with purchasing power parity.

Mr. Kozu:

・As a matter of fact, you may not have to worry too much about the exchange rate but, with latent upward pressures accumulating, it is hard to tell how the foreign exchange market would react if the 2% target were abandoned in Japan.

Mr. Kitamura:

・I think some in the central banking community in the world may start to argue that an inflation target that is unachievable should be abandoned.

Mr. Kozu:

・Such discussions may create an opportunity to lower the target or freeze it for a certain period of time in a globally collaborative manner.

Ms. Suda:

・Some are also of the opinion that the inflation target should be raised further, and there is a risk that the debate will veer off to both sides. I don’t think it is realistic for a central bank to abandon a target it has set for itself. Instead, I think the BOJ needs to put in place conditions that are conducive to an eventual exit, such as setting a permissible range of 1% below and above the official target. We should also remember that the joint statement by the government and the BOJ in January 2012 explicitly noted that achieving the 2% target would take time.

Mr. Fukuda:

・It is only quite recently that BOJ staff acknowledged it would take time to achieve the inflation target. Until then the BOJ had repeatedly pushed back the expected timing of the achievement even while insisting the target would be achieved “at an early date.”

Ms. Suda:

・The BOJ has decided there is no need for further accommodation, probably in part because the momentum of economic activity has been maintained. This stance can be viewed as an acknowledgment that the inflation target need not be achieved immediately as long as economic activity maintains its momentum.

Mr. Fukuda:

・But it is difficult for the BOJ to explain why core-core CPI inflation is at zero if the momentum of economic activity has been maintained.

Mr. Takata:

・I think it will be difficult for the BOJ to say that enough is enough, and if nothing is done monetary accommodation may continue indefinitely. Apart from the question of achieving the inflation target, we need to have a discussion about whether this sort of situation is good for the national economy.

Mr. Kozu:

・It is hard to envision some future government saying there is no need to achieve the 2% inflation target.

Mr. Fukuda:

・I think that, at heart, the government is more concerned about growth than about prices. I can envision a government that would be satisfied with sub-2% inflation as long as the real economy is healthy.

Mr. Takata:

・If wages and stock prices are rising, the government might even prefer an absence of inflation.

Mr. Kozu:

・I think the real problem may be that there was no one around the administration willing to make the sound and reasonable arguments you have made so far today. I hope that the government will discuss the question of which target is truly important hereafter.

Mr. Oshima:

・The yen’s current exchange rate is too low by any standard. There is also an accumulation of positions betting against the yen, and in that sense policies have been effective. On the other hand, it means that a single message from the authorities could trigger a sudden surge in the yen.

Mr. Hosono:

・Would a BOJ decision to abandon the 2% inflation target send the yen higher?

Mr. Oshima:

・I think it would be dangerous for Japan to unilaterally abandon the 2% target as being unachievable. The situation might be different, of course, if we were in the midst of an asset bubble or there were concerns about the side effects of an excessive focus on prices.

Mr. Kitamura:

・Could the FinTech boom trigger an asset bubble?

Mr. Oshima:

・With the current lack of loan demand, small sources of demand for risk capital tend to attract large amounts of funds. At present, however, I think it is difficult to say there is a bubble in FinTech—or in the JASDAQ and Mothers markets.

Mr. Kozu:

・I think the fact that Initial Coin Offerings (ICOs) can attract so much money in such a short period of time is an evidence that monetary accommodation has gone too far on a global basis.

Mr. Takata:

・However, leverage has not increased excessively like it did ten years ago.

Mr. Fukuda:

・The collapse of a bubble does not always harm the real economy. As Mr. Takata notes, the impact is more severe when many economic agents have taken on excessive leverage, such as when Japan's bubble burst or during the global financial crisis. In contrast, when the IT bubble collapsed at the start of the 2000s, there was simply a decline in stock prices, and apart from equity holders there was not a substantial economic impact.

Mr. Takata:

・Even the Black Monday stock market crash 30 years ago did not have any severe after-effects. In contrast, both Japan's late-1980s bubble and the housing bubble in the west a decade ago involved an inordinate degree of leverage, and the subsequent collapse had serious implications for the financial system.

Ms. Suda:

・The BOJ's outlook is based on the assumption that, under the inflation-overshoot commitment, longer-term inflation expectations will converge on 2%. How do market participants and private research organizations view this?

Mr. Fukuda:

・The ESP Forecast conducted by the Japan Center for Economic Research surveys the inflation expectations of private-sector economists. While their forecasts were pulled higher by the BOJ's outlook immediately after Mr. Kuroda was appointed Governor, more recently expectations have been at best around 1%.

