Introductory Summary

Kunio Okina and Naohiko Baba[1]

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.[2]

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.[3]

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.

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

Masayoshi Amamiya	Bank of Japan
Naohiko Baba	Bank of Japan
Jan Marc Berk	De Nederlandsche Bank
Alexis Boher	Banque de France
Diego Capelli	Ministry of Finance of Argentina
William Cox	Federal Reserve Bank of Dallas
Christine M. Cumming	Federal Reserve Bank of New York
Carsten Detken	European Central Bank
Gauti B. Eggertsson	Federal Reserve Bank of New York
Andrew Filardo	Bank for International Settlements
Hiroshi Fujiki	Bank of Japan
Toshihiko Fukui	Bank of Japan
Toshikatsu Fukuma	Bank of Japan
Hans Genberg	Hong Kong Monetary Authority
Hideo Hayakawa	Bank of Japan
Eiji Hirano	Bank of Japan
Akinari Horii	Bank of Japan
Stefan Ingves	Sveriges Riksbank
Kazumasa Iwata	Bank of Japan
Martin Johansson	Sveriges Riksbank
Keimei Kaizuka	Chuo University
Yougesh Khatri	International Monetary Fund
Ulrich Kohli	Swiss National Bank
Yutaka Kosai	Japan Center for Economic Research
Kenneth N. Kuttner	Oberlin College
Dennis Lapid	Bangko Sentral ng Pilipinas
Sylvain Leduc	Board of Governors of the Federal Reserve System
Aviram Levy	Banca d'Italia

David Longworth	Bank of Canada
José Luis Malo de Molina	Banco de España
Abdul Masyhuri	Bank Indonesia
Bennett T. McCallum	Carnegie Mellon University
Ryuzo Miyao	Kobe University
Atsushi Mizuno	Bank of Japan
Thammarak Moenjak	Bank of Thailand
Toshihiro Muto	Bank of Japan
Hiroshi Nakaso	Bank of Japan
Kiyohiko G. Nishimura	Bank of Japan
Maurice Obstfeld	University of California at Berkeley
Junggun Oh	The Bank of Korea
Kunio Okina	Bank of Japan
Fabrizio Perri	New York University
Lucrezia Reichlin	European Central Bank
Anthony Richards	Reserve Bank of Australia
Glenn D. Rudebusch	Federal Reserve Bank of San Francisco
Shen Bingxi	The People's Bank of China
Masaaki Shirakawa	Bank of Japan
Kenneth J. Singleton	Stanford University
Miyako Suda	Bank of Japan
Wataru Takahashi	Bank of Japan
Ellis Tallman	Federal Reserve Bank of Atlanta
Seng-Guan Toh	Bank Negara Malaysia
Hung Tran	International Monetary Fund
Kazuo Ueda	University of Tokyo
Kenichiro Watanabe	Bank of Japan
Olaf Weeken	Bank of England
Tao Wu	Federal Reserve Bank of Dallas
Isamu Yamamoto	Bank of Japan

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