SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR JAPAN AND THE UNITED STATES

The Weill Center, Armonk, NY • OCTOBER 25-27, 2013

DRAFT AGENDA

FRIDAY, OCTOBER 25

5:35 p.m. and 5:50 p.m. *Renaissance Guests – Bus to the Weill Center; meet in front of the Renaissance Hotel*

6:00-6:40 p.m. **COCKTAIL RECEPTION** *Main Lobby*

6:40-6:45 p.m. **GREETINGS** *Dining Room*

- Hal Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law
- Takashiro Furuhata, Executive Director, International House of Japan

6:50-7:50 p.m. **KEYNOTE ADDRESSES** *Dining Room*

- Mitsuhiro Furusawa, Vice Minister of Finance, International Affairs, Ministry of Finance-Japan
- Robert Dohner, Deputy Assistant Secretary for Asia, U.S. Department of the Treasury

7:55-9:30 p.m. **DINNER** *Dining Room*

9:30-10:30 p.m. **AFTER-DINNER COCKTAILS** *Main Lobby*

9:35 P.M., 10:00 P.M., & 10:30 P.M. *Renaissance Guests – Bus back to hotel; meet in Main Lobby of Weill*

SATURDAY, OCTOBER 26

6:55 a.m. – 7:40 a.m. *Renaissance Guests – Buses to the Weill Center- Meet in front of Renaissance*

7:15-8:00 a.m. **BREAKFAST BUFFET** *Dining Room*

**Panelists, Facilitators, and Reporters sit at reserved tables.*

8:15-8:25 a.m. **WELCOME & OPENING REMARKS** *Room H*

8:25-8:45 a.m. **PANEL SESSION** *Room H*

Topic 1: Deteriorating fiscal sustainability and consequences for the government bond markets and the financial system

- Masaaki Kanno, Managing Director, JPMorgan Securities Japan Co., Ltd
- Mark Siegel, Portfolio Manager, Elliott Management Corporation

8:50-10:15 a.m. ***SMALL GROUP SESSIONS***

Group	Room	Facilitators	Reporter
1	Room H	Satoru Murase, Takatoshi Ito	Bill Grimes

2	Room F	David Asher, Shunichiro Kimpara	Shuji Yanase
3	Room J	Ken Dam, Kozo Koide	Akihiro Wani
4	Room A	Doug Hymas, Yoichi Takita	Hamilton Lin
5	Room B	Andy Conrad, Tsutomu Watanabe	Gene Park
6	Dining Room 2	Dave Shuler, Osamu Yamamoto	Alicia Ogawa

10:15-10:25 a.m. **REFRESHMENT BREAK**

10:30-10:50 a.m. **PANEL SESSION** *Room H*

Topic 2: Still too big to fail? - where is SIFI regulation headed?
- Kenneth Dam, Max Pam Professor Emeritus of American and Foreign Law and Senior Lecturer, University of Chicago Law School
- Takashi Oyama, Counsellor on Global Strategy to President and the Board of Directors, The Norinchukin Bank Group

10:55-12:15 p.m. ***SMALL GROUP SESSIONS***

Group	Room	Facilitators	Reporter
1	Room H	Brian Kelly, Akira Ariyoshi	Bill Grimes
2	Room F	Arthur Mitchell, Takayoshi Hatayama	Shuji Yanase
3	Room J	Paul Speltz, Akinari Horii	Akihiro Wani
4	Room A	Jeevan Ramapriya, Takashi Oyama	Hamilton Lin
5	Room B	Terry Suzuki, Tsuyoshi Oyama	Gene Park
6	Dining Room 2	Jim Walsh, Hiroshi Watanabe	Alicia Ogawa

12:20-12:50 p.m. **BUFFETT LUNCH** *Dining Room*

1:00-1:30 p.m. **KEYNOTE ADDRESS** *Room H*
- Koji Tsuruoka, Ambassador, Chief Negotiator for the TPP, Japan

1:30-3:00 p.m. **PANEL SESSION – PLENARY DISCUSSION ONLY** *Room H*

Topic 3: Will Abenomics and Fed's quantitative easing policies deliver global economic growth?
- Chair: Takatoshi Ito, Professor, Graduate School of Economics, University of Tokyo
- Vincent Reinhart, Chief Economist, Morgan Stanley
- Tsutomu Watanabe, Professor, University of Tokyo
- Kozo Koide, Chief Economist, DIAM Co., Ltd.
- John Makin, Senior Advisor, Cornwall Capital & Resident Scholar, AEI

3:05 and 3:30 p.m. *Renaissance Guests – Bus back to hotel; meet in Weill Main Lobby*

3:00-6:00 p.m. **R E P O R T E R S M E E T I N G / F R E E T I M E** *Room F*

5:35 p.m. and 5:50 p.m. *Renaissance Guests – Bus to the Weill Center; meet in front of the Renaissance Hotel*

6:00-6:40 p.m. **C O C K T A I L R E C E P T I O N** *Main Lobby*

6:45-7:45 p.m. **K E Y N O T E A D D R E S S E S** *Dining Room*

- Zion Shohet, Executive Vice President, Financial Regulation Reform, Citi
- Takashi Morimura, Deputy President & Group CEO, Global Banking, The Bank of Tokyo-Mitsubishi UFJ, Ltd.

7:50-9:30 p.m. **D I N N E R** *Dining Room*

9:30-10:30 p.m. **A F T E R - D I N N E R C O C K T A I L S** *Main Lobby*

9:35 P.M. , 10:00 P.M. , & 10:30 P.M. *Renaissance Guests – Bus back to hotel; meet in Main Lobby of Weill*

S U N D A Y, OCTOBER 27

**Please check-out of your room before the Sunday sessions. Luggage will be stored in the front lobby of Weill.*

6:55 a.m. and 7:10a.m. *Renaissance Guests – Bus to the Weill Center- Meet in front of Renaissance with your luggage*

7:15-8:00 a.m. **B R E A K F A S T B U F F E T** *Dining Room*

**Chairs and Reporters sit at reserved tables.*

8:15-9:15 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Room H*

Topic 1: Deteriorating fiscal sustainability and consequences for the government bond markets and the financial system

- Hiroshi Watanabe, CEO and Executive Managing Director, JBIC
- Brian Kelly, Managing Partner, Asian Century Quest

9:20-10:20 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Room H*

Topic 2: Still too big to fail? - where is SIFI regulation headed?

- Takumi Shibata, Executive Chairman, Nikko Asset Management Co., Ltd.
- Jeff Bohn, Senior Managing Director, State Street Global Markets

10:20-10:30 a.m. **R E F R E S H M E N T B R E A K**

10:30-11:30 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Room H*

Topic 3: Will Abenomics and Fed's quantitative easing policies deliver global economic growth?

- Naoyuki Yoshino, Professor, Department of Economics, Keio University
- Benjamin Mandel, Economist, Global Economics, Citi Research

11:30-12:15 p.m. **C L O S I N G L U N C H** *Dining Room*

12:20 P.M. *Buses from the Weill Center to JFK and Grand Central Station*

2013 Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Japan and the United States

The sixteenth Japan-U.S. Symposium was held in Armonk, New York, from October 25-27, 2013. Sessions discussed fiscal sustainability and implications for financial markets in Japan and the U.S., the definition and regulation of systemically important financial institutions (SIFIs), and the impacts of quantitative easing and Abenomics for growth in Japan, the U.S., and globally. Participants were somewhat buoyed by improvements in the Japanese and U.S. economy. However, there was also considerable concern expressed about budgetary brinkmanship in the U.S., long-term fiscal sustainability in Japan, and the implications for both economies of slowing growth in emerging markets.

