

**Topic** Japanese financial markets and the BOJ's policy response

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## Issues for discussion

### 1. Financial market conditions

### 2. The BOJ's policy response

## Summary of comments

### 1. Financial market conditions

#### Inoue <Organizer>:

- Stress in the money markets in Europe has further increased, as evidenced by widening Euribor-OIS spread to the largest level since the end of 2008. In contrast, the money markets in Japan remain stabilized and few signs of stress are observed in the credit markets. Bank loans, after having shown some weakness due to diminishing pre-cautious demand for fund after the earthquake, regain the momentum. And the annual growth rate of its outstanding amount has turned positive on the national banks basis, largely supported by those for municipal governments and households.
- Increase in the JGB yields toward the end of November, probably triggered by some instability of the government bond market in Germany, was short-lived. In addition, medium-term capacity of the market to absorb JGBs remains intact, in light of the gap between bank loans and bank deposits in stock terms. In the meantime, in European sovereign bond markets, more pessimistic views become prevalent for Portugal, but sentiment becomes somewhat stabilized for Italy and Spain after the EU Summit. There is a concern about the contagion of financial stress, however, as implied by the Hungary's recent request for financial assistance by the IMF.

#### (1) Conditions in international financial markets

##### Mr. Kato :

- Market participants remain uneasy despite the reduction in the

cost of dollar swap arrangements announced by the major central banks at the end of November. Fund flows on the interbank market remain insufficient, with Euribor-OIS spreads higher today than when Bear Stearns failed in the spring of 2008.

- The Fed has patiently implemented "Operation Twist", and the scale of its assets, liabilities, and balance sheet continue to trend sideways. From a longer-term perspective, a significant portion of the liquidity supplied by the Fed since "QE2" has gone to foreign banks, which most likely procured these funds at 0.1% or less via federal funds or repos and then deposited them with the Fed to earn 0.25%. This fact is not consistent with the view that "QE2" funds flowed into (and lifted) the emerging economies and commodity markets. Market participants are under the impression that "Operation Twist" has not been as effective as "QE2", but funds supplied by the central bank simply will not feed into the real economy given current economic conditions in the US. Since 2008 there have frequently been outstanding balances in the Fed's "other deposits"—primarily deposits by the GSEs. Until about six months ago the chief cause was GSEs foregoing other investments when market interest rates fell, but since this summer I suspect this state of affairs has been attributable to the GSEs restricting credit to European banks while US banks, which would be the other place for the GSEs to put their money, have been reluctant to accept it, in part because

of deposit insurance fees.

- Last week primary credit outstanding at the Fed's discount window rose to \$393bn in a sharp increase over the week before. While this is still substantially lower than in the wake of the Lehman Brothers collapse, European banks' access to dollar funding remains uncertain. Amounts outstanding in dollar supply operations also rose to a 2011 high of \$54.3bn last week. Use of the ECB's marginal lending facility (a Lombard facility) has also increased. At the most recent meeting of its governing council, the ECB announced it would introduce a three-year long-term refinancing operation (LTRO) and substantially relax the terms for collateral, which should go some way towards relieving market stress. Use of the ECB's deposit facilities has been growing, albeit with some volatility, since July 2011, and financial institutions are increasingly depositing surplus funds with the ECB instead of investing them on the market. I think the introduction of the 3-year LTRO will lend further impetus to this trend.
- The end result is that the major central banks have experienced substantial growth in their balance sheets. But this growth has not stimulated the real economies of the US or Europe amid the general financial unease there. Japan also appears to have fallen into a liquidity trap amid a lack of demand for funds.

**Mr. Uchida :**

- The European crisis has lifted preemptive demand for dollar funds around the world. The major central banks have responded by enhancing dollar supply operations based on swap agreements with the Fed. However, these operations have attracted a stigma, in part because of demands from the US Congress for disclosure and in part because of political criticism of the Fed for providing aid to overseas banks. I think the view that the Fed's policy response will not bring about quick improvements in dollar liquidity has led financial institutions to engage in more conservative fund management. In any event, the tightness in the dollar funds market and the Fed's retention of huge quantities of funds are unlikely to change until the situation in Europe calms down.

**Inoue <Organizer> :**

- The recent increase in the use of dollar funding operations in spite of this stigma may be a sign of market stresses. And if "QE2" made it easier for financial institutions to manage their cash needs, is there a possibility that it will be revived, in part as a means of the crisis measures?

**Mr. Uchida :**

- The key point in my mind is whether the US will play the role of a global central bank or will instead conduct monetary policy based solely on the national interests of the US. Some in the US are arguing that even the names of banks participating in

dollar funding operations conducted by other central banks should be made public because "QE2" provided aid to foreign banks. Although the Fed takes the view that global financial market stresses adversely affect the US economy, I think that—barring major changes in the US economy—it will be difficult to implement "QE3" while this kind of domestic criticism persists.

