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

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Topic	UK economic and financial trends and BOE policy response
Date	December 12, 2017 (6:00pm – 8:30pm)
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Key Discussion Topics

1. **Recent trends in UK economy and financial sector**
2. **BOE policy response**

1. Recent trends in UK economy and financial sector

Inoue (Organizer):

・Today we will discuss the policy response of the Bank of England, which decided in November to raise rates. I would like to start with a survey of the underlying financial and economic environment in the UK by one of our staff members.

Ishikawa (Secretariat)

・Although UK GDP picked up modestly in 3Q, growing at an annualized QoQ rate of 1.6%, a variety of indicators—including retail sales, new car sales, and consumer confidence—point to a renewed slowdown in personal consumption and other components of GDP in 4Q. Gross fixed capital formation decelerated and new home purchases were soft: the number of new residential mortgage approvals—a leading indicator of housing investment—increased only because of refinancing demand. The government's proposed budget, released on November 22, called for abolishing the stamp tax for first-time buyers (subject to a limit of GBP300,000) to prop up the housing market, but it remains to be seen whether this measure will be effective. The rate of growth in housing prices has also slowed recently.

・A look at the international balance of payments shows that the UK's current account deficit shrank as a result of increased imports. In the nation's balance of financial accounts, the disinvestment by foreign investors in UK equity capital was the largest ever recorded, probably because of Brexit. To the extent that much of the UK's growth has been driven by fund inflows from the EU and other nations, this indicator needs to be closely monitored going forward. A basic agreement was finally reached on the first stage of the Brexit negotiations on December 8, and the summit of EU leaders on December 14-15 is expected to bring an announcement of second-stage talks covering the transition period and future trade relationships.

・Turning to prices, CPI inflation has climbed to 3%, and both core inflation and service price inflation are now running at YoY rates in excess of 2%. The rise in import prices due to the depreciation of pound and higher energy prices as provided a significant temporary boost to inflation, but the effects are expected to be slowed in near future.

・On the matter of cyclical domestic inflationary pressures, let us first examine the unemployment rate and indicators of labor market slack based on the relationship between unemployment and inflation indicated by the Phillips curve. The unemployment rate, currently at 4.3%, continues to run below BOE and Office for Budget Responsibility (OBR) estimates of the natural rate of unemployment (4.5%). Sustained growth in employment due to new entrants to the labor force, coupled with continued reductions in the average duration of unemployment, point to reduced labor market slack. Job turnover and firm entry rates have continued to rise since the financial crisis, indicating a more vibrant labor market. With capacity utilization rates gradually picking up and many industries experiencing rising job vacancy rates, there are also growing incentives for companies to hire new staff.

・Yet despite these conditions wage inflation remains depressed. The BOE has cited sluggish productivity as one contributing factor, but it is also important to understand the structural demographic changes—such as increased immigration and a growing senior population—that are behind this phenomenon. UK population growth has accelerated since 2000, particularly in the age 15-64 cohort. We attribute this to 1) a higher birth rate driven by the favorable economic environment and 2) increased immigration to the UK. At the same time, however, the UK is gradually aging, although at a slower pace than other developed nations in Europe.

・Net immigration of people from the EU's emerging economies who come in search of work has slowed somewhat since the Brexit referendum, but has still increased sharply in recent years. One characteristic of these immigrants is that they tend to be younger workers aged 25-39 with relatively little education earning low level of hourly wages. They also tend to find work in sectors with high productivity growth and comparatively high wage growth, such as construction, distribution, and manufacturing. Interestingly, the BOE's assessment of their impact on the UK labor market and prices has changed over time. When the EU economy was expanding, the prevailing view within the BOE was that these workers were helping to lower UK wage inflation by supplying cheaper labor. More recently, however, a typical view is that their growing presence in the work force has given them more bargaining power and that their role as a source of demand has created inflationary pressures for certain goods and services. While some are critical of immigration, noting that it was one of the factors behind Brexit, immigrants' positive contributions to the labor market are gradually being revealed, with prior research pointing to a causal relationship between high rates of immigration and high productivity growth in specific industries.

