

Global Risk Watch Newsletter

Has the prospect of 'Secular Stagnation' receded?

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

◆Has the prospect of 'Secular Stagnation' receded? (Tsuyoshi Oyama, Partner/Head of Centre for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.)

In the last month's volume, we have pointed out the synchronization of bond and equity markets, both of which have been overheated thanks to two market prerequisites that (1) single resilient US economy would lead the world economy, and: (2) Quantitative easing (QE) due to long-standing disinflation in EU and Japan would continue for a while – a wobble in both prerequisites resulted signs of fluctuations in both asset markets.

The past one-month's trends can be observed as enduring doubts looming over the prerequisite of 'long-standing disinflation in EU' on one hand, while various indicators supported the 'resilient US economy' and gradually dispelling the concerns of its slowing down. As the result, the overall strength of advanced economies has become noticeable. In the case of Europe, for example, we have finally observed recovery in France and Italy, which have then firmed the steady recovery process of Eurozone economy. Another good news was a gradual rise of HICP, of which May number has recovered to 0.3% yoy level. Meanwhile in Japan, Q1 GDP growth reached annualized rate of 3.9% on the backdrop of strong capital investment. There has also been a sign of household consumption recovery emerging. And finally, US recent employment and retail sales indicators also showed strong signs of recovery from the disappointed negative growth in Q1 due to bad weather and other unfortunate factors.

These developments shall call for a new set of fluctuations in the financial market. Specifically, surging interest rate in bonds market. The deflationary concerns have receded in Europe, while the anticipation of policy rate hike at an earlier timing has increased in US. Thus, the likelihood of 'secular stagnation' that sustained the recent overheated bonds market have slightly decreased. Simultaneously, stronger economy in advanced countries with an upward trend of interest rate hike led to a significant capital outflows from the sluggish emerging economies. Maybe owing

to the halt of rebounding oil prices, most of emerging economies regardless of oil producing or not have concurrently suffered from currency depreciation and declining stock prices.

The composition of 'Strong economy in advanced countries vs. unable emerging economies' is forming, yet remains at an uncertain stage. Particularly, the underlying macro-economy in the advanced countries remained with a strong reliance on quantitative easing. Whether these countries can emerge away from such condition is the focal point moving forward. As the economy continue to remain on a gradual upward trend, the 'flip side' (e.g. fiscal support for southern periphery countries in Europe, and fiscal finance in Japan) supported by the quantitative easing should also be widely noticed. Moving forward, these dilemmas may create further uncertainties in the market.

2. Overview of Development in Financial Regulations (Trends & Topics)

◆ Again, Critical Regulatory Reforms for the Management of Japanese Bank (Koichi Iwai, Senior Manager, Centre for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.)

In this month, numerous important developments occurred for Japanese banks. The biggest focal point is the consultation paper published by the Basel Committee on Banking Supervision (BCBS) regarding 'Interest Rate Risk in the Banking Book (IRRBB)'. This consultation proposes two options (Pillar 1 and Pillar 2) for the capital treatment of interest rate risk in the banking book. The most fearful scenario for Japanese banks (Pillar 1 proposal only) was avoided; however, banks cannot be complacent by this. There is likelihood that Pillar 1 will be selected as mandatory requirements depending on various developments in the near future. In addition, the proposed Pillar 2 option includes quantitative disclosure of interest rate risk in the banking book based upon the Pillar 1 approach as well as contents to strengthen so-called 'Outlier regulations'. Therefore, a variety of burdens might be added on certain banks (banks operating internationally) in comparison with the current scheme.

The second development is the thematic review on supervisory framework and approaches for systemically important banks (SIBs) published by the Financial Stability Board. The proposed directions on future financial supervisions are: (1) for supervisory authorities to clearly define their supervisory strategy and priorities in line with their 'Risk Appetite'; (2) promote further dialogues between authorities and banks and so on. To define supervisors' own risk appetites is a new concept. Furthermore, the objectives of strengthening dialogues among authorities and banks is said to promote mutual understandings regarding bank's business model, governance, and risk culture. In line with this argument, Japanese FSA specified future supervisory policies to focus on dialogues with various parties such as bank's external board of directors, business units, and internal audit units.

The third is development regarding conduct risk. Financial Conduct Authority (FCA) in UK that has been the biggest advocate for the conduct risk has announced its detailed plan to investigate misconducts in the primary markets. Furthermore, the agency also published long-awaited final report on 'Fair and Effective Market Review (FEMR)' that has been underway since last year. Especially, the latter is aiming for the fundamental reforms of the wholesale

market. The IOSCO (International Organization of Securities Commissions), as well as various international authorities and the US authorities also have carefully followed this. FEMR report indicated: (1) to establish global standard (standards of practice, qualification criteria, etc.) for the FICC (Fixed Income and Commodity and Currency) market; (2) to strengthen regulations in UK FICC markets; (3) to identify conduct risks through enhanced market surveillance, and so on. The contents of standard and regulation are unclear. However, a foreseeable future of stricter stance posed by the authorities towards the wholesale market is inevitable.

The final critical trend is the development with regards to the reform on the deposit guarantee schemes by the European Banking Authority (EBA). EBA published the final guidelines at the end of May on calculating method for deposit insurance contributions. Under the guideline, the calculation methods will include consideration of bank's business model, in addition to traditional indicators such as bank's capital, liquidity, and asset quality as the risk measures. EBA said that both business model with low-earnings and unsustainable high-earnings business model should be regarded as 'high risk'. The focus on business model by the supervisors has been the 'trends' in recent years. This decision by EBA suggests supervisory framework and deposit guarantee schemes have become more closely intertwined. These developments could be considered as references, should discussions regarding risk-adjusted deposit premium system arise in Japan.

As the above mentioned regulatory developments could have various impacts on the Japanese financial institutions, careful observation is critical.

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