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

April 09, 2018

Topic	Policy issues for central banks in the US and Europe
Date	March 19, 2018 (1:05pm – 2:25pm)
Participants	**Mr. Kazuto Uchida,** Managing Executive Officer, Chief Executive, Global Markets Unit, Bank of Tokyo-Mitsubishi UFJ **Mr. Amane Oshima,** Managing Executive Officer (Joint Head of Markets Unit), Mizuho Corporate Bank **Mr. Izuru Kato,** President and Chief Economist, Totan Research **Tetsuya Inoue,** General Manager, Financial Technology and Market Research Department, Nomura Research Institute (Organizer)

Key Discussion Topics

1. Policy issues since the financial crisis

2. Expanding central bank functions and roles

3. Benefits and side effects of changes in central banking

1. Policy issues since the financial crisis

Inoue (Organizer):

・We have informed today's panelists of today's topics in advance. The first concerns the policy issues confronting central banks in the US and Europe in the wake of the global financial crisis. Japan will be discussed in a subsequent panel, but I hope participants will feel free to discuss the implications of these developments.

Mr. Oshima (introductory comment):

・Almost ten years have passed since Lehman Brothers went under, and during that time central banks in the developed economies have taken their policy rates sharply lower and engaged in tremendous balance sheet expansion. They did so to drive a recovery in asset prices and to stabilize the financial system by supplying large amounts of liquidity. The intended effects were largely achieved: financial market risk premia were kept in check and volatility declined. Since then, the output gap has turned positive despite a fall in the natural rate of interest, suggesting that monetary policy in Japan and other developed economies has also functioned as an aggregate demand management policy.

・On the other hand, the divergence between financial markets and the real economy has actually widened, with the velocity of money falling and loan-to-deposit spreads contracting as the corporate sector remains a net saver. Productivity growth in Japan, Germany, and France has drifted lower, and funds may have been trapped in unprofitable businesses and sectors that should have been liquidated. In the US, productivity growth is recovering, but it remains to be seen whether it can be placed on a sustainable upward trajectory. While employment is increasing at the macro level, a rising percentage of workers are in low-wage occupations, and the number of food stamp recipients remains at elevated levels. So while the economy as a whole continues to grow at a healthy pace, there are many problems in terms of resource allocation.

・Financial conditions remain accommodative long after the financial crisis came to an end. Central banks in all of the developed economies now face the question of how to normalize financial conditions.

Mr. Uchida:

・The issue that first confronted central banks in the US and Europe after the global financial crisis (GFC) was how to keep systemic risk in check and prevent an international chain reaction. They responded with large-scale monetary accommodation that was administered over a short period of time. As the crisis wound down, the major issues facing the central banks became how to tackle deflation and proceed with deleveraging. As Mr. Oshima noted, monetary policy generally functioned quite well in this regard.

・Yet vexing issues remain. The US economy, for example, is in the process of returning to an inflationary path, but a variety of uncertainties have arisen, including trade frictions and the implementation of the Trump tax cut. Such environments tend to be conducive to a wider gap in perception between the central bank and the markets, and that is likely to complicate communication regarding monetary policy. In Japan, the BOJ's direct involvement in the equity and credit markets and its adoption of yield curve control are likely to create further obstacles to a smooth exit from QQE.

Mr. Kato:

・Post-GFC monetary policy in the developed economies can be broken down into credit easing policies designed to turmoil in check and the subsequent unconventional monetary policies designed to stimulate aggregate demand. Regarding the latter, central banks boldly capped long-term interest rates at a time when the neutral rate of interest itself was thought to have been drifting lower. However, as former BIS Chief Economist William White noted, if monetary accommodation is sustained at a time when the neutral rate of interest is falling, the central bank risks creating a vicious cycle in which further monetary accommodation becomes necessary to keep unproductive "zombie" companies alive. Countries like the US, where immigration supports growth in the labor force and the environment is conducive to innovation, have relatively high expected growth rates, and as a result the reductions in long-term interest rates provided a significant stimulus. In Japan, however, the concern is that low interest rates have created a negative spiral, as suggested by the fact that wage growth remains weak despite labor shortages. In the US, I think the focus of monetary policy discussion will shift to the question of how to address an overheating economy, taking into account the impact of the tax cuts. In Japan, meanwhile, discussion regarding monetary policy's role is likely to continue treading water.

2. Expanding central bank functions and roles

Inoue (Organizer):

・The second issue I would like to discuss is the expanding function and role of central banks. Since the GFC, the role played by central banks in the US and Europe in economic policy has increased substantially, in part because of governments' tight financial straits. I wonder if you could discuss some of the similarities and differences between these countries and Japan.

