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

May 20, 2016

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| **Topic** | Policy issues for Bank of Japan |
| **Date** | March 14, 2016 (3:50pm – 5:30pm) |
| **Panelists** | **Mr.Kazuto Uchida,** Executive Officer and General Manager, Credit Policy & Planning Division Bank of Tokyo-Mitsubishi UFJ<br>**Mr.Katsuyuki Tokushima,** Chief Pension Consultant, NLI Research Institute<br>**Mr.Kaoru Hosono,** Professor, Faculty of Economics, Gakushuin University<br>**Mr.Noriyuki Yanagawa,** Professor, Faculty of Economics, The University of Tokyo<br>**Mr.Toshiaki Watanabe,** Professor, Institute of Economic Research, Hitotsubashi University<br>**Tetsuya Inoue,** General Manager, Nomura Research Institute (Moderator) |

### Key Discussion Points

1. **Lead comments**
2. **Survey results and free discussion**

### 1. Lead comments

**Inoue (moderator):**

・In this session I would like to discuss policy issues for the Bank of Japan. Although I have already asked panelists in advance to cover certain points, we will take a flexible approach today and include a period of free discussion.

**Mr. Uchida:**

・Since the key transmission mechanism for "QQE with negative interest rates" involves the effect of lower real interest rates on financial markets and the real economy, real interest rates are essential to assessing the policy's effect and identifying any associated problems. Of the two components of real interest rates—nominal rates and inflation expectations—nominal rates have already dropped into negative territory, while inflation expectations have maintained their linkage with import prices. As such, real interest rates may have risen if inflation expectations, reflecting the recent drop in import prices due to sliding commodity prices, have fallen even more than nominal rates.

・Boosting business investment is a key theme of "Abenomics", but its inflation-adjusted growth remains modest, and investment has yet to recover to pre-Lehman levels. Business invetment is also influenced by earnings, and an analysis of the factors driving recurring profit suggests that recently it is the decline in variable expenses due to falling oil prices that is responsible for the pick-up in investment, and not stronger sales. As such, both sales and profits may slip once oil prices rally.

・The propensity to consume—personal consumption divided by employee compensation—has declined steadily since the consumption tax was raised. This probably reflects concerns about the sustainability of social welfare and recent increases in the cost of living. Inasmuch as both of these factors are hard to address using monetary policy, they are likely to hamper the effectiveness of monetary policy. That said, estimates based on the Phillips curve suggest that growth in nominal wages might accelerate if the unemployment rate drops below 3%. Real wage growth could also turn positive inasmuch as the incomes DI is rising and the prices DI is falling. These factors would probably serve to reduce the output gap.

・A comparison of USD/JPY purchasing power parity—calculated using the average of producer prices and consumer prices—and the spot market shows that the yen has recently depreciated to levels on a par with those prevailing before the Plaza Accord, implying there is little scope for further declines in the Japanese currency. In the period since 1Q 2012, Japan's real exports have not increased (with the exception of shipments to the US market) even when monetary accommodation drove down the value of the yen. A weaker yen alone is not sufficient to boost external demand; demand in Asian markets and other emerging economies needs to recover, too.

・In the Eurozone, which adopted a negative-interest-rate policy (NIRP) ahead of Japan, bank lending increased, but nearly all of that growth was driven by loans to individuals; lending to nonfinancial corporates has been stagnant. In Denmark, even lending to individuals began to contract last year. Meanwhile, a look at household financial assets in the Eurozone suggests that NIRP has helped promote a rebalancing of portfolios from cash and deposits into investment trusts. However, Eurozone inflation expectations have been depressed by the decline in commodity prices, just as in Japan.

・One long-term impact of QE has been a sharp increase in the correlation of asset prices. From the standpoint of credit risk, the risk of unexpected losses—the tail of the normal distribution—has increased, and I think QE has clearly played a role in this. Second, the shadow banking sector has grown dramatically. This is particularly true in business lending, where shadow banking's share has climbed to around 25% today from about 10% pre-Lehman.

