Sayuri Shirai: The euro area crisis, the flight-to-safety premium, and cooperation and coordination among central banks

Remarks by Ms Sayuri Shirai, Member of the Policy Board of the Bank of Japan, at the workshop co-hosted by the Asian Development Bank Institute and the Reinventing Bretton Woods Committee, "Adjusting the World to the New Realities of the International Financial System", Tokyo, 12 October 2012.

* * *

I. Introduction

Good morning. My name is Sayuri Shirai, and I am a Policy Board member of the Bank of Japan. It is indeed a great honor for me to be here, giving a talk at the workshop co-hosted by the Asian Development Bank Institute (ADBI) and the Reinventing Bretton Woods Committee (RBWC) under the title of "Adjusting the World to the New Realities of the International Financial System".

Currently, one of the major sources of global uncertainty arises from stresses in the euro area. Therefore, I would like to focus today first on the current situation of the euro area crisis. I would then like to move on to the issue of how the euro area crisis has been affecting Japan and other developed countries through financial channels. Finally, I would like to address the challenging issue of cooperation and coordination among central banks.

II. Current situation of the Euro area crisis

In the euro area, there remains a high degree of uncertainty over political and economic developments. Along with the (short-term) adverse impact of fiscal consolidation measures, the crisis initially led to deteriorating economic conditions in the peripheral countries. Initially, the crisis was largely contained in those peripheral countries. However, the crisis is now affecting the core countries through trade and financial channels and a rapid deterioration in corporate and consumer sentiment. Consequently, the euro area has reentered a recession, and this has contributed to a slowdown in global economic growth. The sluggish economy in the euro area is likely to last at least until the end of the year, according to European Central Bank (ECB) estimates released last month (whereby the central rate of real GDP growth rate for 2012 was adjusted downward from minus 0.1 percent in June to minus 0.4 percent in September).

To deal with the financial sector's funding difficulty in the peripheral countries, the ECB has been actively engaging in a number of accommodative monetary policy measures over the past year – including longer-term refinancing operations with a maturity of 36 months (conducted in December 2011 and February 2012), resumption of the Securities Markets Programme (SMP), reducing the reserve ratio, a cut in key interest rates, and modification of collateral requirements. In July this year, moreover, the ECB cut key interest rates by another 25 basis points: the interest rate on the main refinancing operations was reduced from 1 percent to the historically lowest figure of 0.75 percent, that on the marginal lending facility from 1.75 percent to 1.5 percent, and that on the deposit facility from 0.25 percent to 0 percent.

These actions helped lower the short-term interest rates in the euro-denominated money markets and moderated tensions in the area's financial markets. The yields on long-term sovereign bonds have also declined in the whole euro area, including the peripheral countries. A decline in bank lending rates has also followed in line with the decrease in yields. Nonetheless, the scale of the decline in those rates for the peripheral countries has not been sufficiently large to narrow the gap with those rates in the core countries (Chart 1). This is mainly because the vicious cycles between sovereign and financial stresses – and

their repercussions on the real economy – have not been curtailed in the peripheral countries.

The high bank lending rates in the peripheral countries are closely associated with the high-risk premiums charged on the yields on their sovereign bonds by investors. Given that these premiums are far above those justified by the economic fundamentals, according to an estimate by the Organisation for Economic Co-operation and Development (OECD) (Chart 2), they could be called a "fear premium". The International Monetary Fund (IMF, 2012) also reports that these premiums are predominantly driven by a common factor rather than country-specific macro/liquidity risks. As long as there is the fear of possible reversibility of the euro – even in a situation where the expected probability of that tail-risk scenario is extremely low – the ECB will find it very difficult to lower the yields on sovereign bonds of these peripheral countries on a sustainable basis.

The fear premium has also promoted fragmentation of the financial markets within the euro area by discouraging cross-border financing activities in the private-sector between the core and peripheral countries. This has resulted in greater dependence of the financial sector in the peripheral countries on the ECB's refinancing operations, or Emergency Liquidity Assistance (ELA) provided by their national central banks. These operations have led to expansion of the consolidated balance sheet of the Eurosystem.

However, it is increasingly recognized that the very accommodative monetary policy has not promoted active lending activities that would stimulate domestic demand (such as investment and consumption) as much as had been expected (Chart 3). In the euro area, sluggish lending activities (for example, the August data on credit growth indicated minus 1.1 percent for firms and minus 0.4 percent for households) reflect a sharp decline in credit demand – caused by weak economic outlook, balance-sheet adjustments, and highly risk-averse behavior as well as banks' higher lending rates and tightened lending conditions. These sluggish lending activities also reflect a cautious attitude on the part of lenders – driven by growing uncertainty, elevated funding costs, and tighter financial regulations.

