Comments on Hélène Rey
“Risks in the Financial System”

Takatoshi Ito
Professor, School of International and Public Affairs, Columbia University
And Adjunct Professor, GRIPS, Tokyo; Part time Project professor, Tokyo Tech World Research Hub Initiative

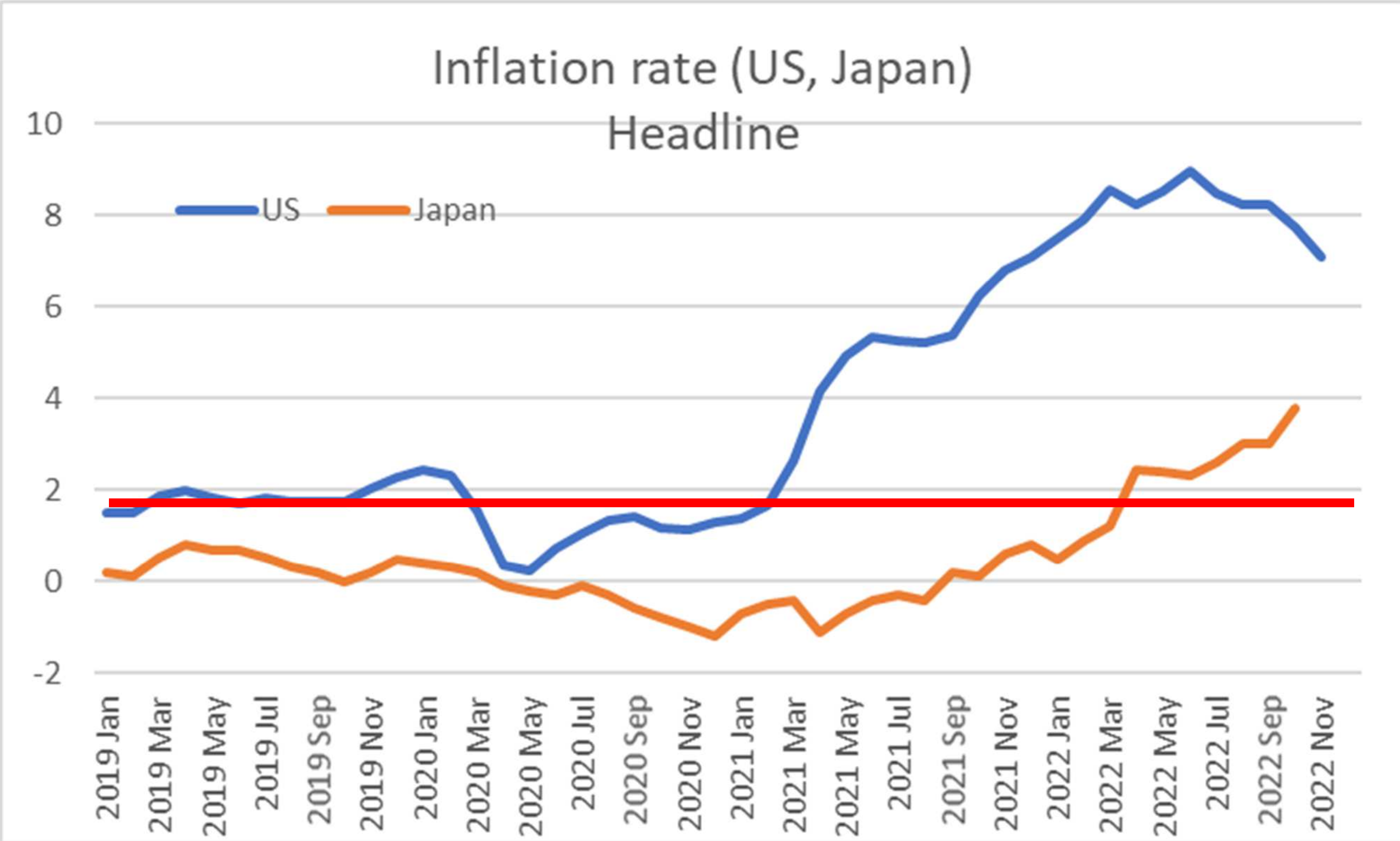
ESRI Post-COVID Economy
December 15, 2022

