

Topic US Financial Markets and Policy Administration and Outlook for Monetary Policy in Japan

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Issues for discussion

(1) US financial markets and policy administration

(2) Outlook for monetary policy in Japan

Summary of comments

1. US financial markets and policy administration

Inoue <Organizer>:

- I would like to summarize recent market trends and monetary policy issues. First, the Fed will deal with excess reserves using Supplementary Funding Program (SFP) by the Treasury, interest-bearing term deposits, and reverse repos. The Fed seems to emphasize the usefulness of interest-bearing term deposits. But the reverse repos are also significant in that they will improve its control over the federal funds rate since their counterparties may include GSEs. Due to expectations of policy rate hikes ahead, it is probable the rates on term deposits and reverse repos will exceed the rate paid by the Fed on current deposits. Raising rates on the discount window would be an important means of preparing for potentially large fluctuations in the fed funds rate once the Fed starts absorbing excess liquidity. Some in the markets also argue that the Fed should—at least temporarily—designate the rate on reverse repos and the rate on term deposits as policy rates in order to clarify its policy stance.
- Second, regarding the sequencing of the Fed's response, the standard view is that the Fed should raise rates only after it has drained excess reserves. But there is also the opinion, expressed in the minutes of the January FOMC meeting, that rates should be hiked either during or at the beginning of the mop-up operation. From a technical standpoint, the payment of interest on current deposits makes it possible for the Fed to consider the quantity of reserves and the interest paid on them independently from each other.
- It is quite common for views on the timing of a rate hike to

vary by market segment in the US: the equity and foreign exchange markets, for example, might prefer an early rate hike, while those in the bond and money markets might seek a more cautious approach to a rate increase. But this time the debate seems to be unique in a number of ways. First, one argument being made in support of an early rate hike is the macro-prudential view that nascent asset price inflation should be nipped in the bud. Second, those in favor of a cautious approach are citing the need for the policy mix to include both fiscal consolidation and continued monetary accommodation. Finally, even those in favor of an early rate hike appear to believe rate increases should proceed at a measured pace for the time being because the momentum of ongoing recovery is weaker than typical cases of economic recoveries.

- Third, two reasons were given in the markets for the Fed's decision to discontinue purchases of MBS at the end of March, as planned: the side-effect of an inversion of Treasury and MBS yields and the Fed's political judgment regarding the continuation of credit easing. It is also a fact that the Fed tried to achieve a soft landing by gradually reducing the volume of its purchases. Still, with foreclosures still running at a high level, it is likely to be some time before improvements are seen in the housing market. Inasmuch as a healthy housing market is essential to a self-sustaining rebound in consumer spending, there is a strong belief in the US that the Fed would resume buying MBS in the event of a sharp rise in MBS yields. At the same time, some in the market are worried that the US government's decision not to make explicit its support for the GSEs would adversely impact purchases of MBS by foreign

investors in particular. Thus, the stabilization of the MBS market would be a long and complicated process.

(1) Sterilization of excess reserves and its impact

Mr. Kato :

- Because it would be difficult for the Fed to sell its MBS in the market, I think the Fed will attempt to sterilize excess reserves using term deposits. This would be very similar to the way in which the People's Bank of China sells bills to absorb RMB funds while intervening on the currency market in response to inflows of foreign currency. In China, market conditions seem to be very accommodative despite this "sterilization."
- Fed Vice Chairman Donald Kohn has stated there is no risk of side-effects from the excess reserves because the economy is currently in a liquidity trap. However, it will be difficult to identify with precision the exact timing when excess reserves begin prompting credit creation, and it might then be too late to begin draining excess reserves.
- Sterilizing excess reserves might also cause larger fluctuations in the fed funds rate. However, the Fed appears willing to leave any adjustments up to market mechanisms, such as by widening the band through an increase in the discount rate. In contrast, the Bank of Japan took pains to minimize the spread between the Complementary Lending Facility (CLF) rate and the policy rate when it ended quantitative easing.

Mr. Takata :

- I think that was largely because the BOJ tightly managed the current accounts balance target under quantitative easing. The Fed does not have to concern itself with such a target and therefore has room to be more flexible.

Mr. Uchida :

- Whether the sterilized excess reserves would lead to a wealth effect or not depends on whether financial institutions have an incentive to create credit. Given the uncertain outlook for efforts to tighten financial regulation and the need to dispose of problem assets, I suspect there are few such incentives in the US at present, but the situation could change once there is more certainty regarding these factors. In China, for example, banks have continued to expand lending even as regulators raised reserve ratios. Ultimately, I do not think it will be possible to control credit creation without raising the policy rate.

