

**Topic** Japanese financial markets post-March 11 and the BOJ policy response

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**Participants**

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## Issues for discussion

### 1. Japanese financial markets post-March 11

### 2. The BOJ policy response

## Summary of comments

### 1. Japanese financial markets post-March 11

#### Inoue <Organizer>:

- On the whole, money market conditions were far more stable in the wake of the March 11 earthquake than during the financial crisis following Lehman Brothers' collapse, which serves as a benchmark for assessing market stability. Overnight call rates quickly fell back to ordinary levels, with downside moves proving more powerful than the preceding moves higher. Libor, TB, and repo rates quickly stabilized, and OIS rates fell modestly and then trended sideways. One exception was offshore S/N rates: yen funding costs rose sharply and Libor increased on 16 March (in overseas markets), although these moves were limited to that day. Commercial paper rates also traded with an upward bias for some time as companies sought to issue more paper.
- In the week starting 14 March the BOJ made frequent use of overnight operations with T+0 settlements to ensure a large supply of funds. Although the auctions were consistently undersubscribed, the Bank gave first priority to reducing the risk of a misdistribution of funds. The BOJ also made use of lending against pooled-collateral and JGB purchases under repurchase agreements to supply funds with later settlement dates. The strength of demand for funds was underlined by the arrest of the decline in bid-to-cover ratios for three-month fixed-rate lending against pooled-collateral. Current account balances at the BOJ consequently surged from less than ¥18trn prior to the disaster to more than ¥42trn on 25 March.
- After moving sharply higher early on the morning of 17 March

(Japan time), the yen gradually fell back following the concerted intervention decided at the G7 Finance Ministers and Central Bank Governors on 18 March. Stop losses on FX margin trades are reported to have accelerated the yen's climb, and short-yen positions on the Tokyo Financial Exchange dropped sharply. Meanwhile, inward portfolio investment data showed overseas investors buying large quantities of Japanese equities and selling almost an equal amount of short-term bonds, proving speculation about the large-scale repatriation of capital by Japanese insurers to be unfounded. As in 2008, a sharp appreciation of the yen accompanied a drop in share prices in Japan and other leading economies and a rise in the VIX volatility index. And as in October 2008, the G7 statement noted that excess volatility in the yen exchange rate was undesirable from a standpoint of financial stability.

- The bond market's reaction thus far has been limited, with only a modest increase in volatility. Market participants have focused on the ramifications of a potential increase in JGB issuance to fund fiscal outlays for disaster relief. Share prices plunged during the first half of the week starting 14 March but subsequently rallied on bottom-fishing by overseas investors and a drop in the yen. However, the shares of companies expected to be affected by the power shortage and supply chain interruptions have remained weak. In the credit markets, companies have held back on issuing bonds but are reportedly issuing more commercial paper to build up cash reserves. In light of the events of late 2008, we expect bank

lending will rise in response to strong corporate demand for reserve funds. In the commodity markets, Japanese fuel and reconstruction-related demand represent potential catalysts for oil, natural gas, and copper.

- It was reported that the BOJ's main objective in enhancing Comprehensive Easing was to lower risk premia in the financial markets. And, in fact, much of the increase in the Asset Purchase Program was earmarked for the acquisition of risky assets.

### (1) Money market

#### Mr. Kato :

- The BOJ supplied funds less as a means of calming uneasiness in the market than as an attempt to prevent such uneasiness from emerging in the first place. The fact that current account balances ultimately exceeded ¥40trn reflects strong demand for reserve funds at financial institutions, including a desire to hold large amounts of cash. The BOJ satisfied this demand and prevented a broad-based rise in interest rates. On the morning of 14 March, the first day of trading after the disaster, the BOJ took the unusual measure of telling market participants that they should remain calm because large amounts of funds would be forthcoming. The BOJ then kept its word by supplying ample quantities of funds for the rest of the week, which helped minimize the tightness in the market for overnight call funds seen in the aftermath of the Hanshin earthquake in 1995. During afternoon sessions, in fact, there were sometimes no bids.
- In the commercial paper market, rates climbed about 10bp at the start of the week beginning 14 March. But rates later fell steeply, with yields on A1 rated paper dropping back to ordinary levels, because (1) the end-of-period funding season was already over, reducing companies' need to issue paper, and (2) the BOJ engaged in operations in the commercial paper market. TB rates also traded with an upward bias initially as financial institutions held back on bidding, driving BOJ and MOF concerns that the rise in yields would spread to short-dated JGBs, but rates fell in the week starting 22 March. In the offshore yen deposits market, players unable to participate in the BOJ operations briefly moved to accumulate yen funds, and transactions do not appear to have increased substantially since then. I expect companies to issue more CP with the intent of building up reserve funds, but any resulting upward pressure on interest rates should be kept in check, in part because of increased BOJ purchases of CP under comprehensive easing.

