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

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FINAL REPORT

2022 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States

The twenty-fifth Japan-U.S. Symposium on Building the Financial System of the 21st Century was held in Washington, DC on December 1-3, 2022. Sessions addressed the future of crypto assets, consequences of the war in Ukraine for international finance, and diverging monetary policy in Japan and the U.S.

Over a quarter century, the Symposium has played an important role in supporting and improving the Japan-U.S. economic relationship. It has nurtured candid and respectful discussions about how to improve the functioning of each country's financial system, resolve bilateral disagreements over access and regulation, and meet mutual challenges posed by financial crises, globalization, technological change, geopolitical tensions, and pandemic. These discussions have contributed to mutual understanding and practical improvements in policy across a range of issues, from prudential regulation to corporate governance to monetary policy to international cooperation to sanctions. Perhaps equally importantly, they have helped to build trust and personal connections among financial regulators and practitioners in Japan and the U.S. that have facilitated policy coordination and crisis management in both tumultuous and prosperous times. When planning for the first Symposium began over twenty-five years ago, the organizers felt an urgent need to address growing gaps between Japanese and U.S. approaches to financial regulation and crisis management. Today, Japan-U.S. financial and economic relations are the closest and most constructive they have ever been. This is due in no small part to the dedication of professionals, officials, and scholars on both sides of the Pacific to work together to find mutual benefit and solve mutual problems. The organizers of the Symposium are proud to have provided one venue for doing so, and look forward to contributing to constructive dialogue and positive bilateral relations for years to come.

Session 1: The Future of Crypto Assets—Regulation, Cross-Border Issues, and Role of Traditional Financial Institutions

In Session 1, participants discussed the current and future status of crypto assets. The recent failure of the FTX crypto exchange raised particular concerns about investor protection and the integrity of crypto platforms. There was considerable discussion over the failure of FTX, contagion risks created by stablecoins, principles for regulation, potential for cross-border regulation, and the model of Japan as a first mover in crypto regulation. Participants expressed concern that the tricky politics of divided government and of crypto issues themselves would impede legislation in the U.S., leaving the SEC and CFTC to devise regulatory strategies based on the limited reach of existing finance and banking laws.

Principles and Priorities in Regulating Crypto

Participants expressed concern with the current regulatory landscape in crypto, particularly in the U.S. In contrast to Japan and the European Union, where efforts had progressed to create clear rules and regulatory authority, crypto regulation in the U.S. was fragmented and incomplete. Recent events such as the failure of FTX and the implosion of Terra and Luna had added to the urgency, as they had demonstrated important gaps in regulation and supervision that left many investors unprotected and could possibly contribute to financial instability. Although opinions varied as to the inherent value of crypto, as well as how to weight competing concerns between innovation, investor protection, and investor choice, there was considerable agreement on principles for crypto regulation.

Many participants were skeptical of claims by crypto advocates that it should be a regulation-free space in which trust was driven by algorithms and a public ledger. They noted that crypto exchanges and currencies had not consistently performed as promised and that evidence for some claims about currency backing or treatment of customer accounts had at times been proven incorrect, even when no fraudulent activity was intended. Moreover, growing interconnections between crypto and the formal financial system raised concerns about the potential for financial contagion.

Participants focused on several goals for crypto regulation. One was investor protection. There was little appetite for prohibiting the holding of crypto assets themselves, on the principle that people should be able to invest in anything they chose as long as they understood what they were buying. Instead, discussion focused mostly on crypto "exchanges," where most trading and price discovery actually occurred and where customers typically held many of their assets in accounts. Participants pointed to a number of instances in which investors had been damaged by the behavior of crypto "exchanges," including lack of proper custodianship, frontrunning, and trade execution. Murky internal controls and corporate governance raised further raised the risks for investors. To improve investor protection, participants called for regulations including segregation of customer accounts, risk management, rules on trading to prevent frontrunning and use of market power by exchange owners, protection of investor data and privacy, and

cybersecurity. In addition, several participants noted the lack of a usable liquidation regime. Unlike in banking, liquidation could take years (creditors from the 2014 Mt. Gox failure were only now being paid) and account holders lacked seniority over other creditors. While some participants noted that under the Dodd-Frank Act, the FDIC could invoke Orderly Liquidation Authority if needed, others countered that was inefficient and unpredictable, and that clear rules would be preferable to after-the-fact determinations by regulators.

A second goal was financial stability. Participants worried that volatility and runs in the crypto space could bleed through into the formal financial system. Therefore, they argued that there needed to be much more visibility into where crypto finance interfaced with the formal system, as well as into the dynamics of crypto trading itself. Two points were seen as particularly important in this regard. One was the importance of understanding and regulating how the formal financial system was providing leverage to crypto investors. Participants feared that large-scale losses in crypto could be transmitted to banks and financial markets if investors were highly levered. Second was the importance of regulating payment rails, in particular stablecoins that were supposed to be backed by the dollar or other currencies. In the absence of regulation and supervision, participants argued that there was no actual guarantee that sufficient backing existed, which could lead to runs and losses of assets. In addition, depending on the types of assets used to back a particular stablecoin, it was possible that large movements in and out of the stablecoin could destabilize those markets, providing an additional pathway for contagion.

Exchanges, which constituted the essential trading infrastructure for crypto assets were another important issue for discussion. From a prudential perspective, participants worried that, unlike formal exchanges and clearinghouses, there was no guarantee that crypto exchanges had sufficient capital or liquidity buffers. While participants felt that, at the moment, crypto exchanges were unlikely to be a cause of systemic risk due to their relatively small size and lack of direct links to the formal financial system, they argued that it would be important to get effective regulations in place before the crypto world grew big enough and connected enough to threaten the financial system.