The weak link between an accommodative monetary policy and private-sector credit growth is a feature observed not only in the euro area but also in other developed countries, including Japan and the United States. There are structural factors behind this issue, but their root causes are country or region specific, and they thus differ from one another. In the case of Europe, the short-term depressing impact of fiscal austerity measures and deleveraging of the banking sector – exacerbated by the fear premium – make it difficult to promote bank lending at present.

All these data point to the fact that the transmission mechanism of monetary policy to the real economy may have been hampered by the severe distortions prevailing in the sovereign bond markets which are largely caused by the fear premium. This is why the ECB announced outright monetary transactions (OMTs) last month (and terminated the SMP) together with a strict, comprehensive conditionality attached to the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) program (whether it is based on a full or a precautionary program) in the event of their activation. This conditionality is a necessary condition, since the ECB Governing Council will decide on the start, continuation, and suspension of OMTs in accordance with its mandate, once a country under examination adopts the program.

I believe that such an imposition of conditionality on the activation of an asset purchase program is an action rarely seen in the recent history of central banking. The ECB made it clear that the proper transmission mechanism of monetary policy could be restored if progress was also made in the following areas: fiscal consolidation programs, structural reforms (i.e., labor-market reform, deregulation, privatization, and efficiency of public administration), and region-wide institution building (or regionally coordinated actions to strengthen the firewall limiting the contagion of a crisis from one country to another in addition to the possibility of EFSF/ESM primary market purchases). In other words, it was

made clear that monetary policy could contribute to narrowing the output gaps and preventing disinflation. This should be regarded as a temporary measure in providing breathing space, while governments and regional institutions (such as the European Union [EU] or the Eurogroup) deal with the structural issues that are necessary to lower the fear premium and raise the potential (trend) economic growth. Here, the IMF could play an important role as a third party in the process.

Meanwhile, Japan also suffers from a weak link between a very accommodative monetary policy and private-sector credit growth (Chart 4). However, the root causes of this weak linkage in Japan differ from those in the euro area. Japan's financial conditions have been very accommodative. The financial sector – which has hardly been affected by the euro area crisis thanks to relatively sound balance sheets, low leverage ratios, and ample deposits – has largely maintained an accommodative lending attitude. Therefore, sluggish credit growth is largely a consequence of limited demand for credit (such as loans to finance business investment and mortgages), as evidenced by the declining trend in new business fixed investment as a percentage of GDP (and cash flow) and the moderate increasing trend in housing investment. This phenomenon is closely associated with the declining potential (trend) economic growth, long-standing mild deflation, and persistent output gaps. These features characterize the Japanese economy and partially reflect cyclical factors. But more importantly, these features are attributable to structural factors – such as demographic changes (the rapid pace of aging, the declining working-age population from the mid-1990s, and the constantly declining population projected from 2011 onward), structural rigidity (which hinders smooth inter-industry and intra-industry structural adjustments), growing global competition, and completion of the catching-up process (Shirai 2012). Against this background, it is becoming increasingly important to differentiate between cyclical and structural factors, when considering the effectiveness of monetary policy. While an accommodative monetary environment is being maintained, efforts by the government and private sector are also important in order to raise potential economic growth and leap from a mild-deflationary phase onto a sustainable path.

III. Impact of the Euro area crisis on Japan and other developed countries through financial channels

The euro area crisis has been adversely affecting the global economy mainly through trade and financial channels. Japan has also been affected through sluggish exports over the past few months owing to both a direct and indirect decline in exports to Europe through the supply-chain network centered on mainland China. The lower-than-expected export activities were one of the factors considered when the Bank of Japan (BOJ) made a downward adjustment of the economic outlook at the Monetary Policy Meeting last month. At the same time, the BOJ decided to enhance monetary easing to ensure the return of Japan's economy onto a sustainable growth path with price stability.

In addition, the euro area crisis has promoted capital inflows to "safe haven" countries, such as Japan, the United States, and core European countries, and it has amplified the "flight-to-safety premium" or "scarcity premium" charged on yields on their long-term sovereign bonds.