Mr. Fukuda :

- In terms of economic theory, whether the impact of the Fed's "sterilization" using term deposits differs from that of the BOJ's literal "absorption" of excess reserves will depend on whether financial markets have emerged from the liquidity trap. However, I remain doubtful that the Fed will be able to carry out the seemingly contradictory action of hiking rates while

large quantities of excess reserves remain in the system. The standard procedure in a situation like this would be to drain the excess reserves first and then raise rates, as the BOJ did when it ended quantitative easing.

(2) Financial and economic environment required for rate hikes

Mr. Takata :

- For the past several years US share prices have tended to rise in the second quarter. The market will be watching closely to see how the Fed responds if this pattern repeats itself this year, or if oil prices rise sharply as they did in 2008. Yield of 2-year Treasury note is already pricing in the risk that the Fed has fallen behind the curve. Amid such anticipatory moves, it remains to be seen whether the Fed can engage in macro-prudential policy administration when credit creation—including bank lending—has yet to recover and the risk premium on many assets has fallen.
- Inasmuch as emerging economies have supported the global economy since the financial crisis, it is no surprise that market participants in the developed nations are investing in these markets. The gap between loans and deposits at US financial institutions has widened to unprecedented levels, making it increasingly difficult for banks to invest their funds.

Mr. Fukuda :

- Rising oil prices will exacerbate global imbalances and help destabilize the global financial system depending on where the oil-producing nations decide to invest their earnings. The governor of Indonesia's central bank, for example, is referring to conditions in his country as a bubble.

Mr. Kato :

- When I visited Jakarta last winter, a local economist said that, in light of past financial crises, it was important to remember that funds flowing into the country now could easily reverse course.

Mr. Uchida :

- We could say we have a bubble in the emerging markets. Along with Asia, investment has overheated in Brazil, where inflation now stands at 7%. Malaysia and India have already begun hiking interest rates, but this could further accelerate fund inflows. Hence it would be reasonable in a sense for the G20 to argue that a temporary Tobin Tax should be authorized. Indonesia has also begun to place restrictions on foreign investors' holdings of short-term government debt.

Inoue (Organizer) :

- If the current slack will persist until economic growth runs above potential for an extended period of time, many would argue that the Fed cannot embark on significant rate hikes at present. Last year many voiced concerns that the potential growth rate of the US economy would be adversely affected

by the loss of skills among the long-term unemployed and by a reduced labor force participation rate, but such concerns recently appear to have eased.

- State and local economies in the US apparently remain in severe trouble. FDIC chief Sheila Blair said in her speech that she expects more banks to fail this year. There is also the discussion that loan modifications, originally intended as a means of preventing foreclosures, might be in fact tying homeowners to their mortgages, with signs of forbearance lending by regional financial institutions. If they are the case, they will not only delay necessary balance sheet adjustments by borrowers but may also postpone the reallocation of labor and capital that is essential to recovery, thereby impeding an acceleration of economic growth.

Mr. Fukuda :

- The financial and real estate sectors have contracted sharply as a result of the financial crisis, and given their importance to the US economy I suspect their impact on the nation's potential growth rate will be significant. However, conditions in other sectors are likely to return to normal once the crisis is over, even though they may have experienced temporary difficulties in obtaining financing.

Mr. Uchida :

- The 10-year Treasury yield has risen about 150bp from its low, but the broader economy has stood the strain. I think the Fed's decision to keep the policy rate near zero can be seen as an attempt to relieve the burden of household balance sheet and employment adjustments, and substantial rate hikes are possible once these adjustments wind down. Given that current conditions—which include negative real interest rates—are extremely accommodative, I think there is no guarantee that rate hikes will be carried out at the same “measured” pace as before.
- Some argue that the potential growth rate of the US economy has fallen to about 2% as a result of demographic factors and the fading impact of the IT revolution. Yet recent economic data have been robust. It will be interesting to see how the Fed interprets this situation. If it still argues that an early rate hike would not be appropriate given the ongoing adjustments in the labor market, it would (from a macro standpoint) have to rely on the logic that national income is flowing overseas in the form of the gap between GDP and GNI.
- Because the US is not an excessively centralized economy and is characterized by great labor mobility, the immobilization, so to speak, of home mortgages and labor resources could have a significant impact. To the extent that most small businesses are reliant on bank lending, bank failures could have severe ramifications in terms of the loss of established business relationships and the resulting obstacles to credit creation.

Mr. Takata :

- During Japan's bubble period, it was lending to three specific sectors—real estate, construction, and nonbank financial institutions—that increased sharply. In contrast, consumers were responsible for one third of the increase in US bank lending over the last 10 years. Japan addressed the issue of bad loan disposals by utilizing the legal framework for corporate bankruptcies, but from a political standpoint it is much more difficult for the US to deal with bad loans to consumers. I think the entrenchment of these loans could obstruct a necessary reallocation of economic resources.

