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

April 09, 2018

Topic	BOJ policy issues and responses
Date	March 19, 2018 (3:40pm – 5:00pm)
Participants	**Mr. Takashi Kozu,** President, Ricoh Institute of Sustainability and Business **Ms. Ikuko Fueda-Samikawa,** Director, Financial Research Principal Economist, Economic Research Department, Japan Center for Economic Research **Mr. Hajime Takata,** Senior Executive Officer and Chief Economist, Mizuho Research Institute **Tetsuya Inoue,** General Manager, Financial Technology and Market Research Department, Nomura Research Institute (Organizer)

Key Discussion Topics

1. **Policy issues over the last 20 years**
2. **Policy measures over the last 20 years**
3. **Japan's economy and policy effects today**

1. Policy issues over the last 20 years

Inoue (Organizer):

・We have informed panelists of today's topics in advance. The first will consist of a review of the policy issues faced by the Bank of Japan over the last 20 years.

Mr. Takata (introductory comment):

・I would like to discuss five structural issues confronted by Japan's economy since the asset bubble burst in the 1990s: balance sheet adjustments in Japan, balance sheet adjustments in the West, the yen's rise to extreme levels, the zero bound for interest rates, and adaptive expectations.

・As the global economy expanded in the 1990s, Japan was unique in experiencing the collapse of an asset bubble and a subsequent period of asset deflation. The balance sheet adjustments undertaken in response consisted largely of 1) having financial institutions shoulder the excess debt taken on by companies and 2) passing those costs on to the government sector and resulting in the issue of more JGBs to pay for it. The ratio of private-sector debt to nominal GDP gradually declined as a result, but when Lehman Brothers went under and triggered the global financial crisis, the US and Europe were also forced to undertake balance sheet adjustments. In Japan, the bubble's collapse was followed by an unexpected and extreme rise in the yen that prevented the traditional reliance on exports to drive economic growth. Japanese companies, facing asset deflation and an extremely strong currency, adopted an "asset-lite" management model by shrinking their balance sheets and also opted for a restructuring-oriented business model that involved cutting wages and margins to survive the intense price competition that was brought on by the strong yen. This would not have become a structural issue if these efforts had lasted only a few years. However, they continued for nearly a quarter of a century, prompting Japanese companies and consumers alike—essentially the entire society—to shift from an aggressive, proactive approach to life and business to a more passive, reactive one. Monetary policy also ran up against the zero bound. A variety of factors overlapped and eventually became entrenched.

・The independence of monetary policy helps central banks keep inflation in check. But when deflationary sentiment becomes entrenched under such unprecedented conditions, the only way out is for the government and the central bank to work together and mobilize all policy tools available. It is ironic that as soon as the revised Bank of Japan Act granted the central bank its independence, conditions forced it to work together with the government on economic policy.

・The BOJ has been through five rate-raising phases in the past, and all of them were heavily influenced by exchange rates. In order to prevent an undesirable rise in the yen, Japan was always the last among the developed economies to begin raising rates, and consequently global stock prices would crash before it had had time to raise rates sufficiently. Inasmuch as the "ceiling" for economic growth is lower than it once was, today's target of 2% inflation is an extremely challenging one for the BOJ. Hence we cannot rule out the possibility that the BOJ will be forced to keep ZIRP in place perpetually and will never be able to raise interest rates. The concern in that case is that the "anesthetic" that was administered in response to the crisis will turn into addictive morphine, with adverse implications for market functions and the financial system.

Mr. Kozu:

・Understanding the structural issues confronting Japan's economy requires a focus on the output gap. Economics assumes that, when supply and demand diverge, prices will adjust in order to restore balance. In Japan, though, a negative output gap, albeit small, persisted for more than 20 years and the price mechanism seemed functioned well. The good explanation for this state of affairs would be that changes in external demand—Chinese economic growth for example—proceeded faster than prices could adjust.

・Nor should we overlook the impact of demographics. Economics generally assumes that an aging population with falling birth rates will result in a smaller labor force and therefore reduce aggregate supply, but in Japan it is the changes in the demand structure that have had the greater impact so far. Much of the new demands for the elders is in the regulated sectors that are not subject to the price mechanism. This is probably one of the reasons why Japan has experienced an extended period of mild deflation.