There are various measures for estimating these premiums. One simple approach is to estimate the difference between the observed long-term interest rate (e.g., the yield on 10-year sovereign bonds) and expected nominal GDP growth (or the sum of expected real economic growth and expected long-term inflation). Based on recent data, the differences indicate a negative figure for Japan, the United States, Germany, and the United Kingdom in the range of between minus 1 percent and minus 3 percent, which appears to confirm the presence of the flight-to-safety premium.

A more sophisticated approach is to conduct a regression analysis using the long-term interest rates as the dependent variable and various structural and relevant indicators (such as fiscal conditions, foreign borrowing, labor productivity, demographics, and inflation) as the

independent variable. Then, the residual could be interpreted as reflecting the flight-to-safety premium, the impact of monetary policies, and so on. To separate the possible impact of monetary policy from this analysis, Ichiue and Shimizu (2012) employed the 5-to-10-year forward rate as the dependent variable (rather than the 10-year bond yield). In this case, the residual could be interpreted as reflecting the flight-to-safety premium (assuming that unexplained factors are limited). If the residual shows a negative sign, it can be interpreted as indicating the presence of such a premium.

The estimates of the residual or the difference between the observed 5-to-10-year forward rate and the estimated forward rate derived from the model indicate a negative figure for Japan, the United States, Germany, and the United Kingdom (Chart 5). This means that the observed long-term interest rates were lower than the estimated rates in those four countries, which suggests the presence of the flight-to-safety premium. This is in contrast to a rising fear premium applied to the yields on sovereign bonds of the peripheral countries.

My view is that the increase in the flight-to-safety premium is attributable to the supply shortage of "safe assets" because the repeated credit rate downgrading on sovereign bonds has reduced the number of high-quality sovereign bonds in Europe. Moreover, the global financial crisis triggered by the bankruptcy of Lehman Brothers had already reduced the number of triple-A-rated private-sector bonds (such as mortgage-backed securities [MBSs] and other asset-backed securities [ABSs]), thus contributing to the relative shortage of safe assets globally. Meanwhile, demand for safer liquid assets has been growing in the world owing to continued uncertainty related to the euro-area stresses, an increase in foreign reserves held by emerging economies and oil-producing countries, and tighter financial regulations.

Consequently, capital inflows into securities investment from abroad have contributed to the appreciation of the exchange rates of some of these countries, as typically seen in the case of Japan (Chart 6). This has adversely affected the export manufacturing sector, which had been recovering from the supply-chain disruption and resultant plunge in exports caused by the Great East Japan Earthquake on March 11, 2011.

Moreover, the flight-to-safety premium, while lowering the cost of financing for borrowers, may amplify the sudden reversal risk in Japan and other related countries. The IMF (2012) stressed the possibility of such a risk in the medium term. Given the high degree of correlation between Japanese government bonds and other sovereign yields during normal periods, such a risk could materialize through a spillover effect from one country to another. That report also suggested that a sudden rise in the yield, when most developed countries' policy rates are at the zero bound, might result in the output of Japan and other countries falling below their baseline growth paths.

IV. Cooperation and coordination among central banks

Finally, I would like to talk about issues related to cooperation and coordination among central banks. It is true that a number of central banks in developed countries, including Japan, have been conducting a very accommodative monetary policy (such as a virtually zero-interest rate policy and an asset purchase program) to cope with weak economic growth and prevent disinflation (or to achieve recovery from mild deflation in the case of Japan). These policies are necessary and consistent with the mandate of our central bank laws under the current situation. But it is also true that such policies could exert positive and/or negative spillover effects on other countries.

It is often pointed out that the exceptionally low interest rates and injection of ample liquidity using nonstandard measures in developed countries have contributed to the generation of volatile capital flows and exchange rates and amplified the boom-bust cycle in emerging economies. For example, Mr Caruana, the General Manager of the Bank for International Settlements (BIS), noted that credit to U.S. households and businesses has barely resumed its growth since the crisis, whereas dollar loans to such borrowers in the rest of the world

have increased by up to 20 percent (2012). He also pointed out that the Federal Reserve's recent large-scale bond purchase has reduced global bond yields under the increasingly integrated international bond markets.

At the same time, central banks in emerging economies may be conducting asymmetric monetary policy to mitigate the volatile exchange-rate movements. For example, some countries have maintained relatively low interest rates for a long time in the face of massive capital inflows, though a rise in the interest rate could be executed relatively quickly in the case of capital outflows. This kind of action could be related to the failure of policy coordination since each country attempts to avoid exchange-rate appreciation relative to competing countries in order to maintain competitiveness, and thus each waits until some other country takes the initiative. This results in the prolonged accommodative monetary policy stance, thereby contributing to a rapid increase in commodity prices, credit growth, and overheating of economies.

