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WORKSHOP

on

Challenges for Fiscal and Monetary Policies

—Effects on Economies and Societies—

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This is a documentary report on a workshop jointly held in Tokyo, July 16, 2013 by the Konrad Adenauer Stiftung and the Institute for International Monetary Affairs under the title of "Challenges for Fiscal and Monetary Policies ; Effects on Economies and Societies."

Welcome Remarks

Jörg Wolff, Konrad Adenauer Stiftung Resident Representative for Japan and Regional Representative for Economic Policy

"Quantitative easing is the most commonly used monetary instrument as a means of stimulating investment nowadays. However, the desired results have not been attained so far."

On behalf of Konrad Adenauer Stiftung, Mr. Wolff welcomed all the attendees and thanked the renowned Institute for International Monetary Affairs (IIMA) for its excellent cooperation in organising this workshop.

Mr. Wolff firstly emphasized the timely importance of the theme of this workshop. Presently, global economy is still under stress and remains vulnerable. Growth has been slowing down, and many economies have to depend on the demand from countries which run chronic fiscal and current account deficits. Recently, the IMF lowered the world growth forecast to 3.1%, highlighting the uncertainties over the world economy as big economies such as China, India or Brazil weaken before the developed markets have recovered. This shows that we live in a connected, globalized and interdependent economic world, and we are not immune to economic disturbances or financial crises on the other parts of the globe.

In Europe, fiscal consolidation is the key issue. In Japan, we see an aggressive monetary easing that pumps unprecedented amount of money into the economy. In India, public finances have deteriorated and inflation and interest rate are high, while industrial output is stagnated. In China, it still takes some time to tackle the combination of excess credit and over-investment that followed the fiscal stimulus package after 2008.

All these examples refer to the close interrelationship between fiscal and monetary policies. Quantitative easing, which was first adopted by the US Fed after 2008 financial crisis, is the most commonly used monetary instrument as a means of stimulating investment nowadays. However, the desired results have not been attained so far.

That being said, Mr. Wolff raised several instructive issues worthy of discussion. How are economies and societies affected at all by fiscal and monetary policies? How do both of them influence the structural side? How do they support economic activity, especially growth and productivity? How can they help create a decent social security and most importantly the wellbeing of a society of our peoples? In addition, how do the changing demographic patterns in many countries fit into fiscal and monetary policies?

This workshop is intended to look closer into the interactions of fiscal and monetary policies, and also elaborate on their effects on economies and societies. These issues are being discussed more and more globally, and Mr. Wolff encouraged all the attendees to be frank and provocative so that we can learn from each other.

A view from Germany

Andreas Hermes, Deputy Director General, Federal Ministry of Finance, Germany

"Listening to each other carefully will help us build a better world – the one in which we take joint responsibility as citizens of the world."

"The widening interest rate spreads of government bonds were signs of a more general political challenge, especially a need for a substantial overhaul of the architecture of our monetary union."

Monetary and fiscal policy has remained over the past years a hot topic – not only in Germany, but throughout the world, thus offering an opportunity to unite in a dialogue to foster a common understanding. Mr. Hermes believes that our response to the financial crisis is not just shaped by the ideas of the most intelligent and influential economists from the world's renowned universities, but also our traditions and cultural backgrounds and our political heritage – including the way we think about money and the economy – often have a more profound impact on the way we respond to the crisis than we tend to realize.

As a German and European, he delivered the speech from the very outset; Germany and Europe are like two sides of the same coin. So far, the European project has always succeeded in its struggle to balance different interests. A fundamental truth based on past experience is that strength lies in unity. After 2008 global financial crisis, for the first time since the beginning of the monetary union, interest rates on government bonds issued by different countries drifted apart – in some cases dramatically. These interest rate spreads were an early warning of growing tensions in monetary and fiscal policies. Even more, they were signs of a more general political challenge, especially a need for a substantial overhaul of the architecture of our monetary union.

For German policy-makers, safeguarding the euro and the euro zone has been the central concern from the very beginning. To put it simply, the German government's response to the financial crisis was essentially to make time for and to set the course for a consolidation of national budgets and for increased competitiveness in the countries whose economies had suffered. To this end, a comprehensive set of new rules has been introduced in Europe. The European Central Bank, the IMF and the European

Commission have collaboratively launched a comprehensive program consisting of various elements to the so-called crisis countries.