・An aging population is ordinarily inflationary given the relationship described by the Phillips curve, inasmuch as a reduced supply of labor leads to a lower unemployment rate. In the UK, however, growth in the economically inactive labor force aged 65-69 has slowed over the past several years, which began to decline in 2016. Meanwhile, the participation rate for those aged 65 and older is rising and high relative to other developed nations in Europe. One reason for the high labor force participation rate of UK seniors is retirement income. Public pensions tend to do little more than guarantee minimum living expenses, and pensioners' income on the whole is quite volatile, inasmuch as investment income and distributions from defined-contribution pensions are closely tied to the economic situation and will actually decline in some years. A breakdown of employee wage levels by age shows that wages do not decline as they once did after employees turn 60, and these higher wages appear to be providing an incentive for older workers to remain in the labor force. If seniors with relatively high wages start to account for a higher percentage of the workforce, an aging population will result in an overall increase in wage levels. Assuming that corporate earnings, the source of wage payments, are constant, an aging population could depress wage inflation. Another characteristic of the UK economy is the comparatively large number of self-employed individuals, with some 40% of those aged 65 and older falling into this category. Both productivity and wage inflation are often relatively low in sectors employing large numbers of seniors (both self-employed and otherwise), including agriculture, forestry and fisheries, real estate, transportation and warehousing, and specialized services.

・Shrinking populations and falling productivity growth also weigh on the economy's potential growth rate. In its latest forecasts, the OBR has revised its estimates of the potential growth rate of the UK economy in 2022 sharply lower, to 1.5% from 2.0%. One contributing factor appears to have been the decision to reclassify the decline in labor productivity since the financial crisis as a structural shift rather than merely a temporary phenomenon. The OBR also lowered its estimate of the natural rate of unemployment to 4.5% in light of the weakness in wage inflation.

・In summary, a combination of declining immigration due to Brexit and growth in the number of senior employees could lead to labor shortages in high-productivity sectors coupled with labor surpluses in low-productivity sectors, thereby widening the wage gap in the UK. Policymakers must therefore decide which areas to target with macroeconomic policy. Additionally, the reduced number of low-wage workers and the increase in the number of high-wage workers could potentially weigh on corporate earnings, placing further constraints on wage growth. Finally, the decline in productivity growth could bolster inflationary pressures as higher costs are passed on to customers. Going forward, the authorities will face the difficult task of implementing policy while monitoring the impact of both cyclical and structural factors.

Mr. Hosono:

・Unlike most other major developed economies, the UK has an inflation rate substantially in excess of 2%. Why is that?

Ishikawa (Secretariat):

・The rise in import prices, including energy prices, was generally cited as the main factor, but now the prevailing view—based on rising core inflation rates and service costs—is that domestic inflationary pressures have picked up.

Ms. Suda:

・As in the US, there is the question of whether phenomenon such as the falling potential growth rate, slower growth in labor productivity, and a lower natural rate of unemployment are structural or cyclical in nature. The Fed is of the view that these indicators will eventually improve cyclically, but it also appears to be considering the possibility that structural factors have played a role. In the UK, what is the basis for the view that these are structural factors?

Ishikawa (Secretariat):

・As for the natural rate of unemployment, the BOE is monitoring the medium-term unemployment rate, while the OBR is more focused on the long-term unemployment rate, resulting in disparities between the two frameworks. Recently, however, the conclusions produced by the two approaches have been consistent with each other because the number of long-term unemployed persons, a key component in estimates of the long-term natural rate of unemployment, has fallen significantly. In its latest report, the OBR noted the repeated downward revisions to its forecasts of productivity growth over the past few years and cited a paper by Summers and Gordon in concluding that the decline in productivity was structural, not cyclical.

Mr. Fukuda:

・One view that I think is common in many countries today is the belief that while the potential growth rate and natural rate of unemployment are still estimated using traditional methods, resulting estimates of the amount of potential output is smaller than the actual one (see Summers et al.). One reason for the substantial revisions to the outlook for the UK may be that the authorities have changed their estimation methodology.

Mr. Kitamura:

・A great deal of uncertainty surrounds the Brexit negotiations, including the EU summit on December 14-15, but it is my understanding that financial institutions in the City are moving ahead with preparations regardless of the outcome of these negotiations. Is it possible that funds that flowed into the UK financial sector and other service sectors in the form of foreign direct investment will now be dispersed to places like Frankfurt and Paris?

Ishikawa (Secretariat):

・The financial sector is seeing annual outflows of about 30,000 employees and some 15% of its total assets, according to some private estimates. The record disinvestment noted earlier is probably one manifestation of this trend, but for the analysis to be complete we need to know where those funds are going after they leave the UK.