#### Mr. Uchida :

- Demand for funds at financial institutions increased in the wake of the 11 March disaster for three reasons: (1) strong demand for funds in the affected areas, (2) the difficulty of transporting cash, and (3) computer system problems at a

leading financial institution. As for the first two, many local financial institutions were directly hit by the disaster, and the nation's leading banks responded by supplying funds to affected institutions via the call market. They also prepared large quantities of cash at branches in affected areas in anticipation of difficulties in transporting cash. As Mr. Kato pointed out, it was this demand that enabled the BOJ to supply ¥40trn in funds.

### (2) Intervention in foreign exchange market

#### Mr. Kato :

- Based on the fact that the BOJ temporarily underwrote some TBs, I estimate that the MOF's yen sales totaled just under ¥700bn [note: the MOF subsequently announced on 31 March that the actual figure was ¥692.5bn]. As for other G7 members, fiscal fund flows suggest the US Department of the Treasury and the Fed bought about \$1.0bn. As purchases by the BOE and Bank of China were almost certainly less than that, Japan probably accounted for an overwhelming share of the total—even if ECB purchases were on a par with those of the US. Barring the use of currency swaps between national authorities, overseas currency authorities are limited in their yen-selling intervention by the amount of yen assets they hold in their foreign exchange reserves. Still, I think the G7 agreement to engage in concerted intervention was effective in generating speculation that the G7 was willing to tolerate Japanese intervention on a relatively large scale.

#### Mr. Fukuda :

- In my view, the fact that overseas authorities tolerated the yen-selling by Japan's Ministry of Finance was more significant than their actual participation in the operation. Incidentally, there has been no mention of acting intervention by overseas authorities on behalf of the Japan's MOF from the G7 or the Japanese authorities.

#### Inoue (Organizer) :

- Many currency market participants expected the MOF to intervene; however, the fact that the G7 Finance Ministers and Central Bank Governors conducted the tele-conference and agreed to engage in a concerted intervention seems to have been taken quite seriously by the market. For reference, when Japan carried out large-scale intervention in 2003–04, trades during overseas trading hours were reportedly executed largely in Tokyo rather than entrusting them to overseas authorities.

#### Mr. Takata :

- There was a great deal of speculation in the currency markets that Japanese insurers would sell foreign government bonds in order to meet increased demand for funds. But a look at their balance sheets suggests that if they had sold any assets for this reason, Japanese government bonds would have been a much more likely candidate. In the event, however,

they have sold neither, and they were also active participants in the latest 20-year JGB auction. I think insurers' ample cash reserves will be more than adequate to cover future demand for funds.

### (3) Credit market

#### Mr. Uchida:

• A key issue from this point onwards will be responding to businesses' demand for funds. With a key issuer of power bonds—the benchmark for corporate bonds—in its current state, many firms are shelving debt issues for another day. And with interruptions in distribution networks making it difficult to collect accounts receivable, companies as a whole are recalling their experiences during the Lehman-inspired financial crisis and building up cash reserves. This demand is showing up in the form of increased bank lending and borrowing against commitment lines, prompting financial institutions to procure larger-than-usual amounts on the interbank market. Expected increases in both JGB issuance and loan demand for reconstruction of the affected regions are making it increasingly difficult to forecast funds supply and demand or long-term interest rates.

#### Mr. Takata :

• At present, corporate loan demand resembles the recent demand in Japan for mineral water. Just as households are accumulating stocks of bottled water in their homes, companies are building up cash reserves “just in case”—while there is some demand for operating capital, we have yet to see a full-fledged surge in reconstruction-related loan demand. Lending by financial institutions increased sharply in Q4 2008 and Q1 2009 in the wake of the financial crisis, but those loans were subsequently paid back quickly. Financial institutions are keeping this experience in mind as they respond to the current situation. Loan demand was relatively strong prior to the financial shock, reflecting the firm economy. The crisis-driven tightening of the market was therefore felt especially strongly. Since then, however, companies have steadily reduced the size of their balance sheets, and as a result I think any rise in risk premia due to stronger loan demand would be relatively muted.

