FRBSF Weekly Letter

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Japanese Capital Outflows

Japan became the world's largest exporter of capital during the 1980s. From a mere $10 billion in 1981, its net long-term capital outflows rose to a peak of $137 billion in 1987. They declined after that year, but were at the still substantial level of $89 billion in 1989.

As the world's largest capital exporter, Japanese investors have been leading acquirers of United States securities and other types of debt. Consequently, many policymakers, especially in the United States, are concerned about the extent to which Japanese investors will continue to invest abroad, in general, and in dollar assets, in particular.

In 1989, when the U.S. current account deficit amounted to $108 billion, Japan's bilateral current account surplus with the U.S. was $47 billion; its net long-term capital outflows to the U.S. were $54 billion. A reduction in Japanese demand for U.S. assets might adversely affect U.S. financial markets by inducing a sharp rise in U.S. interest rates and a decline in the value of the dollar.

This *Letter* discusses recent trends in Japan's capital outflows and the major causes of the increase in those outflows. It highlights the roles of changes in Japanese saving and investment, and the impact of the liberalization of Japan's domestic financial market.

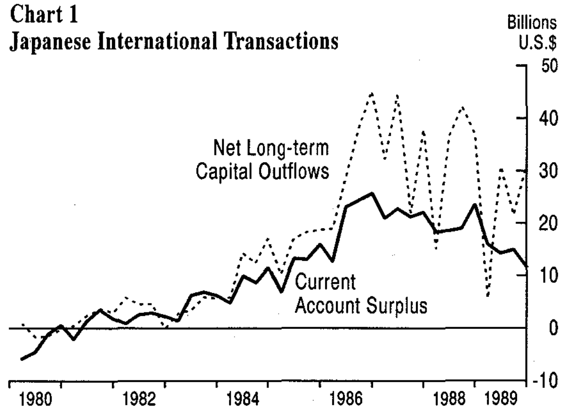
International capital transactions

A country's current account is, in essence, the macroeconomic balance between national savings and investment. To the extent that a country runs a current account surplus by exporting (selling) more goods and services than it imports (buys), it must lend the difference to foreigners. It does so by investing and acquiring an equal amount of net claims on foreigners through its capital account. Japan's capital outflows have therefore been the counterparts to its current account surpluses during the past decade. Correspondingly, a country that imports (buys) more than it exports (sells) must borrow the difference by issuing liabilities to foreigners.

Most discussion of Japan's willingness to finance U.S. current account deficits has focused on the trade in goods and services and factors that influence Japanese net exports and U.S. net imports of goods and services. Those factors include relative price levels and income levels. The logic of macroeconomic accounting, however, implies that capital flows are also important. It suggests that relative savings and investment levels and interest rates, factors that more directly influence the Japanese net demand for foreign assets, are important as well.

As shown in Chart 1, Japanese net long-term investments since 1981 have consistently been much greater than current account surpluses. (Net long-term investments are outflows of gross capital invested in foreign assets *minus* inflows of gross capital invested in Japanese liabilities, all with maturities greater than one year.) This suggests that Japanese capital outflows reflect factors motivating a greater demand for foreign assets, in contrast to the idea that Japanese investors have sought foreign securities involuntarily merely to finance an unbalanced trade in goods and services.

Chart 1
Japanese International Transactions



The changes in net long-term capital outflows primarily reflect movements in net foreign securities outflows. Japan's net direct investment outflows have increased steadily in recent years, but still account for only about 20 percent of total net long-term capital outflows.

Roughly 80 to 90 percent of Japanese *gross* foreign securities purchases have been in bonds, but a trend toward more stock purchases has recently emerged.

Although there are no comprehensive direct statistics on the currency composition of Japanese foreign securities investments, indirect evidence suggests that dollar-denominated assets issued in the U.S. and Euromarkets continue to attract a high percentage of Japanese investment. There is some limited evidence that Japanese investors may at times have sought to shift their preferences from dollars to other currencies, particularly during the period of the sharpest dollar decline from mid-1985 to early 1988, but dollar-denominated assets still constitute the largest share of Japan's overall foreign bond and securities investments.

Excess Japanese savings

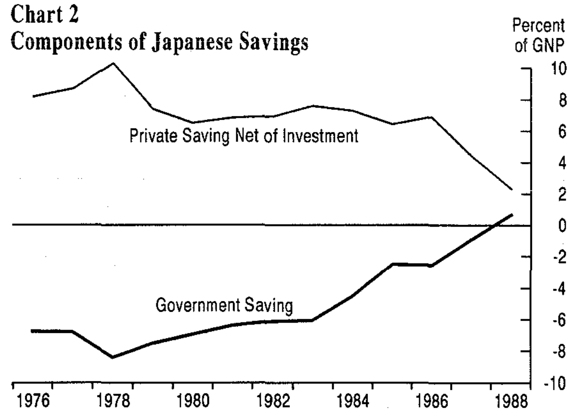
A combination of excess domestic Japanese savings, U.S. needs to finance a growing budget deficit, and financial liberalization account for the rapid growth of Japanese investments in foreign securities during the 1980s.