Session 1: Deteriorating Fiscal Sustainability and Consequences for the Government Bond Markets and the Financial System

Session 1 addressed the problem of fiscal sustainability in Japan and the U.S. Both countries were seen as facing significant economic and political challenges. Many participants expressed cautious optimism about newfound political will to address fiscal sustainability in Japan; in contrast, there was considerable dismay regarding the lack of effective cooperation by U.S. lawmakers to ensure long-term sustainability and to avoid destabilizing crisis-driven fiscal policymaking. Participants also discussed the consequences for Japan's government bond markets and financial system, with mixed opinions regarding the likelihood of interest rate spikes and effects on the solvency of financial institutions holding large amounts of JGBs.

Fiscal Sustainability

Participants agreed that Japan and the U.S. faced some common long-term risks, even as they felt reasonably confident concerning short-term fiscal sustainability and stability of government bond markets. For both societies, participants saw entitlement programs as the main driver of long-term fiscal challenges. Growing numbers of retirees relative to working adults would inevitably imperil the sustainability of public pension systems in the absence of benefit reform or contribution increases. This problem was seen as considerably more severe in Japan, with its declining working-age population and the highest concentration of elderly population in the world; for the U.S., participants generally agreed that social security sustainability could be managed relatively easily from an economic perspective, although significant political challenges remained. Health care was seen as an even more severe problem than pensions, as costs in both countries were being driven not only by aging societies, but also by increasing costs of services provision and increasing expectations for medical care. With an upcoming bulge of new retirements (typified by "Baby Boomers" in the U.S.), many participants stressed that the window for action to contain costs was narrowing.

Intertwined with the problem of entitlements was the issue of economic growth. A number of participants expressed concern that growth would be insufficient to cover the costs of rising demand for government services. This was seen as particularly true for Japan: its fiscal debt situation was much more severe, its growth potential was decreasing due to a declining work force, and it had been producing well below potential output for the past two decades. But participants also expressed unease about the weakness of economic recovery in the U.S. in the five years since the onset of the subprime crisis. Much of the discussion focused on structural reforms and removing barriers to growth, but a number of participants pointed to the effects of long-term economic weakness as compounding the challenges of accelerating growth. One concern was over long-term unemployment. Participants noted evidence that extended periods of unemployment reduced the productive capacity of workers, and expressed concern that the lack of regular employment in the U.S. and (especially) Japan was leading to a de-skilling of the labor force and thus lower potential growth. Some participants also flagged concerns about growing economic inequality in both countries (in this case, more so in the U.S. than in Japan). They worried about both the sustainability of economic growth in societies with stagnant middle class incomes and about the political sustainability of free-market policies over the longer term if income and wealth were to continue to become concentrated among a small share of the population. These participants therefore argued particularly strongly for the urgency of improving growth prospects.

Third, participants noted that the sustainability of government debt service depended to a considerable extent on low interest rates. This was seen as particularly true for Japan, where nearly a quarter of the general account budget was devoted to debt service. Some participants argued that deflation had made Japan's debt service affordable, and that massive quantitative easing raised the risk of rising inflation and long-term bond yields that would overwhelm rising tax revenues resulting from renewed growth. A few participants cautioned that the U.S. could face similar problems if a realistic long-term fiscal plan could not be concluded relatively soon. However, participants rejected alarmist projections of hyperinflation as a result of quantitative easing or of near-term crashes in government bond markets.

Finally, participants noted the significant political challenges of fiscal consolidation, or reducing structural deficits, in both countries. Many made the point that long-term fiscal sustainability would depend on entitlements reform, which would inevitably require reduced benefits for older citizens. However, they noted that older citizens voted disproportionately more than younger ones in both countries; with growing shares of older voters, they worried that the already considerable reluctance of electorates to support entitlements reform was further increasing. Some participants also pointed to systemic aspects of U.S. and Japanese political and party systems, including gerrymandering and rural overrepresentation, as grounds for pessimism about the ability of lawmakers to make difficult decisions to ensure fiscal sustainability. One point on which participants generally agreed was that the benefits of fiscal consolidation would only appear in the long term and would be diffused throughout the population, while the costs would start appearing immediately and would fall primarily on specific groups such as elderly voters. They saw this as the core of the political challenge.

Japan

While Japan and the U.S. faced a number of the same economic and political challenges, participants agreed that the specific patterns were quite different between the two countries. In terms of long-term fiscal sustainability in Japan, participants noted three macro-level reasons for pessimism. First, the sheer scale of Japanese government debt was much larger, even when focusing on net instead of gross figures. Second, the aging of Japanese society and declining workforce was much more advanced than in the U.S., and Japan's low birth rates and net immigration would continue to compound the problem. Third, two decades of deflation and subpar growth had exacerbated the challenges of reviving nominal growth.

A number of participants also pointed to budget rigidity as a challenge to Japanese policymakers in reducing the deficit. With approximately three quarters of the general account budget committed to debt service, entitlement programs (national pensions and health), and local transfers (paid out according to a legislated formula), Japanese budget makers would have very little room to make meaningful spending cuts in the absence of a large-scale political deal over entitlements reform. Thus, much of the focus in Japan's fiscal consolidation efforts had focused on revenue increases, particularly the extremely unpopular consumption tax. (Corporate tax reform was also discussed at length, but mostly in terms of incentives, with an assumption of revenue neutrality.)

Despite these challenges, participants did not express concern that Japan was vulnerable in the short- to medium-term to a crisis in which the government could not finance its debt at affordable rates. They noted that well over 90% of JGBs were owned by domestic investors. Most agreed that there was little or no incentive for these investors to dump government bonds, at least in the aggregate; meanwhile, since the bulk of foreign JGB holdings were held by governments as part of their foreign exchange reserves, there was little chance of foreigners sparking a race for the exits. Participants noted that, while banks appeared to be reducing their demand for new bonds and shortening the duration of their portfolios, insurance companies and pension funds were still buying long-term JGBs. Moreover, the commitment of the Bank of Japan to purchase long-term JGBs as part of its quantitative easing plans was seen as a powerful guarantee that bond yields would not spike any time soon.

Still, some participants argued that it was necessary to consider scenarios in which investors did start selling off their holdings of Japanese government debt. This might happen, it was suggested, if Japan's current account shifted to deficit or—more dramatically—if the return of inflation were to invert the yield curve. (The latter case is addressed in Session 3, below.) In that case, they asked, what would be "Plan B"? Some participants argued that, in the event that JGB prices did start to drop, the relatively small number of investors holding JGBs (dominated by official actors such as the BOJ, Japan Post, and national pension funds; foreign governments; and major Japanese banks and insurance companies) would make coordination easier—either to agree not to sell off holdings or to voluntarily restructure their debt. Others worried that a sell-off could turn into a crisis. In an extreme situation, it was suggested that one possibility would be to close the capital account, then negotiate a haircut with domestic financial institutions. While such an action would be disruptive, it was suggested that it would be easier to do in Japan than in any other developed country, given the level of home bias in portfolio investing.