First, the Stability and Growth Pact has been strengthened by imposing automatic sanctions if deficits go above 3 per cent of GDP. Second, a new procedure has been created to prevent macroeconomic imbalances through broader economic policy surveillance, especially the Commission recommendations in the case of imbalances and the possibility of sanction. Third, European semester is introduced, which includes country-specific recommendations for sustainable budget policies in the Member States as well as economic policy coordination on the basis of annual reform plans. Fourth, as part of a joint fiscal compact, Europe capped structural deficits at 0.5 per cent of GDP per year and introduced debt-brake rules in our national constitutions. Fifth, Europe is also promoting a financial-market reform by setting up new supervisory authorities. Finally, Europe is in the process of setting up a banking union. This will serve as a new regulatory framework for financial markets which will mitigate future banking crises, allow for bank failures, and reduce the risk of taxpayer involvement by linking risks with potential benefits.

However, some worried that the ECB's not only financial but also political involvement in crisis management efforts could lead to a significant redistribution of risks between taxpayers in different countries.

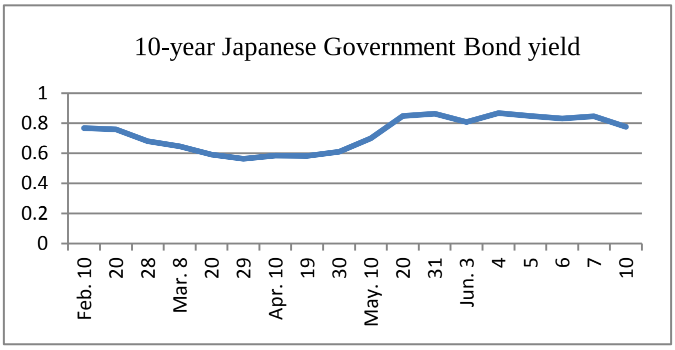
Today, the challenge is to ensure that emergency assistance does not become permanent. The central banks have been successful in stabilizing the financial markets. If this success is to be sustainable, it might be worth listening to the words of Stephen Cecchetti, the outgoing chief economist of the BIS: "Monetary policy-makers must pay more attention to developments in the overall quantity of money and credit. They must avoid becoming dependent on governments and commercial banks. They have to take international effects into account. And they must not place too much confidence in the rationality of financial market participants." After all, we have to prevent future crises and the emergence of new bubbles on the financial markets.

A view from Japan

Yoshihiro Watanabe, Managing Director, Institute for International Monetary Affairs, Member for Japan, APEC Business Advisory Committee

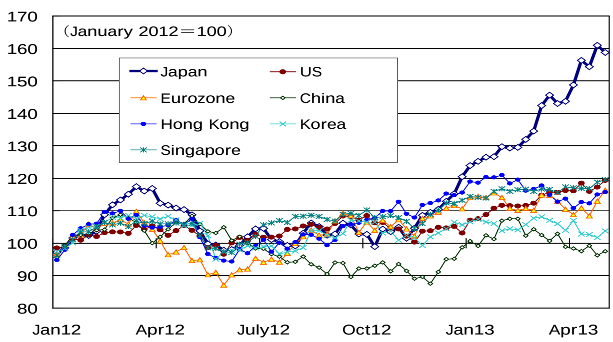
"A stronger Japanese economy would help global growth and make domestic problems such as ageing population and runaway debt more manageable."

Abenomics is the name given to a suite of measures introduced by the Japanese Prime Minister Shinzo Abe after his December 2012 reelection to the post he last held in 2007. His aim was to revive the sluggish economy with "three arrows": a flexible fiscal stimulus, more aggressive monetary easing from the Bank of Japan, and structural reforms to boost Japan's competitiveness. Mr. Watanabe presented the effects of Abenomics and some future challenges. So far, Prime Minister Abe's heady cocktail of massive money expansion, public spending and promised pro-growth reforms has sent Tokyo stocks to five-year highs, a dramatic deprecation of Japanese yen, an increased yield and volatility of JGB. More importantly, both consumer and business sentiments and confidence have rebounded.



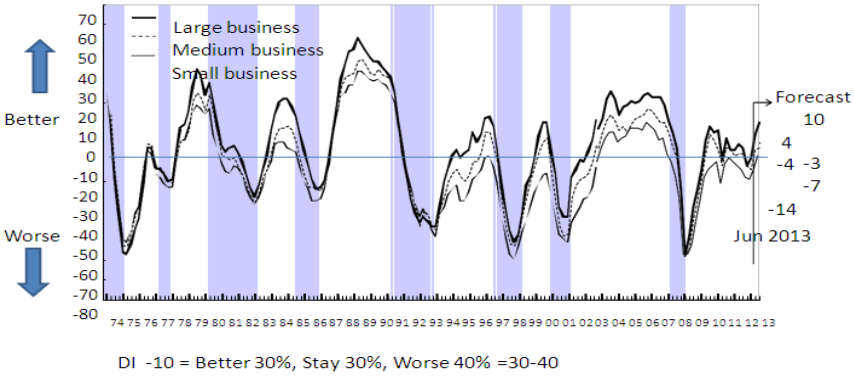
Source: Bank of Japan

Major Stock Markets' Index



Source: Data stream.

