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

April 5, 2018

Topic	Central banks in a new financial and economic environment
Date	March 19, 2018 (5:00pm – 6:00pm)
Participants	**Mr. Kazuhito Ikeo,** Professor of Economics and Finance, Keio University **Mr. Kazuo Ueda,** Professor of International Studies, Kyoritsu Women's University **Mr. Hirofumi Gomi,** Advisor, Nishimura & Asahi LPC **Tetsuya Inoue,** General Manager, Financial Technology and Market Research Department, Nomura Research Institute (Organizer)

Key Discussion Topics

1. **Prospective changes in financial services and the real economy**
2. **Central banks' changing role in the post-GFC era**
3. **Future central bank objectives and policy tools**

1. Prospective changes in financial services and the real economy

Inoue (Organizer):

・I have informed today's participants in advance the topics we will be discussing. The first is "prospective changes in financial services and the real economy." Determining the future role of central banks requires that we project how financial services and the real economy, which are key elements of the policy environment, are likely to change. In the real economy, global supply chains have grown broader and deeper, while network effects and oligopolies have become increasingly common in IT and elsewhere. In financial services, the shadow banking sector has exhibited sustained growth at a time of expanding global capital flows, rising correlations between a wide range of asset classes, and changes in financial regulation and IT. Contributing to these factors has been the increasingly close correlation between monetary policy in the developed economies.

Mr. Ikeo:

・At the heart of this topic is the question of whether we should reconsider the role of central banks—and if so, how specifically to do so—according to the changes in developed economies and their financial systems. I think the current view of central banking, which will serve as the jumping-off point for today's discussion, was created largely by former FRB Chairman Alan Greenspan. Under previous FRB chairmen, including Greenspan's predecessor Paul Volcker, the FRB tended to be seen in the traditional guise of inflation fighter. Greenspan, however, created the impression that the FRB made possible the "Great Moderation"—a period of stable economic performance lasting roughly two decades, from the latter half of the 1980s until just before the global financial crisis—via the skillful conduct of monetary policy. This led to broad acceptance of the view that monetary policy should form the core of any nation's economic policies, and that monetary policy is powerful while fiscal policy is ineffective due to Ricardian equivalence.

・I myself have doubts about this view of the Great Moderation. Even as it was unfolding, some hypothesized that it was due to other factors, such as 1) the disappearance of the inventory cycle due to the growing weight of services in the economy coupled with more efficient inventory management thanks to advances in IT and 2) the fortuitous absence of negative shocks during this period. In other words, it may be that monetary policy simply *seemed* more powerful at the time, even if we put aside the rather extreme view that the Great Moderation was attributable almost entirely to luck. In the end, an exceedingly optimistic view of monetary policy and an extended period of low volatility led to reckless risk-taking and eventually triggered the global financial crisis.

・After the GFC, the FRB under Chairman Bernanke continued along the policy path pioneered by Alan Greenspan, but the impact on the real economy was limited at best. A move to reassess the role of fiscal policy emerged among US economists, and in general the belief that monetary policy should be at the center of economic policy came under attack. Whereas Greenspan ushered in an era in which central bank governors were treated like rock stars by the financial markets (as noted by former Reserve Bank of India Governor Raghuram Rajan), the prevailing view in the new era of central banking may be that the time for such treatment is over. Additionally, while there certainly have been changes in the economic environment in terms of globalization and IT adoption, it was never determined for certain that there was some fundamental change in the global economy following the Great Moderation. Nevertheless, I think views of central banking need to change.

・Mr. Inoue noted the closer correlation between monetary policy in the developed economies. Floating exchange rate systems should enable individual economies to isolate themselves from nominal shocks by adjusting nominal exchange rates. But as was pointed out earlier today, central banks in Japan and elsewhere have a strong attachment to nominal exchange rates, and an aversion to fluctuations in those rates forces them to adopt the same policies. As a result, the correlation between monetary policy must have grown tighter.