Comments on Hélène Rey
"Risks in the Financial System"

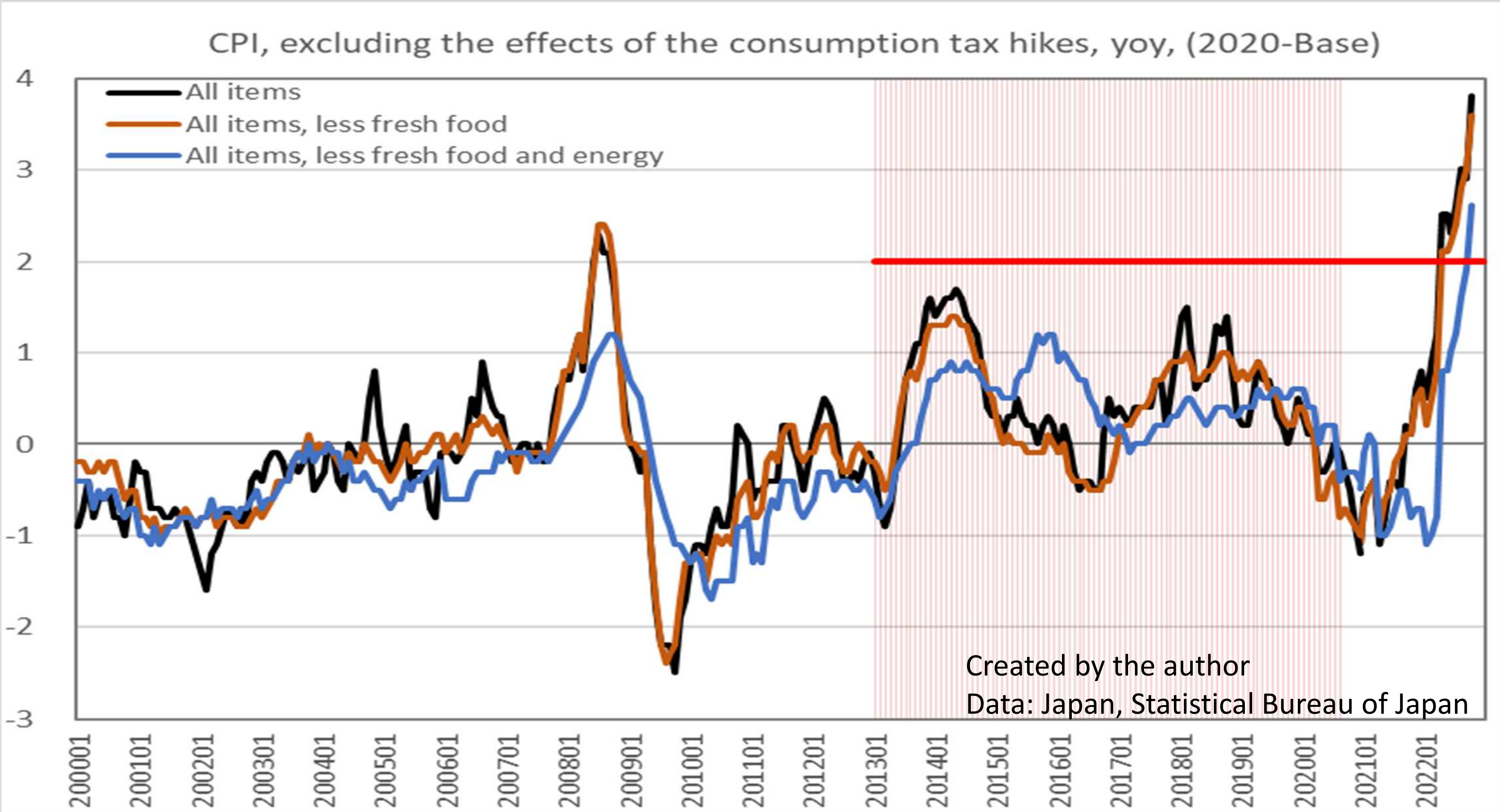
- Rey's agenda:
  - – 1. Monetary Policy Tightening and Valuations
  - – 2. EMs, LICs, Euro area
  - – 3. Climate and Biodiversity Risks
  - – 4. Cyber Risk
- My comments
  - – 1. Monetary Policy Tightening in the US and (lack thereof) in Japan
  - – 2. Central bank B/S and P/L problems (or is it a problem?)
  - – 3. Crypto assets