In contrast, there was little appetite to regulate decentralized trading. As long as investors held their crypto assets in personal wallets and traded directly with other holders, participants did not worry about the potential for contagion and financial stability. The only major concerns expressed by participants were over the use of such crypto assets and trading to evade taxes and anti-money laundering laws.

In addition, most participants advocated much more thoroughgoing and standardized disclosure. Some raised concerns even over “audited” statements, given the lack of standard definitions and practices, as well as the reluctance of many well-established auditing firms to get involved. As noted above, they also agreed that there needed to be much more visibility into trading data, stablecoin backing, and other key information that investors and regulators would need to make informed judgments.

Finally, participants agreed on the urgency of establishing cross-border cooperation. Since many crypto exchanges had chosen to operate in offshore environments, regulators would not be able

to rely entirely on domestic regulation to prevent fraud, runs, abuse of investors, tax fraud, and money laundering.

Failure of FTX

The recent failure of FTX International highlighted many of the concerns that participants held about crypto. While it was not yet clear whether there was actual fraud involved, FTX was a case study in the ways in which global regulation was insufficient to protect investors and prevent contagion.

Participants pointed to several issues at FTX that were particularly problematic. One was the lack of segregation of investor accounts from funds held in the exchange. Commingling of funds was strictly barred in the formal financial sector, but the Bahamas subsidiary where trading accounts were held did not appear to be subject to such rules. Moreover, the reality that FTX was commingling funds was not communicated to investors, who may have balked at using the exchange if they had know about the practice.

In addition, FTX had lent billions of dollars worth of tokens to Alameda Research, which was also controlled by founder Sam Bankman-Fried, without disclosing it or providing real collateral. (Much of the purported "collateral" had turned out to be the FTX-issued token FTT.) This pointed, at the least to serious problems of risk management and internal controls in the exchange. Moreover, some participants argued that Alameda's practice of "yield farming" as a major form of revenue resembled a Ponzi scheme in its reliance on constant inflows of funds.

Poor corporate governance practices and internal controls prevailed in both FTX International and Alameda. Board meetings were not held, major decisions were made on the basis of informal communication and message boards, and the court-appointed CEO John Ray stated that even basic accounting practices had not been followed. And FTX lacked the capital or liquidity to manage large outflows.

Finally, FTX International and Alameda had operated outside of the regulatory ambit of major financial centers. By locating in the Bahamas, they escaped the scrutiny that they might have undergone elsewhere. Ironically, however, the other unit that had gone bankrupt (so far) was FTX US. In that case, because U.S. rules essentially made it impossible to operate crypto exchanges, U.S.-based investors' trades were all routed through FTX International.

Notably, FTX Japan had remained solvent and customers' accounts remained intact. For many participants, this provided evidence that regulation could be effective. They argued that U.S. investors would have been better served by having clear regulations and supervision, rather than being forced into offshore accounts and trading. They made the point that bad actors thrive in unregulated spaces, and expressed hope that good regulation could incentivize better-quality entrants and healthy competition, and therefore better serve investors. While it was agreed that some investors might still prefer to operate in less-regulated offshore markets, either due to lower costs, libertarian beliefs, or criminal activities, most investors would prefer to operate where their interests were protected.

Regulating Crypto

Discussions of crypto focused on two parts of the market. One was stablecoins. There was a high level of agreement among participants that currency-backed stablecoins were a potential source of financial contagion, and thus a top priority for regulation. It was noted that in the U.S., stablecoins were regulated, if at all, by state money transmitter laws that dated back to the days of the telegraph.

Some participants saw stablecoins as essentially unregulated money market funds. For them, the key issue was disclosure regarding the assets backing stablecoins, since insufficient backing could easily lead to price drops and runs. Disclosure would also provide regulators and counterparties with visibility into the potential impact on illiquid short-term asset markets of sudden large-scale outflows and inflows.

An alternative perspective was that stablecoins were essentially unregulated banks, which commingled funds for liquidity and short-term lending operations and provided an essential service as a payment rail. For these participants, a much more robust regulatory regime was needed, including prudential regulation (capital and liquidity rules) and operational rules (information systems, investor data and privacy, internal controls, etc.), among others. While stablecoins would most likely stay outside the banking perimeter in terms of deposit insurance and official backstopping, such rules would still fundamentally change their business models and cost structures.

Some participants argued that stablecoins should not exist at all. If they were properly regulated, there would be little cost advantage to using them. Meanwhile, they saw stablecoins as a potential source of contagion risk. Several suggested that there would be no market for them at all if either central bank digital currencies came to be widely used or banks were allowed to carry out their payment rail functions for crypto. In addition, significant use of stablecoins could pose problems for monetary policy.

With regard to crypto exchanges, participants were highly critical of the ways in which they blurred critical lines, albeit with a few exceptions of exchanges that had entered crypto from the formal financial system. Formal capital markets operated on the basis of separation of functions by institution or by firewall, if within a single institution. These functions included exchange (matching orders), brokerage and market making, settlement, payments, securities lending, and custodianship. FTX and other exchanges combined many or all of these functions under one roof, and with unclear lines of authority.

