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

October 28, 2016

Topic	The Bank of Japan's "Comprehensive Assessment" of the QQE
Date	September 12, 2016 (2:30pm – 5:00pm)
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Key Discussion Points

1. **Policy effects and achievement of inflation target**
2. **Policy tools: assessment and outlook**

1. Policy effects and achievement of inflation target

Inoue (Organizer):

・At this meeting I had planned to discuss the resiliency of unconventional monetary policy in the developed economies in light of the topics discussed at the Jackson Hole symposium this year. However, the BOJ announced at its MPM on July 29th that it would conduct a "comprehensive assessment" of the Quantitative and Qualitative Easing (QQE), so instead we will focus on this assessment. Basically I would like to discuss the policy framework in the first half of today's session and policy tools in the second half, but since they are closely related participants should feel free to bend the rules.

・The reference materials regarding the policy framework summarize the content of the assessment envisioned by the BOJ based on points noted by Governor Kuroda in a speech on September 5. Inasmuch as the BOJ has emphasized its intention to preserve the goal of achieving the 2% inflation target "at the earliest possible time," participants should feel free to discuss the appropriateness of this objective.

・Regarding policy transmission mechanisms, one issue that we should probably discuss is how the financial markets channel, which received a great deal of attention in the initial stages of QQE, has changed over time and why. While this topic is unlikely to be covered in the "comprehensive assessment" for a number of reasons, today I would like to see an explicit discussion of the policy's impact on exchange rates, foreign trade, and outward portfolio investment. As for the BOJ's communications with the market, we should consider the significance of the Kuroda BOJ's initial "shock and awe" strategy—although the BOJ probably denies that it ever had such intentions—and the resiliency of such a strategy. Since mid-2015, the BOJ has repeatedly revised down its inflation forecasts in the Outlook Report while opting not to ease policy. The fact that both Mr. Kuroda and Deputy Governor Hiroshi Nakaso gave speeches in the previous week presenting the broad directions for the comprehensive assessment is also an interesting sign that the Bank has made a change of course.

・The BOJ argues that QQE has brought about marked improvements in corporate earnings, employment, and incomes, and that much is clear from the economic data. But it is also true that these gains have not been sufficiently reflected in the spending behavior of businesses and households. The question of whether this dysfunctional transmission mechanism is the result of factors related to monetary policy will probably be brought up in the assessment, but it is something that I would also like to discuss here.

・Initially there were signs of improvements in inflation as well, and beginning in 2015 the BOJ made the argument that the "underlying trend of inflation" was improving. More recently, however, both the official inflation rate and the trend inflation indicator released by the BOJ have declined. This is attributable to the deflationary output gap, which Cabinet Office estimates continue to put at about 1% of GDP. More recently the BOJ has been emphasizing the "adaptive" or backward-looking formation mechanism for inflation expectations. I think the question of how to capture inflation expectations along with the implications of backward-looking inflation expectations for policy conduct—including the aforementioned emphasis on surprise announcements and the impact of the central bank's commitment to "quantity"—are also important points

Mr. Watanabe:

・Much of the empirical research on inflation expectations—both in Japan and the other advanced economies—suggests that they are formed via a backward-looking mechanism. This may be particularly true in Japan's case because of the long years of low inflation.

Ms. Suda:

・New Keynesian econometric models typically include historical inflation rates as one of the variables. And in Japan's case, it is well known that historical inflation rates have a significant impact on the formation of inflation expectations. One of the implications of this is that it is harder to achieve a price level target than an inflation target. That said, it is not clear whether this characteristic is the result of Japan's prolonged period of low inflation.

Mr. Fukuda:

・I think we need to separate the mechanisms for the formation of inflation expectations into those in effect during ordinary times and those in effect under a liquidity trap. There is a great deal of empirical research in both Japan and elsewhere suggesting that under normal circumstances inflation expectations are formed via a backward-looking mechanism. But when there is a liquidity trap, where the natural rate of interest is negative and a deflationary equilibrium exists, it is not clear a priori how inflation expectations are formed, which means we should not automatically assume that all of the standard mechanisms are still operative. There are probably a variety of reasons why inflation expectations are not rising in Japan, but I think the main one is that the economy has yet to emerge from a deflationary equilibrium.

Ms. Suda:

・I do not agree that Japan's economy is in a deflationary equilibrium. Mr. Kuroda previously argued that there were deflationary expectations in Japan, but more recently he has changed his tune, saying only that inflationary expectations are not anchored around 2%. FRB's Chair Yellen and senior IMF officials have also taken the position that inflation expectations in Japan remain positive.

Mr. Fukuda:

・By "deflationary equilibrium," I mean "liquidity trap"—i.e., a set of conditions in which the quantity theory of money no longer holds. It is because of backward-looking expectations that there are times when inflation expectations do not rise under normal circumstances even though the quantity theory of money remains valid. In today's Japan, in contrast, the velocity of money continues to decline despite the tremendous amounts of liquidity supplied by the central bank.

Mr. Kozu:

・Important to any discussion of inflation expectations is the question of whose expectations we are talking about. A look at households' long-term inflation expectations as reflected in the BOJ's Opinion Survey on the General Public's Views and Behavior in the reference materials shows that these expectations seem neither backward- nor forward-looking but actually very sticky. The findings of the Cabinet Office's Consumer Confidence Survey are also used to estimate inflation expectations, but the survey asks respondents to indicate a range of values, making it difficult to tell exactly where their true inflation/deflation rate expectations lie. Corporate inflation expectations change gradually over time, as shown in the Tankan results, but market-based inflation expectations are something else. When looking at the economy through the lens of a macroeconomic model, the important question is what kinds of expectations businesses have when they invest and households have when they consume, but there is a tendency to view inflation expectations in the financial markets as a representative indicator.

・In the previous week's speech, Governor Kuroda said that while Japan is no longer in deflation, it has yet to achieve a 2% inflation rate. He also said the economy was characterized by near-full employment. If that is the case, the quantity theory of money should start to take effect. Under such circumstances, the rational hypothesis for why observed inflation rates are still rising only gradually would be that adjustments in prices and wages are sticky. Here arises another question: which is whether speeding up the adjustment process for prices and wages in spite of that stickiness would really contribute to improvements in the national welfare.