Mr. Uchida:

・The macroeconomic impact remains difficult to estimate at present inasmuch as some financial institutions have yet to decide where they will move and are still considering how many people to transfer and whether to build new settlement centers in other locations. Additionally, the City's continued status as a financial center will depend to some extent on whether the UK's exit from the EU is "hard" or "soft," and manufacturers will need to decide whether to move their European headquarters, which currently take the form of holding companies. The prevailing view is that if the UK opts for a "hard" Brexit, the economy is likely to enter a recession.

Ms. Suda:

・People in the UK have told me that future uncertainty is responsible for financial firms' decision to do little more than continue essential investments for now. Consequently, I suspect the impact on investment at a macro level is probably not that significant.

Ishikawa (Secretariat):

・Business investment has increased slowly but steadily since falling sharply in the first half of 2016. However, investments by manufacturers declined for six consecutive quarters through 1Q 2017. Investment by firms in the service sector has also slowed recently, apparently in response to a slowdown in domestic demand and future uncertainty. Still, businesses' appetite for investment has recovered somewhat since retreating sharply in the wake of the Brexit referendum, and business investment may accelerate once the uncertainty clouding the outlook clears to some extent.

Mr. Uchida:

・When I visited the UK after the pound had fallen sharply in the wake of the Brexit referendum, the impression I received was of a robust economy with a strong construction sector and solid residential investment. As the currency's weakness left UK assets cheaper in relative terms, investment demand experienced a temporary pick-up, exports increased, and the number of visitors from the continent grew. More recently, however, these positive effects of the pound's depreciation have diminished, and consumption has slowed as higher prices have curbed households' purchasing power in real term. And in the event of a "hard" Brexit, the UK will need to renegotiate trade agreements with all of its trading partners, increasing the likelihood of a temporary slump in business activity and sharp decline in business investment. It is therefore important to consider a variety of scenarios when projecting the outlook for the UK financial sector and economy. Prime Minister May has made significant concessions to the EU on key issues, including the question of how much the UK will have to pay the EU on its departure from the bloc. But given the thorny issues of the Northern Irish border and Ms. May's diminished stature within the Conservative party, the risk of a "hard" Brexit is growing.

Ms. Suda:

・For the moment, the impact of Brexit on the UK would appear to be much smaller than expected immediately after the referendum.

Mr. Uchida:

・However, there are still significant risks to the future outlook. Real interest rates remain negative even though the BOE has begun tightening monetary policy. If inflation were to pick up at some point in the future, the BOE would find itself far behind the curve and could be forced to carry out large rate hikes.

Mr. Fukuda:

・During the pound crisis in 1992, there were initial concerns that the weakened currency would have a negative impact on the economy, but macroeconomic performance significantly exceeded expectations because the cheaper pound provided a major boost to exports, as noted by Mr. Uchida. I think something similar has happened this time, although it is still possible to envision a wide range of scenarios for the UK economy.

Mr. Oshima:

・There is no other city that can provide London's advantages in the areas of language, accounting and legal frameworks, and IT, whether in terms of quantity or quality. And inasmuch as Brexit will require changes to many laws, private businesses are starting to recognize that a great deal of time will be needed before new frameworks can take effect. I think one reason why Brexit does not appear to be having a significant impact at present is that many companies are choosing to preserve the status quo in their existing businesses and put off major decisions.

Ms. Okina:

・It was noted earlier that the UK's senior workers are characterized by a high percentage of self-employment. I think finding out more about how they work and what sort of support they receive from the government could offer useful hints for Japan.

Ishikawa (Secretariat):

・Sectors with a high percentage of self-employed individuals include education, culture and entertainment, transport and warehousing, and construction. The government is encouraging senior citizens to work by raising the retirement age and implementing pension reforms. Businesses have also increased the number of people employed under flexible arrangements, including working from home and so-called "zero hour contracts" that do not specify working hours or contract duration. It may also be the case that not many senior citizens are actually being forced to work, since in aggregate their assets and savings are both increasing.

Ms. Suda:

・I think that British views of immigration were one of the key reasons behind Brexit, but do the people there understand that stopping the inflow of immigrants may cause productivity to fall?

Ishikawa (Secretariat):

・Business owners are already feeling the loss of the immigrant labor pool, but I think most workers believe immigrants were taking away job opportunities still now. Even if the country tries to make up for the value-added generated by immigrant labor using domestic labor (such as senior citizens), the economy will eventually be forced into a declining equilibrium because the population itself is declining. At that point in time, I suspect the British will finally start to understand in broader terms what Brexit entails.