The establishment of mechanisms for custodianship and clear segregation of funds was an issue that many participants considered to be especially urgent. Commingling of funds was both deceptive to investors, who believed that they possessed crypto assets in their accounts, and a cause of losses in multiple cases, including FTX and Mt. Gox. In this case, participants were critical not only of exchanges themselves, but also of regulators, in particular the U.S. SEC. The

SEC had essentially barred U.S. banks from acting as custodians of crypto assets, leaving the management of accounts to the crypto exchanges. It was argued that this was one of the reasons that U.S. investors in FTX had been particularly damaged. More generally, BIS rules mandated a 1250% capital charge for crypto assets, which made crypto custodianship by banks economically unfeasible. Some participants argued that this was a good thing, as banks should not be participating in crypto at all. In any event, the lack of an effective custodian model in the U.S. was seen as having created vulnerabilities for crypto investors.

The exchange functions of crypto exchanges were also seen as problematic, since they were acting simultaneously as brokers, traders, and exchanges. Participants worried that this would give unfair advantages to the exchanges, which could manipulate trades in order to maximize their returns. High levels of fragmentation across exchanges and the multiplicity of crypto assets meant that liquidity in any given exchange tended to be low. Combined with high concentration of ownership within particular crypto assets (with exchanges often also being the largest owners), this exacerbated opportunities for exchanges and major crypto owners to use their market power to disadvantage retail investors. For those jurisdictions that lacked rules mandating best execution, those problems would only be compounded.

Participants raised the question of what effective regulation might look like. Many turned to Japan, which was a global first mover in crypto regulation, including having passed the first crypto regulatory legislation in the world earlier in 2022. Japanese regulators had been grappling with these issues since the failure of Mt. Gox, which was the first major crypto exchange failure. By the time of the Symposium, Japan had put in place nearly all of its comprehensive crypto regulatory regime. Several participants argued that it had already shown its usefulness, with FTX Japan appearing to smoothly ride out the implosion of FTX International and FTX US. Moreover, they stated that Japanese crypto investors had been protected from the implosion since they chose to use the regulated domestic exchanges; in contrast, many U.S. crypto investors had had no regulated exchange option.

Japanese crypto regulation focused on institutions rather than trying to categorize or regulate specific crypto assets or tokens. It operated on three main pillars. The first was user protection. Regulations required exchanges and other institutions that held crypto assets for investors to register with the JFSA as crypto asset exchange service providers (CESPs). All CESPs were required to comply with rules regarding segregation of users' assets, reporting, and market integrity.

The second pillar was strict compliance with rules regarding money laundering and terrorist financing, following the recommendations of the Financial Action Task Force. Like other regulated financial institutions, CESPs were required to monitor transactions and report any suspicious activities to the authorities, with clear penalties for failure to comply.

The third pillar was regulation of stablecoins, which was set to be implemented later in 2023. Stablecoin issuers were required to be licensed as banks, fund transfer service providers, or trust companies. In this way, the regulations were agnostic about what business model issuers had to follow, but they ensured that all issuers of stablecoins would be subject to strict regulations

regarding capital and operations. In order to prevent contagion to the formal financial system, Japan also sought to reduce the involvement of traditional banks by following the BIS capital standard of requiring a 1250% capital charge on any crypto assets.

While the efficacy of Japanese crypto regulation was still to be seen, participants were heartened by the fact that it had created a comprehensive system that addressed their major concerns about crypto markets. Many approved of the decision to focus on entities rather than tokens, which they believed would require players in the crypto world to act responsibly. One small concern was that other jurisdictions might approach crypto markets in different ways, creating incentives for cross-border regulatory arbitrage. However, other participants argued that it was a strong start that protected Japanese investors and financial integrity.

Politics of Crypto

Finally, participants discussed the politics of crypto and the prospects for crypto regulation in the U.S. Participants agreed that the politics of crypto regulation created significant complications for regulators and policymakers. One reason was that the initial impetus for crypto, which remained a major motivator for many investors, was mistrust of governments, big banks, and global finance. For libertarians and populists alike, there was a considerable allure in a financial system that did not require trust in institutions and that could not easily be tracked or surveilled by authorities. As a result, many crypto investors as well as entrepreneurs strongly resisted the notion that regulation should be imposed at all. Some participants suggested that this opposition was further strengthened by the fact that so many investors and entrepreneurs came from the tech world rather than the world of regulated finance—it was argued that those with more grounding in finance were more open to regulation and had constructive ideas of what should and should not be regulated.

Some participants considered the faith in “trustless” transactions ruled by algorithms to be ironic. After all, few investors and market participants actually understood the software and algorithms underlying their assets and wallets; in other words, they had chosen to trust tech gurus and token issuers rather than the legal system and established institutions. Moreover, they pointed out that the reality was that most crypto was traded, and often stored, on exchanges, which meant that they were trusting unregulated institutions rather than algorithms. This reliance on institutions called for regulation, including prudential standards.

Thus, a fundamental question for crypto regulation was whether governments should protect investors from their own strongly-held beliefs. Most participants felt that investors should be free to lose their money if they put it into risky investments. However, they still saw an important role for investor protection. They emphasized that investor protection should be about process, as in the principles noted above. Some also argued that exchanges and other financial actors in the crypto space had a responsibility for investor education, particularly for retail investors.

Finally, participants discussed the prospects for U.S. crypto legislation. There were some grounds for optimism that legislation would be enacted. They noted that two bipartisan bills were already under discussion and that there had been extensive discussion of stablecoins as well as planned hearings on FTX. The failure of FTX, Terra-Luna, and other crypto exchanges and assets was also seen to raise the urgency of legislation, which could help to break the legislative logjams. Other participants were pessimistic. They pointed out that many crypto exchanges, issuers, and investors would continue to resist regulation. Perhaps more importantly, the incoming Congress was seen by many participants as singularly poorly configured to do any legislation. Between the reality of divided government, a razor-thin Republican majority in the House that had declared its intention to focus on investigations of administration officials, and continuing disagreements about some aspects of crypto, the prospects of legislation seemed iffy to many.