Considering the possibility of a fallacy of composition, Mr Caruana stresses the importance of assessing the impact of central bank policies on global outcomes. In this sense, the IMF's attempt to focus on the external effects of policies in major economies in the Spillover Reports launched in 2011 is a welcome step to promote understanding of this issue. Active discussions at the G20 meetings can also contribute to global awareness.

Though fulfilling its mandate is an important obligation for a central bank, each central bank increasingly pays attention to the possible trade-off between price stability and financial stability. This arises from the lesson of the global financial crisis, whereby relatively low policy rates in a low inflationary period can contribute to accumulating financial imbalances. Since financial activities take place on an increasingly global basis and financial markets are rapidly integrating, it is also becoming increasingly important for central banks to pay attention to global investors' risk appetite and capital-flow movements when the transmission mechanism of monetary policy is considered. Thus, I myself feel that promoting further information sharing among central banks is becoming important.

With the growing interdependence of financial markets, the importance of policy coordination among central banks has increased. As an example, I would like to point out one effective coordinated policy action recently undertaken by six central banks (the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, the Federal Reserve, and the Swiss National Bank) – namely, the U.S. dollar liquidity-providing operations. These were aimed at addressing pressures in the global money markets (Chart 7). The action was taken in November 2011 as a response to growing strains in U.S. dollar financial markets. Those central banks agreed to lower the pricing on the existing temporary U.S. dollar liquidity swap arrangements by 50 basis points so that the new rate would be the U.S. dollar overnight index swap rate plus 50 basis points. As a contingency measure, moreover, these central banks agreed to establish temporary bilateral liquidity swap arrangements so that liquidity could be provided in each jurisdiction in any of their currencies if necessitated by market conditions.

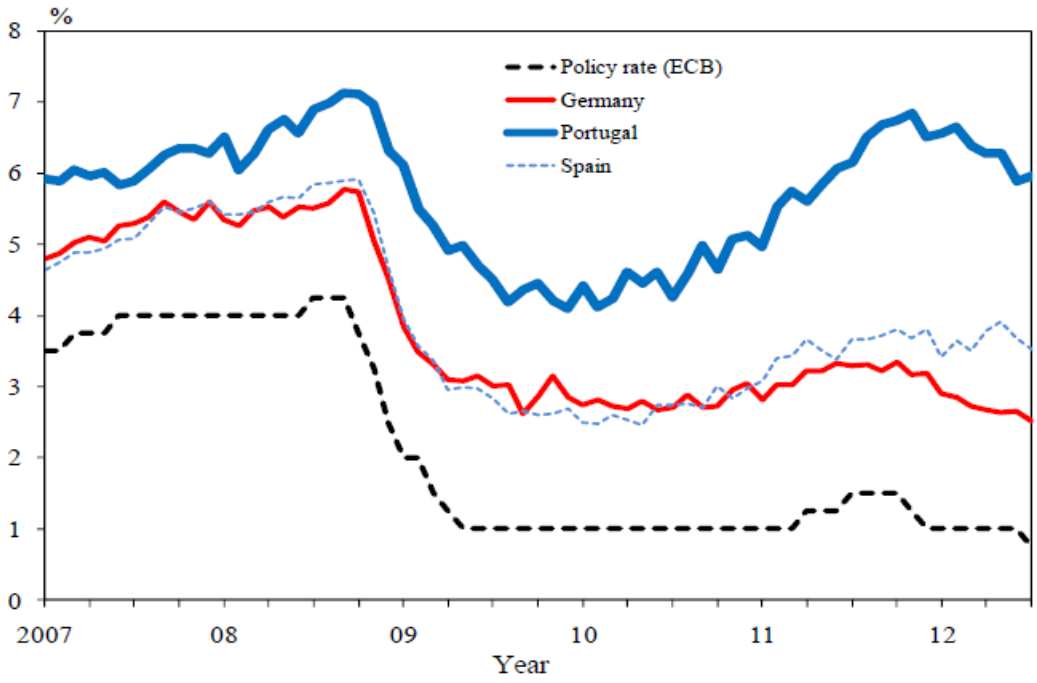
As a result, this action – particularly the cut in the interest rate on the U.S. dollar liquidity-providing operations – succeeded in substantially lowering the cost of swapping euros for U.S. dollars (Chart 8). Furthermore, the decline in the U.S. dollar funding cost encouraged many European banks that were having difficulty in raising funds from the market to borrow directly from the ECB, thereby preventing a forced fire sale of assets and a cut in loans denominated in U.S. dollars.