Mr. Fukuda:

・In the US as well, immigration is basically a positive for productivity, but there are also many people who have been hurt by it, and that has led to the expression of strong anti-immigration views in elections. I suspect the situation is similar in the UK.

Mr. Oshima:

・As in the US, many of the sectors employing large numbers of immigrants—including construction, wholesale and retail, and transport—also tend to employ many people with relatively little education, at a time when structural educational inequalities are growing. Inasmuch as many struggling British workers in their 40s and 50s are thought to have been adversely affected by immigration inflows, I suspect they have a strong political voice.

Ms. Fueda-Samikawa:

・In the UK, an actual unemployment rate of 4.3% at a time when the natural rate of unemployment is estimated at 4.5% means the economy is at full employment. However, while the weak pound has been a major driver of inflation, stagnant wages and the absence of strong domestic inflationary pressures are phenomena also observed in countries like Japan and the US. This may suggest that monetary accommodation has continued for longer than necessary on a global basis.

Ishikawa (Secretariat):

・The BOE decided to raise rates based on the view that the UK economy had achieved full employment and wage inflation would pick up in the near future. Meanwhile, the OBR has revised down its estimate of the natural rate of unemployment and raised its estimate of equilibrium working hours—one component of the potential growth rate—suggesting it may see somewhat more slack in the labor market than the BOE does. All in all, there is no single accepted view in the UK on the question of labor market slack.

Mr. Fukuda:

・In Japan, the macroeconomic indicator of the job offers-to-applicants ratio points to extreme tightness in the labor market, but a closer look reveals substantial disparities between individual sectors. For example, some sectors are now characterized by a surplus of labor: Continued penetration of IT, for example, has reduced demand for general administrative staff, and in manufacturing sectors the introduction of robots and other labor-saving technologies has eliminated many jobs. This sort of phenomenon is probably a global one.

Ms. Suda:

・Even within individual companies, there are divisions suffering from a shortage of labor despite an overall surplus of employees. One reason workers cannot be easily replaced with more suitable candidates is that local labor unions are very strong. Since companies decide whether to raise wages based on overall labor costs, the presence of large numbers of surplus employees tends to depress wage growth.

Mr. Uchida:

・The phenomenon of labor continuing to receive an extremely low share of profits despite an economy characterized by full employment is a global one. This is clearly the result of the continued penetration of ICT (information and communication technology). Consequently, the traditional linkages between employment, wages, and prices are no longer functioning.

Mr. Kitamura:

・In the UK, cuts to headcount have boosted corporate productivity, but the social costs of unemployment have been ignored.

Mr. Fukuda:

・I think this problem reflects a widening gap between the average and marginal productivity of labor. When some factor boosts output or the number of staff is reduced, average productivity—total output divided by the number of workers—improves, but marginal productivity does not necessarily increase. The rate of wage growth depends on marginal productivity, but in recent years corporate earnings have been rising as a result of factors other than gains in marginal productivity. Consequently, wage inflation has not picked up even though earnings are growing.

Mr. Egawa:

・The OECD's indicators of employment protection legislation show that it is hardest for employers to fire workers in Portugal and the Czech Republic, and it was noted today that many of the immigrants to the UK came from these two countries. The UK itself, on the other hand, is considered one of those countries (along with the US and Canada) where it is relatively easy to release workers.

Ishikawa (Secretariat):

・Labor union participation in the UK exceeded 50% at its peak around 1980, but has now fallen to around 20%. Labor unions may still have a strong influence at large enterprises, but with membership among the young at an all-time low, their bargaining power in terms of job protection and wages has probably weakened. Additionally, the adoption of more flexible working arrangements may be conducive to labor force participation but has also been cited as contributing to labor's reduced bargaining power. On a macroeconomic level, it has been estimated that this factor alone has lowered wage inflation by about 0.6ppt.

Mr. Oshima:

・This is an underlying trend in all of the developed economies, and it is expected that many wage earners will eventually experience changes in their working arrangements and find themselves working for different employers at different times of the week with the companies' blessing. Given the pace of technological innovation, I think it will be difficult for business owners to try to increase labor's share of profits. In Japan, company employees can be retrained internally and reassigned to divisions where they are needed, but such opportunities are rare at overseas firms. Industries capable of creating more full-time jobs while simultaneously raising wages—such as IT—are the exception rather than the rule, so the continued application of monetary stimulus in an attempt to boost wage inflation at the macroeconomic level will only lead to higher asset prices in an excessively accommodative financial environment, and only a handful of wealthy households will benefit. This describes the situation in most of the developed world today.