Mr. Uchida:

・We estimated the inflation expectations of households, businesses, and economists over three distinct periods: QQE1 (until the additional easing measures were announced in October 2014), QQE2 (after the additional easing measures were announced), and the period since NIRP was introduced. The inflation expectations of households and economists rose during QQE1 and QQE2. Businesses' inflation expectations, which were estimated using the input and output price DIs in the Tankan, were flat during QQE1 and have since fallen. The cheaper yen drove the input prices DI higher, while the output prices DI just managed to reach zero, and the price transfer indices for both remain negative. We concluded that the recent decline in household inflation expectations has been due largely to the decline in stock prices and the rise in the value of yen.

Mr. Watanabe:

・When estimating inflation expectations using survey data, the results vary significantly depending on which survey we use. And since respondents tend to form expectations based on their own past experience, the inflation expectations of younger respondents, who have never experienced inflation, are characterized by a downward bias.

Mr. Kato:

・If it is difficult to estimate inflation expectations, it is also difficult to determine whether the QQE succeeded in anchoring inflation expectations around 2%. In spite of this, Mr. Kuroda said in his speech last week that the BOJ would encourage the formation of forward-looking inflation expectations by preserving its commitment to achieving the inflation target. How are these elements related?

Mr. Yanagawa:

・From the perspective of economic theory, it is technically difficult to construct a theoretical model that tolerates divergences of inflation expectations from rational expectations and assumes heterogeneous expectations for various economic agents. Also, using survey results to estimate inflation expectations is fundamentally different from looking at the actual behavior of businesses and households. As there is no effective cost to answering a survey, businesses may give little thought to their answers, which casts doubt on the credibility of the resulting estimates. If more accurate estimates of inflation expectations are needed for the conduct of monetary policy, we probably need a more extensive discussion of methodology.

・It has been known empirically for some time now that inflation expectations in Japan are formed via a backward-looking mechanism. It is not fair to say that this was not known until recently. I think the BOJ believed it would be possible to change those expectations by making a relatively credible commitment. While that in itself is a reasonable assumption, it can be argued that expectations did not change because the commitment was unrealistic. That suggests the expectations formation process itself was actually quite rational. If an inflation target of 2% is unrealistic, the BOJ needs to conduct studies to determine exactly what sort of target would be capable of altering expectations.

Inoue (Organizer):

・From an operational perspective, at least, the BOJ made a credible commitment to supply ¥270trn in base money.

Mr. Yanagawa:

・But there was no credible explanation of how far ¥270trn would boost the inflation rate. Arguing that this injection of funds would lift the inflation rate by about 1% might have altered expectations and even allowed those expectations to be realized. In short, I think there may have been a gap between 2% inflation and the policy target that could be reasonably expected to be achieved. However, the BOJ has yet to provide a sufficient explanation of this point.

Ms. Suda:

・The "reflationists" argued the inflation rate would increase by a given amount for a given increase in the monetary base. And the BOJ proceeded to create more base money than even the "reflationists" thought necessary.

Mr. Yanagawa:

・The BOJ's 2% inflation target was quite modest in comparison with the arguments put forth by the "reflationists". Even so, there were only very gradual changes in peoples' expectations.

Mr. Suda:

・Confronted with the reality that inflation expectations did not increase as much as they had anticipated, the "reflationists" began arguing that inflation expectations would rise once actual inflation started to pick up. Observed inflation rates subsequently declined, and inflation expectations fell with them, so in a sense this was a consistent explanation.

Mr. Oshima:

・The BOJ set itself an inflation target of 2% when it unveiled the QQE. From the outset, however, market participants did not place a great deal of credence in this target. Instead, they focused their attention on the questions of what tools the BOJ would use to achieve this objective and the extent to which it would utilize them. By undertaking a variety of actions designed to manage the expectations of financial market participants, the BOJ achieved an impact via exchange rates in the initial stages of the QQE. That said, meeting the 2% inflation target was never going to be possible for an economy with Japan's structural problems, which are symbolized by the lack of growth in bank lending. The BOJ now needs to sit down and think again about exactly what it wants to target and at what level. Without a more realistic objective, growing uncertainty could cause expectations to diminish further.

Mr. Fukuda:

・We also need to focus on the output gap. The BOJ believes the output gap has largely disappeared and that inflation is just around the corner. Hence its argument that the reason why we are not seeing inflation is that inflation expectations are "backward-looking." Meanwhile, data presented by the Cabinet Office indicate there is still an output gap. While the labor market is in fact close to full employment, the BOJ's estimates of the output gap are perceived as being excessively optimistic. I think this state of affairs has created expectations that prices will not rise as long as the output gap remains.

Ms. Suda:

・Prior to the Lehman failure and the global financial crisis, the BOJ estimated the output gap was in excess of 2%. Since 2013, even the BOJ's estimates have put the output gap around zero, indicating that the QQE has not improved the situation. I think the BOJ needs to explain why this is the case.

Mr. Kozu:

・Currently the economy seems to be at full employment, but there are still some excesses as to capital. In general, we simply cannot have sustainable effective demands needed for existing capital to be utilized fully, because temporarily creating unsustainable demands could lead to a situation in which companies eventually have to pay the price for holding unnecessary capital. From a macroeconomic perspective, I think the full utilization of excess surplus capital may cause economists to overestimate the size of the output gap.

Mr. Kitamura:

・Why don't companies scrap surplus facilities or discontinue replacement investment? If there is no outlook for returning to full-capacity output, why aren't they responding appropriately?

Ms. Suda:

・Are there constraints due to accounting and tax considerations?

Mr. Kozu:

・Generally speaking, an individual company's decision to scrap excess capacity could lead to a question of misjudgment of management.

Mr. Kitamura:

・Instead of thinking in a "backward-looking" way, business executives need to make rational decisions with an eye on the future.

Mr. Uchida:

・Not all companies have surplus facilities. Many small businesses are drawing a line between core and non-core businesses and moving ahead with structural transformations of their operations. The inability of the tremendous amounts of base money supplied by the central bank to spark a pick-up in capital investment is a problem shared by all the developed economies. One hypothesis why this is the case is the increased speed of product development. In the past, product life cycles were typically at least a few years, enabling parts manufacturers to expand production capacity. Now that life cycles have shortened substantially—probably in response to the increasing utilization of IT—parts makers are focusing on how to efficiently utilize existing production lines and avoid large-scale investment. From the banks' standpoint as well, the only sectors actively seeking loans since the global financial crisis have been IT, real estate, energy, and so on. The situation today is very different from the era when utilities and chemical manufacturers engaged in large-scale investment.

