Overview

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I would like to thank the Kansas City Fed for making it possible for me to participate in this stimulating symposium in this gorgeous setting. When Paul Volcker asked me, at the last moment, to substitute for him on this panel, I appreciated his trust in me. But, at the same time, I thought that his trust was on the excessive side.

Since the other two panelists have already given excellent overviews of the discussion during the last two days, I think I will provide a brief review of an intriguing episode of capital markets: the movements in international capital between Japan and the rest of the world since the middle of the 1980s. This episode was truly remarkable in two aspects.

First, the amount of the long-term capital outflow from Japan during the second half of 1980s was enormous. During the five-year period from 1986 to 1990, Japan's cumulative current account surplus was about $350 billion, and the net long-term capital outflow was $532 billion. In other words, there was, on average, more than $100 billion of capital flowing out of Japan each year to the rest of the world.

Second, there was a dramatic reversal of this trend in the 1990s. During 1991 and 1992, Japan's current account surplus increased again to $197 billion, but the long-term capital export in this two-year period was reduced to a mere $9 billion. In other words, the net long-term capital export from Japan almost disappeared.

In my comments, I hope to explain how these developments took place.

One important aspect is to understand what happened in the second half of the 1980s. Here I will address two questions. Why was there such a large capital export? And, how was this large gap between the current account surplus and the capital export financed? While there are several reasons behind the large capital export during the second half of the 1980s, there are three major monetary factors behind the capital export.

First, there was a very substantial interest rate differential between the United States and Japan, due to the very easy monetary policy pursued by the Japanese authorities after 1986. This substantial interest rate differential encouraged large portfolio investment by Japanese institutional investors and business corporations.

Second, there was the strong yen. As you recall, after the Plaza Accord in the fall of 1985, the yen appreciated rapidly against the dollar. This appreciation enhanced the yen's international purchasing power. For Japanese investors, investment abroad in foreign securities and foreign properties became a cheap buy. In addition, the strong yen made Japanese industries less competitive in the international market, which led them to transplant their factories to overseas markets. This encouraged their foreign direct investment.

Third, prices in the stock market and property market in Japan soared, a development often called a speculative bubble. This greatly enhanced the ability of Japanese businesses to raise funds at a very low cost. At one point, Japanese business corporations could raise funds through equity financing using warrants and convertible bonds almost at a negative cost. And also during this period, Japanese banks were quite eager to extend credit to borrowers. Given all these different factors, there was a tremendous surge in long-term capital export.

Let me now turn to the second aspect, which pertains to how the large gap was financed. As I said, there was almost a $200 billion gap between the current account surplus and the long-term capital export during the five-year period between 1986 and 1990.

The answer lies in the fact that during this period, Japanese bank borrowing in the Euromarket increased tremendously. During the five-year period from 1986 to 1990, short-term positions of Japanese banks deteriorated by almost $170 billion. In other words, Japanese banks' net external short-term liabilities increased by $170 billion.

As a result, Japanese banks played an important role in the international maturity transformation. They provided long-term assets internationally by increasing their short-term liabilities. However, this transformation certainly bloated their global market share, which became a very topical issue during the period. At the same time, this transformation made their balance sheet structure highly vulnerable.

The second aspect of Japanese international capital flows was the dramatic reversal during the 1990s. What caused this dramatic reversal? In the 1990s, Japan's current account surplus increased for two reasons: the Japanese recession resulting from the collapse of the speculative bubble, and the lagged effect of the weak yen during 1989 and the first half of 1990.

Why did capital exports fall so much? I think there are several factors behind this. First, foreign investments in Japan increased during this period. I think the increase was due to the renewed interest of foreign investors in Japanese securities resulting from the lower prices in the stock market (leading foreign investors to expect some capital gains) and to the appreciating yen (leading to some exchange gains). Also, as was discussed in previous sessions, big pension funds in the United States and elsewhere intensified their diversification strategy into non-dollar denominated securities during this period. On the other hand, the collapse of the stock market and the property market reduced the ability of Japanese investors to raise low-cost funds. This situation is exactly the opposite of the situation I mentioned earlier. In addition, the appreciation of the yen increased the exchange risk of Japanese investments overseas. Furthermore, banks became very conservative, partly due to the fact that Bank for International Settlements capital adequacy requirements were installed. And as a result of these factors, there was virtually no net long-term capital export.

Japanese banks reduced their short-term liabilities in the Euromarket in a very rapid fashion. During the two-year period from 1991 to 1992, Japanese banks' position improved by $170 billion, which, as you recall, is exactly equal to the amount their liabilities increased during the previous five-year period. In other words, the position of Japanese banks was restored to what existed in 1985.

How should we assess this sharp reduction in Japan's capital export? There are strong arguments in Japan that such a reduction has an adverse impact on the global economy due to the growing needs for capital in the developing world and in the reforming economies. However, from the point of view of the international financial flows, Japan's surplus is definitely recycled; it is not hoarded in the Japanese market. The difference is whether the recycling takes the form of investment by institutional investors and business corporations, or whether it takes the form of short-term financing by Japanese banks. One point to keep in mind is that Japanese investors assume a variety of risks—trade risks, sovereign risks, exchange risks—when undertaking direct investment or portfolio investment. But in the case of interbank financing in the Euromarket, Japanese banks incur much less risk.

What will happen to this situation in coming years? I believe that Japan's current account surplus will continue at a sizable level for the coming few years. In addition, investment attitudes of Japanese investors will remain conservative because they have not recovered from the shock they suffered when the bubble burst.

Should we be satisfied with the prospect? I don't think so. When there is a global need for stable and productive capital, Japan should assume a fair share of the risk associated with international capital flow.

Turning to the last question: How can the situation be improved? I have two suggestions. One suggestion is to ask Japan to expedite the recovery from the current recessionary economic situation and to clean up the debris resulting from the bursting of the bubble. This would restore investors' confidence. My second suggestion is to urge the public sector, both national and international, to play a greater role as catalyst or supporter of private investment. The reason is that it is very difficult to expect private investors to increase their long-term capital export. As a result, it is critical for them to be convinced that there is public sector support for their activities. And in that sense, I strongly hope that the Japanese government, and also international financial institutions,can play a useful role. I think that this will help smooth the flow of international capital at a time when there is a great need for smooth and productive capital flows.