**Mr. Watanabe:**

・ Data from surveys are often used to estimate inflation expectations, a key factor in determining real interest rates. There are numerous surveys targeting market participants, economists, businesses and consumers. While historically attention tended to focus on changes in the mean or median result, in recent years the shape of the distribution and the differences between economic agents have come to attract more interest.

・Examples of survey-based research include studies using the BOJ's Opinion Survey on the General Public's Views and Behavior, studies by Yokohama City University's Nakazono drawing on data gathered by research institutes, and studies by Hitotsubashi University's Research Center for Economic and Social Risks. Some studies have also tried to estimate inflation expectations using the prices of index-linked government bonds or inflation swaps. Two points that have been underscored by these efforts are that 1) inflation expectations are very sticky and therefore difficult to move quickly and 2) there are significant differences among economic agents, and the degree of those differences can change over time.

・One theory that attempts to explain the stickiness and diversity of inflation expectations is the sticky information model, made famous in a paper by Mankiw and Carroll. This model is based on the assumption that since there is a cost to collecting information, the number of agents that will periodically collect information and revise their forecasts is quite small. According to this view, some economic agents base their views on information from the prior period, which is why the overall forecasts can be sticky. The noisy information model, meanwhile, posits that an agent's inflation expectations differ depending on what items he or she buys, and since each agent has access to different information, forecasts are bound to vary. My academic advisor Christopher Sims is one of those who have argued for this position, with a paper by Coibion providing a good survey of the literature.

・There is a great deal of research analyzing the factors that drive inflation expectations, with a common conclusion being that inflation expectations are heavily influenced by past inflation rates. There have also been studies based on US data that compare inflation expectations among the young and old, based on the view that expectations are formed based on the inflation one has personally experienced. This research suggests that since younger people have little experience of inflation, their views tend to be influenced by recent price trends, whereas the older generation, with its much greater experience, tends not to revise its inflation expectations nearly as often. Similar research using Japanese data has been published in the BOJ Review series, where it was reported that the inflation expectations of people in their twenties tend to lean towards deflation, whereas seniors also forecast inflation.

・The BOJ Review Series has also featured a study by the BOJ attempting to analyze the impact of monetary policy on inflation expectations. The study concluded that QQE has lifted inflation expectations somewhat. However, other studies have concluded that economic agents' inflation expectations would converge around 2% if they had confidence in the 2% inflation target, but the growing variance of their expectations suggests the policy has not succeeded in anchoring expectations. There is also a survey of past research in Japan and elsewhere regarding the relationship between inflation targets and inflation expectations. It concludes that countries that set inflation targets in order to quell high inflation have succeeded in stabilizing inflation expectations almost without exception, but that setting such a target in order to overcome deflation has not worked in Japan.

**Mr. Yanagawa:**

・Analyzing how inflation expectations are formed and how they change is essential to any discussion of monetary policy, and as Mr. Watanabe noted there is a great deal of empirical research on the subject. However, the discipline of economics has yet to provide a conclusive answer to the question of how to alter inflation expectations. In that sense, the quantitative easing policies adopted by Japan and other developed economies were experimental attempts to address what were clearly challenging problems. Quantitative and qualitative easing produced large changes in asset prices, but it did not move inflation expectations as much as expected. In that sense, it did not produce a major change in expectations or have the knock-on effects that were anticipated.

・NIRP is both consistent with economic theory and easy to understand in that it attempts to lower real interest rates by pushing nominal rates into negative territory. While its short-term impact is unclear, it can be expected to have a certain positive impact in the longer term. But it also presents certain challenges. First is the question of whether a mere 10bp reduction in interest rates will spur increased consumption and investment when a zero interest rate was unsuccessful (naturally this would not be the case if we were considering rates of minus 5% or minus 10%). Second, there are practical and technical issues that have yet to be addressed, including the fact that the computer systems at many financial institutions are incapable of processing negative interest rate transactions. Third, the BOJ was unable to convince the public of the significance or impact of negative interest rates. Ordinary people and most business owners probably asked themselves whether the economy was so bad that this kind of incomprehensible policy was really necessary. Providing a persuasive explanation of the policy to the public should be an essential component of the BOJ's communications strategy. And inasmuch as NIRP is not particularly compatible with quantitative easing, the BOJ's ability to explain the "three dimensions" of easing (quality, quantity, and negative interest rates) will also be important.