1. Monetary Policy Tightening in the US and (lack thereof) in Japan

- Inflation rates in the US and Japan are very different
- Thus, monetary policy in the US and Japan are very different
- One of the consequences is the sharp yen depreciation
  - BOJ has been criticized for keeping the interest rate low



Created by the author
Data: Japan, Statistical Bureau of Japan; and US, BLS



CPI, excluding the effects of the consumption tax hikes, yoy, (2020-Base)
All items
All items, less fresh food
All items, less fresh food and energy
4
3
2
1
0
-1
-2
-3
200001
200101
200201
200301
200401
200501
200601
200701
200801
200901
201001
201101
201201
201301
201401
201501
201601
201701
201801
201901
202001
202101
202201
Created by the author
Data: Japan, Statistical Bureau of Japan

Inflation rate in 2023 is projected to fall below 2.0%

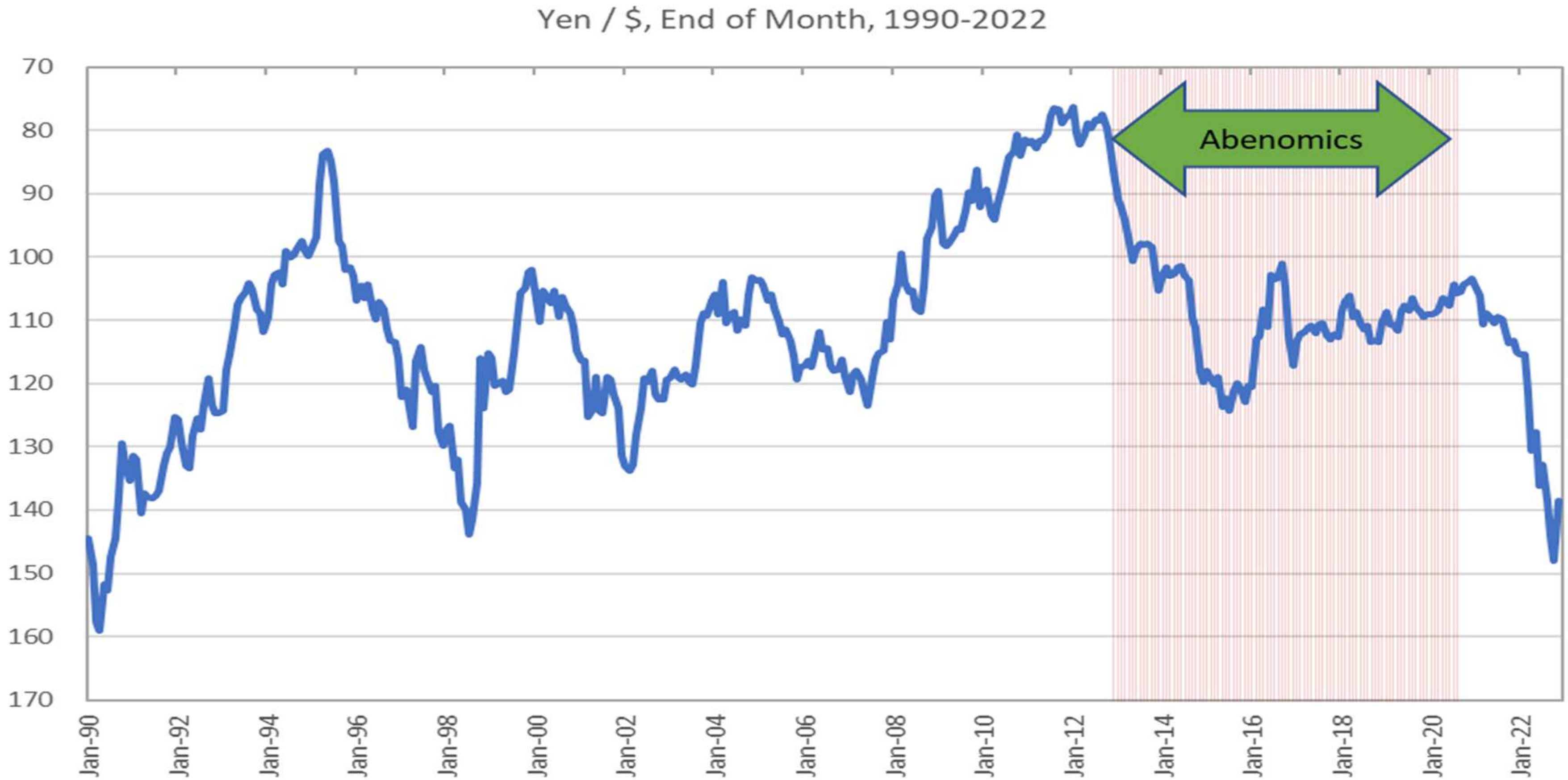
Dates of projection

		CPI inflation rate (excl. fresh food) Projection by Policy Board members (median)				
	"Outlook" date	2020	2021	2022	2023	2024
2020	10/29	-0.6	0.4	0.7		
2021	1/21	-0.5	0.5	0.7		
	4/27	-0.4	0.1	0.8	1.0	
	7/16		0.6	0.9	1.0	
	10/28		0.0	0.9	1.0	
2022	1/18		0.0	1.1	1.1	
	4/28		0.1	1.9	1.1	1.1
	7/21			2.3	1.4	1.3
	10/28			2.9	1.6	1.6

Created by the author

Data: Bank of Japan, Outlook Documents, various issues

Yen depreciation. Any financial risk?



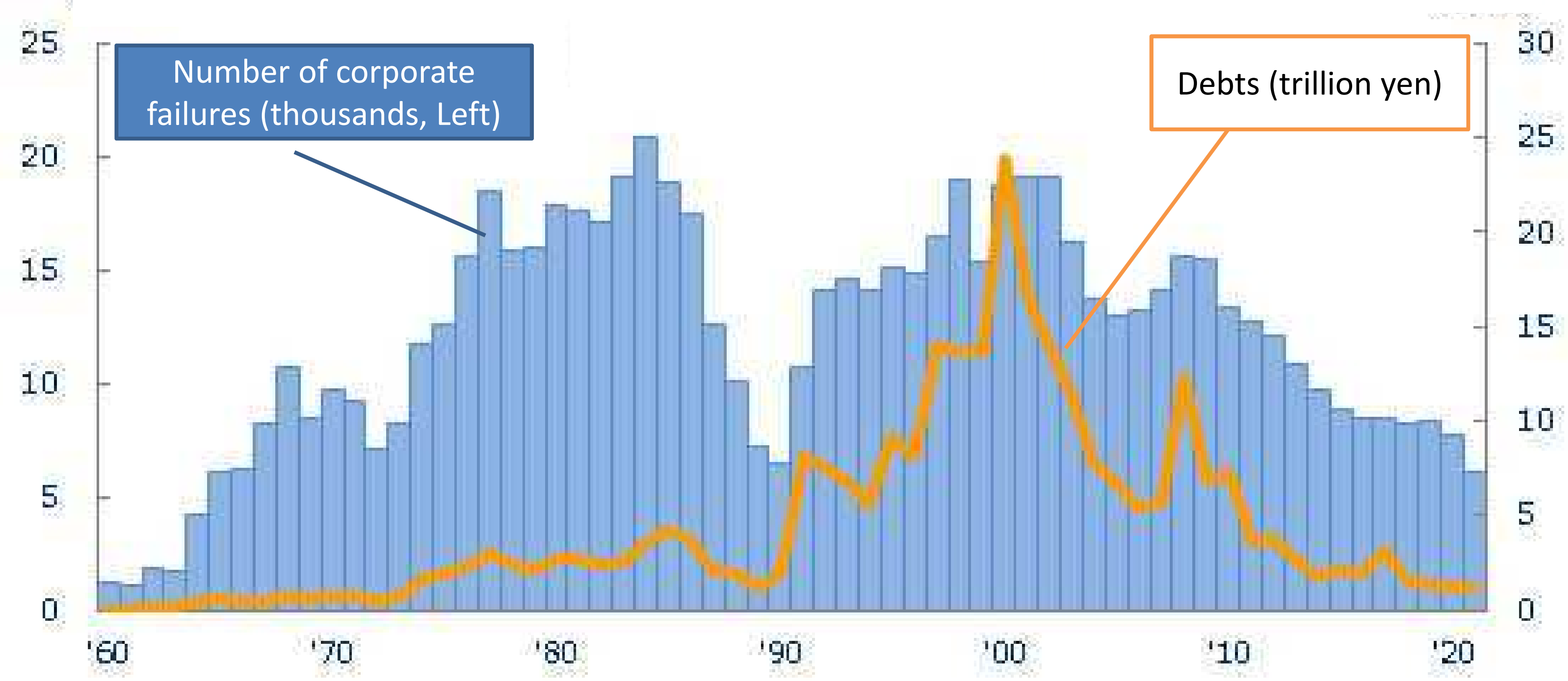
Source: BOJ.