Ms. Nemoto:

・In Japan, the increased participation of women in the labor force has reduced the supply of surplus labor, which means raising the potential growth rate will require greater contributions from immigrants and senior citizens. In the UK, many immigrants have specialized skills, but there are also some who receive the benefits from UK's government which results in increase of the social welfare expenditures. I think Japan can learn from the UK's experience if it eventually decides to take in more immigrants. Companies tend to hang on to senior citizens in Japan, and I think the country needs to do more to increase the percentage of self-employed seniors and firm entry rates, taking hints from the UK.

Ishikawa (Secretariat):

・The British government has detailed requirements for immigrants including education and net worth levels. Partly because of those requirements, it has been estimated that immigrants contribute more to the national coffers than the British themselves. Japan should also be able to benefit from immigration at the macroeconomic level by establishing such a framework. The question remains, however, whether Japanese businesses and the economy itself will be able to attract the kind of immigrant labor capable of generating high value-added.

Ms. Okina:

・I think senior employment also has a positive impact on the economy by reducing government spending on healthcare. The measures implemented by the British government to encourage senior citizens to work deserve our attention.

Ishikawa (Secretariat):

・To some extent, senior citizens in the UK have to work because the government there has raised both the retirement age and the pension eligibility age. Even so, the OBR forecasts that as the overall population ages, the resulting increase in spending on medical care, nursing care, and public pensions will raise the fiscal deficit to 1.8% of GDP in FY25.

Mr. Tokushima:

・In Japan there is a tendency to blame sluggish wage growth on the rise in part-time or temporary job workers, but I think the gathering trend towards self-employment of senior citizens has also played a role. In other words, senior citizens who work only a few days each year and have almost zero income are not counted in the unemployment rate. If this sort of phenomenon is global in nature, we may need to review our existing concepts of the unemployment rate and full employment.

Mr. Fukuda:

・The types of self-employment also differ depending on whether we are talking about large cities or rural areas. In the latter, senior citizens who own land can continue to be engaged in agriculture (or fishing) even after retirement, but there are limits to the opportunities for self-employment in major urban areas.

Ms. Suda:

・There may also be some who opt for self-employment as a way to reduce their tax bill.

Mr. Hosono:

・I have heard that many senior citizens in South Korea work as subcontractors for parcel-delivery companies.

Ishikawa (Secretariat):

・In the UK as well, the rapid growth in internet retailers' share of total amount of retail sales has driven demand for transportation services, and that, I think, has helped increase the amount of work available in the transport and warehousing sectors.

2. BOE policy response

Ishikawa (Secretariat):

・Funding obtained by financial institutions has increased, mainly in the form of corporate deposits. The Term Funding Scheme, under which the BOE supplies funds to banks at rates close to Bank Rate that encourages banks to make loans to small and medium businesses as a cost-effective source of funding, has also played a growing role in bank funding. Banks' lending attitudes toward larger businesses have slowly but surely improved, while their loans to small and medium businesses continue to be characterized by larger spreads and higher fees.

・The number of small and medium businesses keeps growing, with driving new job creation. More than 30% of all employed persons now work at companies with fewer than 50 employees. Small businesses are also characterized by steady growth in sales volume, while sales at larger enterprises tend to be more volatile.

Additionally, it is interesting to note that very small businesses with fewer than 10 employees have achieved marked gains in productivity. The main method of funding for small and medium businesses is bank borrowings, including overdrafts and various types of loans, and more than 50% of these firms say they first approach their main bank when money is needed. More than half the funds obtained are used as operating capital, about 30% for the purchase of fixed assets, and slightly less than 10% for business expansion. Net bank lending to small and medium businesses began increasing in 2015. The economy-wide bankruptcy rate has been gradually declining since 2009, and at firms with fewer than 20 employees the rate is now back to pre-GFC levels. These results suggest that financial institutions may have boosted the survival rate of small and medium businesses by giving them access to necessary funding.