#### Ms. Nemoto :

• Rating agencies has downgraded sharply the credit rating for Japan's largest power company, and are reviewing their ratings for other power companies, referring to the risk that they may also have to bear part of the cost of enhancing safety measures at nuclear power plants and the fuel costs resulting from a partial stoppage of operations. And given the extent of financial institutions' lending to the electrical power industry and their shareholdings in these companies, we need to closely monitor the impact of industry developments. Nonlife insurers have also been downgraded or placed on negative

credit watch based on estimates that the sector's bill for the disaster will amount to ¥600–800bn. When the sector's thick capital cushion and absence of any liquidity issues are taken into consideration, I think the market's concerns are somewhat overdone.

#### Mr. Takata:

• Because the corporate bond market is a key component of the Japan's financial system, we need to consider the implications for this market when dealing with issues relating to power bonds.

#### Mr. Fukuda:

• On one hand, if power bond in fact is the Japanese corporate bond market, we probably need to focus on the importance of maintaining financial stability. On the other hand, a perspective of fairness of treatment between debt and equity holders is also important.

#### Mr. Yanagawa:

• When a debt issuer falls in trouble, the costs should be distributed among the main stakeholders—shareholders, bondholders, and banks. Discussion would then shift to the question of how we should address the resulting externalities in the corporate bond market.

## 2. The BOJ policy response

### Inoue (Organizer)

• The Bank of Japan's policy response can be broken down into three stages. The first involves narrowly defined crisis measures, consisting mainly of actions to ensure the continued operation of the payment and settlement system and to see that demand for banknotes in affected areas is met. The second is intended to maintain stability in financial markets and consists mainly of supplying liquidity to the money market, bolstering the Comprehensive Easing program, and reducing market stresses using such tools as currency intervention. The third stage involves support for economic reconstruction. Relevant issues would include deciding the appropriate mix of economic policy when fiscal outlays are expanded and helping maintain functioning financial institutions in the affected areas.

• As for the third, the BOJ says it will take necessary measures after looking at available economic and financial data at the April Policy Board meeting. Some politicians argue that the Bank should underwrite all JGB issuance needed to fund a supplementary budget for economic reconstruction. The BOJ has firmly rejected this argument, and senior officials at the Ministry of Finance and Cabinet Office have also weighed in against it. Traditionally, the BOJ has treated the purchase of JGBs as a technical tool for facilitating its market operations. The purchase of JGBs via the Asset Purchase Program as

part of Comprehensive Easing has been presented as a temporary and exceptional measure with the goal of keeping longer-term market interest rates in check.

#### (1) Supply constraints and inflation expectations

##### Mr. Fukuda:

- We are closely watching price trends. Reconstruction demand and reduced expenditures due to negative economic sentiment may cancel each other out, resulting in little net impact on aggregate demand, but a substantial reduction in aggregate supply is almost certain. That, coupled with the impact of rising energy prices, is likely to increase upward pressure on prices. Inasmuch as nominal interest rates will also rise, inflation expectations may change. Meanwhile, I find it interesting that in spite of increasingly clear supply constraints, businesses are choosing to let inventories run out rather than to raise prices.

##### Mr. Takata:

- With few concerns about inflation, expectations for the price outlook are quite adaptable. Inasmuch as Japanese companies have been working for a long period of time to shrink their balance sheets, supply constraints like today's are unlikely to spur efforts to build up inventories, nor are financial institutions likely to become more active lenders. Given this kind of sentiment, there is a risk of a contraction of economic activity and real estate-driven asset deflation, which in turn could lead to an expansion of banks' bad assets. That said, such deflationary sentiment will eventually pass, and one possible trigger could be a weakening of the yen. Policy authorities face the difficult task of keeping an eye on both the risk of deflationary expectations and the risk that a credit expansion under supply constraints will spur inflation expectations.

##### Mr. Fukuda:

- The fact that the affect could be either deflationary or inflationary is due partly to the varying circumstances in different industries. Homebuilders, for example, will benefit from reconstruction demand, while many other sectors will experience constraints in terms of parts supply.

##### Mr. Uchida:

- Resource prices overseas have already risen substantially, and Japan—which is under supply constraints—could also experience inflationary pressures eventually.