United States

Despite popular fears of the possibility of a sell-off of U.S. government debt that could lead to a plunging dollar and new global financial crisis, participants dismissed doomsday scenarios. Most agreed that the current fiscal picture was not that bad—net debt remained low relative to many developed countries, and deficit reduction was already progressing significantly due to the sequester and modest economic growth. Moreover, they felt that the dollar's status as the global reserve currency and the absence of viable alternatives would prevent any large-scale sell-offs, despite the high level of foreign ownership of U.S. debt (unlike the case of Japan).

The major concern cited by many participants was political. While there were differing ideas about the correct course for taxes and spending, many participants argued that the key to long-term fiscal sustainability would be a comprehensive deal on entitlements. However, given the level of political confrontation and lack of electoral incentives to compromise, many participants were pessimistic that such a deal could be achieved in the next several years. Some participants also expressed a more short-term concern about how politics could impact government debt markets. They feared that there would be more instances of government shutdowns and possibly even a default. (Few if any predicted a default, but a number of participants felt that there was a live possibility.) While a default would have the worst effect, there was considerable concern about the effects of crisis-driven fiscal policy on the U.S. economy and on the confidence of foreign investors. In contrast, there were some participants who argued that recent politics had had some positive effects on fiscal sustainability—not only had the sequester reduced deficits faster than expected, but deficit reduction had become a primary goal of U.S. politicians across the political spectrum. (However, not all participants felt that short-term deficit reduction was the right priority for slowly-recovering economy.)

Japan's Path to Sustainability

Given its demographics and the size of its government debt, Japan was seen as having a particularly difficult path to fiscal sustainability. Participants agreed that consolidation would be needed over the long term, but were somewhat split over timing, with some expressing concern that attempts to reduce deficits might choke off growth and thus be counterproductive. There was also some disagreement as to whether the consumption tax hike was the right way to raise revenues.

Most of the discussion regarding Japan's path to sustainability focused on Abenomics, the Japanese government's declared comprehensive economic strategy. Participants debated the implementation and effects of each of the three "arrows" of assertive monetary policy, short-term fiscal stimulus followed by fiscal consolidation, and structural reforms to enhance supply-side growth potential. While most were cautiously optimistic, several cautioned that the road to success for Abenomics was a "narrow path" that would rely on positive nominal economic growth as well as effective implementation.

From the perspective of fiscal consolidation, the first two arrows of Abenomics were meant to spur economic growth both for its own sake and in order to justify the consumption tax hike from 5% to 8% scheduled for April 2014. With the recent confirmation by the Japanese government that the tax hike would go forward, participants agreed that the two arrows had at least provided political cover to take that important step toward fiscal consolidation. Participants expressed conflicting opinions about the consumption tax hike. Many felt that it was an important step toward medium-term fiscal consolidation, which would help the Japanese government to achieve its goal of halving the primary deficit by 2015 and eliminating it by 2020. Some, however, were cautious about predicting that those goals would be achievable. It was generally agreed that the planned consumption tax hikes would not in themselves by sufficient to close the gap; thus, the prospects for achieving primary surplus by 2020 would depend on the ability of the government either to engineer a comprehensive deal on pensions and healthcare or to further increase the consumption tax to as high as 20% by 2020. Neither was seen as easy (and many participants were opposed to reopening the consumption tax debate so soon). An alternative criticism of the 2014-15 consumption tax hikes was that they would endanger Japan's economic recovery, while imposing most of the burden on working class and middle class families. While a number of participants expressed some sympathy for those concerns, others countered that there might never be a "right" time to impose new taxes and that focusing on less regressive taxes would not generate enough revenue to address Japan's fiscal gap. (There was also some discussion of whether Japan's 1997 recession had been caused or exacerbated by the consumption tax hike that year. While the debate was inconclusive, it was noted by a number of participants that the Abe administration was making an attempt to reduce the immediate impact of the consumption tax hike on the economy through the introduction of a modest stimulus plan.)

Growth Prospects and the Three Arrows

There was more skepticism about whether Abenomics would deliver the economic growth that would be needed to make fiscal consolidation possible, or at least bearable. Participants raised three questions, each corresponding to one of the Abenomics "arrows." One, which was discussed in detail in Session 3 (see below), was whether quantitative easing could provide more than a short-term spur to growth.

With regard to fiscal policy, a number of participants raised the possibility that the consumption tax hike and other upcoming measures aimed at fiscal consolidation would create a sufficient drag on the economy that Japan would simultaneously suffer lower growth while benefiting from only a modest increase in tax revenues. While the proposed stimulus plan was intended to address this problem, it was not universally accepted that it would be sufficient. It was also argued by several participants that the fiscal deficit was simply the mirror image of excessive saving in the private sector, particularly among corporations. They pointed out that flow of funds data showed that corporations were holding onto cash instead of investing it or increasing wages or dividends; this left the government as the "demander of last resort." These participants argued that withdrawal of fiscal support for the economy was bound to be counterproductive unless businesses could be induced to invest or spend their retained profits. They argued that easy money and the Abe administration's short-term initial fiscal stimulus could only be judged as effective if they contributed to business confidence, and from there to increased investment, payroll, or dividends. While some evidence was presented on both sides of the question—including rising bonuses and tightening labor markets in some sectors—most participants agreed that it was too early to tell.

For most participants, the long-term success of Abenomics was seen to hinge on the third arrow of structural reform. There was a considerable divergence of views about nearly all aspects of the Abe administration's structural reform plans, including the choice of policies, the boldness of the reforms, their likelihood of being fully implemented, and their effects on potential growth. A number of participants criticized the structural reform proposals as being too timid and vague. Others countered that the administration was being strategic about unveiling its plans—first delaying concrete plans due to the Upper House elections, and then in the run-up to the final decision to implement the consumption tax hike. Now, they argued, the administration would propose a comprehensive series of concrete policy measures, with the first set rolled out by the end of 2013. They also argued that, because Prime Minister Abe and his government had such a large majority in the Diet and would not need to face another general election for nearly three years, reforms would not just peter out after the initial set. Both sides agreed that the reform package to be released in December—as well as the response of ruling coalition Diet members—would provide a crucial test of the administration's ambitions and the likelihood of successful introduction of reforms.

Participants also pointed to the uncertainties surrounding the effects of structural reform. Unlike with monetary or fiscal policy, structural reform advocates could not point to any standard forecasting model to predict the effects of the policies under consideration. There was a general recognition that the benefits of structural reforms would likely take time to manifest themselves and that links to success would be difficult to demonstrate, while the costs or disruptions would likely be felt quickly. Moreover, for many of the policies under consideration, the costs would be felt by concentrated groups while the benefits would be more diffuse. These uncertainties were seen to make reforms both more politically difficult and more difficult to calibrate or properly modify over time.