・Since the Great Moderation, there has been little palpable sense of an economic expansion in the developed economies, but they have all experienced gradual but sustained growth over an extended period of time. This may be due to a change in the underlying economic environment, but in any case the use of macroeconomic policy to smooth out the economic cycle has become less important under these conditions. For this reason as well, I think central banks in this new era should perhaps try to be as un-rockstar-like as possible and focus instead on improving the payments system and other elements of the nation's financial infrastructure.

Mr. Ueda:

・According to traditional economics textbooks, monetary policy under a floating exchange rate system should be more effective in a world of globalization and increased IT adoption, since international capital flows become more active and the interest rate sensitivity of those flows should increase. Meanwhile, greater integration in global financial markets means shocks can upset the global order by proliferating over a wide region. Such synchronous shocks are immune to the isolating effect of nominal exchange rates. Meanwhile, increasingly integrated global markets for goods and labor mean flows of goods and labor will help to extinguish shocks occurring in one country, thereby diminishing monetary policy's impact on prices. However, the diminished policy impact that central banks see today is probably due less to such textbook factors and more to the global financial crisis and the subsequent policy response, which took policy rates down to the nominal zero bound.

・Mr. Ikeo noted that the general view of central bank governors swelled during the Great Moderation, leading to an overconfidence in monetary policy. If those views are accurate, it is perhaps largely because Chairman Greenspan was able to conduct policy on the back of the legacy bequeathed to him by Chairman Volcker. Both observed and expected inflation rates were falling at the time, as was the risk premium for inflation. The synchronous trends of globalization and IT adoption not only served to curb inflation but also acted as a positive supply shock on the real economy. It was fortunate that these shocks occurred during the 1980s, when there was still a certain amount of inflation remaining in the system. The financial crisis struck after inflation fell, and since then the US authorities have been made painfully aware of how difficult it is to raise inflation at a time when these supply shocks remain in effect.

Mr. Gomi:

・Historically, Japan's financial system was designed to concentrate capital—which was in short supply—in the banks, which would then make the loans required for economic activity. This system required the financial authorities to keep a close eye on banks' balance sheets because of the significant leverage they employed. However, as the private sector began to run consistent financial surpluses and financial liberalization continued to progress, the financial authorities were forced to change the focus of their oversight. Instead of monitoring individual financial institutions, which had been essential in the past, they now needed to oversee financial *functions*—i.e., to look at whether the financial sector was providing all of the functions required to support economic activity. This is the direction in which Japan's supervisory authorities are moving today. They need to determine what sort of regulatory structure should be used to monitor financial functions and how to confirm the health of the financial system, even when the parties involved are not traditional financial institutions. This is particularly true to the extent that globalization and IT advances have led to growing stocks of financial assets that not only overwhelm the scale of the real economy but can also move independently of it.

・The basic approach in financial administration should be to decide the direction of oversight based on existing regulation. However, the Lehman shock raised the question of who is capable of monitoring and measuring risk in areas not covered by current regulation. Supervisory authorities in both the US and Japan at the time were not engaged in any serious oversight of the ominous developments unfolding. Even after the so-called Paribas shock, Japanese financial institutions claimed (inappropriately) that there was nothing wrong with the securitized assets on their books, citing those securities' AAA ratings. Now, supervisory authorities responsible for micro-level administration are being asked to monitor risk in these regulatory blind spots and establish new regulations as necessary. There is increasing support for the view that they not only need to tighten cooperation with their counterparts in other countries but also should work more closely with their own central banks. In other words, supervisory authorities would like the central bank to identify and measure risk in those regulatory blind spots where it is better qualified to do so.

2. Central banks' changing role in the post-GFC era

Inoue (Organizer):

・The second topic we would like to discuss is central banks' changing role in the post-GFC era. Central bank monetary policy (including unconventional monetary policy) has come to play a central role in macroeconomic policy in the developed economies, in part because of deteriorating fiscal positions. At the same time, central banks' massive asset purchases have blurred the boundaries with fiscal policy, which aims to intervene directly in the resource allocation process. Similarly, the expansion of financial stability policies—including increased financial oversight in response to the crisis—has blurred the boundaries between central banks and financial supervisory authorities. This diversification of central banks' mandate has also contributed to a near-sighted approach to policy conduct and created an environment conducive to policy goal conflicts.