・In a sense it is natural that there are limits on monetary policy's ability to influence the real economy. While it is clearly problematic that low interest rates have failed to boost consumption and investment, not all problems can be solved with monetary policy alone. It is difficult for business owners and consumers to invest or consume without an optimistic outlook on the future. Residential mortgage rates have fallen to levels at which people should be flocking to the banks to borrow money and build new homes; the fact that they have not done so is probably due to concerns about the future. Addressing this issue will require an all-out mobilization of government policy, including growth strategies and deregulation. Banks also have to become better credit assessors, and the financial system itself has to become more efficient. Putting aside for a moment the question of feasibility, I think the central bank might be able to enhance confidence in monetary policy by declaring that it has done everything it can, and now it is the government's turn to step up to the plate. I personally do not see the lack of growth in consumption and investment as a major problem; a more important issue in my mind is what measures would be used to revive the Japanese economy in the event of a major shock at some point in the future. The central bank needs to set aside a trump card to be used in such an eventuality, yet at the moment it appears to have used up all its ammunition.

**Mr. Hosono:**

・The textbook transmission mechanism for monetary policy involves growth in borrowing, investment, and exports fueled by a lower cost of capital and a weaker currency. Academic economists have also come to agree that the "credit channels" emphasized by Bernanke in his research on the Great Depression are important during ordinary times as well. These channels can be divided into those that work through borrowers and those that work through lenders. The former facilitate borrowing as monetary accommodation lifts the prices of the assets held by businesses and households, thereby increasing their value as loan collateral. The latter stimulate the real economy as banks' ability to loan money increases along with the value of the assets they hold and the corresponding improvements to their balance sheets. There is a great deal of empirical research on this subject. I myself have demonstrated that the quantitative easing conducted by the BOJ in the first half of the 2000s stimulated the economy via the channel of bank balance sheets.

・Bank shares rose more than the Nikkei Average when QQE was unveiled in April 2013, suggesting there were strong expectations of bank credit channels at the time. But bank shares have substantially underperformed the Nikkei Average since NIRP was launched in January 2016. This indicates market participants think NIRP may adversely affect the bank credit channel. Inasmuch as monetary policy previously supported the economy via a variety of channels, it was not so important to identify which specific channel or channels were important. But with NIRP we need to give detailed consideration to the knock-on effects.

・I think the cost-of-capital channel is stimulating the economy under NIRP. The household and business balance sheet channels cannot be expected to deliver much of a stimulus for now inasmuch as land and housing prices have not risen appreciably. Finally, stock prices suggest the bank credit channel may be having an unfavorable impact. In the short run NIRP is unlikely to have a negative impact on lending since quantitative easing continues under QQE and banks have adequate liquidity. However, it is not difficult to envision a narrowing of spreads delivering a "body blow" to banks and ultimately forcing them to rein in lending. Today's bank share prices may be reflecting such concerns.

・Even if we assume the cost-of-capital channel has a positive impact and the bank credit channel a negative impact, it is not simply a matter of netting the two, since the situation varies from one sector to the next. Housing and real estate, for example, tend to benefit, while small banks and small businesses tend to be hurt by the bank credit channel. In this way, the adverse impact of NIRP can be distributed unevenly.

**Mr. Tokushima:**

・I would like to discuss several points from the perspective of one involved in long-term asset management. First of all, I am very suspicious of the BOJ's policy of "QQE with negative interest rates." I do not think the BOJ is capable of controlling real interest rates–which are critical to the transmission mechanism–in the longer run, although it may be able to influence them in the short term. While real interest rates are typically calculated as the difference between nominal interest rates and the rate of inflation, in theory they represent the level of interest rates at which money supply and money demand are in equilibrium. As such, the lower that interest rates must be taken under NIRP, the worse shape the economy is in. I cannot help but feel that the policy tool that has been chosen is inappropriate for today's Japan.