**Inoue <Organizer> :**

- Putting aside the political situation in the US, I think the US dollar's status as an international currency necessitates Fed support for the global financial system. Other nations would be justified in asking why the Fed suddenly began talking only about what is best for the US.

**Mr. Kato :**

- The Fed introduced the TAF after the collapse of Lehman Brothers and was subsequently criticized by Congress when it became clear that many European banks also took advantage of the program. The Dodd-Frank Act also placed significant constraints on Section 13(3) of the Federal Reserve Act, which lays down rules regarding the emergency supply of funds by the Fed, which means the Fed may not be able to respond as flexibly as it did to the financial shock of 2008. In that sense, I think the fact that "QE2" ultimately served as a means of channeling liquidity to European banks should be welcomed. However, the fact that foreign banks are earning 0.25% on their deposits with the Fed is likely to provoke questions about why US taxpayers should have to pay interest to European banks.

**Inoue <Organizer> :**

- From another perspective, is it possible that the Fed's decision to discontinue "QE2" effectively contributed to further stresses in the market?

**Mr. Uchida:**

- But the causality flows in the other direction: the dollar liquidity crisis occurred because of the European financial crisis. The crisis would never have happened if Europe were healthy.

**Ms. Okina:**

- Some analyses have emphasized the stimulative effect of the liquidity supplied via "QE2" in the US and quantitative easing in the UK, but if the only result in the end is an increase in reserve deposits at the central bank, any stimulus would appear to be dependent on such subtle mechanisms as confidence in and signaling of monetary policy, as opposed to such conventional transmission mechanisms as long-term interest rates and bank lending. In that sense as well, it will be very interesting to see what the Fed's next move is.

**Inoue <Organizer> :**

- The impact of "QE2" on the real economy is unclear, but I think the general view of it—in the sense of its having helped

stabilize the financial system—is similar to what many said about quantitative easing in Japan.

**Mr. Uchida:**

- I think “QE2” was significant for the real economy in the sense that economic activity took a severe hit once the funds stopped flowing. And from a global perspective, while the Fed’s role is certainly important, I think the Fed needs to coordinate its policy response closely with the ECB and other central banks in order to proactively detect financial crises as they emerge. But this process is always susceptible to political influence, and in the end national interests tend to be given first priority.

**Mr. Kato :**

- Republican candidates in the US presidential election have heavily criticized Chairman Ben Bernanke. Conservatives are arguing that the Fed, by injecting large amounts of money to rescue Wall Street, has become part of Big Government. Many seem to think Mr. Bernanke is unlikely to be reappointed in 2014. This kind of political climate may be one reason why the Fed opted for “Operation Twist” instead of “QE3”. If further liquidity becomes necessary, I think the Fed will opt for the purchase of MBS under the pretext of making it easier for households to make monthly mortgage payments.

**Ms. Nemoto:**

- US bank liquidity has improved substantially. The lack of growth in lending is due less to a liquidity constraint than to financial regulation and the problem of borrower creditworthiness. I think the situation will worsen in 2012: large US banks designated as G-Sifis will need an additional ¥24–30trn in capital (although they have plenty of time to raise the funds), and if they instead try to improve their capital ratios by reducing assets, they will need to slash their assets by one third. US financial institutions with total assets of at least \$50bn will also need to establish an additional capital buffer. As for the impact of the crisis in Europe, US banks have relatively little direct exposure to European banks, but a move by European lenders to sell off assets could force write-downs at US banks.

**Mr. Yanagawa:**

- A liquidity cushion designed to prevent crises could be capable of addressing large stresses, the importance of which is clear today. However, I think this kind of approach also has certain downsides. For instance, a liquidity buffer might prevent the recognition of problems in the financial system and delay the necessary policy response. While such a cushion is helpful when dealing with shocks that do not involve fundamental problems, it can prevent a necessary change of course when the shock is the result of underlying problems. Liquidity alone can absorb substantial shocks to Europe’s financial system. But given the need in the end to bring

Europe’s financial economy back to the ground and assuming that cost is also a consideration, I think we need to consider whether simply supplying more liquidity is the right thing to do, or whether the injections of liquidity need to stop at some point. I personally do not think the continued supply of liquidity will lead to a genuine resolution of the ongoing crisis in Europe, nor do I think this will change as long as the key underlying issues remain hidden.

**Mr. Uchida:**

- The US adopted a liquidation-driven approach and quickly focused on banks’ losses, and in the end I think this helped keep costs down. Europe, in contrast, responded to the Lehman-triggered financial crisis by changing accounting rules, parceling assets out into “good” and “bad” banks, and spreading the costs equally over a period of about ten years. But in the end this strategy was derailed by the sovereign risk crisis.
- The market’s main concern now is achieving a soft landing for Europe. Assuming that at least €1trn will be needed to keep Italian government bond yields below 5%, for example, the focus is on how that amount can be procured without undermining the market’s trust and on how much the IMF and countries outside Europe will be able to contribute to the rescue effort. If the cushion were lost now, I think it could lead to massive losses.