・Households' debt-to-income ratio fell for a long time after the financial crisis, but has recently turned higher on growth in unsecured lending and is now approaching 140%. Growth in the outstanding value of unsecured loans has also exceeded the 3%-plus growth in nominal GDP, with credit card loans rising by more than 5% a year and "other" loans, including consumer loans, growing at an annual pace of about 7%. At a time when consumer lending interest rates have fallen to record lows, financial institutions are increasingly trying to attract customers with new services instead of competing solely on the basis of low interest rates. Some, for instance, are extending the interest-free period offered to customers who refinance their credit card loans. That said, financial institutions have begun to restrict the availability of unsecured loans, probably at least partly in response to rising loan-loss ratios and the "announcement effect" of macroprudential policies by the Financial Policy Committee (FPC). In its latest stress tests, Prudential Regulation Committee (PRC) examined "major UK banks' long-term strategic responses to an extended low growth, low interest rate environment with increasing competitive pressures in retail banking enabled in part by an increase in the use of financial technology (FinTech)." Its conclusion—that financial institution managers had an insufficient appreciation of risk—is worth noting as a new issue for financial stability.

・BOE policy is intended to enhance the resilience of the financial sector and broader economy to key risks such as Brexit and the aging population with a combination of various measures. These include policy rate hikes to keep CPI inflation in check and maintain steady growth in personal consumption, the continuation of quantitative easing to support small and medium businesses and enhance productivity growth, and the normalization of macroprudential policy to slow growth in unsecured lending to households and keep systemic risk in check. In its November Inflation Report, the BOE upgraded its CPI inflation forecast for 2017 to 3%, downgraded its outlook for 2018, and saw inflation converging at around 2% in 2019 after slowing gradually. The Bank also confirmed the market consensus and said it expects the policy rate to reach 1% in 3Q 2020. Meanwhile, the central bank once again revised down its outlook for the unemployment rate, saying it now expects unemployment to trend around 4.2% through 2019.

・In November the BOE raised rates for the first time in ten years, taking the policy rate up to 0.5%. In the area of quantitative easing, it kept the Asset Purchase Facility (APF) for government bonds on hold at £435bn and left its corporate bond purchases unchanged at £10bn. Since the spring of 2017 the BOE has kept its asset holdings steady via a reinvestment policy. Incidentally, the size of the TFS depends on actual demand, and while the framework was originally set at £100bn, an agreement was reached with the finance ministry in November to increase that figure to £140bn. Many members of the Monetary Policy Committee (MPC) noted that the narrowing output gap has helped increase inflationary pressures, but Committee members Jon Cunliffe and Dave Ramsden, who argued for leaving the policy rate on hold at the November meeting, question the slope of the Phllips curve and explanatory power of the curve, arguing that currently available data suggest domestic inflationary pressures remain weak. On the whole, the MPC is of the view that the impact of rate hikes on households will be neutral as higher borrowing costs are offset by higher deposit yields. But with floating-rate loans accounting for about 75% of all residential mortgages, there are concerns about the impact of rate increases—after all, it remains to be seen whether financial institutions will be able to raise deposit rates given their weak earnings. However, surveys show that a pick-up in inflation would weigh on consumption by households with heavy debt loads or little savings, and in that sense an attempt to rein in inflation with rate hikes would help to protect households' real purchasing power.

・The average remaining maturity of government bonds held by the APF now exceeds 12 years. The BOE, pension funds and insurers, and overseas investors each hold about 25% of all outstanding gilts (including inflation-linked securities), and the average time to redemption is about 18 years (or about 15 years for ordinary gilts), which is longer than in other developed economies. The UK's fiscal deficits have shrunk, but improving the state of the nation's finances remains an important element of financial stability. Richard Sharp, an external member of the FPC, argued that by providing adequate "fiscal space," the government could maximize the effectiveness of the policy mix by helping to ensure that macroprudential policy functions properly during a crisis.

・According to BOE surveys of financial system risk, the number of respondents who see a greater likelihood of a risk event (whether political or otherwise) has increased sharply since 2H 2016. That said, a growing number of respondents said they are confident in the stability of the financial system over the next three years, a result that may be due partly to the UK authorities' macroprudential policies and the results of the stress tests. As for macroprudential policies, the FPC raised its countercyclical capital buffer (CCyB) from 0% to 0.5% in June 2017 and announced a further increase to 1% in November. Regarding the stress tests, the Prudential Regulation Authority (PRA) revealed the results of its tests late in November and concluded the domestic banking system had sufficient resilience to survive simultaneous deep recessions in the UK and overseas, with none of the seven banks was judged to need to augment their capital, the first time that had happened since stress tests began in 2014. Naturally, the PRA's risk scenario includes the risks thought likely to occur under Brexit.