Mr. Kato :

- San Francisco Fed president Janet Yellen estimates there is a high risk of deceleration of inflation rate until around 2013, when the output gap is now expected to disappear. This diverges sharply from the market's view. I think the Fed needs to address the risk of rising inflation expectations by emphasizing that excess reserves can be absorbed at any time.

(3) Fed purchases of MBS

Mr. Kato :

- Yields on agency securities have risen only modestly despite the Fed's discontinuation of MBS purchases. This may be attributable to the Treasury's announcement that it would support the GSEs for the next three years, prompting yield-starved US investors to go after credit spreads.
- A market sale of the Fed's MBS is not realistic given the potential impact of higher rates on the housing market. The dominant view at the Fed is therefore that the MBS will be retained on the Fed's balance sheet for now. That means the Fed is likely to begin raising rates in spite of an enlarged balance sheet.

Mr. Uchida :

- I attribute the continued stability in the MBS market to declining issuance and the Treasury's authorization to buy more preferred shares in the GSEs if needed. But with the Treasury expected to exhaust its current authorization within a few quarters, the government will need to come up with a fundamental solution by then. This could be a major capital injection or an attempt to achieve a contracting equilibrium by splitting up the GSEs into smaller entities.

Mr. Takata :

- The BOJ's quantitative easing program consisted mostly of buying and holding short-term assets. Inasmuch as the Fed's large-scale credit easing resulted in a large expansion of its balance sheet, subsequent actions will be far more problematic. An eventual acquisition of the Fed's MBS portfolio by the government could spark serious concerns about fiscal sustainability because of the resulting surge in the budget deficit.

Mr. Fukuda:

- Stabilization of the housing market is not ordinarily part of the Fed's role. Using monetary policy to achieve this end has not led to major problems because the US is in a liquidity trap. But this state of affairs will not continue forever, and the Fed will eventually have to fundamentally rethink its MBS holdings.

2. Outlook for monetary policy in Japan**Inoue (Organizer) :**

- Of the factors influencing the outlook for monetary policy in Japan, we began discussing the implications of fiscal deficits at the last meeting. This time I would like to discuss the ramifications of longer-term downward pressure on prices. The BOJ is committed to tackling deflation and has recently launched a policy similar in character to quantitative easing. As it is difficult for such a policy to have a pronounced impact on the economy or prices, however, I think the Bank is finding it more difficult to maintain a dialogue with the market regarding its intentions.
- Since the 1990s, Japan's CPI has been characterized by larger declines in the prices of goods and services than that of the US. As for the CGPI, there have been periods in which the price of raw materials rose sharply despite remarkably stable prices in intermediate and final goods, causing Japan's terms of trade to worsen. A consensus seems to exist that slackness resulting from overinvestment during the bubble period was sustained for an extended period of time through such practices as forbearance lending, and that this, in turn, contributed to the decline in prices during the 1990s.
- In contrast, there are a variety of opinions as to why the inflation rate also remained depressed after the previous financial crisis. Looking at the macro picture, capital stock and bank lending data suggest that the corrective processes continued into the mid-2000s in some industries. In the labor market, attention has focused on the rising unemployment rate, but a comparison of the capital stock and employment growth points to labor hoarding, and the persistent downward pressures on wage growth could be seen as the price for that. Moreover, both macro (GNI and GDP) and micro (input-output prices) data confirm a transfer of income due to deteriorating terms of trade. If we were to extract working hypotheses from these data sets, they might include (1) excessive price competition as the flip side of inefficiency in certain industries, (2) the overseas transfer of real income that should have offset the downward pressure on prices from productivity gains, and (3) wage adjustments as the price of keeping jobs. Naturally, a rigorous conclusion will require a careful examination of more empirical studies.
- The Panel previously discussed the economic costs of falling prices, and I continue to see little risk of the kind of debt deflation experienced during the previous financial crisis. That

said, rising real interest rates do tend to adversely affect investment, and deteriorating terms of trade to depress real incomes, although there is room for debate over the magnitude of these effects. And for the government, which in macro terms is the largest borrower, rising real interest rates and falling nominal revenue increase the real burden of debt.