Mr. Fukuda:

・There is a surplus not only of capital but also cash, so the anemic demand for loans should not be surprising. Why do businesses want to hold cash when the output gap is zero?

Mr. Kozu:

・Many business executives are said to be unsure as to how they can use cash reserves profitably. Some manufacturers in

Japan are losing international competitiveness and because of that they find it more difficult to make significant changes to their business portfolios in the short term. That may be why they tend to hold large amounts of liquid assets.

Ms. Suda:

・NIRP has increased the cost of holding surplus cash and deposits for businesses. Nevertheless, businesses continue to do so because of vague concerns about the future.

Mr. Fukuda:

・While many businesses may hold large amounts of cash and deposits, there are probably some—like certain companies in the IT sector—that intend to use those funds eventually for large-scale mergers and acquisitions, while others are uncertain what they will eventually do with the money. The latter group is symbolic of the ongoing stagnation in Japan's economy.

Mr. Uchida:

・This also relates to Japan's industrial structure. Japanese manufacturers' main role is to supply parts to the rest of the world, and there are many companies with a 50-60% global market share from Tier 1 to Tier 3. In contrast, leading manufacturers in other countries have taken on the role of coordinators, utilizing their relationships with a large number of parts manufacturers to grow their businesses. Large enterprises have many options, but for a parts manufacturer, the decision of which large enterprise to partner with can be a very difficult decision.

・Another major difference between companies in Japan and the other advanced economies involves corporate governance. Given the high weight of equity financing in overseas economies, a buildup in cash reserves quickly leads to pressure on management to buy back shares or increase dividends. In Japan, meanwhile, many businesses are run by their owners and indirect financing is the norm, so there is a tendency to seek a margin of safety.

Mr. Yanagawa:

・If we assume that prices will not start increasing until the output gap disappears and that eliminating the output gap will require structural reforms and improved corporate governance, there are limits to what monetary policy can achieve in terms of generating inflation. I think we need to ask what monetary policy can do to change corporate behavior so as to eliminate the output gap.

Ms. Nemoto:

・I wonder whether we can state with certainty that Japan has full employment. Job offer-to-applicant ratios vary greatly from one sector to the next, and wages are unlikely to rise in industries not experiencing a severe shortage of labor. Even individual companies face the problem of having to reassign employees from divisions with surplus staff to divisions without enough people.

Mr. Kitamura:

・To take the example of Fintech, Western financial institutions carry out investments valued at tens of billions of dollars, whereas in Japan even the largest investments by financial institutions are on the order of hundreds of millions of dollars. This difference has a significant impact on the quality of the people involved and the future outlook for the business. What is responsible for this difference?

Mr. Fukuda:

・While investments may be small in global terms, I think Japanese financial institutions have been relatively aggressive in their investments. The difference is due to investor characteristics. In the US, for example, the main Fintech investors are IT companies in Silicon Valley, which have a far greater appetite for risk.

Ms. Okina:

・While there are an increasing number of initiatives to encourage open innovation in Japan, it definitely lags behind the US on this front. Unless Japanese institutional investors change their stance towards startups, I do not think this gap will close anytime soon.

Mr. Oshima:

・Japanese financial institutions are engaged in active IT investment in the fields of retail payments and AI-based investment advice. Traditionally, banks opened branches on prime real estate and made a business out of their settlement systems. But as more and more business is conducted via mobile terminals, banks need to strike a balance between the two. There is also the question of how to approach the roles served by regional branches. In that sense, I think IT investment by Japanese financial institutions is relatively small in comparison not only to Western banks but also to Asian and Chinese banks.

Mr. Kozu:

・In other countries, there is a market of "unbanked" customers that is more open to penetration by Fintech companies, and they have succeeded in expanding their operations in those areas. Japan has relatively few unbanked individuals, which means Fintech companies serve as an alternative to existing bank channels, making it far harder to achieve the rapid growth seen in places like the US.

・The same could be true in a sense for Japanese manufacturers. It might be possible for them to shift to a more favorable equilibrium by making a large leap, but as they are currently in a separate equilibrium, which is satisfactory to some extent, they have less incentives to make the jump.

Mr. Fukuda:
・Traditionally Japan has had a large domestic market that allowed companies with good business models to grow. But now many companies appear to be satisfied with their success in the domestic market in spite of the fact that it is expected to shrink going forward. Insofar as it is highly unlikely that Japanese ways of doing business will work in overseas markets, Fintech companies also need strategies designed with an eye on overseas markets.

Ms. Suda:
・Another problem is that private companies―which are the drivers of economic activity―are overly reliant on the government in Japan. As for the government's growth strategies, there is too much talk about how the private sector will respond once the public sector takes action. There is also a tendency for private-sector companies to ask the government before embarking on some new business. It is difficult to shed the impression that Japanese companies suffer from a lack of entrepreneurship.

Mr. Kozu:
・I agree. If there is a possibility for change, I think it might be in cases where the CEO of a company sees a risk of the company failing while he/she is in charge. A sense of crisis makes executives more willing to take risks and jump to a new equilibrium.

・Some argue that Japanese companies simply need to bring in management experts from overseas, but I think that even Japan's so-called global enterprises would find it rather difficult to adopt a system in which all decisions were made in English.

Ms. Okina:
・Few Japanese companies have succeeded in establishing truly global executive structures. But that is the only way to improve global competitiveness, and to that end we need to encourage a revolution in CEO awareness, including the need for stronger governance.

Inoue (Organizer):
・How should we approach the transmission mechanisms of monetary policy given the structural characteristics of Japan's economy? Mr. Oshima argued that the QQE initially had some impact via the foreign exchange and equity markets. Or is it possible to create effective demand by lowering real interest rates?

Mr. Fukuda:
・Real interest rates are already low enough. The standard view is that there are structural reasons for the absence of effective demand, and I suspect that lowering real interest rates further would not have a significant impact.

Inoue (Organizer):
・In theory, the natural rate of interest has fallen sharply because of structural issues. I think it can be argued that policy will have no effect unless real interest rates are lowered even further.