Bank of Japan Tankan Business sentiment



Source: Bank of Japan

A stronger Japanese economy would help global growth and make domestic problems such as ageing population and runaway debt more manageable, so it is no wonder many people give Prime Minister Abe and his economic plans the benefit over doubt. But ultimately even well-wishing observers will want to be assured Abenomics is delivering the desired improved real economy.

The first challenge should be fiscal sustainability. Debt service cost is 24% of the total budget, which has constrained the government expenditure to the investments pursuing strong and sustainable growth. With decreasing household savings ratio and increasing ratio of government debt to household financial assets, how to cope with the widening revenue-expenditure gap has become an economic imperative. Secondly, this ongoing monetary experiment is aggressive both quantitatively and qualitatively. The Bank of Japan has started to diversify its portfolios, purchasing more risk assets, while extending the duration of JGB.

Furthermore, Mr. Watanabe touched upon three dimensions of the growth strategy with structural reform, namely industrial revitalization; creating strategic markets for healthcare, energy, and infrastructure; and enhancing opportunities to boost international trade and investment.

To conclude, Mr. Watanabe inferred the Japanese government’s thrilling intention to increase the active life expectancy by one year or more in 2018, to cover all children with nursery care system, and to double both export of agricultural products and stock of inward foreign investment in Japan in 2020.

Discussion Panel I

<Question from a discussant: 1>

Contrasting the experiences of financial crisis in Japan and Europe, it was the Japanese that were involved in the case of Japan no matter if it was the government to solve the crisis or banks to cause the crisis. On the other hand in Europe, what are the positions of countries like Germany in face of the real bad debts of Spanish banks?

<Answer of Mr. Hermes>

A bad balance sheet of banks means that the real situation is even worse. The German government is making every effort to guarantee the Euro. It shows solidarity and tries to help to improve competitiveness in South Europe. Meanwhile, the European Union is a treaty-based legal union, so it tries to create a better understanding for respecting rules, which is condition sine qua non for trust. For example, in Greece there was almost a rebellion against the recovery-measure, so it is crucial to do the restructuring in a step-by-step approach. If there is once disintegration, there will be no end of it. Furthermore, German has its own issues as well, such as the changing demography. Germany hopes to benefit from Europe by immigration of qualified people.

<Comment from Mr. Wu>

Mr. Wu shared his impression on the European Union monetary and fiscal policy, and compared it to a Chinese situation as follows:

Monetary policy is difficult for the European Central Bank with diverse necessities of various countries. Besides, fiscal policy is not easy for Europe either. A similar development gap exists in the west and east part of China and the Chinese central government has been transferring wealth from the east to the west for many years. However, there has no such Federal or central government in Europe to implement this transferring. Thirdly, insurance system could be a barrier for the cross-border labor force movement in Europe.

<Answer of Mr. Hermes>

The German government has many fields of activities, for example, the French-German dialogue is conducted on a daily basis. This raises a new quality of understanding. The labor market is now becoming gradually a common market. The national budget is regarded as the center of sovereignty due to the highest court of

Germany, but virtually a part of its competences has been transferred to the EU. European countries are giving up sovereignty. They pool it to get stronger outside.
Giving up sovereignty is a political process. Economy in this context follows politics, peace and democracy.

<Question from a discussant: 2>

How can Japan reach economic growth in an aging society?

<Answer of Mr. Watanabe>

Mr. Watanabe addressed three points in light with Japanese aging society. First, the active working age will be extended to 70 years old to enlarge the labor force pool. Second, Prime Minister Abe is encouraging more women to participate in working. Last but not least, innovation will contribute a lot, for example, automated systems and medical robots will help to control the cost for the public.

A view from China

Wu Qing, Senior Research Fellow, Financial Research Institute, Development Research Center of the State Council of P.R.C., China

"*Japan is not going to be hit severely by dollar's exit of QE policy, so Japan has an opportunity to be the saver in Asia, especially to China.*"

Mr. Wu did a briefing on current Chinese monetary and economic issues, and put forward his views on a broader global background.

First, Mr. Wu shared his institute's research about recent US economy recovery. In his opinion, the US economy is recovering with high quality. A kind of transformation is happening, that is, entrepreneurs and capitals are moving quickly from less competitive industries to innovated industries. It is possible that the transforming speed of different economic factors varies. For instance, employees move relatively slowly across industries because they need to capture new skills, which could help explain the prevailing high unemployment rate.