**(2) Developments in Japanese markets**

**Mr. Kato:**

- Current conditions in Japan’s financial markets are far different from those in the west. To be sure, financial institutions lost interest in the BOJ’s fixed-rate pooled-collateral operations for a time, raising the question of whether the BOJ would be able to continue supplying funds. But more recently there has been no shortage of bids. Financial institutions would probably like to obtain longer-term funds amid the instability in Europe, but uncollateralized call rates and repo rates remain steady at low levels because the BOJ is supplying more funds than institutions want for preemptive purposes. Commercial paper rates rose in March but were subsequently reined in by the BOJ operations, and the variation in yields between individual issues is also less than normal. The BOJ is scheduled to meet its current targets for asset purchases by the end of 2012. The Bank’s target for longer-term JGB purchases has been raised repeatedly, so these have a long way to go, but I expect steady progress in 2012. The BOJ has already completed more than 90% of its planned purchases of commercial paper, and buying is likely to continue at the current pace. The Bank’s offers for corporate bonds have recently gone unfulfilled, probably because investors want to keep high-quality paper in their portfolios. The asset purchases have not fulfilled their primary goal of reducing risk premia. Any

further increases in the size of the Asset Purchase Program are likely to focus on longer-term JGBs. It may also be difficult for the BOJ to maintain the amount outstanding under its fixed-rate, pooled-collateral operations if the market settles down and demand for excess reserves drops.

**Mr. Uchida:**

- The BOJ is close to completing its planned purchases of commercial paper and corporate bonds, and yields on corporate bonds and commercial paper have fallen below those on JGBs and T-bills, respectively. Recently fund transactions have normalized somewhat, and the BOJ's current account balances have fallen below ¥30trn. With Japan isolated from the rest of the world, I think the BOJ's decision to continue supplying excess funds has created market distortions that are at the other end of the spectrum from those in the west.

**Mr. Kato:**

- Views on fiscal issues in Japan are clearly split. Older people who have accumulated substantial financial assets are quite concerned about fiscal deficits. On the other hand, there is a growing contingent arguing that the government should continue to run larger deficits and the BOJ should continue to buy JGBs as long as deflation persists. Such arguments are persuasive only because longer-term interest rates are stable, so warnings may be necessary, but once interest rates start rising they may not stop.

**Ms. Nemoto:**

- Japanese bank loans outstanding have finally climbed above year-before levels, but one does not get the sense that lending is growing because of forward-looking behavior. Instead, the recovery in lending that followed the Lehman crisis is simply dropping out of the statistics as a basis for comparison. The markets with robust loan demand are overseas and particularly in Asia. Domestic deposits, meanwhile, continue to grow in a reflection of mounting risk aversion.
- According to people in the REIT market, the BOJ's asset purchases provided psychological support in the wake of the earthquake and tsunami in March. More recently, however, the pace of purchases has slowed, and signs that the BOJ is focusing on quality in its asset purchases are making it more difficult for the market to respond. The requirement that assets be rated AA or higher means the BOJ is supporting issuance of these types of securities only. Some market participants would like to see the range of purchases expanded to include lower-rated instruments.

**Mr. Egawa:**

- The BOJ declared reining in risk premia to be a principal objective of its comprehensive easing program. However, there never was a risk premium for corporate bonds or

commercial paper. On the other hand, there were significant risk premia on equities and REITs. REITs are still cheap, with dividend yields remaining around 5%.

