Several observations on capital flows in Japan

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I am very happy to participate in the joint BIS/SAFE seminar on capital account liberalisation, since the subject of capital flows is one of those economic issues that I have covered very extensively in Japan over the last 19 years. In fact, this seminar has managed to invite two of the more experienced experts on Japanese capital flows, Professor Fukao and perhaps myself. Mr Fukao has covered quite a bit of the development in the 1970s and made a number of very valuable comments on what happened in the 1970s. My experience covering Japanese capital flows actually starts from the 1980s, first from the US side at the Federal Reserve Bank of New York, where we were following these inflows of Japanese money into US markets, after which I moved to Nomura Research Institute, the research arm of Nomura Securities, where all the capital account liberalisation action was taking place. Therefore, the focus of my discussion will be more on the developments of Japan's capital flow liberalisation since the 1980s.

There is an important difference between capital flows in the 1970s and those in the 1980s for Japan. One needs to distinguish the two types of financial flows: banking flows and portfolio flows. Banking flows would always be associated with international trade once an economy has opened its current account. Once portfolio flows are liberalised, they can prove very extended and they may not easily reverse. We all know from both academic literature and actual experience that the opening-up of an economy's current account does help a lot in terms of economic growth, especially in terms of resource allocation. But how much we know about the opening-up of portfolio flows is a very questionable issue, in the sense that we actually do not have a very long history of free and open portfolio flows. In other words, our knowledge of the costs and benefits of open portfolio flows is much more limited in both theory and practice. This is the first point I want to stress.

If one looks at the major economies in the world such as the United States, Japan and Europe, all of these economies were actually largely closed to portfolio flows until the late 1970s. It was only in the late 1970s that the United Kingdom opened up its markets to portfolio flows, and, following this, the United States began to deregulate as well. Only with the Monetary Control Act in 1980 was Regulation Q phased out. In Japan, it was in December 1980 when portfolio flows were deregulated. So, the liberalisation of portfolio flows goes back only some 20 years, and, before that time, no one knew this world of free capital movements.

And in particular, for those of us who studied economics in the 1970s or early 1980s, there were no free capital movements in any of the literature we studied because these free capital flows did not exist during that period. When we talked about open economy, we mostly meant open economy on the current account side, and almost never on the capital account side. So, there was a lot of trial and error. For example, when I was working at the New York Fed, I was assigned to do the current account forecasting for the United States as an input to the New York Fed econometric model. I must say that we never got it right because our senior managers told us to put in US dollar depreciation as an assumption for the current account forecast. Any time we did our forecasting, we had a 10% depreciation of the US dollar, which repeatedly failed to happen; instead, the US dollar kept on appreciating. Therefore, we were consistently wrong about our assumption, but we had no clue why we were so wrong.

Looking back, I think it was mainly because the Japanese investors were buying a huge amount of US Treasury securities and this flow kept the US dollar high in spite of a large trade surplus on the Japanese side and a huge trade deficit on the US side. When the Japanese capital account was opened, the expectations of the parties involved were not entirely the same. On the Japanese side, for example, the market was opened to portfolio flows because many of the institutional investors in Japan, life insurance companies in particular, found that they did not have enough investment opportunities inside the country. Furthermore, they were losing market shares to the domestic banks. Therefore, they wanted to go outside and invest abroad, which amounted to portfolio outflows. But the incentive of the US government was quite different: the United States wanted to pry open the Japanese capital markets so that more money would flow into Japan and push the yen higher. As a result, the current account and trade imbalance problems between the two countries would be addressed. As it turned out, the portfolio outflow from Japan was much bigger than anyone had expected. A large capital outflow from Japan and into the United States turned out to be a very destabilising factor, as it pushed the dollar higher and enlarged trade imbalances between the two countries at least until 1985.

In 1985, the strength of the US dollar and the corresponding weakness of the yen and European currencies led to rampant protectionism in the United States. The President of the New York Fed, Mr Anthony Solomon, used to say that the United States lost as much industry in three years as it would in normal circumstances have lost in 30 years. The strong dollar's evident damage to US industry forced the US government to put together the so-called Plaza Accord in 1985 to push the US dollar down. This was done with quite a bit of "terrorising" by the Bank of Japan, which included the destruction of the government bond futures market that had been put together with very much effort over the years. In October 1985, the Japanese government bond futures market was shut down for three days because the Bank of Japan raised rates so high. Japanese institutional investors concluded that the Bank of Japan was really serious about pushing the yen much higher.