Mr. Kato (introductory comment):

・This April marks the 20th anniversary of the revised Bank of Japan Act, which specifies financial system stability as one of the central bank's mandates. At the time this was a rather forward-looking provision, and it was probably included because Japan, unlike other developed countries, had already experienced the collapse of an asset bubble.

・In contrast, the Fed's mandate as stipulated in the Federal Reserve Act does not explicitly include financial system stability, and the Fed has conducted policy based solely on the "dual mandate" of price stability and maximum employment. However, some have criticized the Fed for not identifying risks that accumulated in the financial system during the subprime bubble. Former Reserve Bank of India Governor Raghuram Rajan, for example, urged revising the Federal Reserve Act and adding financial stability to the central bank's mandate. A lack of public support meant such discussion soon lost momentum, and ultimately it was agreed that while monetary policy would not be employed to ensure financial stability, the Fed would increase its supervisory role.

・The Bank of England, having reflected on its actions before the crisis, chose to invite an outsider from Canada to serve as governor. And after the Financial Services Authority (FSA) was dismantled, the Financial Policy Committee (FPC) was established to oversee financial system stability separately from the Monetary Policy Committee (MPC), which was responsible only for setting monetary policy. Thus the BOE adopted a new approach targeting both price stability and financial system stability. Europe as a whole, however, seems to have gone somewhat overboard on financial regulation, with the MiFID II framework that took effect this year being perhaps the best example. Going forward, I think it will be important to find an appropriate level of financial regulation.

・The balance sheets of the Fed, ECB, and BOE continued to expand even after the stimulation of aggregate demand became their primary policy goal, but as economies have recovered there has been a natural move to normalize monetary policy—in part because of a focus on the initial objective of crisis response. In the US in particular, the underlying belief that extreme market intervention by the central bank would distort the allocation of credit and thereby lead to inefficiencies in the economy was one of the reasons behind the move to normalize policy. In Japan, in contrast, the chief goal of monetary policy is to raise inflation expectations to 2% and keep them there, and as a result there has been no discussion of policy normalization even though the worst is over for the economy. This approach stands in sharp contrast to that of the ECB, which has indicated its intention to push ahead with normalization even as it lowers its inflation forecast to 1.4%. The ECB appears to share the market's view that the process of normalization needs to be tackled while the economy is recovering, or the opportunity will be lost.

・Political factors are also involved in the normalization of monetary policy. In the US, there has been persistent criticism of the Fed, largely from the Republican Party, for engaging in excessive monetary accommodation. In Chairman Powell's Congressional testimony, for example, there was a clear rift evident between the Fed, which did not want to specify a date for shrinking its balance sheet, and legislators, who sought definite reductions. The Fed wants to keep an eye on short-term interest rates as it decides how far to shrink reserves, but heavy pressure from a handful of legislators means it will have to present a timetable for trimming its balance sheet by this summer. There is also growing pressure on the ECB, largely from Germany, to normalize its balance sheet. In Japan there is no such pressure for a normalization of monetary policy, and with politicians on both sides of the aisle supporting a continued easing stance, I think it will be very difficult for the BOJ to normalize policy.

Mr. Oshima:

・The Fed has kept the final destination for its balance sheet at a fairly realistic level, in part because the economy may require reserves of about $3trn if recent nominal growth rates continue. In Japan, meanwhile, any move towards an exit would have to be handled very carefully given the massive size of the BOJ's balance sheet and the fact that low interest rates are not only supporting corporate activity but are also playing a role in social policy by maintaining employment levels. The ECB also faces a number of unique issues such as immigration and the pressure to keep the eurozone together, and the need to avoid policies with major downside risk demands a cautious approach to the removal of quantitative easing. In summary, different political priorities in Japan and Europe mean the likely timeframes for dismantling quantitative easing are different from that in the US.

Mr. Uchida:

・I would like to discuss central banks' function and role from two perspectives: "role and responsibility" and "safety and soundness." Regarding the former, central banks' historical role was simply to serve as "lender of last resort." Since the financial crisis, however, they have begun intervening in the markets as market makers. Central banks in Japan and the other developed economies have tried to fulfill their responsibilities via this kind of role and have been quite effective.

・"Safety and soundness" needs to be assessed from the twin standpoints of transparency and efficiency. In terms of transparency, many central banks have improved their communication policies since the GFC, allowing them to gain the market's understanding regarding policy intent and tools. However, I think there has been some miscommunication inasmuch as "safety and soundness" is now interpreted by market participants to mean low volatility or risk premia, as opposed to the more traditional yardsticks of adequate liquidity or properly functioning markets. Additionally, while the drastic policies implemented in response to the crisis had some impact, the marginal effect of these measures has diminished over time, while the side effects and associated problems have mounted, casting doubt on current policies' effectiveness. The reaction to the process of winding down these measures will need to be closely watched.