Participants also discussed to some extent what they saw as the most important targets for structural reforms. These included financial intermediation, labor markets, and agriculture, among others. A number of participants argued that the major obstacle to private sector-led growth in Japan had to do with financial intermediation. A major concern was what they saw as a continued lack of risk capital, as seen in anemic IPO markets and capital market fundraising opportunities for small and medium-sized enterprises. (Some participants saw signs that conditions were improving, but most agreed that it was too early to tell for sure.) While there were few concrete proposals for how to address that gap, some participants advocated measures that would make it easier for venture capital and private equity firms to operate in Japan.

A second concern about financial intermediation had to do with banks, which appeared to some participants be reluctant to lend, particularly to SMEs. Two competing explanations were offered for why banks were reducing lending while building up government bond holdings. One was that it was the fault of regulation—that Basel III and conservative supervision practices of the FSA discouraged risk-taking on the part of lenders (although it was pointed out that the FSA had very recently begun to encourage SME lending). Other participants argued that the main reason was lack of loan demand among companies; as evidence, they pointed to the high saving rate of the Japanese corporate sector. Thus, they argued, other aspects of Japan's growth strategy, such as the impact of fiscal policies or sectoral policies on specific groups of borrowers, would be more important than focusing on the banks themselves.

Meanwhile, a number of participants called for new mechanisms to mobilize Japan's vast stock of savings to contribute to growth. A particular concern was the continued reluctance of households to invest in financial products other than bank deposits and life insurance. Participants mentioned several ventures to encourage such investments, including the new non-taxable Nippon Individual Savings Accounts (NISAs), Hometown Trust Funds, and crowdfunding (an approach also being undertaken in the U.S.). Others argued that it would be important to allow financial institutions to mobilize their assets under management to contribute to growth through infrastructural investment. Thus, they called for improving the environment for public-private partnerships (PPPs) and private finance initiatives (PFI). A number of participants argued that, rather than focusing on investment-driven growth, the Japanese economy would benefit from higher dividend payouts by companies that were currently hoarding cash. In the absence of activist shareholders, it was suggested that Japan might want to follow the example of Taiwan, which in 1997 instituted a "retained earnings tax surcharge" to force corporations to make use of profits. Others were skeptical, arguing that households would benefit more from wage increases than from higher dividend payouts.

There was also considerable discussion of labor market issues, which had been a major focus of the Abe administration. Some participants supported the need to improve labor flexibility, for example by allowing companies to lay off employees more easily. Others were skeptical, arguing that employment flexibility would be a codeword for employment insecurity. They felt that the negative impact on labor-management relations of easier layoffs might exceed the productivity gains from better deployment of workers. They also worried that the dearth of secondary labor markets in Japan would mean that laid-off workers would be unable to find new employment, creating both economic and social dislocations.

There was considerably more agreement in favor of the Abe administration's support for expanding female labor participation. Participants agreed that well-designed policies to increase female labor participation without negatively affecting fertility could contribute positively to Japanese growth, fiscal sustainability, and intergenerational equity. For a number of participants, this element of the third arrow was the most critical to improving Japanese growth potential. Some participants argued that there were already positive changes in female employment opportunities since the advent of the Abe administration and expressed hope that the administration was adopting concrete measures to improve employment prospects and childcare opportunities for women, although not all were convinced that the administration's policies would achieve their goals. Finally, there was a brief discussion of immigration, either for filling specialized job needs (including high skill jobs such as software engineers and labor-intensive jobs such as caregivers) or for trying to improve the ratio of working adults to retirees. There appeared to be more optimism about the potential for the former than for the latter.

A final element of structural reform that received a great deal of attention at the Symposium was the potentially transformative role of the Transpacific Partnership (TPP) in removing anti-competitive rules and opening up new business opportunities. A number of participants expressed high hopes for the TPP, for two reasons. One was that TPP was comprehensive in nature; thus, its passage would circumvent multitudes of political fights over specific regulatory issues. Second, the role of the U.S. and other trading partners would change the political calculus among interest groups, politicians, and ministries regarding far-reaching economic reforms. There was, however, an undercurrent of pessimism among a number of participants, who worried that TPP would fail—either because negotiators would not be able to come to an agreement in December, or because either the U.S. or Japanese legislatures would be unable to ratify an agreement. There was also a certain amount of uncertainty about the actual contents of TPP due to the strict non-disclosure agreement among negotiators. Some participants worried that this would weaken political support for TPP among Japanese economic groups, since opponents were already attacking TPP while supporters could not cite specific improvements.

U.S. Path to Fiscal Sustainability

Participants agreed that, from an economic perspective, the U.S. path to fiscal sustainability would be significantly easier than that of Japan, due to the relatively smaller size of the debt and more favorable demographics. Discussion focused on two issues: entitlements reform and growth strategy. (The potential role of quantitative easing is addressed in Session 3, below.)

Participants agreed that a key to long-term fiscal sustainability would be to contain the costs of entitlements programs. Although the pressures on the system were not seen as being as severe as in Japan, participants observed that the impending retirement of the Baby Boomers would vastly expand the strain on Social Security and Medicare, while the ratio of working adults to retirees would continue to deteriorate. Medicare and other government health programs were seen as the most problematic, as cost increases were being driven by both aging societies and rising costs of health care provision. Participants were less worried about Social Security, as they felt that sustainability could be ensured with relatively small (albeit politically difficult) adjustments in benefit formulas, taxation, and retirement age. Several participants pointed out that a far greater pension problem could be found at the state and local levels, where many public authorities had established underfunded pension programs for their employees. They argued that many of these authorities would be unable to honor their pension obligations, leading to a series of contentious political and legal confrontations around the country. Looking on the bright side, some suggested that the resolution of these local confrontations could lead to a widely accepted set of principles for managing larger pension insolvencies at the state or even federal levels.

Participants also discussed how to improve U.S. growth prospects. They noted that growth since the crisis had remained relatively weak and unbalanced, which made both the economics and the politics of fiscal sustainability more difficult. In addressing the question of growth, some participants questioned assumptions about what was feasible. They noted that estimates of the output gap assumed resumption of the pre-crisis growth path. However, these participants argued that in reality the last five years had seen a significant erosion of both physical capital (particularly in the form of unused and untended housing) and human capital (as the skills and employability of long-term unemployed workers deteriorated). A number of participants also argued that overregulation in the wake of the crisis was slowing the growth potential of the economy, due either to the costs of starting or maintaining a business (including, for some, “Obamacare”), or to a reduction in the availability of risk capital (caused by new capital requirements for banks and additional regulations on other financial institutions and products). Further, regardless of actual growth potential, many participants agreed that political uncertainty over regulation, fiscal policy, and even the faith and credit of the U.S. government was retarding growth, by making firms hesitant to invest and households wary of increasing consumption.