Ms. Samikawa:

・Policy issues over the last 20 years can be summed up as a fight against deflation giving way to a struggle with the effective lower bound (ELB) for nominal interest rates. Historically, the zero lower bound (ZLB) was thought to mark the limit of monetary policy, but central banks broke through the ZLB by adopting negative-interest-rate policies. Still, the existence of bank notes has constrained central banks' ability to take interest rates further into negative territory, and as a result they have recently been fighting the ELB.

・During this period, the developed economies saw the decline in natural rates of interest, that is, the real equilibrium rate which balances saving and investment at a time of full employment. In Japan, future increases in the natural rate of interest are difficult to envision inasmuch as the working-age population is expected to continue shrinking. With nominal interest rates up against the ELB and no room to take them any lower, difficulty in raising inflation expectations translates to limited downside for real interest rates. A further decline in the natural rate of interest could create a deflationary environment in which monetary policy is automatically restrictive. The government's growth strategy should be responsible for raising the natural rate of interest, but it is the role of monetary policy to guide inflation-adjusted market rates below the natural rate of interest. The question facing the BOJ going forward will be how to create accommodative conditions under the constraint of the ELB.

2. Policy measures over the last 20 years

Inoue (Organizer):

・The second issue I would like to discuss is the policy measures taken by the BOJ over the last 20 years. Inasmuch as the BOJ was a pioneer in unconventional monetary policy, it has experienced particular difficulty in communicating its actions and intentions to the markets and overseas authorities. Perhaps panelists could also touch on the impact that these measures have had on resource allocation efficiency and on financial intermediation by depressing financial institution earnings with low interest rates.

Mr. Kozu (introductory comment):

・The BOJ's unconventional monetary policy came after the zero interest rate policy. It was first and foremost a response to the banking crisis in Japan, and the mainstream view is that it was fairly effective in supplying unlimited liquidity to support financial intermediation and ease market concerns. However, opinion is split on whether the unconventional monetary policy was effective in achieving its another objective of lifting real growth and inflation rates. Those arguing in the negative generally say that fiscal and monetary policies can only serve to smooth out the swings in the economic cycle and cannot actually lift average growth rates over the cycle. Meanwhile, others emphasize the hysteresis effect of shocks—i.e., the impacts of a drop in economic growth to fuel pessimism and weigh on capital investments, thereby lowering average growth in the next cycle—and argue that the unconventional monetary policy can alleviate such effect if it can ease the decline in growth even slightly.

・A look back at the BOJ's unconventional monetary policy since 1999 shows that until around 2005, these measures were largely designed as crisis response measures. They were fairly effective as such, and in 2006 the BOJ moved to wind down quantitative easing. But just as the BOJ was about to normalize monetary policy, Lehman Brothers failed, triggering the global financial crisis. The BOJ initially responded with traditional monetary policy measures, but the stronger focus on inflation and economic growth rates prompted the BOJ to resume the use of the unconventional monetary policy in 2010.

・Other than quantitative easing, there are four major types of the unconventional monetary policy. Forward guidance seeks to influence long-term interest rates by having the central bank commit to future policy actions. Qualitative easing seeks to influence credit spreads and lower the cost of funding for less creditworthy borrowers by having the central bank acquire assets that it would not ordinarily purchase. Meanwhile, negative interest rates and yield curve control use any means necessary to move interest rates, the same as the traditional monetary policy, and interest rates serve as a transmission channel of the policy. These policies also affect exchange rates (via interest rate parity) and asset prices. By doing so, it is thought that they also influence expectations. In short, while they may be classified as unconventional, these policies—like traditional monetary policy measures—are intended to influence interest rates and have been fairly effective in that regard.

・Japan has placed a greater emphasis on price stability rather than on financial stability after we exited from the post-bubble adjustment period. The result has been a flattening of the yield curve and a tightening of credit spreads. Since banks earn profits by borrowing short and lending long, their role as financial intermediaries could be threatened if current conditions continue further longer.