In closing, the recent global and euro-area crises have reminded us of the deepened financial integration and resultant greater spillover effects of shocks from one country to another. I feel that efforts to deepen an understanding of these issues could be an important first step toward achieving economic and price stability globally.

Thank you very much for your attention.

Chart 1

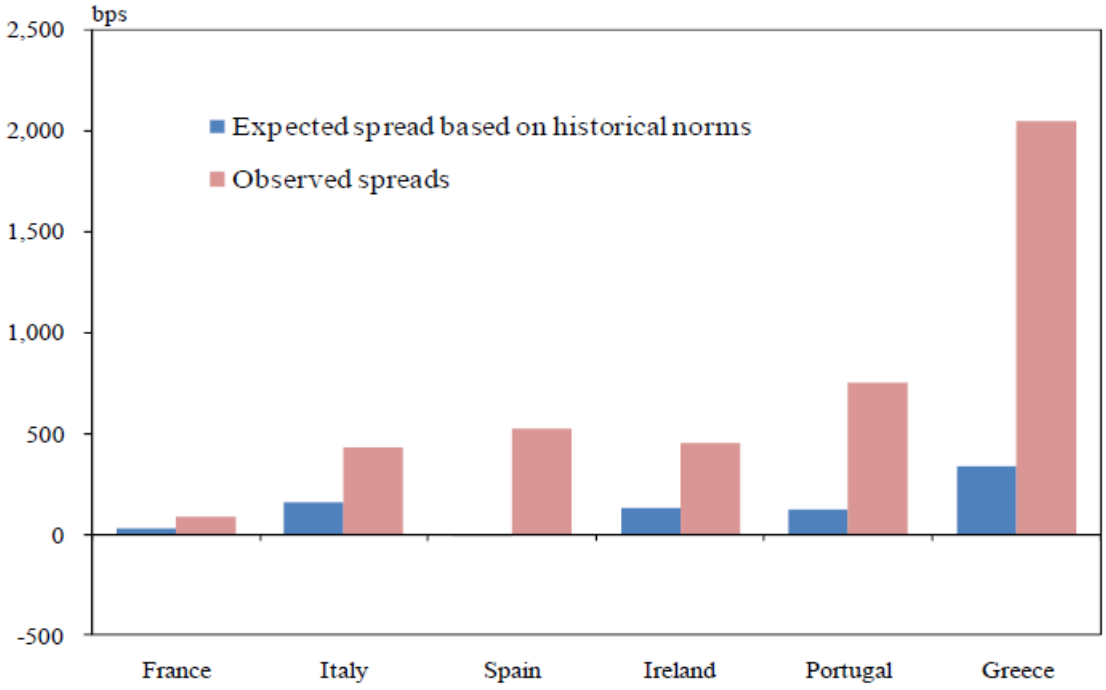
Policy rate and lending rates in the Euro area



Source: European Central Bank.