Mr. Fukuda :

- I find it interesting that discussions about the risk of inefficient resource allocation are also attracting attention in the US. However, it is important to determine why Japan faces stronger downward pressure on prices. If this phenomenon cannot be explained by the size of the output gap alone, then we need to look at other factors.
- If structural factors are responsible for falling prices, the implication is that monetary policy is powerless. Yet many ignore this basic fact, arguing for action by the BOJ and criticizing the Bank for not doing more. I do not expect this debate to end until the BOJ properly analyzes the reasons for falling prices and makes a case for its conclusions. That the Bank appears to be engaged in additional accommodation at the government's behest is very problematic from the standpoint of monetary policy independence.
- While it can be argued that monetary policy should be kept accommodative in order to reduce the burden of the necessary adjustments at a macro level, there is no guarantee that the business community will actually carry out structural adjustments. It will also be difficult for the government to resist the dangerous temptation to use inflation to reduce the fiscal deficit.
- In 2005 as well, CGPI seemed to track changes in the output gap quite well. But it would probably be difficult as a practical matter for the BOJ to administer monetary policy based on movements in the CGPI. Incidentally, I think the drop in prices of durable goods in Japan is attributable largely to the impact of quality adjustments. While such adjustments in themselves are appropriate, it is important from the standpoint of international comparisons that each country performs such adjustments based on relatively uniform standards.

Mr. Takata :

- In the 1970s the theory of adaptive expectations was applied to inflation. With prices now having fallen for more than a decade in Japan, a modest increase in recent inflation is unlikely to change the general mindset, which continues to anticipate deflation. Because this mindset influences corporate price-setting and consumption behavior, it could lead to a lower rate of inflation under the same output gap. Incidentally, good data regarding Japanese inflation expectations are hard to come by. The expected inflation rate as extracted from Inflation-Indexed Bonds yields, for example, suffers from considerable distortions.

- My firm surveys market participants and asks them for their forecasts of prices and economic growth. As of end-March 2010, participants were anticipating higher prices and growth, which suggests they may have had difficulty understanding the reasoning behind the BOJ's decision to embark on additional easing at the March MPM. The minutes of that meeting revealed that two Board members had opposed the decision, and I think the Bank needs to provide a detailed explanation of its rationale. If the decision was made because of persistent structural factors or to root out deflationary expectations, the Bank should make that known.

Mr. Kato :

- There were some distressed sales at retail apparel chains in the US immediately after the financial crisis erupted, but subsequently the liquidation of unprofitable stores was more common. In Japan, I think there may be a tendency for firms to engage in almost reckless price competition, perhaps in part because of the need to maintain staff levels. Regarding the extraction of inflation expectations, I think it would be extremely difficult to ask ordinary consumers what the inflation rate is and get anything approaching accurate answers.
- If falling prices are in fact due mostly to structural factors, that would imply that the expansion of the BOJ's new funds-supply operation was not particularly meaningful although it may have been unavoidable given the dearth of other policy options. The Bank has also explained that it conducts monetary policy in line with two "perspectives," but the latest round of easing would almost appear to have been implemented in line with a third perspective: the BOJ's relationship with government.

Mr. Uchida :

- A negative personal consumption deflator has not been seen since the Great Depression. In addition to structural factors such as the labor structure and inefficiencies at the industry and company level, there are probably various other causes—deflationary expectations may have become entrenched, for example, and there is a negative output gap. But I think downward pressure on prices could abate suddenly if taxes were steadily raised as part of deficit-reduction efforts or if many industries began pursuing vertical integration, resulting in sharp adjustments to overcapacity. In any event, I do not expect the deflationary trend to continue for another 20 years.
- I will be closely watching the price forecasts in the BOJ's semi-annual Outlook, set to be released in late April. When Policy Board member Hidetoshi Kamezaki made his speech, there was a substantial risk of further price declines, but now, if we ignore special factors such as the waiver of public high school tuition, it looks as though the deflationary trend is losing momentum, even if we take into account the level

effects of certain goods. The CGPI, which tends to lead the CPI, is also pointing in this direction.

- Two of the reasons Fitch gave for its two-notch downgrade of Greece's sovereign debt were the difficulty of implementing fiscal consolidation measures and concerns about fiscal sustainability given the nation's high borrowing costs. Japan could also find itself the subject of severe credit downgrades in the event of an increase in long-term interest rates.

Mr. Watanabe :

- I find the possibility that distortions in resource allocation have played a role in price declines quite interesting. If true, it would mean that very different policies are needed. But not enough empirical research has been conducted, in part because we do not have enough data on the period after the previous financial crisis. As for the impact of deflationary expectations, standard macroeconomic models assume rational expectations, and the Fed has released research showing that the fitness of such models could be improved by incorporating data from price forecast surveys.

4. Adjournment

Inoue (Organizer):

- A variety of opinions and hints have been presented today regarding the implications of longer-term price declines on monetary policy. I look forward to continuing this discussion at coming meetings.