**(3) Sovereign risk and ratings**

**Mr. Egawa:**

- In August S&P became the first major US rating agency to rescind the US government's AAA rating. Moody's also lowered its rating on Japanese government debt by one notch, to Aa3, in August, and R&I became the first Japanese rating agency to place Japan on ratings monitor with an eye to revoking the nation's AAA rating. In December, S&P placed the government debt of 15 eurozone countries along with bonds issued by the EFSF on credit watch negative, and Moody's announced to review the debt of the 27 EU nations with an eye to downgrading. Moody's, S&P, and Fitch have also downgraded numerous individual banks.
- Other sovereign debt rating agencies include Japan's JCR, China's Dagong Global Credit Rating, Canada's DBRS, and Germany's Feri EuroRating Services. The impact of their actions varies significantly. For instance, the downgrade of European sovereign debt by the US agencies noted above was big news, but the decision by Japanese credit agencies to leave their ratings of European sovereign debt on hold had little effect.
- Japan previously experienced a downgrade of its sovereign rating during the financial crisis of the late 1990s. Moody's announcement in November 1998 that it had lowered Japan's sovereign rating to Aa1 sparked vociferous debate. When the same agency put Japan's rating on review for downgrade to Aa3 in 2002, then-Deputy Finance Minister Haruhiko Kuroda sent an open letter of inquiry, and company officials were ultimately summoned to testify before the Diet. Japan's credit rating was eventually lowered to A2, which was lower than Botswana's rating at the time. But none of these events had a significant impact on the JGB market. I think there were three main reasons for the market's muted response. First, JGB yields serve as a benchmark for Japanese corporate and municipal bonds, but a change in Japan's sovereign rating does not affect JGB yields via the spread between JGBs and these other debt instruments. Second, and more importantly, financial institutions' JGB portfolios receive special treatment in the context of managing credit exposure, and banks typically have no limits on the size of their JGB holdings. Under the standardized approach, Basel II assigns a risk weighting of zero to credit extended to domestic government borrowers, and the solvency rules governing life insurers assign a credit risk coefficient of zero to loans made to OECD governments. Third, JGBs differ from government bonds in the eurozone in not having an obvious substitute. In addition, many fixed-income investors in Japan use the NOMURA-BPI

index as their benchmark, and one of the criteria for inclusion in this index is a rating of A or above. Consequently, an A rating represents an important threshold in terms of whether investors hold a given bond or not.

- We should keep in mind, however, that the credit ratings of government-affiliated entities, local government entities, and banks tend to rise and fall with the central government's rating. Banks in particular are typically rated after taking into account any special assistance received from the government, and as a result sovereign downgrades often lead to credit downgrades of bank-issued debt. Once a bank's rating falls below a certain level, it can lead to problems on the interbank and currency swaps markets as other banks reduce their exposure to that institution. Many Japanese banks, for instance, obtain foreign currency by selling USD-denominated commercial paper to money market funds in the US. But as these funds are typically prohibited from investing in securities with short-term ratings below A-1 or Prime-1, ratings below these thresholds can make it difficult for a bank to obtain foreign currency.

**Mr. Takata:**

- The muted impact of the JGB downgrade to A in 2002, in my view, was attributable largely to the fact that nearly all JGBs are held by domestic investors. That may change if market participants begin to question the government's commitment to fiscal discipline.
- I have described the rating of the world's government debt as the Sovereign World Cup. The first qualifying round is determined by whether the issuing country runs a current account surplus or deficit. JGBs make it through this round because Japan runs a current account surplus, while "the PIIGS" do not, and consequently their bonds are sold. In that sense, the impact of a sovereign downgrade is felt quite easily in a country with a current account deficit. In the second qualifying round, however, fiscal discipline is not totally ignored. I think such concerns underpinned the rise in German interest rates that followed the undersubscribed Bund auction on 23 November. Although the auction result was probably due in large part to technical factors, I think concerns about governance in the broader EMU also had an impact, given the subsequent widening of spreads of Belgian government debt versus German debt.
- In short, a country is not out of the woods simply because it has made it through the first round. It will be extremely interesting to see how the market views Germany with its current account surplus. If Germany is downgraded, a key test will be whether—like Japan in the past—it is largely unaffected because of its surplus, or whether it feels a significant impact as the nation bears the burden of the EMU. A French downgrade could also undermine confidence in the broader EMU.

- In that sense, I think more attention will focus on Japan's commitment to fiscal discipline. Over the past few weeks, as a number of overseas hedge funds have used CDS on JGBs to bet on rising interest rates, investors have also kept a close eye on the ongoing consumption tax hike efforts and comprehensive reforms to Japan's social security system. If trust in the government's commitment to fiscal discipline is undermined between now and year-end and Japan's debt is also downgraded, I think the risk of a substantial fluctuation in yields could increase.

**Inoue <Organizer>**

- How do foreign investors view the scheme of special funding for the JGBs issued as part of the third supplementary budget?

**Mr. Takata**

- I do not think they see it as a positive. The relative calm in the domestic market in spite of the government's fiscal expansion at a time of substantial budget deficits may itself have been seen as a positive by overseas investors. Since the undersubscribed Bund auction mentioned earlier, however, some foreign investors have taken the view that now is the time to try to push interest rates higher. This movement could receive further impetus if developments in the social security reforms or consumption tax debate further undermine trust in the government's commitment to fiscal discipline.

**Ms. Nemoto:**

- A key reason why sovereign downgrades of industrialized nations have been so common is the post-financial-crisis growth in fiscal deficits and the unexpected threat to the EMU framework itself. Also contributing to the downgrades has been tougher regulation of rating agencies, with new rules forcing them to disclose detailed ratings standards and base ratings decisions strictly on those criteria. Investor confidence in the rating agencies is also an important issue, and I think they are less willing to wait.