3. Benefits and side effects of changes in central banking

Inoue (Organizer):

・The third topic concerns the benefits and side effects of the changes in central banking. We have already touched on this subject, but I would like to focus on the expansion of role and function of central banks in the US and Europe to preserve economic and financial system stability since the GFC and consider what potential advantages and disadvantages that might have in the future.

Mr. Uchida (introductory comment):

・Immediately after the financial crisis, central banks in the US and Europe introduced radical monetary accommodation in an attempt to prevent systemic risk. In contrast, the Bank of Japan opted for a more gradualist approach, in part because Japan was not a direct cause of the financial crisis. The focus of policy in the overseas economies subsequently shifted to disposing of NPLs and tackling deflation, with measures aiming to achieve a signaling effect, whereby central banks commit to an extended period of quantitative easing; a portfolio rebalancing effect, via a decline in real interest rates; and a "financial reflation effect," whereby central banks seek to boost corporate and household investment and consumption by engineering a recovery in asset prices. In the end, many of the developed nations increasingly became "asset-driven" economies where rising asset prices were driving the real economy.

・Since the beneficial impact of these policies has already been discussed, I would like to focus on their side effects. First, the distribution of income grew less efficient. As the use of artificial intelligence and the Internet of Things became a key component of business strategies, companies stepped up their efforts to slash personnel costs. Capital's share of profits exceeded labor's share, with retained earnings being earmarked mainly for share buybacks and dividends, widening the gap between rich and poor in the broader society. Second, there was increasing fiscal dominance and financial repression. In other words, the ultra-low-interest-rate environment in place since the GFC has kept the cost of financing fiscal deficits in check, enabling rising government debt ratios. Third, there was a shift of capital from the developed economies to the emerging economies, and China in particular. In China, where M2 has increased dramatically, critical attention has focused on the size of private-sector debt, and we cannot rule out the possibility that the developed nations' ultra-accommodative monetary policies were one of the underlying causes of this phenomenon.

・Fourth, asset managers came to function as financial intermediaries via the shadow banking sector. Even before the financial crisis, there was some financial intermediation via private equity and M&A funds, but since banks were the primary intermediaries, market volatility had little direct impact on financial intermediary functions. Since the GFC, however, asset managers have come to play a much larger role, leaving financial intermediation itself more vulnerable to large swings in response to changing market conditions. Fifth, markets have priced in a "central bank put"—the conviction that central banks will respond to any crisis—resulting in a paradoxical situation where an exit from QE could itself trigger systemic risk. Sixth is the difficulty of winding down these policies. Ideally, financial conditions should remain somewhat accommodative even after central banks start to wind down the current easing regime. But what we are actually seeing in the US and Europe is a *tightening* of financial conditions due to flash crashes and other factors. These developments show just how difficult it is to mop up liquidity in the markets.

・More communication from central banks in the form of forward guidance, staff economic forecasts, and testimony by central bank heads before national legislatures has helped form a consensus. In the US, however, not only is there a wide divergence between the market's views and the FOMC's views as expressed in the "dot plot," but this divergence has also resulted in sharply higher market volatility as market participants' projections undergo steep revisions just before policy decisions. Similarly, one side effect of the ECB's communications policy has been that discussion on the removal of quantitative easing has led to market turmoil. The BOJ will also have to carefully manage its communications with the market when it eventually starts to consider winding down QQE since it is also implementing a full complement of policy measures, including quantitative easing, negative interest rates, yield curve control, and ETF purchases.

Mr. Kato:

・One reason why communication will become more difficult when the BOJ moves to wind down the current easing regime is that the BOJ is engaged in numerous "open-ended" operations. The ECB and BOE have not adopted this approach, and even the Fed, which was a pioneer in this area, made sure the market priced in an exit early on: Chairman Bernanke mentioned a tapering in his Congressional testimony just five months after the decision to implement QE3.