Chart 2

Gaps between observed and expected spreads over German bonds



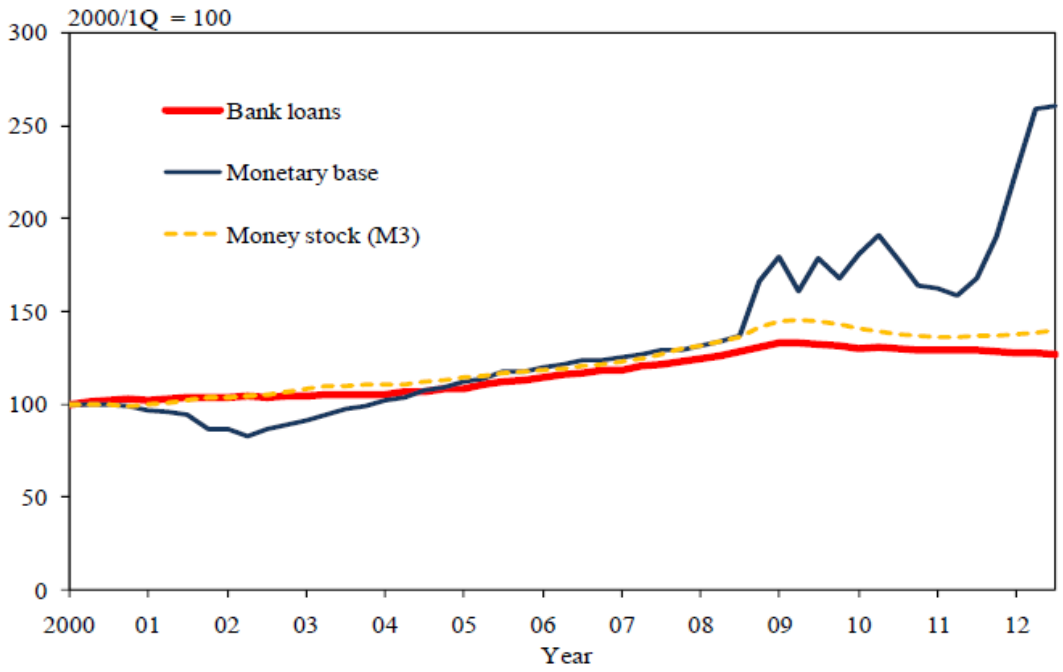
Notes: 1. Actual spreads refer to 10-year bond yields as of September 4, 2012.

2. Expected spreads are based on the past relationships between yields and debt rates.

Source: Organisation for Economic Co-operation and Development.

Chart 3

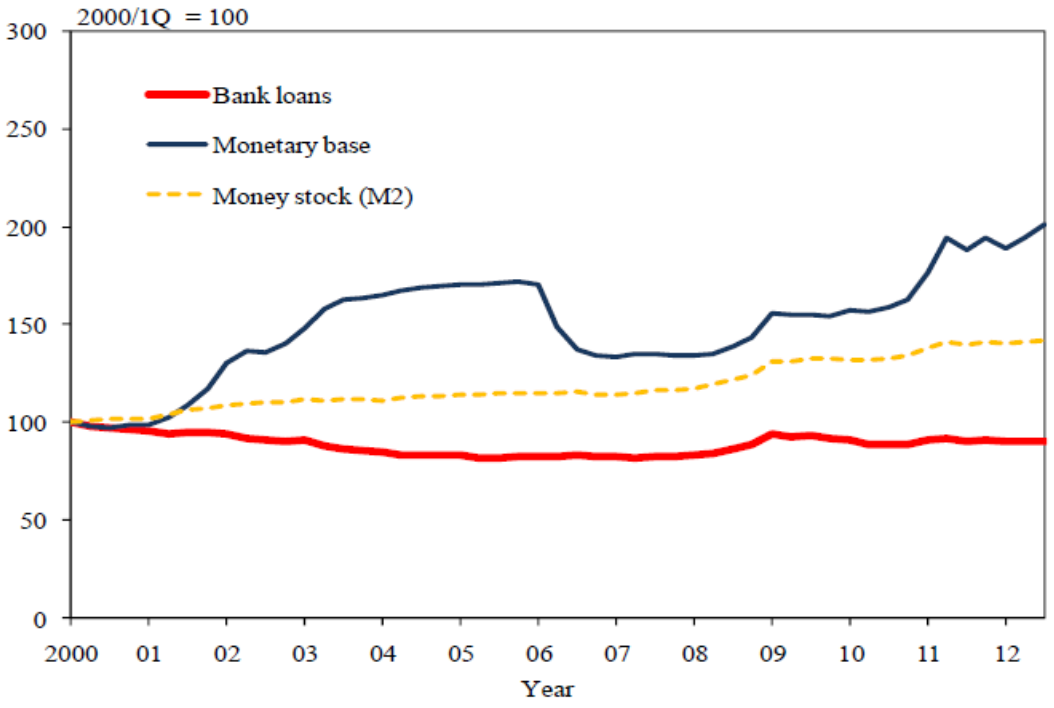
Money stock, monetary base, and loans in the Euro area



Sources: Bank of Japan; Cabinet Office; European Central Bank; Eurostat.