Participants agreed that, despite the spectacular failure of FTX, the most likely area of crypto legislation would be stablecoins. They felt that there was a bipartisan sense that stablecoins were a potential conduit for contagion to traditional finance. Most participants appeared to agree that should be the first priority.

In the absence of legislation, U.S. regulation of crypto assets and exchanges would continue to fall to the discretion of existing financial regulators using existing laws. While both the SEC and CFTC were paying careful attention to the need to regulate aspects of crypto, fragmented authority meant that their approaches were not yet aligned. Moreover, some participants raised questions of whether they had the authority to follow the Japanese model of regulating institutions rather than activities. Even if they did take on more regulatory and enforcement duties, participants questioned whether they would be sustained in the court system. Thus, participants agreed that new legislative backing would be important to provide effective regulation to U.S. crypto markets.

Session 2: The War in Ukraine—Consequences for International Finance

In Session 2, participants discussed the economic and financial consequences of the war in Ukraine. Much of the discussion focused on the financial sanctions imposed by the U.S., Japan, and their partners. Participants sought to assess their effectiveness, as well as the short and long-term consequences for the international system.

Effects of War

Participants agreed that the Russian invasion of Ukraine was a hugely consequential event in political, economic, and human terms. Politically, they saw it as a challenge to the international order in several ways. Many saw it as a threat to the globally-recognized principle of sovereignty, which could increase the likelihood of territorial conquest elsewhere. It also challenged the international community's ability to manage a major crisis. And it accentuated divisions between countries opposing Russia's actions, countries explicitly or tacitly supporting Russia, and a broad swath of countries (mostly in the Global South) that sought to minimize economic disruption and avoid getting involved in growing confrontation.

Economically, participants noted that the war was creating a variety of strains around the world. Price spikes in energy, grain, and other commodities were contributing to inflation. In Europe, reduced access to gas and oil would be difficult to find substitutes for, contributing to slower growth and to economic hardship for many. Patterns of global trade were also being disrupted. In Ukraine, infrastructure, mining and manufacturing facilities, railroads, and farms had all been damaged in many parts of the country, decimating the economy and creating the eventual need for expensive reconstruction. For developing economies, the war exacerbated an already-challenging environment of global inflation, monetary tightening, and post-pandemic supply chain disruptions, raising the likelihood of debt crises. Participants also noted the human toll, including lives lost in conflict and massive refugee flows.

Participants also raised questions about future implications. For Japan and the U.S., one important question was whether the Russian invasion made a Chinese attack on Taiwan more or less likely. Some felt that Russia's action might embolden China to move militarily, whereas others argued that the costs and lack of success of Russia's invasion would serve as a deterrent. They agreed that war across the Taiwan Strait would be both politically and economically devastating for the region. It might lead to direct military confrontation between China and the U.S., in which Japan would almost certainly be involved. It would also destroy the regional supply chains that undergirded economic prosperity in East Asia.

A number of participants noted that multinational companies and financial institutions would have to recalibrate their risk assessments. The Ukraine war had significantly reduced the value of their investments in Russia and Ukraine, increasing awareness of the dangers that military conflict posed for businesses and for supply chains. Given the relatively shallow integration of Russia and Ukraine in the global economy, it was apparent that conflict could be much more

costly if it were to involve countries and regions more directly involved in global manufacturing supply chains and transit, such as China, Taiwan, and the South China Sea. Participants wondered what effects these new considerations would have on companies' risk premiums, willingness to maintain long supply chains, and capital investment strategies.

Sanctions Regime

Participants saw the sanctions imposed by the U.S., Japan, and their partners to be unprecedented in their range and strictness. They included export controls, especially on high-tech and militarily useful items; import bans on many Russian items; the freezing of Russian central bank reserves held in the U.S., Japan, EU, and several other countries; and the removal of the central bank and a variety of commercial banks from the SWIFT network and from dollar-based finance. At the time of the Symposium, the G7 and EU were on the verge of imposing a brand-new type of sanction in the form of an oil price cap, to be enforced by sanctioning any company anywhere in the world that facilitated exports of Russian oil priced above $60 per barrel. Existing sanctions targeted not only the Russian government, but also designated entities such as companies and even individuals considered to be close to President Putin. While many of these sanctions had been used before, including in the form of comprehensive sanctions against Iran and North Korea, participants agreed that the Russia sanctions were unique in terms of both the size of the economy on which they were imposed and the number and unity of countries imposing them.

Despite the ambition of the sanctions regime, participants expressed concern over a variety of leakages that had enabled Russia to earn valuable foreign exchange and to obtain weapons and other needed goods through trade. The biggest concern for many participants was Russia's ability to export oil and natural gas. These commodities were Russia's biggest exports even in normal times, but high energy prices (partly driven by the Ukraine invasion) made them even more lucrative. While the U.S. and Japan had severely restricted energy imports from Russia, much of Europe had made itself dependent on Russian natural gas pipelines, making them susceptible to Russian threats even as their imports helped to finance the war. Moreover, Russia had quickly found willing customers for its oil, including India and China. Participants noted that many countries had chosen to continue to trade with Russia. They worried that the world was being divided into new blocs, with the U.S., Japan, and their partners on one side, countries including Iran, North Korea, and China drawing closer to Russia on the other side, and a variety of countries (mostly in the Global South) seeking to avoid political involvement while continuing trade with all sides to the extent possible.

