Introductory Summary

Kunio Okina and Naohiko Baba

The Institute for Monetary and Economic Studies (IMES) of the Bank of Japan (BOJ) held its 13th International Conference, entitled “Financial Markets and the Real Economy in a Low Interest Rate Environment,” on June 1 and 2, 2006.1

The conference aimed to deepen our understanding of the interaction between financial markets and the real economy in a low interest rate environment and learn lessons for the future conduct of monetary policy from the recent experiences of major advanced countries.

The conference began with an opening speech by BOJ Governor Toshihiko Fukui, followed by keynote speeches by the two honorary advisers of IMES, Bennett T. McCallum and Maurice Obstfeld. The five subsequent sessions each consisted of a paper presentation and two designated discussants’ discussions, followed by floor discussions. The conference concluded with a panel discussion session.2

The main themes of the papers presented in each session and the panel discussion are as follows.

Session 1, entitled “Financial Market Functioning and Monetary Policy: Japan’s Experience,” quantitatively evaluated the effects of the zero interest rate policy (ZIRP) and quantitative monetary easing policy (QMEP) conducted by the BOJ on the Japanese government bond (JGB) yield curve and risk premiums of Japanese banks. Particular attention was given to exploring market perceptions about policy duration and bank credit risk.

Session 2, entitled “The Bond Yield ‘Conundrum’ from a Macro-Finance Perspective,” investigated a phenomenon observed in 2004 and 2005 termed a “conundrum,” in which U.S. long-term interest rates remained very low despite improving economic conditions and rising short-term interest rates under the so-called macro-finance framework.

Session 3, entitled “Interpreting Recent Changes in the Credit Spreads of Japanese Banks,” focused on the development in the default risk premium of Japanese banks under the QMEP and tried to interpret it by analyzing the relationship between the default risk premium and various common factors.

Session 4, entitled “The Mistake of 1937: A General Equilibrium Analysis,” theoretically explored the importance of communication policy by policymakers to derive lessons from the United States in 1937 for the BOJ, which was ending the ZIRP.

1. Director-General of the Institute for Monetary and Economic Studies (IMES; currently, Chuo University) and Director and Senior Economist of the IMES and the Financial Markets Department (currently, the Financial Markets Department), respectively. As the organizers of this conference, we would like to express our sincere appreciation to our honorary advisers, Bennett T. McCallum and Maurice Obstfeld, and all the other participants at the conference. Our special thanks go to Sachiko Kuroda, Junko Miyoshi, and other staff members of IMES who devotedly helped to organize the conference.
2. See Appendix 1 for a list of the participants (the affiliation is as of the time when the conference was held).
3. See Appendix 2 for the program.
Session 5, entitled “The Great Moderation and the U.S. External Imbalance,” analyzed the consequences of the significant fall in U.S. business cycle volatility, termed the “great moderation,” since the early 1980s, particularly in connection with the persistent U.S. external imbalances.

The concluding panel discussion session, entitled “Financial Markets and the Real Economy in a Low Interest Rate Environment,” focused on three topics: reflections on monetary policy in a low interest rate environment; communication policy by central banks; and the remaining conundrums. Three panelists, representing the Federal Reserve Bank of New York, the European Central Bank, and the BOJ, expressed their views on these topics. The two honorary advisers of IMES served as designated discussants.

The discussions at the conference covered a very broad spectrum of issues. First, we summarize the main points of the discussions from Sessions 1 to 5 as follows.

In Session 1, many participants showed strong interests in the relationship between the expected duration of the ZIRP estimated from the JGB yield curve using the Black model of interest rates as options and macroeconomic variables. Some suggested that the results should be examined in terms of established policy rules, such as the Taylor rule. Regarding the relationship between the BOJ’s monetary policy and risk premiums of Japanese banks, many discussed the relative roles of the government and the central bank in addressing the financial system problem. Some emphasized the side-effect aspect of the reduced risk premiums as a consequence of the BOJ’s monetary policy.