Created by the author
Data: Bank of Japan

(Possible) Tightening in Japan. Any financial risk?

- If and when the "exit" comes in Japan (in 2023?), what will be financial risk?
  - Corporate failures?
    - Corporate failures have been too low in in 2020 and 2021
    - It will increase in 2022 with or without BOJ tightening
  - Housing loans problems?
    - Most Japanese mortgages are floating rates. Will leveraged homeowners suffer and walk out when the rate goes up?
  - Financial system instability
    - Not likely according to BOJ Financial stability report October 2022

Very low corporate failures in COVID period



https://www.tsr-net.co.jp/news/status/yearly/2021_2nd.html

BOJ Financial Stability Report, Oct 2022
Little concern

https://www.boj.or.jp/en/research/brp/fsr/data/fsr221021b.pdf

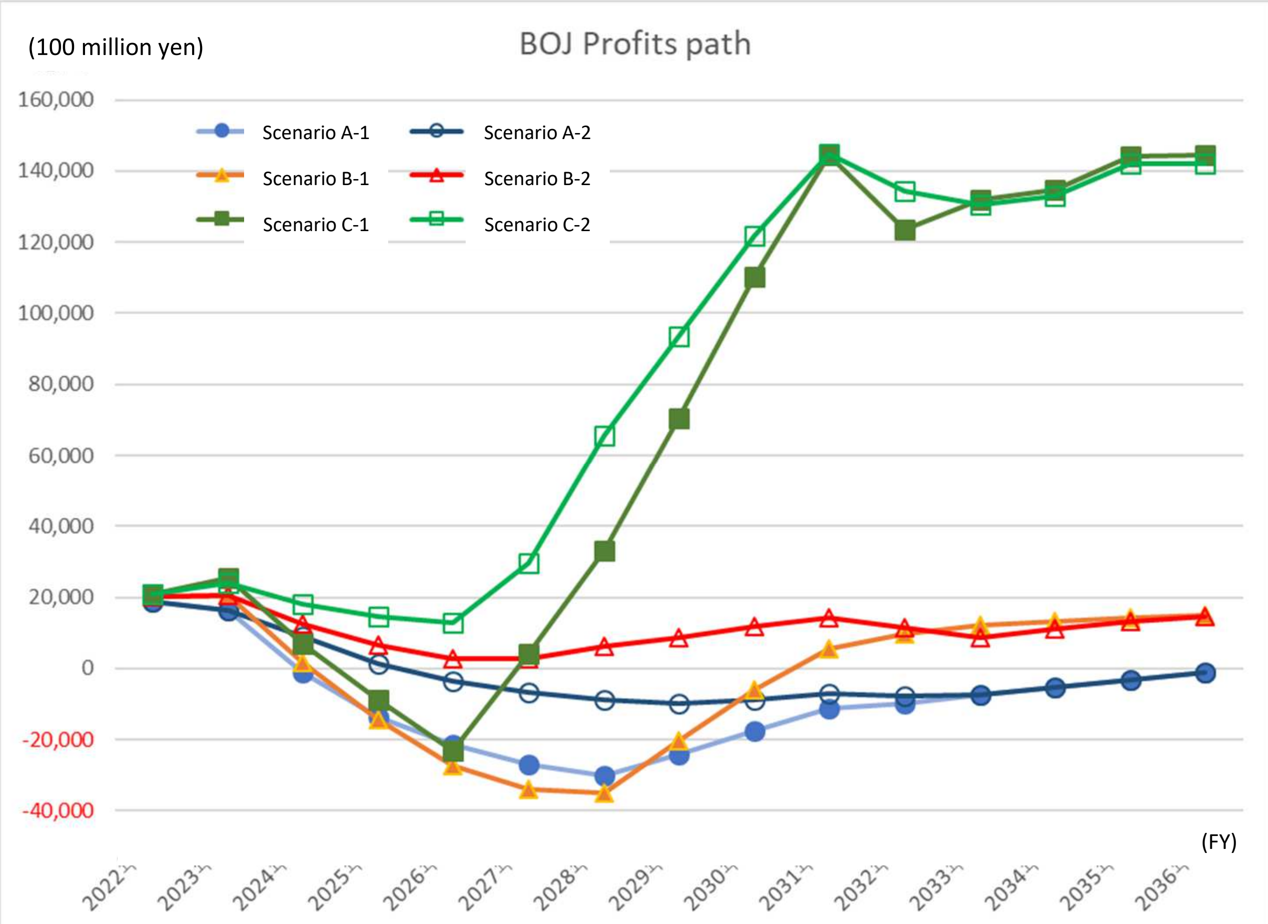
- Japan's financial system has been maintaining stability on the whole.

- Japanese financial institutions (FIs) have kept sufficient capital and liquidity even under various types of stress since the outbreak of COVID-19, including supply constraints and rises in energy and raw material prices under the normalization of economic activity and the materialization of geopolitical risks.

  - However, the period of stress may be prolonged further as policy rate hikes by central banks are continued and concerns about a slowdown in foreign economies are spreading. Financial and capital markets have continued to be nervous.