Given a positive recovery sign, it is believed that the Fed may end its quantitative easing policy in the near future. Consequently, global liquidity will get down from the peak, interest rate and dollar exchange rate will go up. Perhaps, two groups of economies will suffer most, economies in debt like euro zone peripheral countries and economies having a pegging currency to the dollar like China.

Being aware of this potential challenges, Mr. Wu suggested the Chinese government to make a national preparation in advance, including limitation on hot money, a pause in the RMB internationalization, exchange rate regime reform and prompt actions of PBoC for liquidity supply.

In the end, Mr. Wu raised one thought-provoking question that whether a global cooperation solution exists. Regionally, Japan is not going to be hit severely by the dollar's exit of QE policy, so Japan has an opportunity to be the saver in Asia, especially to China. Globally, will the Fed care about its policy externalities on the other economies and could there be a substitutive global currency available when global liquidity is not enough?

A view from Korea

Ki-young Park, Associate Professor, School of Economics, Yonsei University, Korea

"Without an actual sudden outflow of capital, it would be imprudent for the Bank of Korea to take pre-emptive or radical action to raise its policy rate."

Mr. Park introduced the current fiscal and monetary policy in the Republic of Korea and indicated several potential challenges.

Overall speaking, the Republic of Korea seems to be in good fiscal position with a 36.2% debt-to-GDP ratio. However, Mr. Park argued the government debt is prone to be underestimated because of a different accounting standard from international one. In fact, the debt of public companies is not accounted for, and the debt-to-GDP ratio will soar from 33.2% to 76.4% when this part is included.

On July 11st, the Monetary Policy Committee (MPC) decided to leave the policy rate unchanged at 2.5%. The continuing economic growth and export, together with low inflation have spelt good news. However, the possible tapering of QE the US and increasing volatility in financial markets, slowing economic growth of China and other emerging countries also cast a shadow over Korean economy.

Given the high openness of financial markets, the Bank of Korea has much concern on macro-prudential policy. Aiming to reduce the sudden and unnecessary inflow and outflow of funds, the BOK has been consistently utilizing the leverage cap on banks' foreign exchange derivative positions, tax on foreigners' bond investment and non-deposit foreign currency liabilities. Mr. Park argued it is still too early to evaluate the effectiveness of these tools.

Unfortunately, the fast growing government debt is probably not the only thing misleading, so is the unemployment statistics. It is counter-intuitive that Korea has the lowest unemployment rate but also lowest employment rate among the OECD countries. A possible explanation could be the omission of discouraged worker effects. The government has set up a 70% employment target and encouraged higher female labor participation, but in Mr. Park's opinion, this might not resolve the issue fundamentally but produce more temporary jobs of low quality.

Last but not least, Mr. Park insisted that without an actual sudden outflow of capital, it would be imprudent for the BOK to take pre-emptive or radical action to raise its policy rate.

Discussion Panel II

<Question from a discussant: 1>

What is the best solution to contain the shadow banking in China?

<Answer of Mr. Wu>

Mr. Wu told the fact that the scale of shadow banking is not as high as the HSBC data, and the default risk is also not very high because most of the shadow banking business is under the supervision of the Chinese Bank Regulator Committee. Recently the problem lies in how to bridge the understanding gap between the top policy makers and bankers. This banking business form was initially supported by the supervisors as an innovation; however, the PBoC's reaction to the volatile SHIBOR in July has suggested a different attitude. But in many cases Chinese bankers have not interpreted the governments' intension correctly.

According to Mr. Wu, the best solution should be a clear separation of monetary policy from the government policy measures. The central bank should be independent and just focus on making monetary policy but not supervising the banking business.

<Question from a discussant: 2>

What is the precise change of the Internationalization of RMB plan? What role do Chinese local governments play in shadow banking? Are they overly debt-ridden?

<Answer of Mr. Wu>

Mr. Wu suggested central bank should be cautious about the opening of capital account, and act in tandem with the exchange rate system reform.

Currently the debt-to-GDP ratio is about 60% and half of the debt is borrowed by local governments. Mr. Wu noted that under the new Minister of Finance, local governments will be encouraged to start publishing their own balance-sheet in five years. Besides, Mr. Wu argued that the Chinese government should be able to control the current scale of debt and leave room for another round of stimulation when potential crisis hit in the near-term of 8 to 10 years.

<Question from a discussant: 3>

What is Korea's attitude and monetary answer towards the depreciation of the Japanese Yen?

<Answer of Mr. Park>

Korea once worried about the currency war between China, Korea and Japan after Abenomics, but for now, they don't believe Abenomics will achieve its full goal. So Korea will not take measures to counterbalance the effects of Abenomics until something disadvantageous really happens.