Ms. Suda:

・The BOJ has argued that if it declares it will expand the monetary base over the long run, people will believe it and anchor their inflation expectations around 2%. In reality, however, they do not trust the BOJ. The 1ppt gap between the inflation outlooks of the BOJ and the private sector reflect the gap that exists between their longer-term inflation expectations.

Mr. Fukuda:

・It would be a different matter if the gap were shrinking, but the fact that it is actually widening is deeply concerning.

Inoue (Organizer):

・The BOJ is not alone—many central banks have released forecasts that price in policy effects. Producing a forecast that falls short of the central bank's target would be an acknowledgment that the current policy response is insufficient.

Mr. Kozu:

・Any economic forecasts will not change as long as the actual data do not change. As such, the gap in inflation expectations between the BOJ and the private sector to some extent reflects the fact that the actual inflation rate remains depressed.

Inoue (Organizer):

・What should the BOJ do if inflation never reaches the 2% target? Should it argue that inflation *would* reach the target if certain conditions were met?

Ms. Suda:

・The BOJ is arguing that weak inflation expectations are attributable to the recent weakness in prices.

Mr. Fukuda:

・Many believe that prices will rise if only wages rise.

Mr. Kozu:

・Companies are experiencing labor shortages in certain specific areas, but that has not led them to raise the price of goods or services. If more companies come to accept that they cannot attract the staff they need without paying higher wages, corporate price-setting behavior may also change. However, even if wages were to rise, manufacturers would probably consider replacing workers with machines, something that is possible with the current technology. In that sense, it is hard to tell at the moment whether wage gains are sustainable.

Ms. Suda:

・Companies are strongly opposed to increasing their labor costs, and I have heard many discussing plans to lower their overall personnel costs over the next few years.

Mr. Kozu:

・It is still uncertain at all about the impact that new technologies such as AI, big data, and robotics will have on production activities. This uncertainty is one reason why so many firms are setting aside cash and not spending it immediately.

Ms. Suda:

・In Japan's service sector, which has been extremely slow adopters of technology, IT will reduce the need for staff and bring about a corresponding reduction in costs.

Mr. Kitamura:

・Companies' average labor costs as revealed in the MHLW's Monthly Labour Statistics have hardly risen at all. People who only want to see "convenient" numbers then criticize the survey methodology as being inappropriate.

Mr. Kozu:

・The CGPI fell sharply along with the latest drop in oil prices, but the CSPI did not decline. Inasmuch as the rate of CSPI inflation became considerably negative during the deflationary era, this suggests the pricing of business-to-business services may have changed.

Mr. Hosono:

・In the BOJ's Phillips curves for various periods, the intercept has declined but the slope remains almost unchanged. If these estimates are correct, a positive output gap should result in slightly higher inflation than we have seen. Is the lack of observed inflation due to a change in the price formation structure itself?

Takehana (Secretariat):

・The BOJ's data sample excludes the period immediately after the launch of QQE. If the estimates were prepared using data from 2013 to 2017, the slope of the curve could change as well.

Mr. Fukuda:

・There is also the question of whether the output gap itself is accurate. As labor is increasingly replaced by AI and robots, it may not be appropriate to assume that tighter labor market conditions will necessarily lead to a contraction of the output gap. Yet most estimates of the output gap continue to be based on Cobb-Douglas production functions.

Inoue (Organizer):

・If the estimates of the output gap itself are incorrect, what should the central bank use as an interim target for monetary policy? Price stability may be the final objective, but I think there is a persistent belief that keeping the output gap in positive territory is a role the central bank can fulfill.

Mr. Kozu:

・Some argue that achieving full employment is sufficient, but there are others who say the unemployment rate needs to fall further.

Ms. Suda:

・Those who discuss this issue solely on the basis of observed results are bound to conclude that monetary accommodation is insufficient until the inflation rate reaches 2%.

Mr. Kozu:

・It seems that central banks in advanced economies want to reverse the policies instituted as an emergency response to the financial crisis while they still can. Pushing ahead with normalization at a time when the inflation target could not be achieved sufficiently may suggest a return to the world of policymaking by "comprehensive assessment." In that sense as well, I think the central banks would really like to gradually distance themselves from strict inflation targets.

Mr. Fukuda:

・It was the Reserve Bank of New Zealand that adopted the strictest form of inflation target. Its experience helped form a consensus that central banks should allow a certain amount of latitude when setting such targets. The question, of course, is *how much* latitude. In the case of a 2% target, for example, an actual inflation rate of 1.7% might be acceptable, whereas a figure of 0% clearly would not be.

Mr. Takata:

・Traditional inflation targets were set with the goal of lowering, not raising, inflation. When trying to raise inflation at a time when consumer and business sentiment is cold, the target should be set in a range that is achievable and can be reasonably expected. However, the BOJ faced strong criticism of its decisions to end ZIRP in 2000 and QE in 2006 and therefore needed to make a strong commitment to a target in excess of what could be considered reasonable.