・Independence is also an important issue when central banks are forced to implement unconventional policies. In the 1990s, when there was growing talk of central bank independence, economic and financial conditions were such that they could be addressed with conventional monetary policy. The prevailing view then was apparently that introducing outside views would have a harmful influence on policymaking. But now that the developed economies have fallen sick to some unexplained illness, central banks need to listen to experts in a wider range of fields in an attempt to find a solution. In this sense, the criticism of the Fed's large balance sheet by the US Congress is a healthy development. Such views hold little sway in Japan, and since the government has also welcomed the BOJ's easing policies there has been no substantive discussion of the pluses and minuses of the central bank's policy response for the past five years. The Bank of Japan Act charges the central bank with maintaining price stability, but the BOJ's ultimate objective is to contribute to the healthy development of the nation's economy. I think it is time for an extensive debate on whether the current policy is in fact the right one for the Japanese people in the long run. That there appears to be little support for such a debate is, unfortunately, a major difference between Japan and the US and Europe.

Mr. Oshima:

・The Fed presents its forecasts for the path of the federal funds rate using the dot plot, but a substantial gap exists between the views of the Fed and the market regarding the appropriate level for the policy rate. As such, I think the Fed will need to do more to communicate to the market its views on where the equilibrium interest rate lies, based on a comprehensive assessment of demographics, labor productivity growth, innovation, and other conditions. It is not healthy for the central bank to lose flexibility in advance in estimating the appropriate long-term level of risk premia and credit spreads, which have contracted under monetary accommodation, and the amount of time needed to get there.

Inoue (Organizer):

・I have two questions for the panelists. First, my impression in the discussion of central bank independence was that "independence" referred mainly to politics, but should the central bank also keep a certain distance with the markets? Second, as policy issues have changed since the immediate aftermath of the financial crisis, do you think it is efficient to continue using policies originally intended as a crisis response measure?

Mr. Oshima:

・As for the first question, I think there are probably cases in which monetary policy decisions are influenced by market expectations. Basically, I think it is important that the central bank not be overly influenced by market reactions and have the ability to decide when a policy response is truly necessary. One example might be the Fed's decision to disregard the market shock that occurred this February. Regarding the second question, Japan needed to mount a response that went beyond the financial sector and included structural reforms and social security reforms. But the lack of progress in such areas while the BOJ has been buying time has made it difficult for the central bank to move towards an exit. Unless this discussion is held now, while the economy is stable, the BOJ will have to respond to the next crisis with even more powerful monetary stimulus, possibly exacerbating financial imbalances and instability.

Mr. Kato:

・When intervening in the market to ease credit conditions, central banks in the US and Europe designed their measures to enable an exit without great difficulty and thereby reduced the risk of excessive market dependence on the central bank. The BOJ, meanwhile, has kept in place policies—such as its ETF purchases—whose ability to influence inflation expectations remains unclear.

Mr. Uchida:

・In terms of policy efficiency, I think monetary policy in Japan, the US, and Europe was effective in preventing systemic risk and keeping deflation in check as banks wrote off their bad loans. However, we need to give serious consideration to the decision to continue these policies during the normal conditions that followed. In Japan in particular, I think it is essential that the central bank hold discussions with market participants on the objectives for its diverse policy measures and the options for winding them down. During the normalization phase in 2006 and 2007, BOJ Governor Fukui took a leadership role as the authorities worked together with financial market participants to prepare for a revival of the money market. This time as well, I think the BOJ needs to start holding such discussions early on in order to gain the market's cooperation.

Inoue (Organizer):

・Are there any questions or comments from the floor?

Question:

・What is the relationship between monetary policy and currency weakness? Central banks say the only objectives of monetary policy are to overcome deflation and bring employment back to normal levels, but the ECB and other central banks would appear to be trying to weaken their currencies with monetary policy.

Mr. Oshima:

・As a financial market participant, there are many cases in which currency weakness appears to be driven by political motives. The currency is likely to come under upward pressure when the central bank moves to wind down accommodative monetary policy, but as a practical matter I think the dynamic will be one of doing everything possible to remove factors that could adversely affect economic growth. In Japan, too, I think it would be difficult to deny that monetary policy, via exchange rates, has served as one transmission channel for economic policy inasmuch as the yen's decline lifted corporate earnings and share prices and eventually brought about pronounced improvements in corporate sentiment.

Mr. Uchida:

・I think there are two kinds of currency weakness: unfavorable weakness and acceptable weakness. The yen's current weakness is a positive for the economy, but if Japan starts running semi-permanent current account deficits or the nation's sovereign credit rating is downgraded, policies that serve to weaken the yen would not be desirable.

Mr. Kato:

・It has been pointed out previously that monetary accommodation effectively leads to currency weakness, but the dollar's plunge in 2010 due to QE2 led to competitive currency devaluations. The Bank of Japan Act draws a line between exchange rates and monetary policy, declaring the former to be the government's responsibility, but since 2010 there has been a growing tendency for monetary policy to be subordinated to exchange rate policy.

Inoue (Organizer):

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

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