Many participants agreed that the U.S. needed to adopt a clearer growth strategy, although there was much less agreement as to what it should look like. A number of participants focused on the need to incentivize private-sector investment. Many of these participants argued that corporate tax reform should therefore be a key component of U.S. growth strategy, as they felt that high tax rates were a disincentive to domestic investment. They also called for greater certainty regarding key policies and regulation—for example, many argued that the continuing ambiguities regarding financial regulation were reducing the availability of credit and risk capital, to the detriment of the economy as a whole. With regard to the content of regulation, there was some discussion of whether new financial regulations would have positive or negative effects; this was addressed at greater length in Session 2 (below). There was also disagreement regarding the balance of taxes and spending. While some participants emphasized the importance of keeping taxes low, others argued that increased government spending would be necessary, particularly in terms of growth-oriented infrastructure and support for research and development. There were also a number of participants who argued that tax policies needed to be made more progressive to support middle-class and working-class households, in order to make growth more economically and politically sustainable. Finally, there was general agreement that U.S. infrastructure was deteriorating relative to economic competitors, but not all participants agreed that government spending was necessarily the answer. Many participants argued that it would be important (whether as a first-best or second-best policy) to improve means of engaging the private sector in infrastructure development, and called for more extensive use of PPPs and PFIs. Finally, a number of participants argued that immigration reform would be a key component for improving U.S. growth prospects, by reducing uncertainty among undocumented communities and expanding the fiscal base to include more working-age adults. There was not an extensive discussion of this issue, however.

Political Sustainability

While participants spent much of Session 1 debating the virtues of various economic and regulatory policies in improving growth in the two countries, they also recognized that political challenges could easily derail their implementation or effectiveness. Thus, for many participants, the fundamental challenge going forward would be political sustainability of reforms and fiscal consolidation.

Participants identified a number of common political challenges for Japan and the U.S. A great deal of the discussion focused on political cleavages, especially the gap between the interests and political activities of elderly voters on the one hand and young voters on the other. Many participants argued that intergenerational conflicts were responsible for the key driver of fiscal unsustainability—i.e., national pensions and health spending. Noting that elderly citizens voted disproportionately more than younger ones, they worried that the rising share of retirees and near-retirees in the population could doom necessary entitlements reforms. Participants also cited regional and urban vs. rural cleavages, although these were not discussed at length. More broadly, participants noted that both societies lacked social consensus on the basic goals for policy and principles of governance. This was most clearly seen in the U.S., where the Tea Party and other anti-tax and minimal government groups vied against those with visions of activist government. However, a number of participants articulated a similar, albeit less dramatic, split in Japan between those who espoused a more communitarian (some termed it "socialist") worldview and others who argued in favor of more *laissez-faire* approaches. In the U.S., this was seen to have made politics much more confrontational, as competing visions clashed in major legislative efforts from Dodd-Frank to Obamacare to the debt ceiling. Finally, participants argued that apathy and lack of political engagement among moderates was empowering special interests and extremists; while the U.S. primary system and gerrymandering received a lot of attention in this regard, a number of participants also pointed out the ways in which representation of special interests (such as agriculture) was woven into the fabric of the Japanese system.

Despite the many political challenges to fiscal sustainability and effective economic governance in Japan, participants were more optimistic about Japanese politics than they had been since Prime Minister Koizumi completed his time in office. For the first time in six years, the Upper and Lower House were both dominated by the ruling coalition, and Abe's decisive electoral victory had decimated the opposition and (at least temporarily) discredited anti-reformist politicians within the LDP-led coalition. Several participants also noted that Abe's cabinet and leadership team were both highly experienced and united in favor of Abenomics' ambitious reform agenda. Further securing Abe's primacy in setting the policy agenda was the fact that no election would need to be held for nearly three years, reducing the ability of anti-reform forces to delay or subvert legislation. While not all participants agreed that Abenomics would solve Japan's problems or were enamored of Abe himself, there was a strong consensus that Abe had brought strong leadership to the Japanese government for the first time in years. (Indeed, some even suggested that the historic defeat of the DPJ might presage the return of a one-party system.) Still, even with the next national election nearly three years away, supporters of reform warned that Abe's window of opportunity for introducing bold reforms could be short, especially if structural reforms were to start causing pain among some sectors or regions. They called for the government to move assertively in its reform path. Some felt that if the government did not introduce a set of bold and concrete reform measures by the end of 2013 (perhaps including signing the TPP), traditional politics would likely win out, resulting in only tepid reforms.

Participants were, by and large, more dismayed by politics in the U.S. Despite the successful passage of major (albeit controversial) policy initiatives in President Obama's first term, they depicted Washington as politically dysfunctional, marred by confrontation and driven by crises. Many feared that the spectacle of government shutdowns and near-defaults had weakened U.S. credibility at a global level. Some felt that this could have a negative impact on foreigners' willingness to hold U.S. government debt, although most argued that there were no good alternatives. Still, a number of participants argued that if U.S. politicians could not cooperate with each other on important issues like the debt ceiling, both friends and foes would doubt U.S. commitment and ability follow through on initiatives ranging from TPP to intervention in the Syrian conflict. On a more hopeful note, many participants expressed the view that Congressional leaders had learned the lesson that government shutdowns and threats of default were counterproductive, and would avoid them in the future (although some expressed concern that this lesson might be forgotten by the time the next debt ceiling deadline arose in February). Some participants even felt that the political toll of the October shutdown and near-default might prepare the grounds for a grand bargain on spending and taxes that would include entitlements reform, corporate tax reform, rebalancing of spending priorities, and perhaps even immigration reform, as Congressional leaders sought to rebuild their parties' reputations among voters. Few were willing to predict such an outcome, however. And many participants felt that resolution of the deep cleavages in U.S. politics would have to wait at least until the 2014 elections, which could prove a bellwether for whether establishment or extremist political forces would drive governance and the 2016 election cycle.

Session 2: Still Too Big to Fail? Where Is SIFI Regulation Headed?

In Session 2, participants discussed the regulation of systemically important financial institutions. Discussions focused on standards for SIFI designation, content of regulation, and effects of SIFI designation on individual institutions and on the financial system in general. There was also considerable discussion of whether non-banks should be designated as SIFIs and whether a banking regulation model was being improperly forced onto non-banks, including insurance companies and asset managers.

Who Is (or Should Be Designated) a SIFI?

Participants discussed the concept of a systemically important financial institution at length. While recognizing that the Financial Stability Board (and FSOC in the U.S.) had developed a rough definition and set of criteria for judging whether a financial institution was systemically important, many participants expressed dissatisfaction either with that definition or with designation of specific financial institutions.

Participants ran through the usual list of principles for designating SIFIs, including size, complexity, and interconnectedness. Some also added additional criteria that they saw as important, including responsibility for maintaining liquidity in markets. There were questions raised about each of these criteria, particularly with regard to where lines should be drawn. Measurement was seen as a major challenge, and many participants felt particularly uncomfortable with relying on current metrics of interconnectedness or complexity. Although size was clearly easier to measure, even in that respect there were questions about where the thresholds should lie.

Some participants even questioned the concept of systemic importance itself. Citing the U.S. savings and loan crisis, as well as the role of German *landesbanken* and Spanish *cajas* in those countries' experience of the global financial crisis, they argued that the focus on large financial institutions ignored the fact that many financial crises in history had begun and spread through smaller institutions. Others criticized the concept on the basis that it was impossible to determine in advance which institutions or markets might have systemic importance—for example, until the global financial crisis, no one had expected that money market funds or asset-backed commercial paper markets would lead to widespread contagion effects. These participants argued that the reach of SIFI designation was potentially infinite, and as <u>any</u> institution participating in financial transactions could in theory be considered systemically important, including insurance companies, asset managers, clearinghouses and exchanges, and even trading companies. Finally, some participants argued that better risk management among all financial institutions was the key rather than focusing on size or interconnectedness. Summarizing many of the failures of risk management that led to the subprime and global crises, one participant concluded, "That's not a SIFI problem, that's an idiot problem."