Chart 4

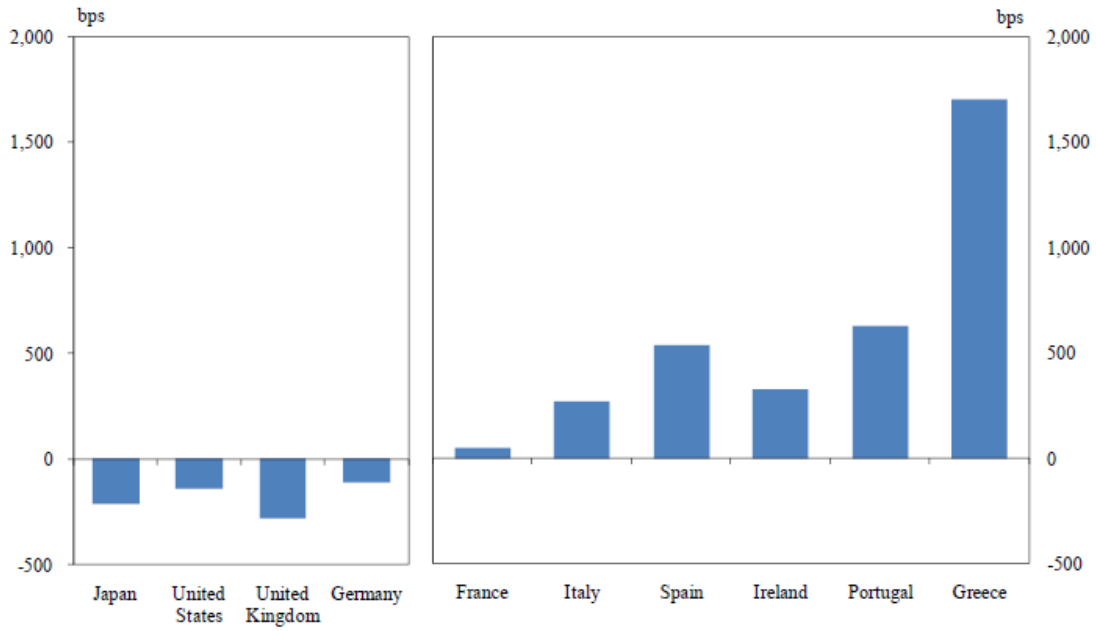
Money stock, monetary base, and loans in Japan



Sources: Bank of Japan; Cabinet Office.

Chart 5

Estimated premiums charged on sovereign bond yields



Note: Estimated premiums in Japan, the United States, and the United Kingdom are differences between observed and estimated 5-to-10-year forward rates as of May 2012, and those in France, Italy, Spain, Ireland, Portugal, and Greece are differences between observed and expected 10-year bond yields, shown in Chart 2.

Sources: Organisation for Economic Co-operation and Development; Bank of Japan.

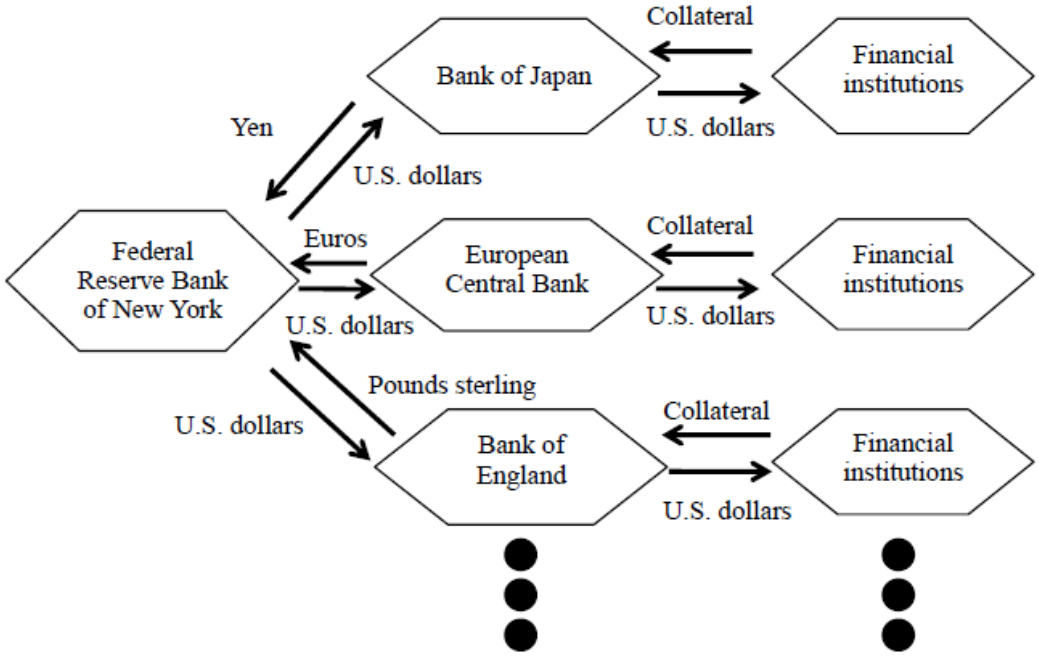
Chart 6

Nominal effective exchange rates

Sources: Bank of Japan; European Central Bank; Bloomberg.