・If the government hopes to accelerate economic growth, it cannot continue to rely entirely on monetary policy while giving short shrift to fundamental responses such as demographic policy and productivity improvements. When launching QQE the BOJ Governor pledged that the BOJ would not engage in "piecemeal" easing and said it would do everything it could to pull the economy out of deflation. However, the results were far from favorable. There are concerns that NIRP will end similarly, having had little impact beyond the initial surprise value. The party that benefited the most from this policy has been the nation's largest borrower–the Japanese government. It benefited at the expense of banks, insurers, pension funds and other institutional investors. From the macro perspective, the profits that should have accrued to these investors were simply repurposed for reducing the government's debt service costs.

・Second, fund management in the JGB market has been greatly affected. Until last December the 20Y JGB was yielding about 1%, and long-term investors such as insurers and pension funds were able to earn acceptable yields. But since the adoption of "supplementary" easing measures last December and NIRP in January, not only has the 20Y yield dropped to around 0.30%, but volatility has also picked up amid a low interest rate environment, with yields surging higher last Friday. Long-term investors such as insurers and pension funds cannot engage in short-term trading of JGBs like banks or securities companies; nor can they buy and hold bonds with negative yields. Instead, according to Ministry of Finance data, they have been increasingly buying foreign securities. Pension funds, unlike insurance companies, can take on a certain amount of risk because they do not have to comply with solvency margin rules. But with leading bond indices delivering negative returns, some pension fund managers are starting to ask whether it makes sense to hold domestic bonds at all or whether they should simply deposit the money with a bank. If it becomes more difficult to generate investment returns, they will have to lower their costs, including their guaranteed returns. While that would be hard to accomplish in practice, it is a topic that will have to be addressed in the longer run.

・Third, credit market investments will also be affected. In part because there are many buy-and-hold investors in the credit market, few negative yields have been observed since January 29, the exceptions being instruments eligible for purchase by the BOJ and highly liquid issues. But with the coupon rate dropping to 0.001%, it is becoming increasingly difficult to price FILP bonds and highly rated issues in the 3Y to 5Y sector. For issuers, this is an excellent opportunity to issue super-long debt in the over 10Y sector given such strong investor demand, but creditworthy issuers can borrow all they want from the banks. I think we may see a "rebalancing" of debt from corporate bonds to bank loans.

・Fourth, there is an impact on corporate balance sheets. While negative interest rates have made it easier for companies to borrow, the question of what to do with "idle assets" has arisen now that yields on bank deposits are so low. A bigger problem is that not only will it become more difficult for companies to invest their retirement benefit reserves, but the assessed value of their retirement benefit liabilities will also increase, putting stresses on their balance sheets. Here, too, companies may be forced in the longer run to either lower their expected investment yields or provide compensation for losses in the form of special contributions.

## 2. Survey results and free discussion

**Inoue (Moderator):**

・I would now like to ask the audience to fill out a questionnaire. The first question asks what sorts of policy measures the BOJ should implement in the event of a downside scenario. "Enhance credit easing" and "other" measures were each noted by almost 40% of respondents, followed by "further cuts to negative interest rates" at 15% and "increased JGB purchases" at 8%. The second question asks how respondents felt about the 2% inflation target. Almost 60% said the target itself should be reconsidered, while just under 40% said it should be made a longer-term objective. The remaining few thought the BOJ should try to achieve the target as quickly as possible. I would now like to ask panelists for their thoughts on these results.

**Mr. Uchida:**

・To the extent that the role of a central bank is to supply necessary funds to the economy while maintaining a healthy financial system, NIRP is an unprecedented and risky experiment. Nor does the

BOJ have anything to gain by supplying more liquidity when there is so much liquidity in the system already. If anything, what Japan needs now is more mezzanine and equity financing for riskier ventures. Japan does not have the deep pool of private equity funds that the US does, and there are probably limits on banks' ability to provide such funds.