Despite such strong action taken to push the US dollar down and the Japanese yen up, the dollar's decline only lasted for three years or so. If you look at the 1980s as a whole, the US dollar was up for seven years and only down for three years. So in this sense, the large portfolio outflow from Japan at that time was a very destabilising development. Finally, the US government came up with a solution, the so-called Structural Impediments Initiative (SII). The core argument behind the SII was captured by a question: why should the Japanese, who live in less desirable houses than American houses, buy US Treasuries? In other words, why were the poor people lending money to the rich people? It did not make any sense. Many Japanese fund managers who were buying US Treasuries at that time also felt the same way. They asked the question, why do we live in rabbit hutches while lending money to these Americans who are living in such fantastic houses?

The answer given was that there was something structurally wrong in Japan. The problem might be the many prevailing restrictions on investment in Japan, particularly in the area of housing. The US government, using the research done by Japanese researchers, including my work, told the Japanese government to deregulate land use, to change the tax laws on land, and even to deregulate how many hours department stores were open in Tokyo. The important message is that, once an economy deregulates capital flows, such an opening can become very destabilising, particularly on the trade front. When that happens, then everything that affects capital flows in the domestic economy will become fair game for international discussion. If the economy does not open up the capital market, then only trade flows matter. If so, there will be a self-regulating mechanism within the trade flows and exchange rates that tends to more or less keep things from becoming excessively unstable. But once the economy opens up its capital markets, there could potentially be sustained large outflows from a surplus economy, which actually exacerbates the current account surplus for the surplus economy and worsens the current account deficit for the deficit economies. In this situation, once the capital flows turn out to be destabilising, issues that would normally remain domestic issues would probably become international issues.

The other point I want to address is the lesson we learn from the Asian currency crisis. Once the Asian currency crisis hit, some people, particularly those in Washington DC and New York, started talking about transparency, accountability, proper bankruptcy laws, strong regulations and strong banking systems. But a senior statesman of Singapore, Mr Lee Kuan Yew, put it very nicely at one conference: "Nobody told us that these things were necessary before we open our capital account. We only found out after the disaster that these things were necessary". This is a corollary of my earlier point that the opening-up of capital flows is all very new to us, and there is relatively little in the academic literature about the benefits and costs, and the conditions for capital flows. All of us are still learning about capital flows.

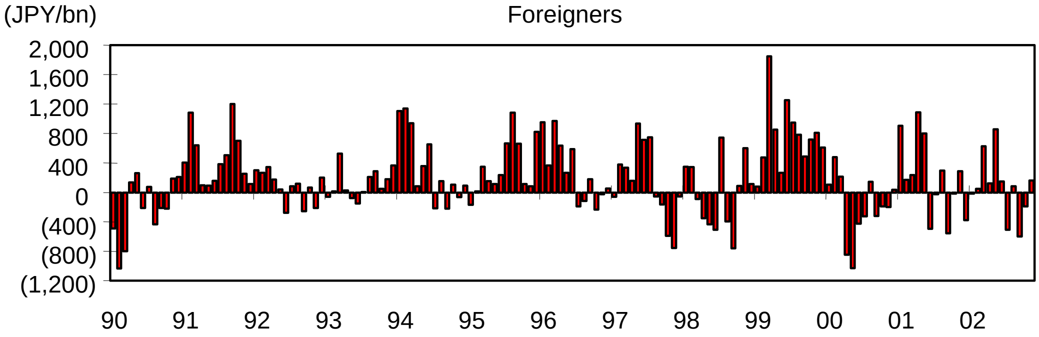
Furthermore, the fact that so many people after the Asian currency crisis talked about the bankruptcy laws in Thailand and accountability problems in Indonesia suggests that these people did not know what the bankruptcy law in Thailand was. This observation suggests that a lot of international investors, I am afraid, do not do their homework. They are like sheep: when everybody goes there, they just have to be on the bandwagon. In fact, when I was assigned to the foreign exchange desk of the New York Fed, the first thing my supervisor told me was that, in graduate schools, everybody tells you how efficient the market is, but in actual fact only about 15% of the market participants know what they are doing. 85% are just following the crowd. In the Asian currency crisis, we saw what damage the 85% can do. Thai people never tried to keep their bankruptcy laws secret. Anyone who wanted to know what the Thai bankruptcy laws looked like could just go to the law book and it was all there. But none of these investors bothered to look at it. They did not care and assumed that the banking and corporate numbers were good and reliable in these Asian economies. Of course, we now know in the United States that some of those numbers are no good as well.