Mr. Fukuda:
・To be sure, real interest rates may currently be at elevated levels relative to the natural rate of interest, and I think it would be desirable to bring real interest rates down to that level.

Mr. Takata:
・"Adaptive" or backward-looking formation of expectations applies not only to prices but also to economic growth. I think a major reason why business investment has not increased despite an improving economic outlook is that business executives are forming their outlook for the future based on historically low levels of growth. Moreover, it is not clear how far actual growth rates would have to improve before corporate growth expectations finally pick up.

Mr. Kato:
・Mr. Kuroda and Mr. Nakaso both said in their speeches in the previous week that the BOJ would focus on lowering real interest rates and asked the government to implement policies designed to raise the natural rate of interest. I felt the latter in particular was a novel attempt inasmuch as the BOJ officials have seldom discussed this issue explicitly. Incidentally, the ECB is asking European governments to do the same thing. It was noted in the minutes of the ECB's April meeting that while inflation is a monetary phenomenon in the medium term―which is the horizon over which the BOJ is trying to achieve its inflation target―the specific timeframe will depend on how governments within the region approach the issue of structural reforms.

・While there may be problems with a scenario in which governments act in response to statements by the central bank, I think the BOJ should explicitly express these views. In the initial phases of the QQE the BOJ probably believed it was possible to manage expectations using announcements, but inasmuch is that is no longer possible (if it ever was), the BOJ should use the comprehensive assessment to clearly communicate its views regarding policy transmission mechanisms.

Ms. Suda:

・The BOJ and the government should return to the "joint statement" of 2013. The original agreement was that the central bank would pursue a 2% inflation target while the government would be responsible for undertaking structural reforms. Unless the government upholds its part of the bargain, it will be extremely difficult for the BOJ to achieve the 2% inflation target.

Ms. Okina:

・I agree. The 2% inflation target assumed both the BOJ and the government would fulfill the pledges made in the joint statement. And the government has clearly not satisfied its commitment, including fiscal consolidation.

Mr. Takata:

・Under the QQE, the BOJ maintained the view that prices were the sole responsibility of the central bank. But now I think it needs to shift its stance to one of pursuing the growth strategy together with the government or of presenting a roadmap to 2% inflation that incorporates the private sector's response.

Mr. Uchida:

・The BOJ has two contrasting options. One is for the government to engage in structural reforms and fiscal consolidation while the BOJ uses monetary policy to ease the resulting pain. This approach would eventually bring about 2% inflation and healthy economic growth, but would likely entail substantial deflation along the way. The other option is for the government to engage in massive fiscal stimulus while the BOJ provides support in the form of monetary accommodation. This unified approach would be inflationary in nature. Not even the joint statement makes it clear exactly which path the BOJ has chosen.

Inoue (Organizer):

・Many of the people I have talked to in the other advanced economies have expressed their disappointment that BOJ was unable to implement the first option noted by Mr. Uchida in spite of having such a strong government.

Ms. Nemoto:

・I agree with the idea of coordinating monetary policy with structural reforms. But the question is how the central bank should respond when there is little progress on structural reform. For example, one ECB official argued in a speech at Jackson Hole that the ECB's monetary easing was intended as a short-term strategy designed to last until structural reforms had time to take effect, and that the central bank would have no choice but to further enhance its accommodation if such policies were not forthcoming.

Mr. Fukuda:

・There are also two views within the BOJ. One is that the Japanese economy is fundamentally strong but has fallen into a deflationary equilibrium as a result of a kind of coordination failure. If this is the case, what policy needs to do is change expectations. The other view is that Japan's economy suffers from structural problems that have depressed the natural rate of interest and tipped the economy into a deflationary equilibrium. If so, policymakers need to push ahead with structural reforms. The "comprehensive assessment" could lead to an inappropriate policy response unless it takes both views into account.

Mr. Kitamura:

・Under the current Bank of Japan Act, the BOJ makes decisions independently of the government. But this is difficult to achieve in reality as long as key personnel—including the governor, the deputy governors, and Policy Board members—are appointed in accordance with the wishes of the government. To the extent that it is difficult for people inside the BOJ to discuss this issue, we need outside experts to talk about it.

Mr. Fukuda:

・In contrast, one issue that *can* be discussed within the BOJ but is not being discussed is the question of how long the QQE can be sustained if time is needed to achieve the BOJ's inflation target. The BOJ appears confident in the policy's sustainability, including its ability to continue increasing its JGB holdings by ¥80trn a year. But I think it needs to do more than simply express its confidence without engaging in any proper discussion of the issue.

Inoue (Organizer):

・Concerns about the sustainability of the QQE were probably one of the reasons why the BOJ conducted the comprehensive assessment. However, it is unclear whether the central bank will provide the kind of clear explanations sought by Mr. Fukuda. For example, it may provide a de facto answer by adopting some new policy tool that is more sustainable.

Mr. Uchida:

・When the BOJ argues that the QQE is infinitely sustainable, it is relying on two assumptions: 1) that any losses can be written off using seigniorage, and 2) that its JGB portfolio can eventually be trimmed via redemptions. However, if there is a period of zero or negative interest rates ahead, the flows from seigniorage would be zero or negative. Additionally, perpetual assets such as ETFs or REITs that are not redeemable would eventually have to be sold on the market to reduce the central bank's portfolio, raising concerns about their effectiveness. This would have a major influence on our view of the policy's sustainability, including the appropriateness (or lack thereof) of defining the central bank's capital in relation to outstanding banknotes and retained earnings.

Ms. Suda:

・The old Bank of Japan Act contained a provision allowing the government to compensate the central bank for any losses incurred. This clause was eliminated in the new Act, however, and the BOJ is now required to conduct policy autonomously within the scope allowed by its capital. However, the QQE has already gone beyond this (even if we take into account the increased reserves set aside by the BOJ in recent years), and if we were to apply mark-to-market accounting, the central bank might become insolvent or be forced to discontinue its payments to the government for an extended period of time.