In Session 2, most of the discussions focused on the possible explanations of the U.S. bond yield conundrum. Participants raised a wide range of explanations including pension funds’ high demand for U.S. long-term bonds after changes in the regulatory and accounting framework, enhancement of the Federal Reserve Board’s transparency in communicating with financial markets, and carry trades. Some raised in addition the possibility of global transmission of the conundrum as an issue for discussion.

In Session 3, some discussed the perception gap about specific events such as capital injection by the government between credit default swaps (CDSs) and equity market participants as a possible interpretation of the paper’s main finding. Others questioned the assumption of the loss (recovery) rate in estimating the default intensity from CDS spreads. There was also a discussion about the increased co-movement between the U.S. equity market volatility and CDS spreads on a global basis as one of the potential sources of financial turmoil in the future.

In Session 4, participants basically shared the view that the effectiveness of communication policy by central banks depended upon the monetary policy regime currently adopted, as well as the degree of credibility. Some questioned the validity of the paper’s assumption that central banks can control inflation expectations through communications. There was also a discussion about the difference in the meaning of the zero lower bound between the United States around 1937 and present-day Japan in light of global capital mobility.

In Session 5, some argued the possible overestimation of the size of external imbalances stemming from the paper’s assumption that the persistence level of
external imbalances was the same for the United States and the rest of the world. Some also discussed the importance of the degree of risk aversion on the calibration results. Others raised the possible extensions of the model to enrich policy implications by incorporating foreign equities in the representative individual's portfolio.

Second, we summarize the main points of the discussions of the concluding panel discussion session as follows.

1. Regarding the effectiveness of monetary policy in a low interest rate environment, many participants agreed that the effects through interest rates significantly declined particularly as a tool for solving non-monetary problems such as financial instability and crises. Some argued that anchored inflation expectations are its main cause, although little has been known about the relationship between the zero lower bound and the liquidity trap. With respect to the QMEP of the BOJ, some noted that the expectation channel is more important than other channels such as the portfolio rebalance channel.

2. Regarding the communication policy by central banks, there was an active discussion about the effectiveness of the conditional statements, compared with the unconditional statements, taking the Fed’s actual communication policy as an example. Some argued that central banks’ clear explanation to financial markets regarding the unconditional forecasts was more important. With respect to the BOJ’s recently adopted two-perspective approach, it was argued that a high degree of uncertainty over the Japanese economy lay behind its adoption.4

3. With respect to the remaining conundrums, some pointed out the increased cross-country correlations of nominal and real interest rates as one example. In response, several factors, including anchored inflation expectations, a lower inflation risk premium, and the effects of global competition from emerging countries, were raised as potential explanations of this phenomenon. Others also raised the consistency between the correlation of interest rates and exchange rate movements as another conundrum.

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4. On March 9, 2006, the BOJ released the “Introduction of a New Framework for the Conduct of Monetary Policy,” in which it states that in deciding the conduct of monetary policy, it would examine economic activity and prices from two perspectives: one to two years in the future and in a longer term.
# APPENDIX 1: LIST OF CONFERENCE PARTICIPANTS