Total excess savings resulted from a large surplus of domestic private savings over domestic investment in combination with shrinking government budget deficits in Japan. These excess savings, in effect, provided the resources for foreign investment.

Chart 2 shows the patterns of both private saving net of investment and government saving in Japan. Between 1980 and 1986, Japan's surplus of private saving over investment averaged nearly 7 percent of GNP. During that period, the private savings rate actually fell, but declining domestic investment generally offset the drop. Compared to other industrial countries, of course, Japan's private savings rate remained relatively high. Reasons for the decline in savings included a deceleration in Japan's long-run growth rate that began in the 1970s, as well as the ongoing aging of Japan's population. Slower growth may have accounted for the decline in investment as it reduced investment prospects.

Since 1987, however, economic growth has boomed. Domestic investment rose to meet the more favorable investment opportunities. As a result, the balance between private saving and investment fell sharply to 2 percent of GNP in 1988. (Later figures are not yet available.)

Chart 2
Components of Japanese Savings



With excess private savings relatively flat or falling for much of the 1980s, most of the increase in Japan's net capital outflows has been associated with an increase in government saving (that is, government receipts minus expenditures). Mainly because of reduced spending, the Japanese government budget deficit declined steadily beginning in 1978, when it amounted to more than 8 percent of GNP. It fell throughout the 1980s and turned into a small surplus in 1988. This improvement in the government budget balance reduced the public sector's demand for domestic saving, and contributed to excess total savings.

Financing U.S. budget deficits

Rising budget deficits in the United States from 1980 to 1985 and a corresponding demand for capital were other major factors generating Japanese foreign investment. In a global context, Japan's capital outflows are net capital inflows to the rest of the world, and the U.S. has become Japan's largest external debtor.

The relationship between Japan and the U.S. is evident in the trends followed by real long-term interest rates during the 1980s. U.S. real interest rates (rates adjusted for expected inflation) rose sharply in 1981 and have generally remained above those in Japan throughout the 1980s.

Declining borrowing by the Japanese government combined with relatively loose monetary policy and falling interest rates reduced the supply and attraction of Japan's domestic investment outlets. The relatively higher return on U.S.

financial assets boosted demand for U.S. assets. This series of developments is consistent with the movement of net capital outflows from Japan to the U.S. as well as the appreciation of the dollar that occurred from 1980 to 1985.

Financial market liberalization

Another major factor behind the sharp rise in Japanese capital outflows has been the progress of financial market liberalization in Japan. This liberalization permitted greater financial market competition and relaxed foreign securities investment controls. In turn, these changes allowed more Japanese investors to engage in international capital transactions.

Domestic interest rate liberalization induced depositors to shift their funds from low-interest, fixed-rate deposits to relatively high-interest, floating rate funds. To offer their savers more competitive returns, Japanese financial institutions turned to higher yielding foreign investments.

The relaxation of stringent government controls on capital flows allowed Japanese investors to diversify their portfolios more into foreign assets. Enactment of the Foreign Exchange and Foreign Trade Control Law in December 1980 revised capital control regulations. In general, the new law eliminated restrictions on individuals and nonfinancial corporations, but left ceiling restrictions on overseas investments by most Japanese financial institutions. In 1985 and 1986, when the ceilings became significantly binding, Japan's Ministry of Finance raised them and greatly expanded the opportunities for financial institutions to invest abroad.

For example, when Japan raised the limits on holdings of foreign securities by Japanese life insurance companies from 10 to 30 percent of total assets in 1986, the companies' foreign securities holdings began to rise dramatically. Between 1985 and 1989, life insurance companies increased their holdings of foreign securities more than fivefold to $119.6 billion. In 1989, foreign securities accounted for 34 percent of their overall securities purchases, and 15 percent of their total assets. Other institutional investors increased their relative foreign securities purchases by similar amounts.

These trends suggest that much of the growth in Japan's foreign asset holding during the 1980s represents, in part, an adjustment toward desired levels that were not previously attainable for regulatory and other reasons.

Future capital outflows

The process of integrating the Japanese financial market with world financial markets appears virtually complete. However, even without any further increases in the portfolio share of foreign investments, the magnitude of foreign securities purchases by Japanese institutional and non-institutional investors is likely to remain high. It will remain high as long as Japan has an excess of total domestic savings and as long as its wealth keeps growing.

In addition, most of the foreign investments should remain in dollar-denominated assets because of the relative thinness of other markets. Thus, we should not underestimate the desire of Japanese investors to invest continuing domestic savings at current yen exchange rates and interest differentials.

Although Japanese foreign investment flows are likely to remain large for several years to come, they may not grow as rapidly as in the past. Indeed, Japan's rate of increase in long-term capital outflows has already slowed somewhat in the last two years because of greater domestic investment. Recent legislation intended to expand future fiscal spending in Japan may contribute to further declines in excess domestic saving in the 1990s. By that time, one hopes, U.S. current account deficits will have declined as well.

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