##### Mr. Fukuda:

- Having an estimate of the damage from the disaster is important when thinking about the size of the reconstruction budget. How should we view the Cabinet Office's early estimate of ¥16–25trn, given the difficulty of coming up with an accurate estimate of the damage?

##### Mr. Uchida:

- The Cabinet Office figure is limited to direct damage and does not take into account the impact of the rolling blackouts and so on. Incidentally, direct damage from the Hanshin quake in 1995 was estimated at ¥9.9trn, but ultimate economic losses reached ¥22trn. Based on the assumption that that experience can be applied to today's situation, there are concerns that the ultimate economic losses from the 11 March disaster could be double the Cabinet Office's estimate.

##### Mr. Yanagawa:

- Even if we exclude the impact of the rolling blackouts, it is difficult to obtain an accurate grasp of the extent of damage to supply capabilities in the affected areas. When considering an economic policy response we need to determine whether supply capabilities will recover relatively quickly or not.

##### Mr. Uchida:

- If April output remains 20% below capacity and reconstruction demand then picks up as it did following the Hanshin earthquake, I estimate the FY11 growth rate will be about 0.4ppt lower than initially forecast. But the hit to growth could be 1.0ppt or more if the rolling blackouts leave production 20% below capacity through the Jul–Sep quarter, delaying a real pickup in reconstruction demand until September or later. The outlook for the macroeconomy will therefore be heavily influenced by supply-side conditions.

##### Mr. Takata:

- Financial institutions and research organizations have all reassessed their growth forecasts for FY11, and their revised outlooks vary greatly. While many foreign organizations are now predicting negative growth for the year, other institutions are projecting growth in the 1–2% range. Given the extent of the shift in expectations among experts, it could be argued that this is the opportunity Japan needs to uproot deep-seated deflationary expectations. But if it goes too far and prompts excessive inflationary expectations, the side effects would be significant.

##### Mr. Yanagawa:

- The economy will be fine as long as inflation expectations fall within an appropriate range. The risk is that a sudden increase in prices will trigger panic.

##### Mr. Fukuda:

- Accelerating inflation would make it impossible for the BOJ to maintain its current accommodative stance. On the other hand, the BOJ may not be able to tolerate rate hikes if supply constraints send the economy into a slump.

##### Mr. Kato:

- The fear is that a prolonged period of supply constraints will cause the production of important components to shift to overseas manufacturers, leaving demand depressed even

after reconstruction work is finished. I also think the high and increasing average age of people in the affected areas will pose special problems for the reconstruction effort.

**Mr. Fukuda:**

- It is said that the government also lacked good ideas or a grand design for a “new” Tokyo following the Great Kanto Earthquake in 1923. Even before the recent quake, the government was having difficulty finding ways to revitalize local economies in the Tohoku district.

**Inoue (Organizer):**

- How do you view the multiplier for reconstruction-related public works investment?

**Mr. Fukuda:**

- Under the Keynesian framework, the investment multiplier is largest at times of macroeconomic slackness. Given that we are now dealing with supply constraints, I think those assuming there will be an investment multiplier may be misreading the situation.

**Mr. Yanagawa:**

- If reconstruction demand emerges before power supply recovers, increasingly severe supply constraints could trigger price increases without significant growth in GDP.

**Mr. Uchida:**

- I suspect we will get through this year with emergency measures like the rolling blackouts and conservation efforts. In 2012 and beyond, the power companies are likely to embark on full-scale efforts to increase supply capacity, and many companies will have put in place their own generators by then. All will be well if these changes in thinking have the healthy effect of snuffing out deflation expectations. The risk is that they will create stresses for the financial markets by sparking severe inflation concerns.

**(2) Fiscal policy, long-term rates, and the BOJ's role**

**Mr. Takata:**

- While the reconstruction of affected areas will inevitably present a fiscal burden for the government, the size of the necessary increase in JGB issuance remains unclear at this point in time. Japan's largest-ever supplementary budget was the ¥16trn budget compiled in Mar–Apr 2009 in the wake of the global financial crisis. Our estimates suggest the risk premium component in JGB yields began to rise around this period and increased further in response to the announcement of policies championed by the new DPJ government. The risk premium then stabilized, but the question is how it will react to discussion about the size of the upcoming supplementary budget and methods of funding it.