Mr. Takata:

・The BOJ has truly been a pioneer in the use of monetary policy over the past 20 years, having implemented zero interest rates, quantitative easing, and qualitative easing. But with the exception of those measures intended as crisis response measures, I think these policies' main impact was on exchange rates. While they have had a significant impact in this sphere, their future effectiveness is not guaranteed inasmuch as it is determined to some extent by US monetary policy. There are also concerns about the negative impact of contracting long-short interest rate spreads and credit spreads on financial institution earnings. Simulations suggest that net operating profit at regional financial institutions will drop to less than half of FY16 levels by FY23, something I have dubbed the "Year 2023 problem." The BOJ needs to take these side effects into account when conducting policy.

Ms. Samikawa:

・It is also important to note that if the next recession strikes at a time when both inflation and the natural rate of interest remain depressed, the BOJ may have few remaining policy options. It has already sharply reduced the pace of its JGB purchases, and if additional easing becomes necessary, any attempt to raise the target for annual growth in its government bond holdings would probably run up against a wall quite quickly. Nor do I see any assets other than JGBs that the BOJ might reasonably buy given the market scale required.

・Finally, even if the BOJ were able to prepare some sort of policy measure, there would still be a debate over the costs involved in winding down the easing measures. The long-term JGBs held by the BOJ currently have an average yield of 0.326%, and since it is paying 0.1% on the "basic balance" portion of current accounts, the spread is very small. Our analysis shows that gradual rate hikes to 2% from FY2023 would lead to cumulative losses of about ¥19trn. The BOJ's ¥8trn in capital would be insufficient to cover these losses, and raising the required reserve rate would be unrealistic inasmuch as it would effectively be a tax on private banks. While changes to accounting methods would make it possible to create the appearance that the losses had been eliminated, the losses would still have to be borne by taxpayers.

3. Japan's economy and policy effects today

Inoue (Organizer):

・The third topic concerns Japan's current economy and policy effects. While the economy has been experiencing firm growth, inflation remains depressed. Stimulating the economy will require a focus on interest-rate-elastic demand, but what sort of relationship exists between BOJ policy and these sorts of fundamentals? If prices have been depressed by structural changes in the labor market and low inflation expectations, the BOJ may have to consider whether to view inflation as a monetary phenomenon and continue with quantitative easing, or whether instead to say its work is done as soon as the output gap becomes established in positive territory. Also, the risk of side effects from powerful monetary accommodation such as a surge in inflation or asset prices remains unclear in Japan, but there is the potential impact on fiscal discipline, which is more long-term in nature and harder to visualize.

Ms. Samikawa (introductory comment):

・In Oct–Dec 2017, Japan's inflation-adjusted GDP grew by 1.6% at annualized rate, marking the eighth straight quarter of growth. Five years have passed since Abenomics was launched in December 2012, and the current expansion has moved beyond the Izanagi boom of the 1960s to become the second-longest in postwar history. Corporate earnings are at an all-time high, and ordinary profit at all companies ex financials climbed to ¥75trn in FY16. Capital investment also rose to some ¥43trn in FY16, nearing pre-GFC levels. Share prices have trended higher, reflecting strong corporate earnings, and a variety of labor market indicators—including the unemployment rate, the job offers-to-applicants ratio, and the employment conditions DI in the BOJ's Tankan—suggest the economy is at full employment, with labor shortages growing increasingly common. The output gap has also been in positive territory for three consecutive quarters.

・On the other hand, the core CPI rose only 0.9% annually in January, and the BOJ's core CPI, which excludes fresh food and energy, was up just 0.4% YoY, far below the 2% target level. This is due in part to structural factors such as the shrinkage of the labor force as baby boomers retire. The rising ratio of job offers to applicants is also a phenomenon limited to certain sectors, including safety services, construction, and nursing care. Even if an increase in the number of part-time workers is the main factor keeping wage growth in check, we still need to discuss whether this lies within the central bank's remit. Only structural reforms and growth strategies, not monetary policy, can raise the natural rate of interest. When the BOJ finally decides to wind down monetary accommodation, we will need to discuss ways of enhancing the economy's growth potential.