Mr. Fukuda:

・I agree that it is harder to raise inflation than to lower it. That said, inflation has picked up in the US and Europe—only in Japan has it refused to move higher.

Mr. Oshima:

・I think the market fundamentally dislikes policymaking based on a comprehensive assessment since it is unclear what criteria the central bank will employ and how far it will go. In the US and Europe, such an approach may be acceptable to some extent since there have been clear improvements in both the macroeconomic and financial environments. But the shock to the markets will be greater when (as in Japan's case) the assessment criteria suddenly change in spite of the fact that the policy has produced no obvious results.

Ms. Suda:

・While I think it was appropriate to wind down quantitative easing in 2006, sharp criticism followed. This experience probably left the BOJ feeling it had to do something that might be considered excessive in order to avoid outside criticism. In that sense, I think the BOJ itself expected QQE would be criticized as being overly aggressive. As it becomes clear that the policy was not as effective as the reflationists anticipated, the time is approaching when it will have to be wound down. That the BOJ has yet to do so may reflect a lack of external criticism.

Mr. Fukuda:

・Once the central bank implements QQE, it is difficult to return things to their original state.

Mr. Kitamura:

・If the BOJ itself finds it difficult to make this decision, then perhaps it needs to be presented with a list of options from the outside and voters and markets allowed to decide.

Mr. Kozu:

・Many market participants do not seem to care about the soundness of the argument as long as they can make profits, but they are sometimes taken as though they are indeed the market's representatives.

Ms. Suda:

・Unless market participants criticize policy from a neutral position, there is always the possibility that they will be seen as just "talking their book." But it is also true that the BOJ sometimes takes a cynical view of the market's opinions. I think the BOJ needs to learn how to objectively accept outside criticism.

Mr. Oshima:

・Market participants come from a variety of sectors and perspectives, and the impact of policy changes is far from uniform. More discussion is needed on the question of how to make gradual revisions to monetary policy. For instance, one approach to fine-tuning policy might be to change the target for long-term rates to a shorter maturity and gradually give the 10-year yield more room to fluctuate.

Mr. Tokushima:

・The approach suggested by Mr. Oshima would probably benefit life insurers and other long-term institutional investors, but it might hurt the regional financial institutions.

Mr. Kozu:

・Which would have a more positive impact on the market: ending NIRP while keeping the zero 10-year yield target on hold, or abandoning the 10-year yield target while leaving NIRP in place?

Mr. Oshima:

・Market participants would prefer a steeper yield curve, which would also lead to a normalization of lending rates.

Mr. Kozu:

・The higher the costs involved in pegging long-term interest rates, the more difficult fine-tuning becomes, given the possibility that long-term rates may surge as soon as the peg is released.

Mr. Takata:

・Financial institutions would prefer a steeper yield curve, but those holding large quantities of JGBs could see major impairments to capital in the event of a sharp rise in interest rates.

Mr. Oshima:

・I agree that some institutions might not be able to withstand a sudden withdrawal of the peg. There should be no problem if capital losses can be offset by income from roll-down, but that will take a long time.

Mr. Takata:

・The impact of a sharp rise in interest rates would be more severe for regional financial institutions, whose bond portfolios have longer duration.

Ms. Suda:

・Japanese investors are expanding their investments in foreign bonds. Would a rise in US interest rates lead to major losses?

Mr. Oshima:

・Given the difficulty of finding investments and the contraction of term premia, there is little likelihood of US interest rates surging higher without a sharp contraction in the money supply. With the FRB's gradual pace of monetary policy "normalization," I think the market consensus is that US rates will not rise significantly anytime soon.

Mr. Fukuda:

・Even with the improvements in real economies in the US and Europe, I find it odd that the markets have almost totally ignored geopolitical risk.

Mr. Oshima:

・While there is in fact substantial geopolitical risk, I think the uncertainties for market participants are diminishing as each major event passes without incident.

Mr. Takata:

・A collapse of the euro could bring about disparities between European sovereign yields, but I think the current rise in geopolitical risk has been, if anything, conducive to inflows of funds to government bonds.

Mr. Hosono:

・One side effect of QQE that has been cited is the disappearance of credit spreads. Will credit spreads recover if a modest steepening of the yield curve can be achieved?

Mr. Oshima:

・I think an observable recovery is unlikely inasmuch as Japan continues to be characterized by a glut of funds.

Mr. Kozu:

・Other than YCC, the BOJ would also need to make changes to its ETF purchases in order to recover natural credit spreads.

Mr. Oshima:

・Another important question concerns how strictly the fixed-rate purchase operations should be implemented.