**Mr. Fukuda:**

- Discussion regarding the size of necessary fiscal stimulus

often invokes comparisons with the Hanshin earthquake, but in stock as opposed to flow terms today's fiscal deficit is far worse.

**Mr. Takata:**

- Pessimists worry that expanding fiscal outlays will cause a full emergence of Japan's fiscal problems, bringing an end the current account surpluses that have historically supported the stable absorption of government debt issues. Growing concerns about such a scenario could lead to another “sell Japan” episode.

**Mr. Uchida:**

- To the extent that long-term funds will have to be provided by the issue of JGBs, I think market participants are aware of the risk that fiscal stresses will emerge sooner rather than later. In that sense, it is important for the government, the BOJ, and market participants to do what they can to maintain stability in the government debt market. For instance, risk management efforts by market participants could destabilize the market if carried out with an exclusive focus on company-level risk.

**Mr. Fukuda:**

- While extreme destabilization of the JGB market should be avoided, I question the desirability of a situation in which JGB yields remain steady despite market participant awareness of fiscal risks.

**Mr. Yanagawa:**

- I think the almost complete absence of a response from the JGB market has encouraged the view that it will be possible to fund fiscal outlays for reconstruction with additional JGB issuance. And it is not even clear whether BOJ underwriting of those bonds would contribute to increased market stability or would instead destabilize the market.

**Mr. Takata:**

- The Ministry of Finance and market participants have joined the Bank of Japan in expressing strong reservations about BOJ underwriting of reconstruction-related JGB issues. But the political situation was quite fluid to begin with, and the political character of the current debate makes it difficult to read the outcome. Consequently, we cannot rule out the possibility altogether. Foreigners in particular would probably respond negatively, sparking concerns about the impact on Japan's sovereign rating. The BOJ has strived to enhance JGB market stability by stepping up purchases of JGBs in March 2009 and by initiating purchases of longer-term JGBs via the Asset Purchase Program under the Comprehensive Easing framework launched in October 2010. Whereas short-term interest rates can be kept in check by supplying funds, however, long-term rates are more difficult to control inasmuch as they tend to track longer-term rates in the US

and Europe. Given the importance of these problems, I think we including this panel need to engage in a proper discussion of the issue of BOJ underwriting of JGBs and communicate our views to policymakers.

**Mr. Kato:**

- In the wake of World War II, the BOJ underwrote government bond issues designed to fund support measures for returning servicemen and the munitions industry. This boosted aggregate demand at a time of depressed aggregate supply, pushing inflation higher from around November 1945. Inflationary pressures finally eased around 1948 when aggregate supply recovered. Today, aggregate supply has not fallen to the extent it did after the war, and the BOJ underwriting of a ¥10trn issue of reconstruction bonds might have only a limited impact on the market. But given financial markets' lack of confidence in politicians' fiscal discipline, even a one-time underwriting could lead to fears that it would become standard operating policy.

**Mr. Fukuda:**

- A destabilization of the JGB market would force the BOJ to intervene on the markets. The BOJ is capable of exercising direct influence over short-term interest rates, and it also has the tools—such as JGB purchases—to exercise influence over longer-term rates.

**Mr. Yanagawa:**

- But if the BOJ does underwrite a JGB issue, that in itself could destabilize the market by invoking concerns among market participants.

**Mr. Kato:**

- In Europe, despite the instability surrounding the situation in Portugal, the euro has not dropped like it did in 2010, and further widening of sovereign credit spreads has been arrested. One reason for this, in my view, is that market participants have begun to understand that problems in the European periphery nations are unlikely to spill over into “core” nations like Italy and Spain. Inasmuch as that means the focus in global financial markets may shift to Japan's fiscal problems, I think we need to pay more attention to the domestic policy response.

**Mr. Fukuda:**

- I think the reaction will depend to some extent on the inflation situation in Japan. If the nation remains in a liquidity trap, there would probably be few side effects to an increase in JGB purchases by the BOJ. But the direct underwriting of a bond issue by the BOJ at a time of significant inflation expectations could exacerbate those expectations and cause an abrupt deterioration in JGB market conditions.

**Mr. Yanagawa:**

- So you are saying that, in the event the 11 March disaster alters Japan's economic structure by eliminating the traditional surplus of supply at the macro level, the market's reaction will differ depending on when and how that happens?