Mr. Kozu:

・The net present value of seigniorage would be considered an asset of the central bank if mark-to-market accounting were used. Once that is taken into account, there is a far reduced likelihood that the central bank would become technically insolvent at some point in the future. I do not think the BOJ can currently be considered insolvent in that sense of the word, and personally I do not think the outlook is as dire as Ms. Suda seems to suggest. Of course it will depend on how long NIRP is left in place and how deep into negative territory the BOJ takes interest rates, but I believe the BOJ will wind down NIRP sometime in the future. In any case, if one takes the view that the Japanese government and the Bank of Japan can continue to exist as long as the nation itself does not fail, I think there is scope for the Bank to continue buying assets based on the net present value of its seigniorage, even if that entails temporal capital losses.

Mr. Uchida:

・Put more simply, seigniorage can be expressed as a fraction with nominal interest rates as the numerator and real interest rates as the denominator. The BOJ's explanation is that it can continue to purchase assets because ultimately nominal interest rates will be positive. There is the possibility, however, that nominal rates will be zero or negative for an extended period of time during this process.

Mr. Kozu:

・Even if the BOJ were to become technically insolvent for a short period of time because of such factors, it should be possible to resolve the problem in the end. Hence I see no need for market participants to be worried about a BOJ bankruptcy as long as they have a rational understanding of the situation.

Ms. Suda:

・Any potential future losses can be covered with seigniorage if we assume that the BOJ will continue to exist forever and that at some point it will be able to "normalize" its asset holdings. But if it is forced to stop making payments to the government at some point during that process, we can expect severe criticism from the general public claiming that unelected BOJ officials are wasting taxpayers' money, and this could heavily undermine the credibility of monetary policy. It is because of such concerns that the FRB is seriously considering normalizing its own balance sheet. When thinking about central bank asset purchases, I think we need to give serious consideration not only to the endgame but also to the path leading up to that endgame.

Mr. Fukuda:

・Even if the BOJ decides to use seigniorage, it is the government sector that would benefit, so from a macroeconomic perspective it is not as if seigniorage has declined. Hence I am not so sure that the public would complain.

2. Policy tools: assessment and outlook

Inoue (Organizer):

・As the discussion has already progressed to the subject of policy tools, I would like to move on to the second half of the reference materials. The maturity profile of the BOJ's JGB holdings is not uniform from either a flows or a stock perspective. Mr. Iwata presented some estimates at the Panel's March conference, and I think more analysts are now thinking about the BOJ's ability to continue buying BOJ's and the likely timeframe for an end to the program, based on various investors' need to hold JGBs.

・It is also important when considering NIRP's knock-on effects to look at changes in the distribution of the holders of current account deposits as well as the mechanisms for interest rate formation in the money market. I would like to ask Mr. Kato to follow up on this point later on. Recent data show financial institutions' loan-to-deposit spreads continuing to shrink (since March) as the share of low-yielding loans has risen sharply.

・Among market participants, one focus of discussion concerns the fact that the JGB curve flattened after the announcement of

NIRP and, despite a modest recent correction, remains relatively flat today. Incidentally, the Financial Markets Panel has been watching this since soon after Switzerland adopted its own negative-interest-rate policy. The market appears to be attributing the flattening of the JGB curve to 1) a growing "search for yield," 2) the unique characteristics of Japan's JGB management policy (in comparison to that of the eurozone), and 3) fears that NIRP will become entrenched, reflecting an extended period of low growth and inflation expectations.

Mr. Fukuda:

・Will it be possible for the BOJ to continue buying JGBs even after it owns 60% or 70% of all outstanding government debt?

Mr. Takata:

・At present, we estimate that private-sector investors have room to sell some ¥230trn in JGBs. Assuming that the BOJ continues to increase its outstanding holdings by ¥80trn per year, that means it only has three years to go. And once we take into account the fact that financial institutions need to hold JGBs for use as collateral and so on, I suspect we will start to see undersubscribed buying operations in a year or two. Actually, the central bank will be able to buy a certain amount of bonds if it is willing to pay any price, but it would be difficult to continue buying in current quantities. Even if other instruments are added to the list of assets eligible for purchase, none of them have nearly as deep a market as JGBs, which means such actions would only serve to prolong the eventual end.

Mr. Oshima:

・I believe the BOJ will be able to continue buying JGBs at current quantities for only another year or so. Financial institutions need to hold on to one-third to one-half of the JGBs they currently own for use as collateral, etc. In fact, they will face a growing need to hold JGBs for use in derivative transactions and cross-border repos if they are to preserve their financial functions.

Mr. Uchida:

・The reference materials noted Japanese financial institutions' low loan-to-deposit spreads. In contrast, typical spreads in Europe and the US are about 200bp and 300bp, respectively. Even in the eurozone, which has its own version of NIRP, there are some transactions on the interbank market at deeply negative interest rates, but most of those involve transactions with banks in countries that maintain currency pegs with the euro, and to that extent include a premium to cover the risk of the peg being dropped. The rates on residential mortgage loans and ordinary commercial loans remain firmly in positive territory. In Japan, meanwhile, the rates on residential loans have fallen to levels approaching zero once insurance fees are deducted. From an interest rate standpoint, financial institutions use three tools to manage their balance sheets: total risk, value at risk, and net interest income. If NIRP remains in place, it will affect banks' balance sheet management via the factor of net interest income. That, in turn, will crimp their risk-taking appetite, as Mr. Kuroda and Mr. Nakaso have recently pointed out. When the BOJ examines the costs and benefits of NIRP in its comprehensive assessment, I hope it also takes into account national differences in financial structure as well as the policy's impact on bank balance sheet management via future interest income.

Ms. Nemoto:

・Eurozone banks enjoy higher lending rates and spreads than Japanese banks, but lending rates to both individuals and businesses have recently fallen substantially, and lending has increased. In Denmark and Sweden, for example, residential mortgage rates have increased, partly because the supervisory authorities have responded to an overheated housing market by raising the capital charge levied on such loans. In both countries, the pressure on banks to reduce their lending rates does not appear to be particularly strong inasmuch as negative interest rate policies were introduced with the objective of stabilizing exchange rates.

・Even if it is the case that NIRP is partly responsible for the pressure on Japanese bank earnings, there are a number of other factors that have also played a role, including elevated dollar funding costs (via currency swaps) and depressed sales of investment trusts and insurance, due in part to the soft market environment. Effects on market functions include 1) the difficulty of engaging in arbitrage between derivatives that can be traded at negative rates and cash instruments that cannot and 2) the inability to use risk-management models that never envisioned negative interest rates.