**Mr. Takata:**

- Recently some have argued that the Basel Committee on Banking Supervision's new capital rules should attach a risk weighting to government bonds denominated in the bank's own currency. Under the current framework the decision how to account for such instruments is left to the national government itself. I think such national approach should be continued. However, I worry that tighter across-the-board restrictions in the form of leverage ratio caps and so on could impact on government bonds inasmuch as those rules do not take into account the type of bond.

**Mr. Kato:**

- If the risk weighting of government bonds denominated in a bank's local currency was not zero, Greek banks would have sold Greek government debt sooner, and the European crisis

might have emerged earlier than it did. Warnings from the financial markets might also have sounded sooner.

**Mr. Takata:**

- From the perspective of Japan's national interest, I think attaching a risk weighting to government bonds denominated in the local currency should be avoided at all cost. However, I worry that this view may gain support as the global debate proceeds.

**Mr. Yanagawa:**

- A variety of new regulations were simultaneously placed on what were previously tax ratings. Consequently, financial institutions did a variety of things that led to major problems. Now the attempt to enhance the transparency of ratings has resulted in less flexibility, and the automatic downgrades appear to have tied financial institutions' hands via the new regulations. It is difficult to say which of these two aspects should be given precedence. At a more fundamental level, I think the application of regulation based solely on ratings, which are insufficient in themselves, is problematic, but at the same time there is little usable information other than ratings.

**Ms. Okina:**

- Ratings were incorporated in regulation based on the view that market discipline was necessary. Under ordinary circumstances, ratings may function well as a means of enforcing discipline. During a crisis, however, they are more likely to make the situation worse. Ultimately I think the only answer is to design regulation so as to operate differently during normal times and periods of crisis.

**Mr. Takata:**

- I think it is more difficult to decide on an approach to sovereign rating criteria than in the case of corporate debt ratings. With sovereign debt we have to deal with such concepts as the stock of debt and cash flows, taking into account the difference between domestic- and foreign-currency-denominated debt.

**Mr. Egawa:**

- The rating agencies also assign ratings to debt issued by financial institutions and nonfinancial companies, but it is questionable whether these ratings are consistent with those given to sovereign borrowers. The only G20 nations to have defaulted since World War II are Argentina and Russia. As such, it is difficult to make a case for the validity of sovereign ratings for the industrialized economies based on historical rating migration or default data.

**Ms. Nemoto:**

- When establishing rating criteria, credit agencies solicit comments from experts outside the organization and also draw on academic research. The criteria used for sovereign ratings are completely different from those used for nonfinancial companies. Complicating the sovereign rating

process is that, while historical rates of default for sovereign borrowers are lower than for nonfinancial companies, it is uncertain whether this feature could be sustained when creditworthiness of sovereign debt depends more on the conditions of global capital markets.

- It is understandable that JGB ratings and bank ratings fell together during Japan's financial crisis, in part because government money was injected into the banks. But even when their ratings fall below A-1, I would not expect any difficulties of obtaining funds on the spot. During the years of our financial crisis, large banks with A-3 short-term rating did not have problems in raising domestic funds. However, in overseas markets, banks could have difficulty obtaining funding, if the institutions were in serious financial trouble or carried questionable assets on its balance sheet. In the past the Japanese government could have rescued such institutions, but that might be difficult when the nation's fiscal conditions have deteriorated. Nor do I think international organizations like the IMF would be of much help given the scale of the funds necessary for the operations.

**Mr. Egawa:**

- Japanese banks are able to obtain all the yen funds they need from retail deposits. The cost of that funding is simply the sum of deposit rates, administrative costs, and deposit insurance and premium has nothing to do with the bank's rating. Banks can also use currency swaps to transform yen into dollar funds. As noted earlier today, however, large banks' access to funding provided by US money market funds is likely to diminish if credit ratings are downgraded. Some European banks have already experienced such problems.

**Inoue <Organizer> :**

- Does the likelihood of this happening depend ultimately on structural factors such as Japan's international balance of payments or household and corporate money flows? And could currency swaps between central banks provide a meaningful backup in the event that Japanese banks found it difficult to obtain foreign currency funds?

**Mr. Uchida:**

- There are two points to note about the local currency supply framework adopted by the BOJ and Thailand. First, foreign currency funding is something that Japanese banks will have to think about because their support for Japanese companies' move overseas will entail an overseas shift in their own business. In other words, Japanese banks will need to obtain funding in local currencies, and particularly in Asian currencies. Second, the framework makes effective use of the JGBs held by financial institutions. Of course there is still a risk of haircuts and margin calls in the event JGBs are downgraded beyond a certain point. But assuming aging demographics and a deterioration in the household balance of savings and

investment, Japan will need foreign investors willing to hold JGBs—even if the government pushes ahead with social security and taxation reforms. Other nations' foreign reserve funds would be key potential buyers in this case. As such, I think Japan should establish fund-supply facilities with the emerging markets of Asia (where Japanese companies are investing) and have them hold JGBs as collateral.