Others felt it was more useful to focus on the concept of "too big to fail"—even if a large financial institution was not at the root of a crisis, they argued, regulators might not be willing to allow a large financial institution to go under during a crisis. This would create unfair competitive advantages and moral hazard. Some argued that SIFIs should perhaps not even be allowed to exist, and referred to the potential benefits of restrictions on size or scope (such as the Volcker Rule or Canadian-style bank regulation). Others were skeptical of such an approach. While understanding that some smaller economies might be unable to handle the resolution of a very large financial institution, they felt that this did not apply to Japan and the U.S., where market concentration was much smaller and resources for resolution comparably large.

Finally, some participants argued that, by concentrating on SIFIs and regulatory capital, regulators were "fighting the last war." They instead urged regulators to address new challenges. The massive expansion of central clearing of derivatives, for example, was seen as a new development that could become the epicenter of a future crisis. Some focused additionally on the ubiquitous challenges raised by information technology, expressing concern about both the robustness and the security of networks. They warned that the next crisis could well arise from a cyberattack or a failure of software or hardware in a major financial institution, clearinghouse, or exchange.

Managing "Too Big to Fail" Banks

Much of the discussion of SIFI regulation focused on banks, which were also the financial institutions that had so far received the most regulatory attention. Participants discussed both efforts to prevent failures and plans to manage failures.

As in previous Symposiums, there were differing opinions about each aspect of SIFI regulation. With regard to prevention of failure, some participants were critical of the regulatory emphasis on increasing capital. They argued that capital adequacy was seldom an effective predictor of which banks would fail in a crisis, and expressed skepticism that regulators were necessarily getting the requirements right for countercyclical buffers and capital surcharge. Others disagreed, arguing that capital was essential not only to encouraging prudence, but perhaps more importantly to lowering the costs to the public of bailouts or liquidation. Another criticism of capital requirements was that the standards of risk-weighting as they applied to Basel III regulatory capital and the SIFI surcharges would actually have perverse effects on banks' lending practices. Some participants expressed concern that the new capital regulations would discourage lending to companies while encouraging purchases of government bonds. This would have negative effects on economic growth, while also creating concentration risk for the banks.

There was a widespread agreement that liquidity was the key to banks' ability to weather crises. Nonetheless, there were a several criticisms of the way in which rules on liquidity were being imposed. One concern was that metrics such as the liquidity coverage ratio were too mechanistic and rigid to capture the differences in business models and risk profiles across banks. A more fundamental criticism was raised by some participants who made the argument that central banks were created to be lenders of last resort if a bank were in a liquidity crisis (as opposed to a solvency crisis). Unless central bank liquidity provision were to be construed as a "bail-out," they reasoned that much of the liquidity agenda was unnecessary.

Other participants defended SIFI regulation. They argued that, as providers of public goods, major banks had an obligation to engage in safer business practices, and that SIFI regulation was indeed making the system safer. They pointed to significantly improved capital buffers and liquidity among major U.S. and Japanese banks, as well as other reforms that they felt would improve the safety of major banks and the banking system, including bail-ins, central clearing, and improved transparency and disclosure. Perhaps more important, they argued that enhanced SIFI supervision provided opportunities for supervisors to ensure that SIFIs' risk management was robust, and to order changes if risk management were inadequate. While other participants expressed wariness about the ability of supervisors to judge sophisticated risk models, these participants felt that it was healthy for banks to have to justify their internal risk management systems.

Participants also discussed the ways in which SIFI failures would be managed under the new regime. They agreed that the fundamental principle of SIFI regulation was to prevent taxpayer-funded bailouts. Thus, in addition to enhanced regulation and capital surcharges, SIFIs and their regulators would have to establish plans to ensure that even complex transnational financial institutions could be maintained as a going concern in the event an institution was under resolution. Several participants spoke in praise of recovery and resolution plans ("living wills") that were meant to map out the liquidation of the holding company while keeping depositors whole. They argued that the plans were forcing bank management to create organizational structures that would reduce the negative external effects of a failure. Others countered that the new rules were essentially relying on ring-fencing or subsidiarization to reduce the risk that taxpayers would be forced to bailout a bank due to a crisis in a foreign branch. They felt that this would reduce the benefits of a multinational organization, while also increasing the costs of capital to the bank holding company, which would not be able to draw funds from constituent banks in the event of a funding crisis.

This approach to bank failures raised two questions of principle for participants. First, is it reasonable to expect that taxpayer money will never be used in a bailout of a major financial institution? Participants argued that much of the SIFI regulation failed to recognize the distinction between a taxpayer-funded bailout and liquidity provision by a lender of last resort. There was widespread agreement that regulations (such as those contained in Dodd-Frank) that constrained the lender of last resort function were potentially very dangerous. Moreover, some argued that in the event of an actual crisis, the economic costs of a bailout might actually be much lower than the cost of an orderly bank failure, but lawmakers had tied regulators' hands. (Some also worried about the opportunity costs of changing the organization and risk management of banks in order to reduce the risk of bailout to zero.) Second, is a one-size-fits-all approach appropriate in a world in which domestic authorities have vastly different capacities to respond to bank failures? A number of participants argued that the SIFI capital rules were more appropriate to smaller economies in which major bank assets might be multiples of GDP (e.g., Switzerland) than to countries like Japan or the U.S. Political imperatives were also seen to be different—in the U.S., authorities had categorically ruled out the use of public funds for bailouts, while it was seen as more politically acceptable in Japan. Why then, asked some participants, should large Japanese banks be forced to accept the same restrictions as U.S. or UK or Swiss banks?

Implications Beyond SIFI Banks

Another major question for participants was whether and how SIFI regulation should apply to non-banks, in particular insurance companies and asset managers. While the FSB and national authorities had already designated some non-banks as SIFIs, many participants were skeptical that the choices made sense.

With regard to insurance companies, a number of participants made the case that, regardless of size, insurance companies did not meet the SIFI criteria of complexity, interconnectedness, or provision of critical liquidity. Instead, insurance companies typically matched duration of assets and liabilities, buying and holding high-quality long-term securities, and maintaining high levels of reserves. Moreover, these participants saw the stability of insurance funds as already adequately protected by mechanisms such as state insurance pools, reinsurance, and catastrophe bonds. As one participant put it, "At the end of the day, banks die due to liquidity. This is never a problem in insurance." Participants argued that regulators should draw a clear distinction between traditional insurance business, which they saw as not having systemic contagion risk, and financial insurance products such as CDS and CDO^2 undertaken at the holding company and not in actual insurance companies. In addition to the issue of whether insurance companies should be regulated as SIFIs, there were also concerns raised about the substance of the additional requirements being imposed on SIFI-designated insurance companies, including enhanced capital requirements and risk models based on mark-to-market. A number of participants saw these as simply applying SIFI bank rules to insurance companies without taking into account the very differing types of risks.