Mr. Gomi:

・In Japan's own financial crisis during the late 1990s, the banks at which real-economy risk had been concentrated were making poor business decisions and were not receiving proper guidance from the supervisory authorities. The collapse of the asset bubble therefore led to severe bad loan problems, triggering systemic risk that the banking sector could not recover from on its own.

・The definitive difference between this crisis and the one that followed was that in Japan the risk was clearly located in credit risk and took the form of bad loans. Inasmuch as this credit risk had a one-to-one correspondence with the real economy, it was relatively easy for the authorities to determine where risk might emerge, how large it might be, and how big the attendant losses were likely to be. In retrospect, things might have turned out differently if, when the bubble was still growing, the financial authorities had properly applied standard oversight measures to individual financial institutions. In reality, they probably lacked the understanding of the situation needed to make the first move. Additionally, while the BOJ was deeply concerned about the expanding bubble, officials decided it would be difficult to address it with monetary policy inasmuch as they were dealing with an increase in asset prices, not general prices. After the bubble burst, the central bank responded with monetary accommodation, focusing on the traditional method of injecting liquidity into the markets. After the financial crisis, the BOJ also employed unconventional policy tools such as zero interest rates, but the problems in the financial system persisted for an extended period of time.

・In the GFC, meanwhile, it was difficult for the supervisory authorities to tell where the risk lie, and there was a fundamental impairment of the basic financial function of taking on risk to supply funds. There had been a rapid proliferation of financial products as new financial technologies enabled the transfer and dispersion of risk. Not only that, but a growing number of products piggybacked on this first tier of securitized assets, causing the market to grow far larger than the real economy. As a result, it was not clear who would bear the losses in the event of a significant shift in the real economy, which was the underlying asset being referenced by all of these securities. The inability to tell which securities were at risk forced investors to refrain from investing in all similar products and eventually caused the market's interest rate function to shut down. The supervisory authorities responded with traditional methods, such as injecting capital into troubled financial institutions, and as economies emerged from the financial crisis, central banks also implemented quantitative easing and other forms of unconventional monetary policy from a macroprudential perspective.

・The Bank of Japan's "quantitative and qualitative easing" (QQE) tends to have many points of contact with other economic policies not only because of its "unconventional" characteristics but also because it has such a large quantitative impact. As someone who came up through the Ministry of Finance, I am deeply concerned that leaving ultra-low—in some cases negative—interest rates in place for such a long period of time will eventually contribute to a loss of fiscal discipline. The fiscal authorities, who do not know when inflation will finally reach the 2% target level, probably want the BOJ to continue monetary accommodation on a semi-permanent basis, and in fact they have not made sufficient efforts to reduce fiscal deficits. This will lead to a variety of problems in the future. To begin with, the central bank will incur losses on its asset holdings when market interest rates rise, thereby increasing the government's fiscal burden. To the extent that private-sector financial institutions' earning power declines under ultra-low interest rates, there is the risk that they will not be able to fulfill their role as financial intermediaries. Under such conditions, the central bank needs to work closely with both fiscal and supervisory authorities to confirm their current situations and determine what sorts of policy measures need to be implemented to ensure the effectiveness of monetary policy.

・It was noted earlier today that for the Japanese economy to grow, new businesses need to enter areas with new demand on a commercial basis, with the most efficient players driving out vested interests. There are limits to what the central bank can achieve when this kind of mechanism no longer functions, and it is essential that the government prepare a fundamental response to the problem, including structural reforms, while the economy remains "anesthetized" by monetary accommodation. The financial authorities also need to engage in proper oversight of financial institutions to ensure that individual institutions can create value-added in this economic environment while enhancing their own sustainability. Inasmuch as central banks no longer serve as "inflation fighters," they need to work closely with fiscal and supervisory authorities to pursue a balanced, integrated policy response. Without such coordination, there is the risk that policy issues will paralyze central bank policies and render them ineffective.