・When the BOJ introduced the yield curve control policy in September 2016, it adopted an inflation-overshoot commitment under which it pledged to continue expanding the monetary base until observed CPI inflation rose above 2% in a sustainable manner. As a result, the central bank's balance sheet climbed to ¥513trn in 1H FY17, bringing it roughly in line with the nation's GDP. Its outstanding JGB holdings also grew to ¥427trn, or 43.2% of all bonds issued and outstanding. The BOJ held nearly 70% of outstanding issuance in the 5y sector and nearly 50% in the 2y and 10y sectors. It also buys about 70% of all freshly issued 10y JGBs within two months of issue, causing JGBs to quickly evaporate from the secondary market. This has led to criticism that the BOJ is effectively monetizing fiscal deficits. Since adopting QQE in April 2013, the BOJ has also shelved two voluntary rules it previously followed: the bank note rule and the JGB purchase rule. This, too, has led some to criticize the BOJ for encouraging a loss of fiscal discipline.

Mr. Takata:

・Losses incurred by either the BOJ or the government during the next tightening phase are likely to be within an acceptable range. The greatest risk of unconventional monetary policy is that the central bank will be unable to find an exit, leaving financial institution earnings permanently impaired. The BOJ's ETF purchases should be praised for preventing asset deflation and a rise in the yen, although they may raise issues in terms of corporate governance.

Mr. Kozu:

・As the BOJ's new Deputy Governor Masayoshi Amamiya said in his testimony before the Diet, all policies have costs and benefits, and when the government changes its stance on fiscal policy, or the BOJ changes its stance on monetary policy, the only possible approach is to weigh the likely costs and benefits over, say, the next 10 years and change the policy stance if the benefits outweigh the costs. When considering a shift in policy stance, I think it is much more important to compare how the economic welfare of the nation as a whole would fare than to point out the risks inherent in specific policy measures.

・The business cycle continues in Japan despite sustained structural adjustment pressures. We may already be at the peak of the current cycle and should probably give some thought as to whether the economy is optimally balanced under the current conditions. There is also a possibility, as Mr. Takata noted, that once QQE is wound down we will find ourselves not in a completely different world but rather in a similar world in which the peaks and troughs of the economic cycle have been flattened. If so, we will need to consider what sort of monetary and fiscal policies are best suited to this new environment.

Inoue (Organizer):

・Are there any questions or comments from the floor?

Question:

・When deciding the timing of an exit from QQE, I think we need to give serious consideration to the policy costs. If, as Governor Kuroda has proposed, we leave quantitative easing in place until the 2% inflation target is achieved, the losses on the JGBs held by the BOJ and the private sector will probably be massive even if the target is eventually met. I think there would be lower overall costs and less market turmoil if the BOJ moved gradually towards an exit by leaving ZIRP in place while starting to remove quantitative easing before the inflation target had been achieved.

Mr. Takata:

・I agree that it may be necessary to adopt a flexible approach to the 2% inflation target based on a cost-benefit analysis. In the US, the Fed has already raised rates five times even though inflation remains below 2%. The ECB faces a similar situation, and it has already begun talking about an exit in preparation for a rate hike next year.

・I think there should be "gimmes" for the BOJ just as there are in golf. In other words, even if inflation has not strictly reached the 2% target, there should be a level that is "close enough" for all concerned. What is important—and this is true in golf as well—is that permission needs to be given by the other players and not requested by the BOJ. In that sense, I think it would be beneficial for other institutions to establish a sense of where that permissible level might be, and when they should make the announcement, with an eye on inflation and exchange rates.

Ms. Samikawa:

・We estimate that losses on the central bank's JGB holdings would amount to ¥19trn if it waits until inflation reaches 2% to wind down QQE but could be reduced to ¥14trn if it begins the process as soon as inflation hits 1%.

Mr. Kozu:

・As I indicated earlier, communication is extremely important to any shift in the monetary policy. And as pointed out, it would probably be desirable to modify the current policy if a cost-benefit analysis shows any improvement of the national welfare.

Inoue (Organizer):

・With that, I would like to conclude our panel discussions. Please give a warm round of applause to our panelists.

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