**Mr. Yanagawa:**

- Nearly all JGBs are held domestically, and I see little likelihood for now of domestic investors suddenly rushing to sell those bonds. More likely is an attack on JGBs by foreign investors, as noted by Mr. Takata, but the key point here is how large a shock a move like this on the margins could provoke.

**Mr. Takata:**

- As foreign investors do not hold large quantities of cash JGBs, their only recourse in that case would be to use derivatives. As they would eventually have to cover their shorts, the main issue is whether such an attack would succeed in prompting domestic investors to jump on the bears' bandwagon. If interest rates moved enough, risk management could prompt investors to engage in pro-cyclical behavior of the kind seen during the so-called VaR shock.
- Historically, large moves of this kind by foreign investors tended to occur less because of concerns about the government's commitment to fiscal discipline than because of existing concerns about an increase in domestic rates driven by (1) rising overseas rates or (2) a favorable turn in Japan's economy. In contrast, targeted selling of JGBs by foreign investors in response to sovereign downgrades of Japan—something we saw in the first half of the 2000s—has not always been successful. Such an attempt may have had a meaningful impact if it had been made when German government bond yields were rising, but the odds are against such an action now that both German and Japanese yields have begun to fall. In Japan, of course, fiscal debate will continue through the end of 2011, and longer-term interest rates could rise to some extent if the debate casts doubt on the government's commitment to fiscal discipline.

**Ms. Okina:**

- I suspect that one reason why long-term Japanese bond yields are so stable is that senior citizens effectively hold JGBs via their savings deposits. We also hear that pension managers' stance is basically risk-averse and that they are reducing their equity positions and shifting the proceeds into JGBs. In that sense as well, I think investors may continue to buy JGBs even if the situation in Europe worsens.

**Mr. Uchida:**

- I agree. JGBs are the one financial asset that investors have continued to buy throughout the 15 years of deflation in Japan.

Pension funds that invested in equities from a theoretical risk-return perspective incurred heavy losses and are now reviewing their investment portfolios with an eye to putting more money into JGBs. The Basel capital rules and the new solvency margin rules for insurers also create an incentive for managers to hold government bonds, and the macro flow of funds is conducive to holdings of JGBs.

**Mr. Takata:**

- In my conversations with pension fund managers, they have begun to use the term “carry” when talking about bond investments, which suggests a fundamental change in their views regarding JGB holdings.

## 2. The BOJ's policy response

### (1) Support for Japan's economic growth

**Mr. Yanagawa:**

- At the risk of exaggerating, I think the current situation is one in which all savings are flowing into JGBs, all investments are effectively funding fiscal expenditures and flowing into long-term social security instruments rather than areas with growth potential. That has depressed the growth rate of Japan's economy.

**Ms. Nemoto:**

- The BOJ's operations to supply funds to “strengthen the foundations for growth” have not been particularly well received. The outstanding value of these operations has already reached the designated ceiling, leaving only the rollover of existing loans. I think the upper limit should be increased or other measures taken to bolster this program. Banks are taking an essentially passive stance at the moment. While they argue that lending is not growing because there is no demand for loans, I think they could do more to develop new demand, and I also think that statements by the authorities would have an impact. Of course this might have the side effect of creating market distortions, but with lending rates as low as they are, an increase in lending would probably have relatively little additional impact.

**Inoue <Organizer>:**

- There was a discussion someone at our open panel session in May that conditions in Japan's lending market might change in the aftermath of the earthquake and tsunami in March. Why haven't they?

**Mr. Uchida:**

- A big reason has been the delay in full-fledged reconstruction efforts; spending under the third supplementary budget, for example, will not kick in until mid-2012. However, reconstruction demand from local government bodies is now having an impact, and that is contributing to growth in lending at regional banks. From a longer-term perspective, companies' demand for reserve funds increased in the wake

of the Lehman crisis, bringing liquidity on hand to extremely high levels. Since then loan demand has fallen steadily. Another factor contributing to dampen domestic loan demand is the fact that healthy companies are increasingly moving their operations overseas.

- Consequently, both Japanese banks' financial business and the MOF policies for utilizing the nation's foreign reserves are working to support overseas investment by Japanese companies, the goal being to bolster economic growth with overseas investment income. Of course the end result could be different if structural reforms within Japan—such as a lowering of corporate tax rates or the establishment of special economic zones—succeeded in attracting inward investment.