There was considerable discussion of what the U.S., Japan, and their partners could do to reduce leakages and further isolate Russia in order to weaken its war effort. Participants acknowledged that there could be no global coordination via the UN Security Council in this instance, given the positions of Russia and China as permanent members. Instead, they focused on the G7 as the locus of cooperation. A number of participants argued that the only way to further economically isolate Russia would be by secondary sanctions, or imposing sanctions on companies anywhere in the world that violated the sanctions regime. This was already the case for banks operating on the dollar system, which risked losing access to global finance if they lent to an entity trading

with Russia. The oil price cap was seen as an additional type of secondary sanctions, as it would be enforced by sanctioning companies involved in any way—including not only purchase, but also transportation, insurance, trade finance, or other services—with the import of Russian oil priced above the limit.

Effects of Sanctions

Participants discussed at length the effects of the sanctions regime. One point of discussion was whether the sanctions were actually having the effect of weakening Russia's ability to wage war in Ukraine or its resolve to do so. Another was the about the unintended short-term and long-term consequences to the global economic system. Finally, participants addressed the political effects in the countries that were imposing sanctions.

Effects of Sanctions

Participants identified a number of goals that had been articulated by sanctioning countries. These included degrading Russia's war capability or resolve, punishing it for violating Ukrainian sovereignty, deterrence of future aggression by Russia or others, and as a symbolic gesture of disapproval. A number of participants also stressed the importance of having an alternative to a military response, given the dangers of direct military involvement by NATO or the U.S. in conflict with nuclear-armed Russia. Sanctions, combined with arms provision, economic support and intelligence support, offered the strongest possible response short of direct action.

Opinions were mixed as to the effectiveness of the sanctions to achieve these goals. There was a general sense that sanctions had reduced Russia's ability to obtain key military materials, including dual-use technologies that were produced in the U.S., Japan, and other sanctioning countries. However, some noted that Russia was able to at least partly offset that damage. It had stockpiled weapons for years and was also able to gain access to many needed materials by purchasing them from non-sanctioning countries or via smuggling networks. Russia's status as the world's second largest oil producer also enabled it to keep its war machine going, even if less effectively and at higher cost. Nonetheless, most participants agreed that supply constraints had damaged Russia's military effort, making it more possible for Ukrainian forces to resist.

While participants saw benefits in terms of degrading Russia's war efforts, they saw little effectiveness in reducing its resolve to wage war. Popular resistance had been minimal. Participants attributed this not only to political repression, censorship, and a patriotic rally-around-the-flag effect, but also to the ability of the government reduce the costs of sanctions for many Russians. Several argued that the only way that Russia would abandon the war would be if Putin were to be removed from office, but that there seemed to be no indication of a weakening of his political position. Some participants noted that this was in line with the longer history of sanctions—the larger the goal, the less likely sanctions were to achieve it. Regime change in particular was a goal that had rarely, if ever, been achieved through sanctions. Thus, they argued, it was an unreasonable yardstick for evaluating success or failure.

Sanctions could also be seen as punishment. Some participants questioned whether punishment was an appropriate goal if it did not fundamentally change the dynamics on the ground in Ukraine. They noted that there were significant economic and political costs to imposing sanctions and argued that there needed to be better cost-benefit analysis. Others disagreed. They argued that punishment had several important effects. One was the possibility that it would erode support for the war by hurting the economy. More importantly, punishment was essential to the larger goal of deterrence for other countries considering aggression against their neighbors. While the threat of sanctions had not deterred Russia from its invasion, these participants argued that the size and scale of sanctions demonstrated the credibility of the threat in future cases.

Finally, there was some debate as to whether even stricter sanctions would have a bigger effect on the Russian war effort or in creating economic pain within Russia. The major one still to be tested was the oil price cap. Whether that would actually limit Russia's oil revenues, or would be politically sustainable, would depend on how third countries reacted.

Unintended Consequences

Participants recognized that there were considerable costs to the sanctions regime, including a variety of short-term and long-term unintended consequences. Some even raised the question of whether it would lead to a new era of deglobalization or cold war, or put the dollar-based global financial system at risk.

Participants noted a number of consequences that were already appearing. Countries that had been particularly dependent on trade with Russia —for example, Europe in terms of oil and natural gas—would feel particular pain, at least until they could find alternative suppliers or significantly reduce their demand for those products. For developing countries already dealing with higher energy and food prices, sanctions compounded the challenge of feeding their populations, fueling their economies, and avoiding debt and currency crises. It was noted that some of these countries did not feel the same commitment to countering Russian aggression in Europe that the leading developed countries felt; thus, they felt that they were unfairly being victimized by sanctions.

Many participants also noted the costs imposed on companies and financial institutions. They pointed out that actual enforcement of sanctions largely fell to those companies, which operated under the threat of fines and bans. Compliance with sanctions was costly for companies. It required shifts in the geography and logistics of their operations, unexpected changes in prices and availability of goods and services, and significant new compliance costs. Several participants noted, for example, the significant losses to companies that had rolled up or sold their Russian operations at firesale prices. Some also noted that many companies were being so careful not to violate sanctions or appear to be on the wrong side of the war that they were going beyond what was legally required of them—for example, selling off all Russian assets or refusing to do business with partners whose extended activities they could not verify.

A number of participants warned that shifting patterns of economic activity might well extend into the long term. In particular, they anticipated that some individuals, companies, and countries

would seek to reduce their dependence on the markets and financial systems of the sanctioning countries. For these participants, the Russia sanctions had demonstrated to parties around the world their vulnerability to sanctions driven by the foreign policy preferences of the U.S. government. Several participants argued that China in particular would be looking for ways to reduce its dependence on the markets, technology, and financial systems of the U.S., Japan, and their partners. Others were more skeptical. They questioned whether that would even be possible, given China's deep integration into the global economy—unlike Russia, which was primarily a commodities exporter, China was essential to a host of supply chains. Thus, they argued, it would be too costly for China to really disengage itself, except at the margins. By the same token, it would be too costly for the U.S. and its partners to impose large-scale sanctions on China. However, others cautioned that if China were to invade Taiwan, then all bets would be off.