Mr. Oshima:

・Immediately after the adoption of NIRP it became difficult to price certain derivatives referencing short-term interest rates. Financial institutions subsequently resolved many of these problems, but some transactions are still difficult to deal with. Further enhancement of NIRP would probably send a substantial portion of the rates on floating-rate loans into negative territory, which would not only weigh on bank earnings but could also upset customer relationships. I think it will be difficult to reinforce NIRP given the implications for exchange rates and other policy effects.

Mr. Kato:

・The sharp decline in the number of call market participants followed the introduction of NIRP has reversed to some extent, but the reversal appears to have peaked over the last few months, and there are some players that refuse to deal in negative-rate transactions. Under NIRP and the three-tiered current account deposit structure, financial institutions have resumed fine-tuning their fund positions with an eye to minimizing policy rate balances, and more attention is paid to the BOJ's forecasts for funds supply and demand. In the commercial paper market, yields have declined but issuance remains depressed. There is a strong incentive for companies to secure long-term funding by issuing corporate bonds while long-term interest rates remain low. Banks worried about the impact on lending rates have refused to accept negative commercial paper yields. While some intermediaries and financial institutions are doing deals at negative rates as long as the paper can be sold to the BOJ in its buying operations, such behavior is being observed only on the margins inasmuch as there are almost no private-sector investors willing to hold commercial paper at negative yields.

・While both Japan and the eurozone have negative-interest-rate policies, the shapes of their respective yield curves and the spreads available on loans to customers are very different. While the BOJ argues that it could, like the ECB, take interest rates farther below zero if necessary, I believe the shock to Japanese financial institutions would be greater than has been the case in Europe. The going rate for a 10-year fixed-rate residential mortgage in Sweden, for example, is currently about 3%. Reasons why demand is still strong and the supervisory authorities are tightening loan-to-value regulations include the nation's high birth rate and substantial population inflows, which have led to an outlook for a tight housing market, along with generous social benefits that mean people have few post-retirement concerns. The interest rate elasticity of residential mortgage demand is quite high under such circumstances.

Inoue (Organizer):

・As Mr. Fukuda noted at the last meeting, even if the BOJ were able to keep super-long interest rates in check, there is still the question of whether that would have a meaningful impact on the real economy. Mr. Kato's Swedish example is not the only one. In the US, for example, the FRB often talks about the major role that residential investment plays in the transmission of monetary policy.

Mr. Fukuda:

・Super-long-term interest rates have little role to play in stimulating business investment. That requires reductions in medium-term (e.g., 5-year) interest rates. While lower super-long rates can stimulate residential investment, there is still the issue of real demand. Residential investment has picked up significantly in Japan, but much of this is for investment or tax purposes (the latter representing buy-to-let demand). And as long as bank deposits continue to increase in Japan, I think it will be extremely difficult for banks to raise their lending rates.

Ms. Suda:

・I would like to see the QQE replaced with a more sustainable framework, and I do not think it would be desirable to further enhance NIRP at this point in time. But what sorts of policy tools would involve relatively low costs if the Japanese economy experiences a shock at some point in the future and the BOJ must act?

Mr. Uchida:

・The BOJ, like the ECB, will probably move in the direction of enhancing sustainability. If the Japanese economy experiences increased stress, I suspect the BOJ will take a pinpoint approach to dealing with it. If the yen strengthens dramatically, the BOJ will probably move to reinforce NIRP. Levying an interbank penalty for holding yen assets would probably be the most effective way of curbing the yen's rise. If GDP growth falls precipitously, the government would probably increase fiscal expenditures with a supplementary budget while the BOJ provided support in the form of monetary accommodation.

Ms. Nemoto:

・Is there any way to reduce the side effects of enhancements to NIRP?

Mr. Uchida:

・Unless the yield curve steepens a bit more, no forward-looking expectations will form under the current "backward-looking" mechanism, leaving insurers and pension funds unable to generate investment income. This could develop into a major social issue. For that reason, I believe the BOJ will adopt policies designed to steepen the yield curve.

Mr. Kato:

・The BOJ has taken the position that the JGB curve has flattened excessively under the QQE. It is possible to argue that this has happened not because the BOJ bought large quantities of super-long JGBs but rather because the central bank's forward guidance—its announcement that it would keep QQE in place until inflation was consistently running at 2%—has been so powerful, or because real interest rates did not fall far enough to spark future inflation expectations.

Mr. Oshima:

・The rise in long-term interest rates following Brexit had a major impact. Inasmuch as there are likely to be a variety of situations going forward in which long-term interest rate volatility increases, the shape of the yield curve—including appropriate risk premia—will become increasingly important. This may have been discussed at Jackson Hole, but I think there is a growing view that rather than using large-scale central bank purchases of government bonds to force down long-term interest rates, keeping long-term rates within a given range while restoring a more appropriate shape to the yield curve would do more to encourage healthy economic activity and a stable financial system. I also think we should take a different approach to thinking about the level of long-term interest rates themselves. Pension funds and insurers are finding it extremely difficult to invest their capital, and if nothing is changed this will undermine the impact of NIRP.

Mr. Kozu:

・In the initial stages of the QQE, the BOJ intentionally emphasized the monetary base in its explanations, but I suspect it will downgrade the significance of the monetary base to some extent in the "comprehensive assessment." The main transmission mechanism for monetary policy would probably be expansion of the central bank's balance sheet, much like the FRB's large-scale asset purchases (LSAPs). As for the argument that the central bank's bond purchases are approaching their limits, the BOJ would not be bound by the concepts of "quantity," "quality," and "interest rates" so far shown if it were to argue that balance sheet growth in and of itself would have an accommodative effect, and it could also acquire alternative assets such as gold bullion.

Mr. Takata:

・I think expansion of the balance sheet is an appropriate policy, and while in theory there are a variety of assets that the central bank could buy—including gold, real estate, and bank loans—JGBs are the only asset in Japan that can be purchased in quantities amounting to trillions of yen. Any expansion of the balance sheet using other assets will necessarily be limited in scale. The BOJ argues that it can acquire any amount of assets, including JGBs, but its task over the next few years will be achieving a balance between this theory and the reality of the markets.