**Mr. Takata:**

- I agree. At present, both the corporate and household sectors in Japan, the US, and Europe are characterized by a financial surplus—ie they are net savers. This is a post-World War II first and underlines the severity of the credit contraction in these “old” industrialized countries. The lack of domestic loan demand is therefore not surprising. However, there is loan demand overseas, and especially in Asia, and if western financial institutions no longer have the wherewithal to lend to those markets, it would be an excellent opportunity for Japanese institutions. The Japanese government could also provide policy support for overseas investment by Japanese firms.

**Mr. Kato:**

- I also think it is important that we (1) increase growth expectations in Japan and (2) lend support to the overseas business operations of Japanese firms. In a recent visit to China, I felt keenly that Japanese manufacturers were rapidly losing their edge in terms of export competitiveness. The ranking of Japanese manufacturers has clearly fallen in brand image surveys conducted by Chinese economic periodicals. In the materials presented by Mr. Takata, one of the “implicit beliefs” held by Japanese investors was that Japan will eventually return to a growth trajectory. In other words, they believe that some factor has caused the Japanese economy to stumble and that eventually it will return to a growth path. Unfortunately, those holding this view ignore the fact that Japanese companies are rapidly being overtaken by Asian competitors.
- While Japanese companies have faced an uphill struggle in China and other emerging economies, German and other European firms have enjoyed robust profits in the same markets, something that is reflected in the post-Lehman disparity between business sentiment as recorded in the German IFO index and the BOJ's Tankan survey. I think it is also extremely important from a perspective of bolstering tax revenues that Japanese banks support the Asian operations

of domestic companies and that the financial authorities in turn encourage these efforts.

**Ms. Okina:**

- I agree. A key reason why Japanese competitiveness has suffered is that the yen has strengthened while the euro and won have weakened. The question of how the BOJ should respond to upward pressure on the yen therefore remains an important policy issue. Each time the yen reaches a new threshold, the Bank has been forced to take action. Meanwhile, the hollowing out of Japan's economy will continue unless some thought is given as to how to foster new industries in Japan.

**Inoue <Organizer>:**

- I think the question of how to maintain the external competitiveness of Japanese companies over the long run is a critical one for Japanese economic policy. The BOJ's recent monetary accommodation has at the very least been carried out to coincide with the MOF's currency interventions. If upward pressure on the yen mounts again, forcing the BOJ to buy more assets, and if it is already difficult to purchase more credit instruments, one of the few remaining options would be to increase purchases of JGBs. However, increases in BOJ purchases of JGBs would have to be approached cautiously if we are concerned about foreign investors' views of the government's commitment to fiscal discipline. That noted, many domestic market participants are of the view that the BOJ should buy more JGBs because such problems are not an issue in Japan.

**Mr. Takata:**

- The economies of the industrialized nations are alike in relying exclusively on the corporate sector. There is no scope for further increases in fiscal expenditures, and domestic politicians continue to follow a populist course. Meanwhile, policy dependence on central banks is growing: the US at heart agrees with this trend, and the ECB is now facing similar pressures. I think the ECB needs to discuss its response to this situation. While it may be difficult for the BOJ to discuss, for example, the option of buying foreign government bonds as a means of—or on the pretext of—curbing the yen's rise is likely to attract attention.

**(2) Central bank communication policy**

**Mr. Kato:**

- The Fed is currently revamping its communications strategy and is likely to come to a decision at the next FOMC meeting regarding its approach to managing market expectations. Fed watchers say the most likely scenario is one in which the Fed presents forecasts for the policy rate. The Fed already publishes FOMC members' forecasts for the real economy each quarter, but under this scenario it would also present projections for the federal funds rate. Opposing views probably

kept the FOMC from adopting this measure at the December meeting, but if adopted many feel the Fed would extend its forecasts out to the second half of 2013 or even 2014 with an eye to reinforcing the policy duration effect.

- However, the central bank's presentation of policy rate forecasts would also entail certain risks. A change in the Fed's forecasts, for example, could sharply increase market volatility. The central banks of northern Europe and New Zealand have already adopted similar policies, but these are uncharted waters for a country with an economy and financial markets as large as those of the US, and the jury is still out on whether it would be a good policy. And if the Fed is successful, would the BOJ be next?

**Ms. Okina:**

- Sweden's Riksbank was the first central bank to begin publishing its own forecasts for the policy rate. The policy was successful at first, but the Riksbank's forecasts increasingly diverged from market projections. Although it did not prompt any major turmoil because of the nation's small markets, it left the impression of being very much a trial-and-error approach. Naturally, this kind of policy can enhance the transparency of monetary policy and represents a good medium of communication for a central bank seeking to digest market views while implementing a policy response. But given the high probability of unexpected events in the financial economy, it is also likely to lead to confusion unless the central bank makes it clear just how it will respond.