Mr. Fukuda:

・Does the fact that the MPC and FPC are independent committees within the BOE complicate simultaneous discussion of risks to the macroeconomy and the financial system?

Inoue (Organizer):

・The MPC's primary responsibility is price stability, while the FPC's key mandate is financial system stability. However, the BOE's executive directors are drawn from both committees, and it would appear that the members of both committees and their supporting staff share information and opinions among themselves.

Ms. Suda:

・While in an ideal world the MPC and FPC would complement each other, the two might not always be able to come to an agreement, thereby complicating the conduct of policy. At the Fed, financial system issues are noted when the FOMC makes a monetary policy decision. How are things done at the BOE?

Inoue (Organizer):

・I suspect that the decision of whether to use macroprudential tools or the policy rate to stabilize the financial system is made largely on a case-by-case basis, even when the stability of the financial system is threatened, since in the end they often involve separate areas. We should also remember that while monetary policy is characterized by relatively simple policy objectives, such as the inflation rate, the goal of macroprudential policy is to avoid systemic risk, making it more difficult to determine whether the policy goal has been achieved or not.

Ishikawa (Secretariat):

・The monetary accommodation and lowering of the CCyB that followed the Brexit referendum were one example of the MPC and FPC working together synergistically. However, the BOE continues to discuss the direction of policy at the FPC.

Ms. Suda:

・Key issues being discussed probably include accountability and the Bank's communication with the market.

Mr. Uchida:

・On the subject of macroprudential policy, it should be noted that quantitative easing and other actions taken by the central bank can by themselves have a significant impact on financial stability. Additionally, the fact that all of the new regulations introduced since the financial crisis were intended to be forward-looking creates the risk that the financial sector will shrink in a pro-cyclical fashion during the next economic recession. Future policy is bound to be different in a country like the UK, which employs macroprudential policy, and Japan, where policy is highly procyclical. I hope that various regulations will take into account actual conditions in the financial system so as to prevent fallacy-of-composition problems.

Ms. Nemoto:

・The UK has encouraged the use of peer-to-peer (P2P) lending with the creation of special legislation, and this area is growing rapidly, albeit from a small base. This sort of lending has the potential to diversify the sources of funding for small businesses and increase firm entry rates, although it is vulnerable to shocks.

Mr. Fukuda:

・When policy authorities become involved in P2P and other new forms of finance from the standpoint of financial system stability, it is important to determine how much systemic risk they entail.

Mr. Oshima:

・I think the BOE could do more to explain the linkages between the MPC, the FPC and the PRC as well as those committees' use of policy tools.

Ishikawa (Secretariat):

・I think it has been adequately explained that the MPC utilizes interest rates and "quantity," while the FPC uses macroprudential tools such as the CCyB and the loan-to-income ratio. However, the BOE needs to explain why it has left quantitative easing in place while raising interest rates. In terms of macroprudential policy, the authorities are sorting out the methods for dealing with residential mortgage risks, but they appear to be still looking for the best response to the issue of expanding unsecured lending. There is also a shortage of quantitative analysis of these policy effects.

Mr. Hosono:

・How much does the CCyB constrain the activities of financial institutions in practice? Once a financial institution builds up a large capital buffer, for example, does reducing the required size of the buffer actually have an accommodative impact?

Mr. Oshima:

・A larger buffer has an impact on dividends by affecting the institution's capital target. It also influences an institution's behavior via risk tolerance. And since institutions proactively set aside more capital in anticipation of a given increase in the CCyB, there can be a significant impact on the business in the medium term.

Mr. Fukuda:

・The CCyB was not designed to be frequently raised and lowered. If it is changed about as often as the policy rate, its effects will manifest differently, as noted by Mr. Hosono.

Mr. Uchida:

・The Bank of Spain (the central bank of Spain) was already using a CCyB before the global financial crisis, and it was not particularly effective. That is why the developed countries have used a variety of tools to force financial institutions to increase their capital in a multifaceted approach to preventing systemic risk.

Ms. Nemoto:

・Ratings agencies argue that financial institutions' capital has become more robust as a result of introducing the CCyB. If banks cannot meet the requirements of minimum capital adequacy ratio (CAR) including CCyB, the ratings of the banks become significantly deteriorated. Appropriate adjusting of CAR would bring more stable ratings of the banks and their businesses.

Ms. Suda:

・Is the current regulatory regime for financial institutions excessive or appropriate?