<table>
<thead>
<tr>
<th>Name</th>
<th>Institution</th>
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<tbody>
<tr>
<td>Masayoshi Amamiya</td>
<td>Bank of Japan</td>
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<td>Naohiko Baba</td>
<td>Bank of Japan</td>
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<td>Jan Marc Berk</td>
<td>De Nederlandsche Bank</td>
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<td>Alexis Boher</td>
<td>Banque de France</td>
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<td>Diego Capelli</td>
<td>Ministry of Finance of Argentina</td>
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<td>William Cox</td>
<td>Federal Reserve Bank of Dallas</td>
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<td>Christine M. Cumming</td>
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<td>Carsten Detken</td>
<td>European Central Bank</td>
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<td>Federal Reserve Bank of New York</td>
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<td>Toshihiko Fukui</td>
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<td>Toshikatsu Fukuma</td>
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<td>Hans Genberg</td>
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<td>Eiji Hirano</td>
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<td>Stefan Ingves</td>
<td>Sveriges Riksbank</td>
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<td>Kazumasa Iwata</td>
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<td>Martin Johansson</td>
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<td>Keimei Kaizuka</td>
<td>Chuo University</td>
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<td>Yougesh Khatri</td>
<td>International Monetary Fund</td>
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<td>Ulrich Kohli</td>
<td>Swiss National Bank</td>
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<td>Yutaka Kosai</td>
<td>Japan Center for Economic Research</td>
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<td>Kenneth N. Kuttner</td>
<td>Oberlin College</td>
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<td>Dennis Lapid</td>
<td>Bangko Sentral ng Pilipinas</td>
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<td>Sylvain Leduc</td>
<td>Board of Governors of the Federal Reserve System</td>
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<td>Aviram Levy</td>
<td>Banca d’Italia</td>
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David Longworth  
José Luis Malo de Molina  
Abdul Masyhuri  
Bennett T. McCallum  
Ryuzo Miyao  
Atsushi Mizuno  
Thammarak Moenjak  
Toshihiro Muto  
Hiroshi Nakaso  
Kiyohiko G. Nishimura  
Maurice Obstfeld  
Junggun Oh  
Kunio Okina  
Fabrizio Perri  
Lucrezia Reichlin  
Anthony Richards  
Glenn D. Rudebusch  
Shen Bingxi  
Masaaki Shirakawa  
Kenneth J. Singleton  
Miyako Suda  
Wataru Takahashi  
Ellis Tallman  
Seng-Guan Toh  
Hung Tran  
Kazuho Ueda  
Kenichiro Watanabe  
Olaf Weeken  
Tao Wu  
Isamu Yamamoto
APPENDIX 2: PROGRAM

Thursday, June 1, 2006

Morning  Opening Session

Chairperson:  Kazumasa Iwata, Bank of Japan
Opening Speech:  Toshihiko Fukui, Bank of Japan
Keynote Speeches:  Bennett T. McCallum, Carnegie Mellon University
                    Maurice Obstfeld, University of California at Berkeley

Session 1 on “Financial Market Functioning and Monetary Policy: Japan’s Experience”

Chairperson:  Hiroshi Nakaso, Bank of Japan
Paper Presenter:  Naohiko Baba, Bank of Japan
Discussants:  David Longworth, Bank of Canada
             Anthony Richards, Reserve Bank of Australia

Afternoon  Session 2 on “The Bond Yield ‘Conundrum’ from a Macro-Finance Perspective”

Chairperson:  Kiyohiko G. Nishimura, Bank of Japan
Paper Presenter:  Glenn D. Rudebusch, Federal Reserve Bank of San Francisco
Discussants:  Carsten Detken, European Central Bank
             Kenneth N. Kuttner, Oberlin College

Session 3 on “Interpreting Recent Changes in the Credit Spreads of Japanese Banks”

Chairperson:  Ulrich Kohli, Swiss National Bank
Paper Presenter:  Kenneth J. Singleton, Stanford University
Discussants:  Hung Tran, International Monetary Fund
             Kazuo Ueda, University of Tokyo

Friday, June 2, 2006

Morning  Session 4 on “The Mistake of 1937: A General Equilibrium Analysis”

Chairperson:  Eiji Hirano, Bank of Japan
Paper Presenter:  Gauti B. Eggertsson, Federal Reserve Bank of New York
Discussants:  Andrew Filardo, Bank for International Settlements
             Kunio Okina, Bank of Japan
Session 5 on “The Great Moderation and the U.S. External Imbalance”

Chairperson: José Luis Malo de Molina, Banco de España
Paper Presenter: Fabrizio Perri, New York University
Discussants: Hans Genberg, Hong Kong Monetary Authority
Aviram Levy, Banca d’Italia

Afternoon Concluding Panel on “Financial Markets and the Real Economy in a Low Interest Rate Environment”

Chairperson: Stefan Ingves, Sveriges Riksbank
Panelists: Christine M. Cumming, Federal Reserve Bank of New York
Lucrezia Reichlin, European Central Bank
Masaaki Shirakawa, Bank of Japan

Discussants: Bennett T. McCallum, Carnegie Mellon University
Maurice Obstfeld, University of California at Berkeley