Similarly, many participants expressed concern about the possibility that asset managers might also be designated as SIFIs. Participants argued that in most cases asset managers were simply fiduciaries; legally, they were only investing their customers' money at the direction of those customers. Therefore, they did not see asset managers as equivalent to other financial institutions that relied on their own assets and capital. There was a broad agreement on this point, with two exceptions. First, some participants noted that asset management firms were often major players in ensuring liquidity in specific markets, such as parts of the CP markets. Also, there was a tendency toward herd behavior, due to widespread tracking of indexes, as well as significant use of leverage. Thus, they might be responsible for contributing to contagion under certain circumstances. Second, many participants drew a line between money market funds and other asset management activities, arguing that MMFs were particularly involved in providing market liquidity while being particularly vulnerable to runs by investors if concerns were raised about "breaking the buck." (While some participants mentioned proposed rules such as floating NAVs, there was not much discussion of whether those rules would address the problem.)

There were still many skeptics, however, who pointed out that contagion risks could arise from any corner of the financial markets. If MMFs or other asset managers were to be considered SIFIs because of their role in providing liquidity to specific markets, they wondered, where could one draw the line? Some suggested that, in theory, any financial institution could be considered systemically important; but in that case, SIFI designation would be meaningless.

In addition to doubts about SIFI designation, many participants were skeptical about the actual application of non-bank SIFI rules, arguing that regulators were seeking to apply rules developed for banks to financial institutions with very different business models and risk profiles. Some warned that this would force non-bank SIFIs to change their business models, possibly increasing systemic risk. As one put it, "If you regulate everyone like banks, they'll become banks." In contrast, other participants argued that if non-banks were providing products or services that competed with those of banks, they should be facing equivalent regulations.

Scarlet Letter or Veiled Opportunity?

An important issue for many participants was whether SIFI designation was good or bad for business. Participants had somewhat mixed opinions. A number of them emphasized the increased costs associated with SIFI designation, including the regulatory burden of enhanced supervision and resolution planning, reduced return on equity due to the capital surcharge, and the potential for forced reorganization and restructuring in order to improve the resolvability of the institution. Moreover, some participants noted that SIFI designation could hurt a financial institution's public image, given the political environment in many countries of suspicion towards big finance.

Other participants countered that the benefits of SIFI designation were much more substantial. Although regulators were careful to distinguish between "systemic importance" and "too big to fail," many participants felt that SIFI designation was tantamount to saying that an institution would not be allowed to fail. Whether this would be understood by markets as implicit government guarantees or just an official imprimatur on risk management and resolution plans, they argued that it would offer a host of benefits to the designated SIFI. These included lower cost of capital due to lower risk premiums and greater attractiveness to depositors, policyholders, investors, and counterparties. These participants also raised concerns about moral hazard, arguing that SIFI designation and the resulting implicit guarantees (as well as the need to raise returns to make up for higher capital adequacy requirements) would encourage excessive risk-taking, although regulators would seek to control such behavior. Moreover, it could create incentives for financial institutions to grow ever larger, thus exacerbating the "too big to fail" problem.

In general, participants tended to see SIFI designation as an advantage for banks, but not necessarily for other financial institutions. For example, although SIFI designation might help an insurance company to attract policyholders, the extra costs of bank-like capital requirements would be much more significant than the benefits. Asset managers also saw the threat of enhanced supervision and regulatory attention as being much more onerous than did banks.

Participants also debated the question of fairness. For those who saw SIFI designation as providing benefits, the exercise would inevitably disadvantage smaller financial institutions. It would also encourage the pursuit of scale, further helping to entrench large banks and non-banks as dominant players in finance. Other participants argued that SIFIs would be disadvantaged relative to less regulated players. For example, regular U.S. banks were seen by many participants as likely to be disadvantaged in favor of various shadow banking entities. This also raised questions of whether systemic risk was actually being reduced, or just shifted into the less-regulated shadow banking sector.

Moreover, some participants raised the possibility that smaller or otherwise less prominent financial institutions would feel pressured by clients and depositors to match the capital and liquidity regulations being applied to their major bank competitors. Given the economies of scale associated with SIFI supervision, costs of compliance could be substantial. A number of participants argued that medium-to-large banks would be particularly subject to such pressure, which could further encourage mergers and concentration.

Finally, several participants raised the possibility that governments could tax any windfall profits created by designating a financial institution as a SIFI, so as to reduce the implicit subsidy. Some participants argued that this was already happening (at least informally) in the U.S. They saw recent settlements with J.P. Morgan and other major banks as effectively being retribution for their size and success.

Session 3: Will Abenomics and the Fed's Quantitative Easing Policies Deliver Global Economic Growth?

Session 3 addressed the question of whether quantitative easing by the Fed and the Bank of Japan could spur economic growth, either domestically or globally. There was a lack of consensus on whether quantitative easing was delivering growth. Even among those participants who agreed that quantitative easing could deliver growth, there were differences of opinion as to what the mechanism was, whether such growth would be sustainable, and whether its effectiveness was in decline.

Quantitative Easing in the U.S. and Japan

Participants discussed at some length the implementation of quantitative easing in Japan and the U.S. They noted that, despite long-term mild deflation, the Bank of Japan had not been very assertive in expanding the monetary base prior to the election of Prime Minister Abe and the installation of Haruhiko Kuroda as governor. In contrast, the Fed had quadrupled its balance sheet between 2008 and 2013, and the Bank of England had quintupled its balance sheet in the same period. With the advent of Abenomics, however, the BOJ had committed to a course of action (formally dubbed "quantitative and qualitative easing") that would approach the extent of Fed easing by 2015.

The Kuroda plan also committed Japan for the first time to a positive inflation target of 2% and a nominal growth plan of 3% in that period, with a pledge to do "whatever it takes" to achieve those goals. Previously, the BOJ had been reluctant to set firm targets even when it was engaged in quantitative easing between 2001 and 2006; moreover, its definition of price stability at that time had been seen by many economists as deflationary in practice. The new inflation target put Japan in line with other major central banks, which had seen targeting inflation as a key tool of central banking.

Meanwhile, the Fed was still in the midst of its third round of quantitative easing, despite expectations earlier in the year that bond purchases would begin to taper off by September. Most participants appeared to expect that the "taper" would not begin until early in 2014. While short-term interest rates remained at historically low levels, long-term rates had edged up somewhat over the previous year.

Although in theory, quantitative easing could involve the purchase by the central bank of virtually any asset, the quantitative easing policies of the BOJ were focused on purchases of long-term government bonds, with the intention of keeping long-term interest rates low. (This was less true of the Fed, whose quantitative easing measures also included large-scale purchases of mortgage-backed securities.) While some participants argued that unsterilized foreign exchange market intervention might be more effective in spurring inflation, others emphasized that the BOJ had consciously eschewed that option in order to avoid the appearance that it was seeking growth through depreciation of the yen.

In both Japan and the U.S., asset markets had responded to expectations of easy money. Stock market indexes in the U.S. were hitting historic highs, and Japanese stock prices also rebounded significantly since the end of 2012. (However, the Nikkei had peaked in May 2013, before significant easing had taken place, suggesting that the rise was largely the result of announcement effect.) Meanwhile, the yen depreciated sharply over the same period, benefiting Japan's exporters and import-competing industries.

Does Quantitative Easing Work?