・Most demand for funds is for reverse mortgages and other old age-related sources. But since Japan, unlike the US, has no public housing insurance or housing asset valuation bodies, it is difficult for private-sector financial institutions to take on the risk of reverse mortgages. There is strong demand for funds in the healthcare sector, but as this is also a fairly risky industry, government support is needed in the supply of credit.

・We will have to accept a certain amount of disinflation as the world's population grows older. An inflation rate of 2% corresponds to a rate of 4% or 5% when converted to living expenses ex goods. An economy in which living costs increase by 4–5% each year is simply not acceptable unless the average age is around 30. In Japan, where the average age is now over 50, I think inflation of zero to 1% (i.e., disinflation) is an appropriate rate for a stable economy.

**Mr. Watanabe:**

・As for Question 1, I think taking interest rates further into negative territory would entail many problems. Competitive currency devaluations could intensify, leading countries to continue pushing interest rates lower and lower. If further increases in government bond purchases are impossible, I think an enhancement of credit easing would be an effective option given the lack of other alternatives. As for Question 2, I do not think the BOJ should modify the 2% inflation target. Inasmuch as inflation expectations are sticky, a change in the target will not be immediately reflected in expectations and is also likely to spark volatility in asset prices. On the other hand, since a 2% inflation rate cannot be realized in the short run, I think we should make it a longer-term objective, and I suspect that most people already see it as such.

・I agree with Mr. Yanagawa's contentions that 1) monetary policy alone is not sufficient to revive the economy and 2) the BOJ should leave some powder dry in preparation for a major shock. However, I think it is equally important to ask what we can do right now to improve the economy. Fiscal policy is difficult to implement given the size of the deficit, and it takes time for structural reforms to boost corporate productivity. Are there any effective tools besides monetary policy in this sort of environment?

**Mr. Yanagawa:**

・We need to ask how the problem should be framed and what exactly should be targeted. In an environment where it is difficult to lift the potential growth rate, is it appropriate to try to stimulate demand? With real wages starting to rise and some industries reporting a shortage of labor, I do not think we should go any further in terms of recklessly pursuing an expansion of demand. If political considerations require that we expand the economy, fiscal expenditures are the only tool we have.

・The answer to Question 1 in the survey depends on the magnitude of the downside being envisioned. If we are anticipating a Lehman-like crisis, buying government bonds and otherwise supplying funds will be both necessary and effective. But I suspect that we are actually considering something on a smaller scale. In that case, as Mr. Uchida noted, credit easing—including the supply of funds to riskier sectors—will be needed. With today's global emphasis on financial stability and bank health, one aftereffect of the global financial crisis is that there has been insufficient investment by private-sector financial institutions in high-risk areas. In the US, hedge funds and other entities operating outside the regulatory framework provide funds to start-ups and other high-risk sectors, and I think Japan should consider creating a similar kind of funding channel. This is the shadow banking sector, and inasmuch as the funds are flowing only because of monetary accommodation, there is a non-negligible probability that this funding will dry up suddenly at some point in the future. Still, I think there is truth in the argument by a famous economist that we have the bubble to thank for the current innovation in the IT sector. If there were no bubbles and everyone made only reasonable decisions, risky firms in the IT sector would never have received the funding they needed.

・It may be that central banks should acknowledge that there are limits to what monetary accommodation can achieve. However, the BOJ simply cannot do that. Amid a global interest rate war, the BOJ cannot leave the party on its own given the likely impact on the market. If a change in course is necessary, it would best be done within the framework of the G20 or G8, for example. As such—and this relates to Question 2 in the survey—I do not think modifying the inflation target is a realistic option. The question of what sort of dialogue the central bank should pursue with the markets is not just an issue for the world's central banks but also something that scholars need to investigate.