**Mr. Uchida:**

- Long-term interest rates are stable at present, partly because we just experienced a steep fall in share prices. But it may not take the risk of a fiscal crisis to destabilize long-term interest rates once the new fiscal year starts in April. Prices will see upward pressure due to bottlenecks in the supply of various components and, once reconstruction work picks up, a pick-up in demand for construction materials. As for money flows, increased demand for bank loans could alter the status quo, in which financial institutions have contributed to the stable absorption of government debt against the backdrop of a long-term decline in lending.

**Mr. Fukuda:**

- Japan has already issued large quantities of government debt, but the increase in debt service costs has been relatively modest because interest rates have been so low. This could quickly become a problem if long-term rates rose.

**Mr. Takata:**

- Two key factors determining long-term interest rates are exchange rates and the current accounts balance. Exchange rates can either restrain or exacerbate inflationary pressures, depending on their direction. The current accounts balance is the flipside of domestic savings and relates to domestic investors' ability to absorb government debt issues. Other important factors include the views of overseas investors and especially the response by rating agencies.

**Mr. Kato:**

- The Japanese government reined in the yen's sudden advance by leading a concerted intervention by the G7. But the more serious concern from a longer-term perspective is a significant depreciation of the yen, which would quickly exert upward pressure on JGB yields. For that reason as well, I think the yen should ideally stabilize around its current level.

**Mr. Uchida:**

- Overseas there has been a growing focus on inflation risks, with some now expecting the Fed as well as the ECB to hike rates within the year. This would favor a weaker yen by widening the differential in interest rates between Japan and other major economies. Given that the price differential with other developed nations is only about 2%, domestic inflation could easily reverse this difference, diminishing Japan's price competitiveness and putting downward pressure on the yen. At a time of severe supply constraints, the impact of a weaker

yen–falling terms of trade—could be entirely negative. On the other hand, if the yen were to weaken after progress in reconstruction efforts had removed some of the supply constraints, the benefits—ie, support for exports—would outweigh the costs, as they have traditionally.

**Mr. Takata:**

- While the kind of extreme yen weakness triggering capital flight would be unwelcome, I think a modestly weaker yen would have significant benefits for the many companies whose operating forecasts are based on the assumption of a lower yen. The situation this time was not as bad as after the Hanshin earthquake inasmuch as concerted intervention halted the Japanese currency's advance. But policymakers need to keep in mind the fact that while private-sector balance sheets are substantially smaller today than in 1995, the government's balance sheet has grown tremendously.
- In Europe, we need to keep an eye on the outcome of fiscal consolidation, monetary tightening, and the tightening effect of a stronger euro. European economists appear to have confidence in the economic outlook even though they anticipate a number of rate hikes within the year.

**Mr. Kato:**

- I think the ECB would be better off conducting one or two rate hikes and then adopting a wait-and-see stance. Accelerating the tightening in response to Germany's unprecedentedly strong economy could create major stresses for surrounding nations.

**Inoue (Organizer):**

- What kinds of policies would be effective in restraining the risk premium in JGB yields? Possible measures include providing explicit timeframes for the reconstruction budget and the JGB issues used to fund it as well as setting up a separate government account outside of the general account.

**Mr. Takata:**

- At the very least, I think we should avoid BOJ underwriting of debt issues. In recent years, rises in estimates of the risk premium have almost always been precipitated by fiscal discipline concerns. Specific triggers have included the compilation of large supplementary budgets under LDP governments and attempts by the DPJ to make good on its campaign pledges. If funding for the reconstruction budget is simply piggybacked onto the existing fiscal deficit with no attempts to scale back existing policies, market participants will probably start to grow concerned. Increased issuance of the FILP bonds to fund economic stimulus in the wake of the Lehman-inspired financial shock in fact triggered the market concerns about expansion of JGB issuance, but the funds raised were not utilized. Rather, increasing issuance of government-guaranteed bonds and applying the proceeds to

reconstruction could keep the risk premium on JGB yields in check.

**Mr. Uchida:**

- Increases in JGB issuance in recent years have been concentrated in the super-long sector, reflecting the needs of institutional investors. If the reconstruction-related issuance were added to the monthly issues of 10-year debt, in contrast, it would become more difficult for financial institutions to absorb it at a time of rising demand for bank loans. Market participants and rating agencies would take an even more critical view of the situation if the BOJ were to underwrite JGBs. The preferred approach would be for the government to cut existing policies and implement some temporary tax increases first and only then to rely on increased issuance of JGBs to make up the shortfall.