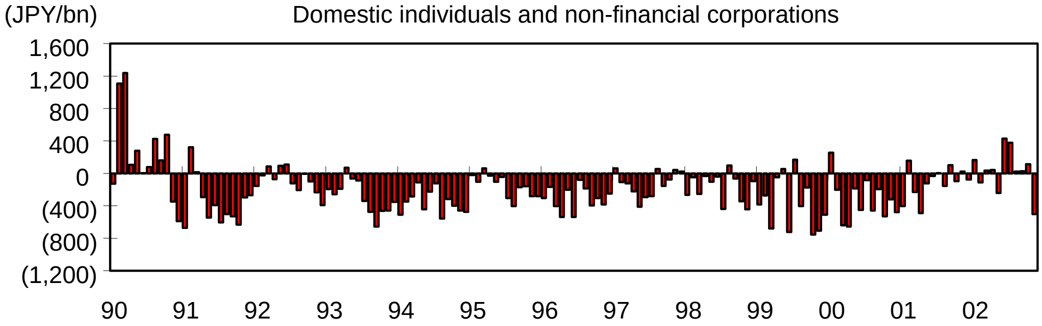
But when a newly opened economy has those investors who do not do their homework coming to the home market, these less well informed investors tend to panic very easily. Once they do panic, it may give rise to horrendous problems facing the government of the opening economy. Even if some of the American graduate schools tell you that the market is always efficient and an open economy is better than closed economies, I am afraid that the real world is not that simple. When there are a lot of investors who do not do their homework coming into a newly open market, there could potentially be real problems. Therefore, I think it is important for governments to have some controls in place to make sure that such less well informed and easily panicking investors do not destroy the economies.

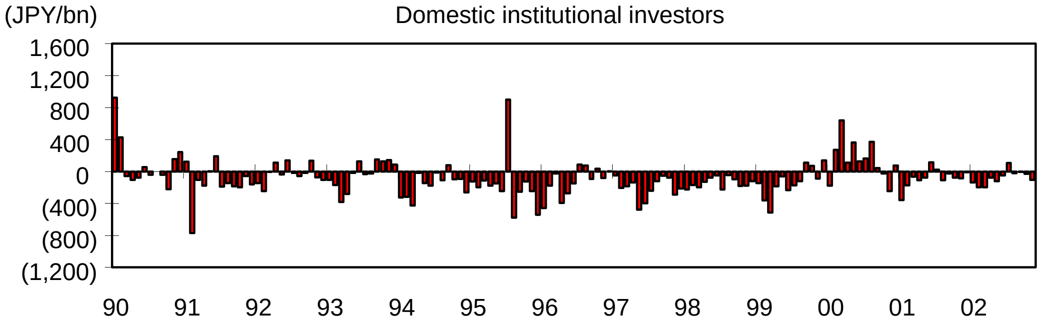
Having said that, I must mention that the countries that did benefit greatly from the freedom of capital movements are none other than Japan and the United States, despite the initial destabilising developments. Japan benefited from the opening of portfolio flows because in the 1990s, when the Japanese economy suffered a very serious and what I call balance sheet recession, it was the foreign investors, particularly the US investors, who kept the Japanese stock market from collapsing. If you look at Graph 1, it shows that it was the foreign investors, not Japanese investors, who kept the Japanese stock market up. Japanese investors were so devastated at that time by what happened to asset prices in the country that they had no capacity to take additional risk. The foreign investors kept the stock market up, so the total value of the whole stock market from the peak fell by around 60% to 65%. But in those markets where foreigners did not come in, such as commercial real estate or golf club memberships, prices fell to just one tenth of their peak values. Therefore, foreign investors in the Japanese stock market were a very stabilising factor, at least for this period. And in the United States, I might add, in the 1980s, when the United States was running large trade and budget deficits that needed to be financed, Japanese investors provided that financing through large purchases of US Treasury paper and kept a crisis from happening. Thus, the two largest economies in the world, Japan and the United States, did benefit strongly from the freedom of capital movements.

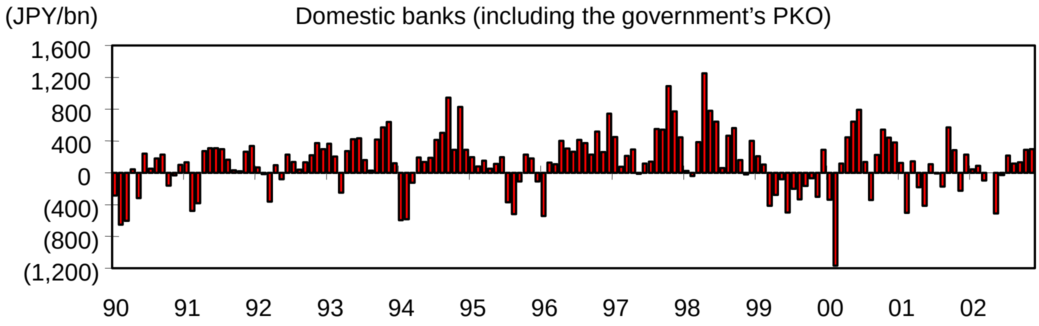
But for smaller, emerging markets, sometimes, free capital movements can cause pretty horrendous damage to their economies. I think it is important to make sure that investors who do come to these markets do their homework before they are allowed to invest.

The Japanese stock market has been led by foreign investors (net purchases)









Source: Tokyo Stock Market.