As Abenomics' first arrow, a great deal was seen to be riding on the success of quantitative easing. Participants discussed three ways in which it might address the needs of the Japanese economy: ending deflation, jump-starting demand and buying time for supply-side reforms to take effect, and—more controversially—weakening the yen.

Participants discussed at length the question of whether quantitative easing worked, and if so how. It was noted that the BOJ's earlier episode of quantitative easing had not quelled the problem of deflation, let alone ignited nominal growth; while some participants took this as reason to be skeptical of the policy, others argued that it had been too timid. Thus, they had higher expectations for the new version. For the U.S., there appeared to be a general consensus that quantitative easing had supported economic demand following the crisis, but estimates of the extent of its effects varied. Moreover, most participants agreed that successive rounds of quantitative easing had had smaller and smaller impacts on growth. Overall, evidence on the impact of quantitative easing on growth was seen by many participants as equivocal, although others argued that it was the most effective policy for reducing the output gap under deflationary conditions. Indeed, some participants advocated planning for new rounds of quantitative easing for Japan. They argued that the announcement effect of Abenomics was wearing off, and that a bold new initiative would be needed in order for the Japanese economy to hit the BOJ's growth and inflation targets.

With regard to how quantitative easing might affect economic growth, several invoked economic theory to argue that it could increase aggregate demand by shifting consumption and investment decisions either intertemporally (by shifting the relationship between short-term and long-term interest rates) or internationally (through currency depreciation). Others suggested that much of what quantitative easing could actually achieve would be by monetizing debt-driven government spending—as one participant pointed out, since government spending was effectively being financed at the overnight call rate of zero percent, the marginal cost of deficit spending was also zero. Thus, they argued, quantitative easing was essentially operating as fiscal policy.

Participants were more in agreement regarding the potential role of quantitative easing in addressing deflation. Several argued that there were signs of emerging inflationary expectations in Japan, which were being reflected in wages. Others were more skeptical, noting that surveys of Japanese economists showed expected inflation as remaining significantly below the BOJ's targets. Looking at current data, they argued that evidence on wages was still largely anecdotal and that price increases to date had largely been driven by the price of imported energy rather than increasing aggregate demand. Still, there was a general agreement that, even if quantitative easing might not meet its stated price goals, it was likely to end deflation. While not all participants agreed that this would necessarily lead to more consumer spending, it was seen as important in its own right, as it worsened the fiscal situation in two ways. First, deflation means deterioration of the ratio of real debt to GDP even when nominal growth is zero. Second, it increases the real cost of pension outlays, since the Japanese pension system has no provisions for negative indexing.

While data was still lacking on consumer prices, participants generally agreed that quantitative easing had been effective in raising asset prices in the U.S. and Japan. Some saw this as a positive sign, demonstrating positive expectations for future growth and providing wealth effects to support household spending. Others were more wary. One concern was that easy money might be fueling new speculative bubbles in equities, bonds, and possibly U.S. real estate; a number of participants expressed concern about what would happen when they burst. Some participants also worried about the effects of low long-term interest rates, which could damage banks' profitability and keep non-viable companies afloat.

Participants generally agreed that quantitative easing could be effective in weakening the home currency. While macroeconomic authorities had been careful to emphasize that they were targeting domestic money supply rather than exchange rates, participants pointed out that quantitative easing in the U.S. and UK had kept those countries' currencies weak after the crisis while the yen grew strong. But now the shift to Abenomics had weakened the yen dramatically. This raised the question of whether it was possible for the U.S. and Japan to simultaneously pursue successful quantitative easing strategies, if there was no relative depreciation of one currency over another. For a number of participants, the answer was a qualified yes, based on empirical studies of spillover effects of monetary policy. However, many participants anticipated that the Fed would begin to taper soon even as the BOJ continued to pursue quantitative easing, so the proposition would not be tested.

A final question was whether quantitative easing in Japan and the U.S. would have a positive effect on other countries, or would simply divert demand away from them through the mechanism of currency depreciation. Several participants argued that the positive effects of increased demand in the U.S. and Japan would outweigh the negative effects of home currency appreciation for other economies, although few were willing to predict that the net positive effect would be large. The magnitude was likely to depend on whether quantitative easing could overcome the effects of fiscal drag, which had already begun in the U.S. and would begin in Japan with the consumption tax hike. There was no consensus among participants regarding this point.

Inflation Targeting and Communication

While most of the discussion in Session 3 focused on quantitative guidance itself, some participants argued that inflation targeting and forward guidance were actually much more important in influencing business confidence and inflationary expectations. A number of participants pointed to the consistency of the Fed's inflation targeting and communication as having had an important steadying influence on markets and confidence that had contributed to the U.S. recovery.

Several participants suggested that such communications were particularly important in Japan, where investors had grown used to the idea that the BOJ was eager to tighten money at the first signs of inflationary expectations. They were therefore enthusiastic about Kuroda’s pledge to hit specific targets, even though few expected them to be completely fulfilled. Indeed, some argued that a two-year window was not sufficient, and called for a longer-term pledge of assertive monetary policy.

Although generally complimentary of the role of the Fed’s forward guidance in helping to stabilize expectations in the post-crisis period, a number of participants raised the question of whether it would be possible to effectively communicate tapering without impacting markets. These participants noted that this question was made more urgent by the reactions of markets to Fed signals over the summer, particularly in emerging economies, where the expectation of tighter money in the U.S. led to capital flight and asset price drops. Others were more sanguine about the effects going forward, arguing that markets had now priced in the likelihood of Fed tapering, so emerging markets were unlikely to experience severe stresses on financial markets or currencies. An additional concern was that unprecedented turnover at the Fed would mean that the FOMC would likely be the most inexperienced in history, raising concerns about miscalculations in monetary policy or messaging.

Financial Effects of QE

Finally, participants discussed the effects of quantitative easing on financial institutions and financial markets in Japan. They agreed that quantitative easing carried both promise and peril; which would dominate was a major topic of discussion.

Much of the discussion focused on banks. Quantitative easing was seen as posing a number of risks for banks. First, while in place, it would perpetuate ultra-low interest rates, reducing banks’ lending margins and profitability. Perhaps even more seriously, once inflation began to rise and be reflected in long-term interest rates, it would reduce the value of banks’ outstanding loans and government debt holdings (although the actual extent would depend on duration as well as how far rates rose). It would also adversely impact bank capital. On the positive side, if quantitative easing succeeded in spurring growth, it would provide new lending opportunities and higher margins. The question was which effect would dominate. Several participants further noted that small and regional banks were more likely to have large holdings of long-term JGBs than money-center banks, which raised the likelihood that they would be more adversely impacted by a sudden rise in long-term interest rates.

While insurance companies were seen as being better equipped to deal with a drop in the value of their JGB holdings since the duration of those holdings was matched to liabilities, participants did raise two concerns. First, they noted that problems could arise if policyholders sought to withdraw their funds. Second, they worried that if the value of assets fell far enough, insurance companies might not be able to meet their obligation of protection of principal.

Participants raised the question of how the Japanese authorities would handle widespread financial institution failures if inflation outstripped nominal growth. There was no clear answer, although several argued that the losses would have to be socialized in one way or another. Some participants argued, however, that a crisis was unlikely, as the BOJ would be able to prevent a spike in interest rates, even if it were to lead to a deterioration of its balance sheet.

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