**Mr. Yanagawa:**

- Two reasons why a central bank might want to present forecasts for the policy rate are (1) the effect on the transmission of information and (2) the commitment effect of influencing market forecasts. Regarding the latter, this policy will not function as a commitment unless the central bank is able to keep the policy rate within its forecast range. In other words, it suffers from the potential pitfalls of undermining the market's trust or of preventing the central bank from responding flexibly to changing conditions. Ordinarily, therefore, either conditions would be attached to the policy or the commitment would be expressed as a range. Realistically, I do not think policy rate forecasts would be presented as a strict commitment; instead, the central bank would probably leave itself room to respond flexibly. For the policy to be a success, the market must also understand how the central bank intends to transmit information. For its part, the central bank, in sharing this understanding with the market, will have to consider whether to start with a soft commitment and work from there or to start with a hard commitment and gradually relax it.

**Mr. Kato:**

- The minutes of the November FOMC meeting contain a

comment to the effect that an abrupt change in the Fed's communication strategy at a time of market instability could trigger market turmoil, and that it would therefore be best to proceed cautiously. That suggests discussion is still under way. A strong commitment has certain side effects, but adopting a broad range with various conditions attached could result in a loss of efficacy.

**Mr. Uchida:**

- I can understand a policy of enhancing communication in order to help the central bank achieve its policy goals for prices and employment. However, the adoption of a strong commitment creates an environment that is conducive to speculative actions. And given the practical difficulties associated with predicting even developments in the broader economy, I think we have to assume that policy rate forecasts are likely to miss the mark. I think it would be dangerous to plant such forecasts in the minds of market participants. That poses the difficult questions of how the central bank should explain its forecasting errors and how it should get back on track.
- Ideally, I think the central bank should present targets consistent with stable and sustainable economic growth, ensure that the market shares its understanding of the kind of approach needed to achieve those targets, and at the same time tacitly accept, to a certain extent, that the market is driven by a variety of factors.

**Inoue <Organizer>:**

- As many have already pointed out, market functions have been impaired by central banks' response to the crisis, and market participants may wonder why central banks are suddenly so concerned about this issue. Nevertheless, I think it is important for a central bank to utilize the information absorbed by the market in conducting policy. Planting policy rate forecasts in the minds of market participants is likely to shut down this route.

**Mr. Uchida:**

- The EMU's experience also suggests that once policy authorities come out and say that convergence should be expected, market participants will completely ignore national differences in economic strength and competitiveness based on the conviction that convergence is right. In other words, the central bank risks sanctioning a certain kind of speculative behavior, unless it simply presents its policy goals and policy administration targets, and stops there.

**Mr. Kato:**

- I think the Fed's repeated use of the expression "policy accommodation can be removed at a pace that is likely to be measured" in FOMC statements from 2004 onward almost certainly lent impetus to real estate investment during that period.

**Mr. Uchida:**

- I agree. While it is difficult to deny that Alan Greenspan's market communications helped usher in the Great Moderation, I think it is best to avoid trying to directly plant policy rate forecasts in the minds of market participants.

**Mr. Takata:**

- In that sense as well, I can understand the BOJ's adoption of a time commitment based on economic conditions, but the Fed's approach—one in which conditions are attached to specific maturities—entails certain risks. While it may be relatively simple to extend maturities, the process of shortening maturities can present problems in terms of its communication with the market. If the Fed makes a change in the wrong direction, it risks sharply destabilizing longer-term interest rates. I would be very interested to hear what Fed officials think about this.

**Ms. Nemoto:**

- I have heard that the BOJ places a great deal of emphasis on the rising share of non-traditional assets among all the assets it buys, but I wonder whether this point is being properly communicated to the market. Is the BOJ actually trying to find ways to influence market expectations while taking into account feedback from the market?

**Mr. Kato:**

- Market participants believe the BOJ will always be behind the curve. But in fact I think the BOJ has done a great deal. It has a larger balance sheet than the Fed or the ECB as a percentage of GDP, and I think it has done almost everything a central bank could do—including the purchase of ETFs and REITs and the recording of losses on those assets. That the BOJ is still frequently criticized for not acting more boldly may be a result of a problem in communications or public relations strategy.

**Mr. Uchida:**

- At the very least, the BIS has praised the BOJ for purchasing corporate bonds, ETFs, and REITs, unlike western central banks.

**Mr. Kato:**

- Generally speaking, central banks worry about their earnings because their influence with the government tends to diminish if they start losing money. While some politicians seek bolder policy initiatives from the BOJ, others think it would be inexcusable for the BOJ to operate at a loss.

**3. Adjournment****Inoue <Organizer>:**

- Thank you all for your time today. I think the second half of the discussion in particular provided some valuable hints for our February open conference, which will focus on central

banking in 2012.

- This marks the end of the final 2011 meeting of the Financial Markets Panel. I would like to thank all of you for taking time out of your busy schedules to participate and wish you a happy new year.

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