The freezing of central bank assets and exclusion of Russian banks from the SWIFT network was seen by many participants as being particularly likely to lead to long-term effects. Even before the Ukraine invasion, sanctioned countries and entities had developed work-arounds for transferring money across borders. While these measures were often inefficient or vulnerable, and therefor increased costs and uncertainty, they provided access to necessary financial services. Moreover, they had become more efficient over time. Participants predicted the same would be true for Russia. Some pointed to crypto as one channel for sanctions evasion, possibly creating further incentives for the growth of crypto finance.

The big question was whether the financial sanctions would spur some countries to create alternative payment systems that bypassed U.S. banks and the dollar system. The main candidate was China, the largest strategic competitor of the U.S. and its allies, which was also seen as the most capable of creating an alternative system. Some argued that China's extensive network of bilateral currency swap arrangements and even its rollout of a "digital yuan" would provide the backbone for any such system. Nonetheless, since large payments had to go at some point through international banks subject to sanctions, the development of an alternative payment system faced severe obstacles.

Participants agreed that the consequences of long-term financial decoupling would be enormous. For one, it could help to reinforce a division of the global economic system along the lines of a new cold war. Moreover, some participants worried that it could undermine the global dollar system, which would be an extremely large price for the U.S. to pay for sanctions that had not stopped Russian aggression.

Several participants also argued that the seizing of individuals' assets was a slippery slope. What would be the limits on U.S. willingness to take property? And what would prevent other states from imitating such seizures in the future? They argued that criminalizing individual support for aggression or repressive regimes would not only create bad precedent that any powerful state could follow, but also that there was scant evidence that it actually had the effect of reducing support for targeted regimes.

In short, many participants worried that the Russian invasion and the sanctions regime that followed could be contributing to the creation of a new world order that would be more divided and less stable. While the Russia sanctions alone would not drive such large-scale change, they could accelerate trends that were already appearing in the global economy, including friend-shoring, increased use of industrial policy and protection, and capital and investment controls. While some participants expre+ssed the opinion that deglobalization would be too costly for key governments to allow it to happen, others predicted significant shifts toward deglobalization and reregionalization.

Consequences for Japan, U.S., and Their Partners

Participants also discussed some of the direct effects on Japan, the U.S., and their partners. Some participants argued that there may actually be some positive effects, particularly in the form of energy transitions. The war and sanctions had increased the sense of urgency of reducing dependence on fossil fuels, shifting the political rationale from climate change to energy security, and therefore expanding coalitions in favor of decarbonization. Other participants were more skeptical. They pointed out that inflation and fiscal consolidation would likely reduce the capacity of governments and companies to invest in new energy technologies and generation, which could slow transitions. They argued that governments would need to proactively use a variety of policy measures ranging from environmental regulation to carbon taxes to financial incentives for conservation in order to speed transition, given the long-term nature of energy infrastructure.

A final question was whether the sanctions regime was politically sustainable, and for how long. While solidarity among sanctioning countries had been impressive, even in the face of economic pain, many participants noted popular frustration with inflation, the volatility of food and energy prices, and the direct costs of aid to Ukraine. In the U.S., divided government and skepticism of support for Ukraine within the Republican Party were seen as exacerbating the political challenge. The prospect of a cold winter, energy shortages, and high bills for households in Europe raised the possibility that populist forces (many of them pro-Russian) might increase their political power and shift the terms of the debate.

Japan was also seen to be in a sensitive position. The Japanese government had been highly proactive in supporting strict sanctions on Russia, due to its firmly-held commitment to international law and aversion to military aggression. Participants agreed that the public also supported the government's position. However, Japan's geopolitical position was seen as tricky. Not only had it been trying to improve relations with Russia and expand energy and economic relations prior to the invasion, its proximity to China created important challenges. Any moves toward deglobalization or reregionalization would require Japanese companies to make difficult choices and to incur significant costs. Moreover, if deterrence in the Taiwan Strait were to fail, Japan would be on the front line in terms of economic and political impact, and potentially military impact as well. However, most participants predicted that, despite the costs, Japan would likely support sanctions as long as needed.

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Session 3: Monetary Policy in Japan and the U.S.—Battling Deflation, Inflation, and Stagnation

In Session 3, participants discussed deflation and inflation in Japan, the U.S., and the rest of the world. They considered both supply-side and demand-side causes of recent inflationary pressures, and the impacts of monetary and fiscal policies. With inflation rising around the world, they discussed how monetary policy makers should respond and whether recession was inevitable. They also discussed the sustainability of government debt, in both developed countries and the Global South.

Causes of Inflationary Pressures

Starting in mid-2021, economies around the world began to experience inflationary pressures, which persisted through 2022. Even Japan, which had long been plagued by deflation despite aggressive monetary easing, saw above-target inflation for the first time in many years. In the U.S., and UK, inflation would reach peaks not seen in four decades. For many developed macroeconomic policy makers, who had been debating causes of persistent low inflation or deflation and low growth, the shift to inflationary pressure came as a surprise.