A view from India

Rajat Kathuria, Director and Chief Executive, Indian Council for Research on International Economic Relations, India

"Given such a young country as India, one of the biggest challenges ahead is creating employment to meet the growing demand for jobs, especially in manufacturing, otherwise the

demographic dividend will likely unleash all its energy into social unrest"

The problems of India are quite different from the previously addressed countries, and Mr. Kathuria provided a new perspective on those issues.

Ongoing Euro area example shows that high public debt is one of the big threats to economic stability. Heavy dependence on deficit financing since independence has resulted in accumulation of large public debt in India. Fortunately, most public debt in India is domestically held, primarily by public sector banks. Despite slowdown in economic growth, government managed to contain the fiscal deficit last year within 4.89 percent of GDP by reducing expenditures. Projected increase in economic growth in 2013-14 and 2014-15 is expected to further consolidate the fiscal deficit to 4.8 and 4.2.

Moreover, Mr. Kathuria identified some of the challenges in the path of fiscal consolidation lying in the few years ahead, including the populists schemes before the general election of 2014, weak economic recovery and potential increase in defense expenditures. To improve the effectiveness of fiscal policy in India, further steps need to be implemented, for example, strengthening the Fiscal Responsibility and Budget Management Act (FRBMA), rationalizing subsidies, widening the tax base and improving independent debt management. Two crucial systems to be introduced in India are DTC (Direct Tax Code) that simplifies the tax compliance, and GST (Good and Service Tax) that could unify India into a single market. According to studies by policy institutes like Indian Council for Research on International Economic Relations and National Institute for Public Finance in India, the implementation of GST itself will give a bounce to the GDP growth by 1.5% point.

In India, monetary policy has multiple objectives including growth with price stability and financial stability, maintaining external stability and promoting priority sectors. Mr. Kathuria argued that the tension between monetary and fiscal policies in India is caused by the weak monetary transmission in terms of the interest rate channel.

Given such a young country as India, one of the biggest challenges ahead is creating employment to meet the growing demand for jobs, especially in manufacturing. A million of new jobs per month need to be created in India for the next few years, otherwise the demographic dividend will likely unleash all its energy into social unrest.

A view from ASEAN

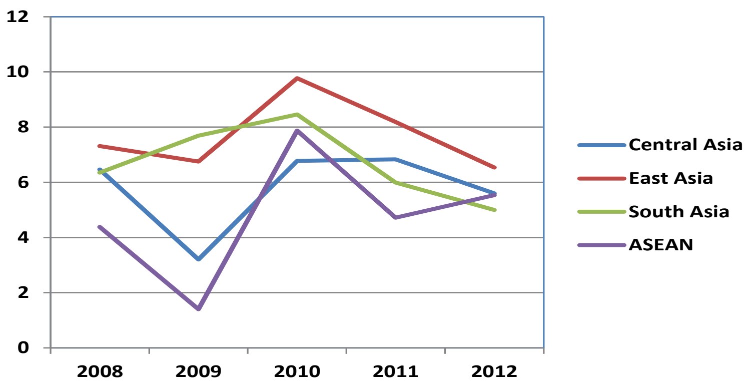
Angelo Taningco, Assistant Professor, School of Economics, De La Salle University, Philippines

"Among the potential benefits of reserve accumulation are that it can serve as a self-insurance mechanism against a financial crisis, that it can help boost exports, and that it can promote exchange rate stability."

Mr. Taningco addressed the challenges facing fiscal and monetary policies from an ASEAN perspective with some emphasis on his home country the Philippines as well.

During the 2008-09 global economic crisis, ASEAN was the most adversely affected subregion in developing Asia, with its GDP growth at 1.4% in 2009, the lowest amongst Asian subregions (Figure 1). However, ASEAN economic growth immediately rebounded from that crisis and even accelerated between 2011 and 2012, whereas growth for other Asian subregions moderated, while those of Western advanced economies, namely, the United States (US) and the European Union (EU) remained sluggish.

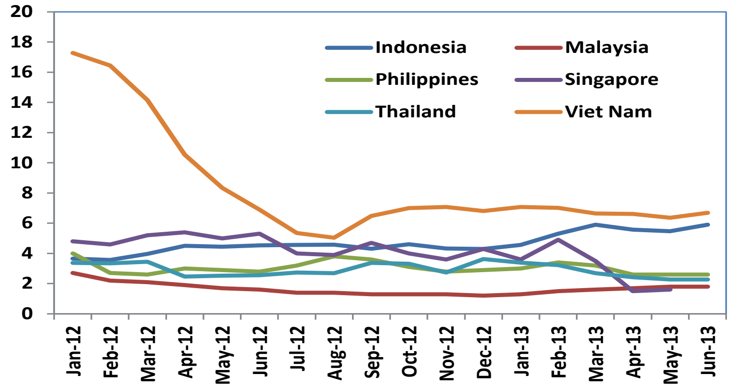
Figure 1: GDP Growth by Asian Subregion, 2008-2012



Source of basic data: Asian Development Bank's (ADB) Asian Development Outlook 2013.