**(3) Maintaining financial stability**

**Inoue (Organizer):**

- Is there anything to be learned from the Hanshin earthquake in terms of the disaster's impact on the financial system and measures for maintaining the soundness of that system? Or was the external environment then too different, in the sense that the aftereffects of the bubble collapse were beginning to make themselves felt?

**Mr. Uchida:**

- In 1995, the earthquake's impact on the financial system lasted only a few months, and the focus in financial circles soon shifted to the failure of a UK investment bank and the substantial rise in the yen due to automotive trade frictions between the US and Japan. Whereas the market absorbed only ¥33trn of JGBs at the time, issuance has increased to ¥144trn today.

**Mr. Takata:**

- In addition to the factors pointed out by Mr. Uchida, the bad-loan problems at Jusen (mortgage-lending institutions created by banks) became to draw attention in the second half of 1995. In hindsight, this was the year when the Japanese economy began to experience serious balance sheet adjustments as it moved closer to the financial crisis of 1997. Although corporate and bank balance sheets are cleaner today, business and consumer sentiment is far weaker. Boosting sentiment should be a key role of any macroeconomic policy, in my view.

**Mr. Uchida:**

- I think the reconstruction fund established for the Hanshin earthquake may also be instructive. Affected government bodies created a fund that issued ¥900bn in bonds that were taken up by local financial institutions. The fund's profits were then used for longer-term funding needs. I think one option today would be for the affected prefectures to jointly establish

a similar fund, with money contributed by private financial institutions and the BOJ offering to accept the fund's securities as eligible collateral in its operations. Urgent tasks such as reestablishing lifelines and constructing temporary housing need to be addressed with fiscal outlays, but I think the use of private funds might enable a more appropriate response to longer-term loan demand.

**Mr. Yanagawa:**

- The government has declared it will be responsible for all reconstruction, but in reality some kind of brake on government spending will be needed. A framework for private-sector finance, like the one proposed by Mr. Uchida, is also important.

**Mr. Fukuda:**

- It is fine for the government to talk about its duty to the people as part of its political message, but market mechanisms need to be brought into play in the actual reconstruction effort unless the government wants to leave behind a legacy of moral hazard.

**Mr. Kato:**

- BOJ underwriting of bond issues would make it easy to procure large amounts of money, but it would also increase the likelihood that the funds would be used inefficiently, the opposite outcome to a situation in which market mechanisms were utilized.

**Inoue (Organizer):**

- Assuming that local financial institutions in the affected areas have the best understanding of what reconstruction demand there will be, one option would be to facilitate lending by these institutions by providing guarantees for their obligations, much as the FDIC did during the US financial crisis. How should we approach the question of policy finance? Could we also utilize the BOJ's fund-supply operations to strengthen the foundations for longer-term growth although funds sought under the third of those operations fell somewhat?

**Mr. Fukuda:**

- Generally speaking, introducing a lending program for use only by the people who need it is preferable to distributing subsidies to everyone. Naturally, market mechanisms should not be required across the board—some preferential treatment will be required in the form of lower interest rates, relaxed lending terms, etc. But requiring participants to repay the loans would prevent moral hazard. One means of funding such a program, as noted by Mr. Takata, would be to allow local lenders to issue as much government-guaranteed debt as necessary.
- The BOJ supplied credit to individual financial institutions in the aftermath of the Hanshin earthquake. The policy approach today—at least thus far—is clearly different, with the Bank

supplying large quantities of funds to the broader market. The Asset Purchase Program is playing an unexpected role in this regard.

**Mr. Takata:**

- The reception to the BOJ's fund-supply operations to “strengthen the foundations for economic growth” may not have been particularly favorable, but I think the reconstruction effort offers an opportunity to reconsider this framework.

**3. Adjournment**

**Inoue (Organizer):**

- Today's discussion suggests that if the 11 March disaster has changed Japan's economic paradigm, the policy authorities need to reconsider the weightings attached to various policy objectives. There has been a variety of debate regarding the role of monetary policy in the event that supply-side factors prompt changes in the economy and price outlook, but there are no easy answers. Inasmuch as the disaster's impact on Japan's economy and financial system is likely to change over time, I would like to discuss related policy issues at future meetings of the Financial Markets Panel as new developments arise.

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