Mr. Kozu:

・I suspect that even within the BOJ opinions are divided on the question of how rigidly the staff follow the given market operation guidance. If the BOJ continues controlling interest rates as strictly as it is today, it becomes more difficult to raise the market participants' acceptable level of long term interest rates gradually and smoothly enough.

Mr. Fukuda:

・From a standpoint of governance, however, isn't it the role of the BOJ staff to faithfully carry out the decisions of the Policy Board?

Ms. Suda:

・If the absence of an acceptable range would prevent the staff from conducting market operations, I suspect they have already been provided with some kind of guidance. If so, the realistic option would then be to gradually expand that range.

Inoue (Organizer):

・Unless the operations are linked to some kind of policy target, things will be left entirely to the discretion of the staff. Wouldn't that make it *more* difficult to maintain a dialogue with the market?

Mr. Kozu:

・I think the key would be to find a good balance which is not as vague as the "comprehensive assessment" in the past but at the same time which is not excessively rigid from the market's perspective.

Ms. Suda:

・When the BOJ brought quantitative easing to an end in 2006, it announced what it called a "New Framework for the Conduct of Monetary Policy" that called for a "comprehensive assessment" that took into account whether the outlook for the economy and prices was on a sustainable upward trajectory and whether risks had accumulated in the conduct of monetary policy. When the approach to policy conduct was modified last September, I was somewhat reassured in the sense that the BOJ seemed to have moved closer to its 2006 approach.

Mr. Fukuda:

・Another approach that is similar to a comprehensive assessment would be a dual mandate for the central bank. Would this be easy for the market to digest?

Mr. Oshima:

・The FRB does not conduct policy mechanistically based on specific targets for prices and employment. Instead, it changes its focus flexibly depending on prevailing conditions. I suspect market participants would tolerate this sort of approach.

Mr. Fukuda:

・Putting aside the question of whether it should be called a comprehensive assessment, I think shifting to a dual mandate-like approach would be one possible direction.

Mr. Takata:

・Rather than using a single indicator as the sole target, it might be preferable to use it as one of several targets.

Inoue (Organizer):

・As Ms. Suda notes, if the central bank argues that it is on the right path but that achieving the target will take time, could it not come under criticism if the policy's side effects were deemed excessive?

Mr. Kitamura:

・To the extent that we do not understand how prices are determined and the tools for controlling them remain unclear, I doubt whether a central bank that claimed to be "moving in the direction of the goal" would be able to earn the markets' confidence. It would seem to be talking about something far off, not unlike controlling the economy or GDP.

Mr. Watanabe:

・There are empirical findings indicating that inflation expectations depend on past experiences of inflation. If this is the case, it will not be easy to move inflation expectations in Japan. Inflation expectations as measured using JGBi's remain low.

Inoue (Organizer):

・Does that mean the BOJ should set some other indicator that has a stable relationship with prices as an interim target?

Mr. Kozu:

・There is one internet survey asking about 1,200 investors what inflation rate would be best for themselves and what would be best for the Japanese economy. The most common responses, respectively, were "deflation" and "I don't know." These results suggest that, even among individual investors who are supposed to have a certain degree of financial literacy, many do not have a concrete view on what level of inflation is most desirable for Japan's economy. I found that very interesting.

Ms. Suda:

・While 2% is said to be the "global standard" for inflation targets, this figure has no strict basis in the empirical research. I think it would be difficult to *a priori* set a desirable level of inflation regardless of how much empirical research is conducted.

Mr. Fukuda:

・I think we should distinguish between optimal and achievable targets. For instance, the optimal unemployment rate is clearly 0%, but that is also unachievable.

Ms. Suda:

・In terms of setting targets, there are a variety of oft-cited issues that can be discussed, such as the need for a margin of safety, the bias inherent in the CPI, and the public's actual experience of prices. However, it is difficult to state with certainty whether the target resulting from that discussion will actually be desirable for the public. Empirical research tends to be influenced by the researcher's subjective viewpoints, and it is difficult to present a desirable inflation rate in a strict form to the public.

Mr. Fukuda:

・In the original discussion by Professor Krugman, a key point was that allowing inflation to continue rising for a while after the target was achieved would help lift current inflation expectations. I suspect the BOJ's 2% inflation target was set based on this approach, but at some point this shifted to a debate over what constitutes the optimal inflation rate.

Mr. Kitamura:

・Even without relying on strict empirical research, I think the common-sense conclusion would be that the public and markets alike find average historical inflation rates to be "comfortable."

Ms. Suda:

・I agree. That is why I was surprised to see the BOJ declare 2% to be the desirable rate of inflation.

Inoue (Organizer):

・Although we have not yet finished this discussion, our time is up. I hope to hold the next meeting as soon as possible so that we can bring this topic to a close. I would like to thank all the panelists for a long and stimulating discussion today.

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