However, the first half of 2013 saw mixed growth trends for ASEAN countries. On the one hand, the Philippines, Singapore, and Viet Nam posted faster GDP growth; On the other hand, most other ASEAN countries posted slower growth in the two most recent quarters with available GDP data. As for the labor market, recent data shows that some ASEAN countries, such as Indonesia, Singapore and Thailand, were able to reduce unemployment. Meanwhile, inflationary pressures at present are relatively benign for most ASEAN countries, exhibiting downward trend in their respective inflation rates in recent months (Figure 2).

Figure 2: Consumer Price Inflation in ASEAN Countries, Jan. 2012 – Jun. 2013



Source of basic data: Bloomberg LP.

The first challenge facing ASEAN is the accumulation of foreign reserves by ASEAN central banks in recent years. Among the potential benefits of reserve accumulation are, that it can serve as a self-insurance mechanism against a financial crisis, that it can help boost exports, and that it can promote exchange rate stability. But it also has potential costs, specifically in that it can trigger inflationary pressures due to the growth in the domestic money supply, that it can worsen the fiscal burden, and that it could increase domestic interest rates. It has been observed that the current foreign reserve levels of the major ASEAN countries have largely exceeded the traditional liquidity requirements, based on certain measures of reserve adequacy. The challenge now for central banks in the region is on how to better manage the excess reserves.

Another challenge for ASEAN countries is the financing of its huge infrastructure needs. For the Philippines, this is clearly a big challenge given that the country's tax base is still small, and that revenue effort and tax effort have in fact deteriorated recently despite widely publicized information of more aggressive revenue collection by the current administration.

Moreover, both private and public debt levels are now relatively high because of fiscal stimulus packages and accommodative monetary policy coupled with low interest rates over the past five years. General government debt (as a share of GDP) rose for most ASEAN countries between 2008 and 2012, with Indonesia being an exception, and stood at above 40% as of 2012, ranging from 42% for the Philippines to 97.9%% for Singapore. Compared with such advanced economies as Japan and the United States, government debt levels are still relatively manageable in most ASEAN countries. However, governments in the region ought to be careful that their debt positions don't rise too rapidly nor should they be elevated on a prolonged basis. More crucially, the governments should keep close watch on the constant rise of corporate and household debt especially when the borrowing cost is still relatively low as now.

Finally, Mr. Taningco highlighted the increasing degree of intra-ASEAN integration in both the goods and financial markets, with the ASEAN Economic Community (AEC) on target by 2015.

Discussion Panel III

<Question from a discussant: 1>

What is the situation of microfinance in India?

<Answer of Mr. Kathuria>

The microfinance companies in rural area in India have very poor performance in the last two years. The public banking system fails to include the low-income borrowers in rural area and the private banks don't necessarily go to rural area, which makes room for the microfinance business. However, it is very difficult to control the interest rate charged by the microfinance companies, which may go up to 100% or even up to 1000% per year. As a result, the government introduced an interest rate cap of 26%.

<Question from a discussant: 2>

In which currency are the soaring debts in ASEAN countries denominated?

<Answer of Mr. Taningco>

There is no currency composition of current debts in ASEAN, so what Mr. Taningco gave is just his personal expectation. Debts of households are usually held in local currencies while corporate debts are supposed to be held in a combination of local and foreign currencies with higher proportion of foreign currency.

Of course the current action for tapering the bond purchase by the Fed will have a negative impact on the household debt, especially with adverse effect on private consumption which is the main driver of economic growth in ASEAN. In that regard, economic growth may slow down further if household debt is not managed to more comfortable levels.

Conclusive Panel

Mr. Joseph Zveglich from Asian Development Bank first thanked the IIMA and the KAS for holding such an interesting workshop, and introduced Professor Andre Schmidt to give a broader-view presentation on the limitation of monetary and fiscal policy.

Andre Schmidt, Professor, University Witten, Germany

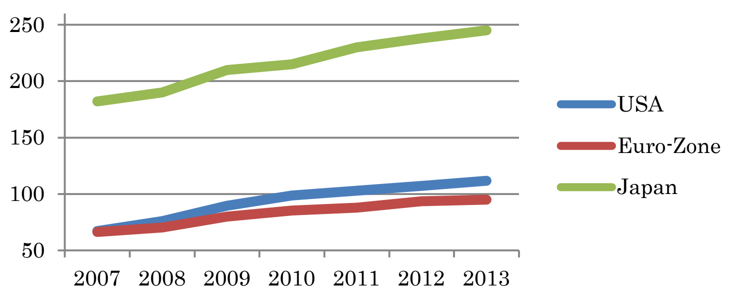
"Special problems caused from debt-financed expansionary fiscal policy include violation of intergenerational justice, shifting the tax burdens into the future."