Ms. Okina:

・I agree with Mr. Uchida when it comes to the BOJ's response to a major economic shock. When the BOJ introduced NIRP, I do not think it expected the yield curve to flatten as much as it has. That has had a significant impact on financial institution earnings and has forced insurers and pension funds to turn overseas for their investment opportunities. If this state of affairs continues, households will grow increasingly concerned about their retirement. Hence I think the curve needs to steepen. Once that happens, we will return to the questions of how the BOJ views inflation expectations and how those expectations are affected by large-scale asset purchases.

Mr. Kozu:

・Last year the BOJ presented the concept of a "natural yield curve." Given the various problems that arise when the yield curve is too flat, the BOJ may declare that it will adjust its JGB purchases with an eye on the relationship between this natural yield curve and the actual yield curve. In that case, the BOJ would be seeking a "twist" of assets and with it a reinforcement of NIRP.

・If the BOJ judges that the labor market is at full employment, it may also take the view that inflation will gradually pick up as the impact of stickiness in wages, etc., gradually dissipates. It may also need to implement additional easing to support expectations in the event that this process is in danger of running aground. In that case, the BOJ may use the tools of balance sheet expansion and adjustments to the shape of the yield curve. It still needs to continue its slow but steady efforts.

Mr. Kato:

・While a steeper yield curve is desirable, if the BOJ is to make adjustments to the shape of the curve based on what it believes the natural yield curve to be, targeting medium- and long-term bond yields would require it to determine where to set those targets and how to adjust its JGB purchases accordingly. Additionally, I think the central bank would be concerned that a pronounced steepening of the curve might put upward pressure on the yen.

Mr. Oshima:

・Although it remains to be seen whether or not the FRB will hike rates, in general the overseas environment is quite stable, and the risk of significant yen appreciation is modest. In that sense as well, I think the climate for the "comprehensive assessment" is very favorable.

Mr. Fukuda:

・Macroeconomic policy should take into account the overall impact on the economy, inasmuch as it is difficult to avoid having different impacts on various economic agents. While some would like to see both a stronger yen and higher interest rates, others would be on the opposite side of the spectrum. Policymakers must choose the policy that has the greatest overall positive impact at a given point in time while trying to win the support of those opposed to the policy.

Mr. Kitamura:

・A central bank policy of buying up the JGBs that financial institutions need in their ordinary operations seems to me to have entered the realm of the extreme. Specifically, acquiring the same JGBs that supervisory authorities are telling financial institutions to hold seems to raise questions that go beyond a simple cost-benefit analysis. Returning the shape of the yield curve to a market-determined state should be the underlying priority, and I think it is far from healthy for the central bank to continue intervening in all aspects of the markets. It should reaffirm its policy goals and reorganize its policy tools accordingly.

Mr. Uchida:

・From a technical standpoint, I think the problem of a shortage of JGBs for use as collateral or for regulatory purposes could be addressed by having the BOJ take the JGBs it has acquired and supply them to financial institutions in negative-rate repos.

Inoue (Organizer):

・Generally speaking, does the BOJ have the leeway needed to consider a mixture of monetary policy and macroprudential policy, as the BOE did in August when it implemented additional easing?

Mr. Uchida:

・I am not sure that is necessarily a favorable development.

Inoue (Organizer):

・Ultimately, it comes down to a question of which policy goals should receive priority.

Mr. Fukuda:

・At the BOE, a separate body (although it is headed by the same people as the BOE itself) is responsible for discussing the two types of policy. At the BOJ, in contrast, I think the priority will always be on monetary policy, and there is probably limited scope for, say, the Financial System Report to discuss policies that are at odds with the BOJ’s official monetary policy.

Ms. Suda:

・Would it be possible to steepen the yield curve while maintaining a target for the quantity of JGB purchases? When the BOJ buys bonds in sectors with ample supply, it tends to end up focusing on the long-term sector.

Mr. Takata:

・Eventually the BOJ will run up against limitations on the quantity of its bond purchases, the framework will not be sustainable unless it somehow puts a greater emphasis on interest rates. Before long the BOJ will be forced to adopt a policy framework centered on interest rates, even if it is in a somewhat “fuzzy” form.

Mr. Kato:

・In Sweden, the central bank has taken the policy rate deeper into negative territory than the BOJ, yet the yield on the 10-year government bond is about 0.10%, which is substantially higher than the equivalent yield in Japan. Contributing factors include the fact that the Swedish central bank has not bought nearly as many bonds along with its decision to indicate the projected path of the policy rate using fan charts. These fan charts currently show that the policy rate will return to positive territory in 2018, and market participants view negative interest rates as a temporary phenomenon.

・Under the BOJ’s forward guidance, in contrast, market participants do not know how long the “QQE with NIRP” will continue, which is conducive to a flattening of the curve. Consequently, it is unclear just how great an impact a reduction in the BOJ’s JGB purchases would have on the shape of the yield curve. This also gets back to the question of the credibility of the BOJ’s 2% inflation target.

Mr. Fukuda:

・Regarding credibility, the BOJ’s forward guidance itself is a problem, but even more important is the fact that actual inflation rates have not improved, and the central bank has continued to overestimate the outlook for inflation.

Mr. Takata:

・The Swedish central bank may fall into the same situation as the BOJ depending on how inflation behaves going forward. Since Sweden is targeting an exchange rate vis-à-vis the euro, the actual inflation rate will be influenced by eurozone economic performance and monetary policy.

Inoue (Organizer):

・There is a strongly held view among market participants that the weights assigned by the BOJ to the dimensions of “interest rates” and “quantity” will change as a result of the comprehensive assessment, and many believe the “natural yield curve” will be referenced when determining the appropriate level of steepening for the curve. On the other hand, is the BOJ not concerned about sending the message that it is capable of controlling JGB prices under severe fiscal straits?

Mr. Oshima:

・While I don't think the BOJ should officially comment on price control, I think there is scope for it to encourage the market to price in a change in its buying methods—in the past, for example, it increased purchases of bonds in sectors where yields had risen sharply.

Ms. Suda:

・It is my recollection that the "natural yield curve" itself was quite flat.

Mr. Kozu:

・Yes, but would the natural level of the 10-year JGB yield be negative?

Ms. Okina:

・I think the smooth take-up of government bond issuance and efforts to influence the shape of the yield curve—including liquidity-supply auctions—would normally belong under the jurisdiction of the Ministry of Finance.