Chart 7

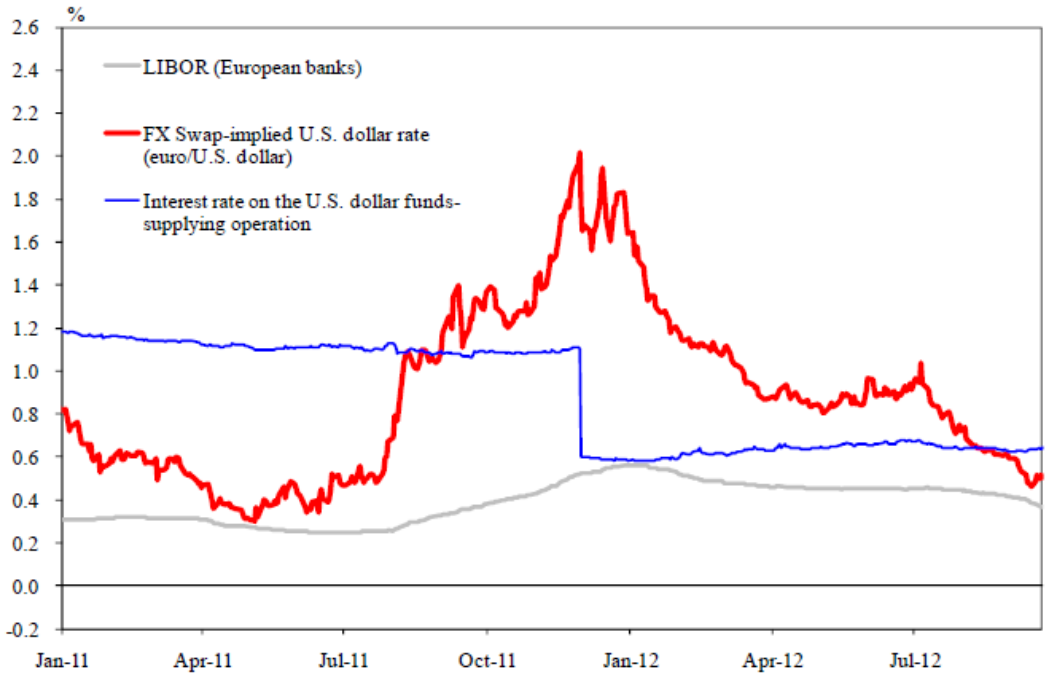
Basic scheme of U.S. dollar funds-supplying operations



Note: Participated in by the central banks of Canada, the United Kingdom, Japan, the euro area, the United States, and Switzerland.

Chart 8

European banks' U.S. dollar funding costs (3-month)



Source: Bloomberg.

References

Caruana, Jaime, "Policymaking in an Interconnected World", Luncheon Speech at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium on "The Changing Policy Landscape", Bank for International Settlements, 2012.

Ichiue, Hibiki, and Yuhei Shimizu, "Determinants of Long-Term Yields: A Panel Data Analysis of Major Countries and Decomposition of Yields of Japan and the US", Bank of Japan Working Paper Series, No. 12-E-7, 2012.

Ichiue, Hibiki, and Takeshi Kimura, Toshifumi Nakamura, and Hikari Hasebe, "*Anzen Shisan no Jyukyu to Kokusai no Kishousei Puremiamu*", Bank of Japan Review Series, 2012-J-1, 2012 (available only in Japanese).

International Monetary Fund, "2012 Spillover Report", 2012.

Organisation for Economic Co-operation and Development, "What is the Near-Term Global Economic Outlook? An Interim Assessment", 2012.

Shirai, Sayuri, "Have Demographic Changes Affected Japan's Macroeconomic Performance? – Some Implications for Monetary Policy –", Speeches at the Bank of Finland, the Riksbank, and Stockholm University, Bank of Japan, 2012.

Shirakawa, Masaaki, "International Policy Response to Financial Crises", Remarks at the Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, Bank of Japan, 2009.