**Mr. Hosono**

・Taking interest rates further below zero is not a good idea, in my view. In addition to the impact on banks' business, it would risk undermining the government's fiscal discipline. This issue was discussed when quantitative easing was first adopted, but the markets have grown used to the current environment, in which they feel there is nothing to be gained by making obvious arguments. In a world where government bonds can be issued at almost zero interest rates, politicians may lose the will to undertake fiscal consolidation, and that risk will only increase if interest rates remain negative or fall further below zero. That will also complicate the exit from NIRP. Mr. Kuroda succeeded in surprising the markets with his monetary easing policies, but surprises are problematic when it comes time to wind down those policies, and unless the BOJ gradually prepares market participants it risks sparking major turmoil in the markets. This is another reason why taking interest rates further into negative territory should be avoided. In the longer term, it will be necessary to ask whether measures intended to prop up the bank-centric financial system are the right policies. As Mr. Uchida noted, we need to think about how to strengthen the financial system by supplying more equity-like funds as opposed to debt.

・In the questionnaire, I replied that we should adopt a longer-term inflation target. Attempts to raise inflation more quickly not only entail questions of feasibility but can also have side effects. On the other hand, there is the concern that revising the target will have an impact on asset prices, and given the target's role in anchoring inflation expectations I think drastic revisions should be avoided.

**Mr. Tokushima:**

・BOJ monetary policy is rapidly running out of road, so the answer to Question on policy measures is really all the same. As for Question on the inflation target, I answered that the BOJ needs to revise the target. In corporate management, there is an ironclad rule that says you should never set an unachievable target. No one expected energy prices to fall this far when the BOJ set its objective at 2%, and given the subsequent changes in the environment the target should be lowered to an achievable level.

・Mr. Uchida argued that Japan needs more mezzanine and equity financing, and I agree. It is problematic that the pension funds that should be supplying funds are not very proactive in taking on risk, but it is also easy to understand why fund managers would hesitate to act upon hearing the abstract argument that "Japan needs more risk money." What we need now is fiscal policy. Monetary policy has run up against a wall, and the government's growth strategy will have little immediate impact. But given the size of the fiscal deficit, I think we need to use private-sector funds to fund fiscal stimulus with public-private partnerships in the broad sense of the term.

**Inoue (Moderator):**

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

**Mr. Okubo (Japan Macro Adviser):**

・First, the reason why QQE has failed to boost the economy is that exports have not grown despite the weak yen, and consequently business investment has not increased. Why is it that the cycle that worked in the early 2000s did not work this time? And what sorts of policies should be adopted? Second, it was noted in today's panel discussion that it is difficult for market participants to believe the BOJ's roadmap to achieving its goals. What should the BOJ do in order to restore its credibility?

**Mr. Uchida:**

・Regarding the first point, Japan's export structure has changed greatly over ten years. The automobile, chemical, and electrical equipment manufacturers that used to lead the economy have already moved their production and development to countries in ASEAN and elsewhere. Japan used to export producer goods and capital goods to these bases, but today most of its exports are in the form of finished products, which hinders overall growth in exports. The earning power of Japanese companies has not declined, however, nor has Japan's total income, and viewed in terms of GNI or GNP these profits are being brought back to Japan in the form of investment returns. We should view this as evidence of the globalization of Japanese enterprises.

**Mr. Yanagawa:**

・Regarding the second point, if the BOJ loses the confidence of investors, we will need to think carefully about what that means. The most likely scenario is that investors lose confidence in the central bank's ability to achieve the 2% inflation target, not that they lose all confidence in its ability to conduct monetary policy. The way to restore that confidence is to provide greater disclosure—i.e., to explain why it was unable to reach the target and how we should think about it going forward. I think that is the key to enhancing public confidence in the BOJ.

・When a company that has reported a decline in earnings or seen some scandal come to light wants to restore confidence, it cannot adopt a purely defensive posture and deny all the allegations. It must provide full disclosure of the real state of affairs and indicate exactly what it plans to do going forward. When the coach of a national soccer team pledges to win the World Cup and his team fails to make it past the qualifying round, no one calls the coach a liar, because they understand the coach's role is to inspire the players. There is nothing wrong in adopting a more realistic target when a goal is no longer feasible. If anything, doing so is more likely to win the understanding of others.

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