Mr. Fukuda:

・That may have been the case when the BOJ was only buying short-term government bonds. Now that it is buying so many longer-term bonds as well, I don't think the BOJ can avoid taking responsibility for the functioning of the JGB market.

Ms. Okina:

・I agree, and I think the BOJ needs to pay more attention to maintaining bond market functions, including the conduct of repo operations.

Mr. Takata:

・For all intents and purposes, the BOJ's monetary policy has become one with the MOF's debt management policy.

Ms. Nemoto:

・The BOJ has noted the reduced functionality of the JGB market in its Financial System Report, but the analysis does not appear to be as concrete as in other reports.

Mr. Oshima:

・The Financial Markets Department periodically publishes the results of its surveys, and they indicate a sign of severe shortage of market liquidity.

Mr. Takata

・If the BOJ's share of outstanding JGB issuance continues to increase, the discussion will have to extend beyond the realm of simple market liquidity.

Ms. Okina:

・Inasmuch as that is very easy to predict, I think market participants will suffer if the BOJ does not clarify its position on this issue.

Mr. Uchida:

・The BOJ is absorbing market liquidity in a variety of markets, but it is also important to focus on the suppliers of liquidity. Under current conditions, profitability is declining in many markets, including commercial paper and corporate bonds as well as the short-term interbank market and the JGB market, and consequently there are fewer providers of liquidity. The responsibility for reversing this situation probably lies with the private sector, but the concern is that it would entail a great deal of turmoil.

Ms. Suda:

・While it is difficult to generalize because of the different scale and methods of operations involved, I remember that when the BOJ wound down its first experiment with quantitative easing, the functions of private-sector agents were restored quite quickly once yields turned positive, creating profit opportunities.

Mr. Uchida:

・In 2006 the BOJ embarked on a project to revitalize the money market under Governor Fukui, and it spent about six months working together with key market participants to encourage a recovery in transactions. At the time, excess reserves amounted to only about ¥30trn, and all market participants had experience with positive rates. In that sense as well, there is no guarantee that the number of market participants will increase or that transactions will naturally recover.

Ms. Okina:

・I agree, and that is why I think the BOJ needs to explicitly discuss its plans for an exit from the current policy framework. In 2006, it was precisely because the BOJ had discussed an exit strategy that both the BOJ and market participants were able to respond in the way they did.

Ms. Suda:

・Since more than three years have passed since the adoption of the QQE, the BOJ appears to be taking the position that it makes no sense to discuss its efforts to achieve the two-year inflation target, but I think it is still important to reaffirm the fact that the QQE was possible because it was a short-term strategy.

Mr. Fukuda:

・I agree, and I think the BOJ should engage in a comprehensive assessment of this point.

Mr. Kozu:

・I presume the BOJ will attribute its inability to achieve the 2% inflation target to factors beyond its control in the comprehensive assessment.

Mr. Kitamura:

・When the BOJ introduced the QQE, it should have talked about how far it was possible to raise inflation, taking into account factors beyond its control. Adopting the policy without doing this, as Mr. Kozu noted, was irresponsible.

Mr. Kozu:

・Some would criticize BOJ when it explains that inflation expectations are "backward-looking" or that it attributes its inability to achieve the price target to factors beyond its control. That said, I think it can be argued that the 2% inflation target is achievable if the influence of a number of factors disappears. In making such acclaim, we need to capture the underlying trend of inflation, something the BOJ has tried to do by stripping out overseas factors and so on using a variety of methods. However, this is not easy from a technical perspective. The GDP deflator may serve as a useful reference if it accurately reflects "homemade" inflationary/deflationary pressures. Historically, however, the inflation/deflation rate calculated using the GDP deflator has tended to be lower than CPI inflation in Japan, which suggests the real output gap was potentially larger than the BOJ's estimates suggested. The BOJ's use of CPI inflation to describe conditions as being "mildly deflationary" might therefore have to be reconsidered. The upcoming comprehensive assessment will not go back that far, however, and it will just tell that more time will be needed to achieve the target of 2% CPI inflation and hence the BOJ will adopt a more flexible "quantitative" target until the inflation target can be achieved.

Mr. Kitamura:

・Estimates of the policy's impact should naturally take into account the market's reaction. Additionally, the initial effect of the QQE also includes the results of policies implemented under the previous regime.

Mr. Fukuda:

・The BOJ has chosen to attribute the initial market-based impact of QQE to the policy itself, but when the market moved against the policy, it began to treat those factors as being exogenous.

Ms. Okina:

・The ultimate goal of the BOJ's monetary policy is to enhance the welfare of the general public. Given that, is it really appropriate to pursue the 2% inflation target exclusively?

Mr. Fukuda:

・Under the BOJ Act, the goal is to promote national economic development via price stability. In other words, it is responsible for contributing to economic growth by maintaining stable prices.

Ms. Okina:

・For example, a decline in oil prices makes it more difficult for the central bank to achieve its inflation target, but from a macroeconomic perspective it contributes to national economy.

Mr. Kato:

・I suspect the comprehensive assessment will present a rationale that presents the BOJ's actions in a favorable light. For the markets, however, it is difficult to accept such reckless operations without any attempt by the central bank to revise its initial explanation. Even if the BOJ tries to present its actions in a favorable light, I think it is important that the markets accept the BOJ's explanation in order to encourage it to take appropriate steps towards normalizing policy.

Mr. Kozu:

・The BOJ has explicitly stated that the comprehensive assessment will not involve any reduction in the degree of accommodation. Therefore I imagine it will try to find a way of enhancing monetary accommodation that the markets find more acceptable while providing more thoughtful discussion of the policy's various side effects.

Mr. Kitamura:

・The BOJ should be somewhat more direct in its message.

Ms. Suda:

・The text of Mr. Kuroda's speech in the previous week also suggests the BOJ's explanation of events has slowly evolved over time. If it can use the comprehensive assessment to present a more sustainable framework, I think it would be good for the market to "accept" the assessment.

Ms. Nemoto:

・Many overseas investors continue to take a very critical view of NIRP, and the IMF is not nearly as supportive as it once was.

Inoue (Organizer):

・There is much more to discuss, but unfortunately we are out of time and I will have to call an end to this session. I would like to thank all of the panelists for a very lively discussion. ***