Participants discussed a variety of causes of inflationary pressures. One set of causes focused on supply shocks driven first by the COVID-19 pandemic and subsequently by the Russian invasion of Ukraine. The pandemic was seen to have had several effects. First, disruptions in production facilities and shipping caused goods reduced supply of a variety of goods. When global demand rebounded, prices rose. In the U.S., labor transitions during the height of the pandemic led to declining employment in services such as hospitality and tourism; this led to insufficient labor supply and consequently wage pressures once demand resumed for in-person activities. Despite rising wages, labor was slow to return to the service sector, fueling price rises throughout the economy. From 2021, commodities prices started increasing, driven by reductions in oil production by OPEC+ and unexpectedly high demand in developed economies and China. Commodities price inflation was significantly exacerbated by Russia's invasion of Ukraine, which led to disruptions in oil, natural gas, grain, and other commodities. Energy and food prices had been the earliest and most persistent components of inflation around the world.

Although energy and food contributed to inflation throughout the world, there was significant divergence among countries. For Europe, which was highly dependent on pipeline gas from Russia and therefore had limited LNG processing capability, energy price hikes were particularly painful. In Japan, imported inflation due to both commodity price rises and a depreciating yen accounted for most of the unexpected price hikes.

In the U.S., rapid rises in energy and food prices combined with other idiosyncratic factors threatened to create a wage-price spiral. A number of participants noted that total U.S. employment had not fully recovered to pre-pandemic levels. This was due to a combination of workers leaving the labor force, aging work force, low immigration, and societal factors. Declines in labor participation were particularly apparent among female workers, who had been

disproportionately affected by shifting child care and elder care needs during the pandemic. This also contributed to shortages in the service sector.

Participants offered several alternative explanations for reduced labor force participation. One was that pandemic-era policies such as extended unemployment and lump-sum payments to families had reduced incentives to work, leading to what media had dubbed "the great resignation." This was particularly true among lower-income and less-educated Americans. This situation was contrasted with Japan and much of Europe, where pandemic support programs had focused on maintaining employment rather than subsidizing household consumption. (Although the U.S. did have several employment-supporting programs, including the Paycheck Protection Program, overall policy was tilted in favor of providing funds directly to households.) Although support programs were coming to an end, it was argued that many people still had substantial savings and were choosing not to work. This was seen as creating substantial wage pressures for hourly workers, particularly in the service and transportation sectors. On the positive side, several participants presented evidence that inflation was not hurting workers. Rather, the rapid rise in nominal wages had outstripped inflation and moreover had disproportionately benefited the lowest quartile.

Another explanation was that employment had not been able to shift as rapidly as demand. For example, many service and transportation workers had left those jobs during the pandemic due to lack of demand but lacked skills to shift to more technologically challenging jobs that could be done as work from home. Other participants argued that many older or less healthy workers were likely avoiding workplaces due to COVID concerns. Meanwhile, declines in immigration had reduced the overall labor force by over 3 million, according to one estimate. Taken all together, mismatches in labor supply and demand had given workers considerable leverage, as seen in rapid wage growth that outstripped productivity gains. Workers were seeking to lock in those real wage increases even as energy, food, and housing prices had risen substantially. This suggested the possibility of a sustained wage-price spiral that would require a recession in order to re-anchor price expectations.

Monetary and fiscal policy also came in for criticism. A number of participants argued that the Fed had been too aggressive in its quantitative easing in 2020 and 2021, which had created a surge of excess credit. While the effects were seen initially in asset prices and housing, they argued that it had eventually contributed to wage and consumer price hikes. As inflation numbers started to rise in the U.S. from mid-2021, the Fed waited, some believed much too long, to begin its tightening cycle until early 2022. Fiscal policy also came in for criticism, with some participants arguing that the federal government had overreacted to the pandemic, causing overheating and high household consumption. Others were less critical of the early pandemic-era stimulus packages, but argued that they should have been discontinued by early 2021.

In Japan, despite significant rises in energy and food prices, most participants saw few signs of sustained inflation, let alone wage-price spirals. Decades of deflation and low inflation had anchored inflationary expectations at a low level. Meanwhile wage increases had remained modest even as labor conditions had gradually tightened due to societal aging and a declining labor force. Declining population also meant that many companies did not foresee growth in

domestic demand and so had focused on cost-cutting rather than new investment that could improve labor productivity. Meanwhile, in the service sector much of the new capital investment was focused on replacing labor rather than increasing labor productivity. Beyond these long-term trends, Japan had also had a very different pandemic experience than the U.S. In particular, both employment support policies and the lack of lockdowns had meant that there had been relatively little shifting of employment patterns, preventing the kind of sudden bottlenecks that had caused wage and price spikes in the U.S.

Policy Responses and Effects

Participants expressed mixed reactions to the responses of central banks in the U.S. and Japan to inflationary pressure, based on differing interpretations of its causes and costs of inflationary pressures.

While many participants were critical of what they saw as the Fed's slow response to rising inflation, there was a general agreement that it was essential to take the threat of inflation seriously by tightening monetary policy and raising interest rates. However, there were differences of opinion as to how far and how quickly the Fed should move. One reason was interpretation of the causes of inflation. Some argued that inflation was driven primarily by supply side factors, in particular bottlenecks. If commodities prices, which had begun to flatten, were driving inflation, then inflation would naturally fall as a result of base effects. In this interpretation, prices were already moderating, so it would be unnecessary to further squeeze demand and likely force a recession.