Mr. Ikeo:

・Prior to the global financial crisis, the belief emerged that monetary policy should form the core of economic policy, along with the belief that the central bank's role should be limited to the conduct of monetary policy. The Bank of England is a classic example. The BOE "spun off" its role in maintaining financial system stability and made it clear that its sole responsibility was to make and implement monetary policy decisions. The prevailing view since the GFC, however, has been that this approach failed, and the BOE has consequently reassumed responsibility for financial stability. When the Bank of Japan Act was revised, Professor Mikitani at the University of Kobe argued that the Bank of Japan should focus exclusively on monetary policy. Fortunately, however, the BOJ remained responsible for preserving financial stability, and at least through the Shirakawa era it conducted monetary policy with an emphasis on this part of its mission. Under quantitative and qualitative easing, in contrast, monetary policy has sometimes served to undermine financial system stability. After the policy rate hit the effective lower bound, the BOJ used unconventional monetary policy to lower the yield curve, which took a heavy toll on financial institution earnings.

・As I noted in my opening remarks, I think it is preferable when striving for a balance between monetary policy and financial stability policies, to place a somewhat greater emphasis on the second. Central banks should return to their original role as "the banks' bank" and focus more on their role in maintaining financial system infrastructure. While Mr. Gomi's vision of finding an appropriate balance between the central bank, fiscal authorities, and supervisory authorities is an attractive one, my impression is that the reality is not always so pretty.

Mr. Ueda:

・I basically agree with Mr. Gomi's view that there are limits to what micro-level financial administration can achieve when faced with growth in financial intermediation in areas like shadow banking, and that the involvement of the central bank is needed in those cases. However, I do not think it is always the case that the central bank has better information about the shadow banking sector than the administrative authorities. If anything, I think there are other reasons why the central bank should be given responsibility for this area and become involved in macroprudential oversight. First, there is the fact that adjustments to the policy rate can have an impact on both traditional banks and the shadow banking sector. And in the event of a financial crisis originating in the markets, where liquidity premia surge and market liquidity dries up, I think central banks with their flexible balance sheets are best placed to temporarily remove these assets from the market by purchasing them. That said, this is not a role that can only the central bank can fulfill. The central bank also has more flexibility than the administrative authorities in implementing policy, but despite this advantage, expanding its role in maintaining financial stability can also raise complex questions regarding the independence of monetary policy.

3. Future central bank objectives and policy tools

Inoue (Organizer):

・The third issue we would like to discuss is future central bank objectives and policy tools. In the era of globalized economies, price stability—central banks' traditional policy goal—has become more difficult to achieve solely via adjustments to domestic supply and demand. A world in which asset price fluctuations have a significant impact on economic trends has now become the norm. And amid shifting regulation and technology, there have been major changes in both methods and institutions when it comes to banks' financial intermediation—a mechanism that central banks have traditionally relied on as a transmission mechanism for monetary policy. Meanwhile, it remains to be seen how central banks will employ their communication policies, which have come to be viewed as an important tool in implementing unconventional monetary policy, especially during the normalization process.

Mr. Ueda:

・I think it might be more effective to discuss specifics (with Japan in mind) than to engage in abstract discussion. The other sessions today have made it clear that Japanese monetary policy has lost its compass in terms of economic theory over the last 20 years. The theoretical framework relied upon by most economists is the New Keynesian approach, which assumes a world in which prices can move flexibly in the long term but not in the short term. If we define monetary policy as a tool for adjusting the money supply within that framework, we can derive an equilibrium showing the neutrality of money in the long run. If that can be applied in reality, an increase in the money supply should lead to a rise in prices within a temporal framework of five to 10 years. This view—that increasing the supply of money will eventually cause prices to rise—is called the reflationist view in Japan and is the position taken by orthodox economists.