- From a long-term perspective, if FIs' core profitability were to stagnate, financial intermediation could be impaired due to a decline in loss-absorbing capacity, or vulnerabilities in the financial system could increase through excessive risk-taking.

Bank of Japan P/L



Takatoshi Ito, a Keizai Kyoshitsu column in Nikkei, August 24, 2022

Scenarios

Scenario A. No rollover for maturing government bonds

Scenario B. Rollover 2/3 of maturing government bonds. Replace with new 5-year bonds

Scenario C. Rollover all maturing government bonds. B/S remains constant

Case 1. Policy rate change from -0.1% to 0.0% in 2023. Raise by 0.5 % point every year from 2024 to 2028. Maintain at 2.5% thereafter. Assume the ten-year bond rate rises from 0.25 to 0.5 (end-FY 2022) to 4% by 2029.

Case 2. Policy rate change from -0.1% to 0.0% in 2023. Raise by 0.25% every year from 2024 to 2.5% in 2033. Maintain at 2.5% thereafter. Assume the ten-year bond rate rises from 0.25% to 0.5% (end-FY 2022) to 4% by 2029. The yield curve is steeper in this case.

BOJ “insolvency”. Any financial risk?

- No

Crypto assets and financial stability

- (Potential) Regulators
  - US. SEC and CFTC (fighting over their turfs)
  - Japan. FSA (registration system)
  - Europe?
- FTX lesson? (Can ring-fencing work?)
- Why regulate?
  - Investor protection (esp. stable coins)
  - Systemic risks through investment banks, hedge funds, pension funds