Mr. Schmidt shared his sceptical attitudes towards the current expansionary fiscal and monetary policies from a social market economy perspective. First of all, fiscal and monetary policies are instruments in order to smooth business cycles. Based on the analysis of causes, it is explicit that current crisis is more a structural rather than cyclical one. Yet, fiscal and monetary policies are not suitable to address structural problems of an economy.

Special problems caused from debt-financed expansionary fiscal policy include violation of intergenerational justice, shifting the tax burdens into the future, acquirement of private savings, increasing dynamics of excessive public debts and so on.

Since the outbreak of the economic and financial crisis in 2007/08, the national debt has increased massively in the leading economies of the world (see figure 1). Assuming that the debt must be repaid, this means that either the present generation in the future has expected heavily increased tax payments or that the future generation have to do without investments to pay off the national debt. While in the first case, the disposable income of households is reduced, the investment opportunities are reduced in the second case. In both cases there is a risk that the growth of these economies is reduced and this could lead to a serious decline of potential growth. This is also the reason why economies with higher levels of indebtedness have long-term lower growth rates than economies with a lower level of debts. Therefore, with the current expansionary fiscal policy, the largest economies in the world are in danger of losing its future growth potential.

Figure 1:General Public Debts as Percentage of GDP



Source: World Bank, IWF 2013.

In addition to the macroeconomic concerns that are mentioned above, the expansionary fiscal policy can be also discussed under politico-economic arguments very sceptically. The allocation of funds of expansionary fiscal policy is the result of a political decision-making process. Considering that the political actors are not benevolent dictators and that they act more as an optimizer of the votes to win the next elections, then fiscal policy is often not based on the criteria of economic efficiency. Rather, distributional aspects are in the foreground. Fiscal policy is then an instrument to serve special interest groups. Therefore, fiscal policy is not neutral for an economy. Fiscal Policy serves always specific sectors.

Another consequence is that fiscal policy will primarily be used for consumptive purposes and not for investments. Therefore, the effectiveness of fiscal policy is to be critically questioned. The benefits accrue to only a few sectors, while the costs are distributed to the general public.

Meanwhile, expansionary monetary policies will lead to misallocation of capital, asset price inflation, increasing incentives of a higher indebtedness, redistributive effects in favour to the debtors and expropriation of savers, contagion effects for emerging markets by carry trade, and more severely less independent central banks.

In view of the expansionary monetary policy, the zero interest rate policy should be in particular regarded critically. This type of policy fails to recognize that the interest rate has an important function of efficient allocation in the capital markets. The amount of the interest rate separates unprofitable investments from efficient ones. Therefore, the interest rate has the task of an optimal allocation of available funds to the individual uses. In the case of a zero interest rate policy, particularly when negative real interest rates are available, this increases the incentives to shift capital more in unprofitable or inefficient investments. This threatens the emergence of speculative bubbles that can burst uncontrollably if the expected profits have not been met. This is especially the case if the central banks would be forced to raise interest rates again. Therefore, the central banks now will be forced to keep the interest rates over the next years very low.

In the euro-zone one of the current problems is that the commercial banks use the cheap liquidity to purchase government bonds of their own governments, rather than to direct them into profitable investments on the goods markets. Thus, the national debt increases further without the economic growth being stimulated. In this respect, the zero interest rate policy helps primarily unprofitable commercial banks and governments. However, it brings no achievements to the macroeconomic development.

Another important problem is the fact that the expansionary monetary policies of western economies are forcing the central banks in emerging economies to an expansionary monetary policy. To prevent currency appreciation, the central banks have heavily purchased foreign currencies, by which the central bank balance sheets in these countries were greatly expanded (see figure 2). Thus the central banks of those countries that were not directly affected by the economic and financial crisis were forced to take over the expansionary monetary policy of the countries in crisis. Therefore, the expansionary monetary policy is exported to emerging economies and can destabilize the macroeconomic situation in these countries.