Mr. Oshima:

・It depends on a variety of factors, including the external environment. That said, the measures implemented by the authorities have in fact enhanced the quality of capital and reduced leverage.

Mr. Fukuda:

・It may not be possible to know whether regulation is appropriate or excessive until after the fact. That was clearly the case with the Bank of Spain.

Mr. Hosono:

・Are you saying that the effectiveness of the CCyB is asymmetric? By that, I mean that a larger buffer prompts financial institutions to set aside more capital and lowers their risk tolerance, but a reduction of the buffer will probably not cause them to increase their risk tolerance.

Mr. Egawa:

・The large UK banks currently have capital adequacy ratios of 13% to 14%, with bank executives targeting capital levels far in excess of the minimum regulatory requirements. Since raising the Common Equity Tier 1 ratio takes time, a modest reduction in the CCyB is unlikely to prompt institutions to take on more risk and increase their lending.

Inoue (Organizer):

・What is the signaling effect of raising and lowering the CCyB? For example, increasing the buffer may be a way for the authorities to send a message to financial institutions that supervision and inspections will also become more rigorous.

Ms. Suda:

・I think that sending a macroprudential warning using standard communication tools, as the BOJ does, is better than trying to send a message by implementing measures that have an actual impact on financial institutions.

Mr. Takemura:

・The BOE's recent rate hike was probably intended not only to control domestic inflationary pressures by curbing consumption and investment but also to check imported inflation due to the weak pound. Does the fact that the pound did not rise significantly after interest rate hike present an argument from the standpoint of the effectiveness of central bank's communications?

Ishikawa (Secretariat):

・I think the recent rate hike was driven mostly by a traditional desire to curb domestic inflation. Many MPC members have cited concerns about a potential increase in inflation volatility as a reason for the hike, emphasizing the need for a forward-looking policy response. That said, some MPC members have expressed doubts about the effectiveness of a forward-looking policy response. It should also be noted that the BOE has established a blog ("Bank Underground"), and we will be closely watching to see how it is used as a communication tool.

Ms. Suda:

・The BOE could have decided to raise rates sooner than it did. Although the weakness in the pound that was at the heart of recent inflationary pressures was treated as an external factor, it is also an endogenous variable that is affected by monetary policy.

Ms. Okina:

・The BOE has large outstanding bond holdings under the APF, and many of those bonds have long maturities, so an "exit" from quantitative easing may require the Bank to sell its bonds. The resulting costs would be borne by the HM Treasury. The BOE would appear to be very conscious of the importance of disclosing information regarding the potential losses from such sales.

Ishikawa (Secretariat):

・One reason why the APF was established was concern about potential losses from bond sales when winding down QE, inasmuch as many of the bonds purchased by the BOE have long maturities.

Inoue (Organizer):

・In terms of accountability, the BOE provides a substantial amount of information in its Asset Purchase Facility Quarterly Reports. The Fed also publishes a similar report about its own asset purchases. This is an area where I think Japan could learn from the US and the UK.

Mr. Takemura:

・I suspect one reason why the BOE has left quantitative easing in place is that foreign investors hold a high percentage of UK government bonds. In order not to lose those investors, it is important that long-term interest rates remain stable even as the BOE raises the policy rate. There is a possibility that the BOE determines the amount of APF considering the effects of the monetary policy on the long-term interest rates at the same time.

Ms. Fueda-Samikawa:

・In the UK, the maturity profile of government debt has been increasing ever since Lehman Brothers collapsed, and the remaining maturity of the bonds held by the APF has also increased along with quantitative expansion. The relationship between the nation's debt management policy and monetary policy is also interesting.

Ms. Okina:

・In the UK as well, demand for short-term gilts has increased in response to new liquidity rules, and perhaps also because of recent increases in issuance of short-term debt by the Debt Management Office.

Ms. Suda:

・UK law requires that government spending also contributes to the achievement of the price target, so it would not be surprising if the two were being coordinated.

Mr. Egawa:

・An overwhelming portion of gilts have a maturity of more than 15 years, and the government also issues 50-year bonds.

Mr. Takemura:

・There is reportedly vigorous demand from pension funds for ultra-long-term and inflation-linked gilts.

Mr. Uchida:

・Increased issuance of long-term bonds can be justified under the debt management policy as long as inflation remains stable, but that means the price stability target must be carefully managed.

Inoue (Organizer):

・I'm afraid we are out of time. Discussion of the eurozone will have to wait for another opportunity. I would like to thank all of the panelists for a long and insightful discussion.

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