Other participants disagreed that inflation was transitory. They argued that U.S. wages had been rising rapidly over the last two years and that increasingly employers were being forced to commit to even higher wages due to workers' inflationary expectations. Unemployment rates were very low (even if employment had not yet fully recovered) and more workers seemed to be opting out of the workforce, whether due to earlier-than-expected retirement, child or elder care, health concerns, or fiscal support. The net result was excess demand and high pricing power for part of labor, thus calling for more assertive monetary tightening. They warned that inflationary expectations had been rising and that unless the Fed acted resolutely, a wage-price spiral would occur and it could take years and a severe recession to re-anchor expectations near the 2-3% range. Many participants agreed that inflation risks were clearly on the upside, and that the risk of a mild recession in the near term was worth taking in order to avoid wage-price spirals.

As for Japan, there was general agreement that inflation to date had been imported, resulting from rising commodities prices and a weakening yen. Prices in services had remained stable, implying that there was as yet minimal pass-through from food and energy into broader indices. There was some evidence of wages starting to increase modestly, but not yet faster than productivity. While labor unions were calling for a 5% overall wage increase in the coming spring negotiations, few predicted that it would be that high. Moreover, it was argued that thirty years of stagnant prices had led to strongly anchored zero-inflation expectations that made a wage-price spiral extremely unlikely.

Not surprisingly, most participants did not anticipate major changes in monetary policy. The BOJ's target remained firmly at a sustainable rate of 2% and, although inflation was exceeding that goal in 2022, BOJ models anticipated below-target inflation in 2023 and beyond. Still, a number of participants warned that the BOJ should be planning for the possibility of exiting its period of extreme monetary loosening. While no one predicted a rise in short-term interest rates, several recommended or predicted a gradual tightening by relaxing yield curve control and reducing the BOJ's balance sheet through reverse repos. These predictions were borne out by the BOJ's decision to loosen yield curve control less than three weeks after the Symposium.

One additional concern of many participants regarding Japanese monetary policy was the exchange rate. With interest rates rising in the U.S. and many other countries around the world, while Japan maintained its ultra-low interest rate policy, the yen had depreciated significantly, despite several large-scale interventions by the Japanese authorities. While some argued that this had produced some positive effects by reversing deflation and improving competitiveness of exports, a number of participants worried that its negative effects outweighed the positive. One was the hit to Japanese households' consumption capacity. Looking forward, several participants expressed concern that there would be continued downward pressure on the yen that could lead to increasing sales of JGBs and in turn force the BOJ to raise interest rates drastically. This could weaken banks' balance sheets and create financial instability. Some felt that allowing long-term bond yields to increase could moderate yen depreciation without having to move toward broader tightening, but recommended that the BOJ continue to monitor the situation closely.

Debt Sustainability

Several participants added concerns about debt sustainability, in both developed and developing economies.

For emerging markets, the reliance on external debt denominated in foreign currencies (typically dollars) meant that they had little choice but to raise interest rates in response to tightening by the Fed and other developed economy central banks. However, with the exception of a few major oil exporters, that would also mean clamping down on demand at the same time that rising commodity prices were already dampening domestic economic activity. Moreover, in the absence of capital controls, a flight to safety could easily lead to runs on their currencies and inability to finance imports. Participants pointed to a number of emerging markets that were already facing serious problems of debt sustainability, including Sri Lanka and Pakistan. They worried that there would be more such examples and that the international system might not be able to manage them effectively. Several suggested that developed economy support would likely be needed to reduce the threat of international financial stability, including debt restructuring and support for IMF liquidity programs.

Some participants also raised the issue of debt sustainability in developed countries, including Japan and the U.S. Arguing that "That which is unsustainable will not be sustained," they pointed to massive government debt as a potentially insurmountable problem. The argument was that massive government debt could only be sustained by keeping interest rates extremely low

through massive central purchases of government bonds, but that central banks would eventually reach a point where that would be impractical since they would go into steep negative capital. It was argued that Japan might be approaching that point. Eventually, the debt trap could only be escaped through default, restructuring, or inflation.

Other participants were skeptical. They pointed out that central banks do not need capital to operate (although lack of such capital could damage their reputations). They also pointed out that as long as the economy's growth rate exceeded debt service, there was no danger of collapse. Further, the quality of fiscal policy could have important impacts on market confidence. Some noted the poor example of the UK, whose proposed fiscal package in September 2022 had spooked markets and brought down the Truss government. But as long as investors know that a state can raise taxes or cut spending if necessary, there would be no justification for a run. They pointed out that in both the U.S. and Japanese cases, there was ample room for increasing taxes; the real danger, they argued, was bad policy. Meanwhile, Japan also benefited from the fact that the vast majority of its debt was held domestically, while the U.S. benefited from the privileged position of the dollar as the backbone of the global financial system.

Forecasts

Looking ahead, participants offered a mix of forecasts. Many expressed the view that the U.S. would experience a recession in 2023, although most predicted it would be mild. Other countries were also seen as likely to experience recessions due to supply issues and the global tightening cycle. For example, Europe was considered to be particularly susceptible to further energy shocks stemming from the war in Ukraine. There were few expected engines of growth for the world economy, including China, which was expected to have low growth again due to its COVID policies and high levels of domestic debt, although subsequent to this Symposium China relaxed its restrictive COVID policies.

One important question was whether central bank tightening and declining demand in many countries would build on each other to create a global recession, as opposed to various unsynchronized local recessions. The possibility of a vicious cycle was a serious concern for participants, and they urged G20 countries to work together to coordinate economic policies and manage any debt or currency crises effectively.

However, most participants appeared to anticipate that the coming economic slowdown would be manageable and would not lead to serious financial stability or debt crises. They were cautious in their optimism, as the pandemic and Ukraine war were reminders of the constant potential for new and unexpected challenges to arise.

Program on International Financial Systems (PIFS)
134 Mount Auburn Street, Cambridge, MA 02138
www.pifsinternational.org