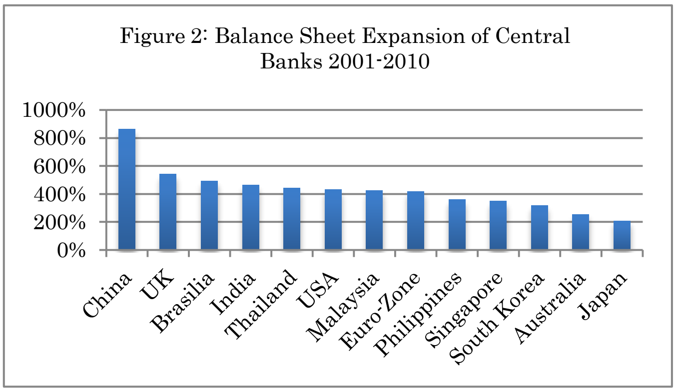


Figure 2: Balance Sheet Expansion of Central Banks 2001-2010

Source: IWF 2012

To conclude, Mr. Schmidt emphasized that monetary and fiscal policies cannot replace the necessary structural reforms in order to increase the competitiveness of the economies. This means primary importance lies in labour market reforms and the deregulations on the markets for goods and services in order to improve the competitive position and achieve higher growth. In his impression, monetary and fiscal policies have been comfortable political strategy to prevent unpopular reforms; however, there is the risk that macroeconomic imbalances will be enlarged due to this reluctance. That being said, monetary and fiscal policies should be used only as flanking measures, but more essential question is how to efficiently implement structure reforms.

Final Discussion Panel

<Question from a discussant: 1>

What are your suggestions for the success of the Abenomics program and at which point do you see the third arrow becoming an important factor as we move out of the initial stage?

<Answer of Mr. Watanabe>

Mr. Watanabe first explained the historical background of the Abenomics. Japan has a history of 20 years' continuous price and assets deflation due to the mismanagement of policy alliance between the Bank of Japan and the Ministry of Finance. What is expected to the Abenomics is a readjustment of market expectation, and Prime Minister Abe is in good position to use his political capital to implement painful reforms.

Secondly, Mr. Watanabe commented on the intergenerational issue, arguing that the current generation carries over not only debts but assets to the next generation. Right now the issue with Japan is that the expenditures don't meet the revenues. What size of government is needed remains a question.

<Comment from Mr. Sakuma>

Mr. Koji Sakuma, general manager and chief economist from the Institute for International Monetary Affairs, gave his comments with emphasis on three points. Firstly, while the previous Japanese central bankers have repeatedly emphasized that monetary policy alone cannot save Japan from deflation, the current governor initiated the bold monetary policy decisively without any excuse. This is likely to have an effect on the sentiment of markets. Secondly, this round of reform is not the first in the Japanese history. In fact, many reforms had been effectuated after the burst of bubble. The Koizumi reforms, for example, addressed much on the supply side and sharpened the competitive edges of big cooperations and major banks. Thirdly and most importantly, the present Abenomics measures focusing on monetary easing and growth strategies are accompanied by a long term commitment of fiscal discipline that has been carried over from the former Noda administration. Without this balance of monetary and fiscal policies, no foreign investor can be convinced at all.

<Question from a discussant: 2>

Although it is understandable that we need structural reforms to improve structural weaknesses, such reforms have deflationary pressures for a short term. What will be the efficient structural reform that will actually work during the crisis? What will be the appropriate alternative policy the government can use?

<Answer of Mr. Hermes>

Mr. Hermes indicated that certainly we do know structural reform is essential in Europe. However, to inaugurate structural reform, the existence of a congruous structure is the prerequisite. The Euro zone has to achieve a common business model at first that can be restructured. In particular the peripheral countries need to establish their economic models based on where they have competitiveness. Until they achieve it, someone needs to pay for them.

In the end, it is not economics but philosophy that matters. What Mr. Schmidt said intellectually is incontrovertible from an economist position, but it is biased with reality. Different states have different economic structures, and the puzzling fact about Europe is that the countries have a shared goal but diverse interests. That being said, certain compromise is indispensable. It is necessary for a politician to be an optimist and sell positive outlooks to win the election without neglecting the real fact.

<Responses by Mr. Schmidt>

Mr. Schmidt provided his responses on the following two points.

First, the crucial determinant of discussants' different positions is their time frame. In the short run, monetary and fiscal policies are essential to flank the necessary reform and promote further social acceptance. The appropriate alternative should be incentive-oriented policy, which means increasing the expenditures on education and innovation activities. Some countries in Europe have given the idea of institutional settings and reforms overlapping generations.

Second, it is no doubt that overlapping generation model can be theoretically right. But there exist only two approaches a government can do in financing the expenditures, either by taxes or by debt. For countries like Japan and Germany, public debt is probably less a problem since it is domestically financed. But for those countries depending much on external savings, what will they do if the funding countries are not willing to give fresh credit anymore? In this case, the sustainable solution for the country is to reuse the assets of its own society.

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