・One reason why this approach has not worked in Japan is that the policy rate hit the nominal zero bound or the effective lower bound, while the supply shocks noted earlier kept inflation in check, preventing a decline in real interest rates and thereby curbing aggregate demand for an extended period of time. In the face of this reality, the thesis that increasing the money supply would raise prices lost its persuasiveness, as did the argument that a central bank commitment to an inflation target would revive inflation expectations, amid doubts about the existence of a long-term equilibrium. And in fact inflation expectations have not risen substantially.

・The Bank of Japan is currently waiting for “something good” to happen while keeping both short- and long-term interest rates around zero, but I would like to point out two potential risks with this approach. First, in the event that “something good” actually happens and the BOJ is able to achieve its inflation target, there could be a severe clash with fiscal policy. As Mr. Gomi suggested, the fiscal authorities would appear to suspend serious consideration, but that is possible only because both inflation and nominal interest rates remain so low. Once the inflation target is achieved, the BOJ will need to wind down its accommodation, bringing an end to both of these conditions. The fiscal authorities could ask the BOJ to keep long-term interest rates in check, but it would be impossible—at least in a textbook sense—for it to do so. It is my hope that the Financial Markets Panel will have the opportunity to discuss this scenario.

・Second, in the event that the global economy enters a recession and prices in Japan come under downward pressure, the BOJ will almost certainly be asked to provide powerful monetary stimulus. The BOJ would have little scope to take the IOER further into negative territory, and increasing its bond purchases would have relatively little economic impact, in my view, so it would probably have to step up its purchases of equities and REITs. This would lead to wide-ranging impairment of the market mechanism in financial and capital markets. Another option would be a coordinated policy of sharply increasing fiscal expenditures while having the BOJ buy the newly issued JGBs used to fund that spending. This would also imply a collapse of the market mechanism in the sense that it would cause major turmoil in the goods market. Negative interest rates’ adverse effect on regional bank earnings may be one harbinger of that.

Mr. Gomi:

・The institutions responsible for providing financial functions are undergoing revolutionary changes not just in Japan but around the world. There are now many entities capable of providing perfectly satisfactory financial functions at low cost without being subject to financial regulation. And on the internet, a variety of entities have developed direct transaction models that can effectively substitute for existing financial functions. The administrative authorities cannot control financial intermediation or develop an accurate macro-level picture of risks if they are focusing solely on banks and similar institutions. As such, one important question concerns how the administrative authorities will share 1) the information collected by central banks for the purpose of conducting monetary policy and 2) information about the changing institutions providing financial functions, including those not subject to financial regulation. In the event that such oversight alone is insufficient, the administrative authorities may need to introduce new regulation.

・Full independence for the central bank may be acceptable when it is responsible for a relatively narrow area, such as monetary policy. But when its responsibilities are wider ranging, it will probably be argued that we need a framework allowing outside influence over the central bank’s affairs. This is an area in which it is difficult to strike a balance, as Mr. Ueda noted. In other words, the scope of a central bank’s remit must be limited if we are to maintain the independence of monetary policy, but at the same time it must be expanded to enable the central bank to have the authority it needs over new providers of financial functions.

Mr. Ikeo:

・The standard understanding of prices is that they represent the exchange rate between money and goods and services. However as the monetary base, which represents external money under a managed currency system, constitutes a part of the combined government debt, I think a case can be made for the fiscal theory of the price level—i.e., the argument that prices represent the ratio of 1) the entire quantity of goods and services that can be mobilized by the combined government to redeem the public debt to 2) the public debt. Even without going to that extreme, I do not think a consensus exists in modern economics that prices are necessarily determined by monetary policy only. If anything, the consensus is that prices are determined via the interaction of monetary and fiscal policy. Meanwhile, I believe the view that the central bank can affect asset prices via monetary policy is too extreme, even if they are generally determined by interest rates

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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