

Drowning in Excess Liquidity

By Kyoji Okada

The velocity of circulation of money is a commonly used indicator of excess liquidity. According to Fisher's conversion ratio, the correlation between the amount of money and income may be expressed by the formula $VM=PT$, where M is money, V velocity of circulation of money, P price level, and T the volume of transactions.

Thus when the quotient P·T is rising slower than the growth in the money supply (M), the velocity of circulation of money (V) decelerates. In effect, when the money supply grows faster than the nominal transaction volume as a determinant of demand, we speak of there being excess liquidity. By implication, when the velocity of circulation is stable or predictable, the monetary authorities are able to influence the growth rate, price levels and other facets of the economy by manipulating the money supply.

While there are differences of opinion on what statistics are to be used for M, P and T in order to actually measure V, I am taking for M the money supply in the United States as M1 and in Japan as M2+CD. For P·T, I am using nominal gross total demand (GTD, meaning nominal GNP plus nominal imports).

In the United States, the velocity of circulation of money was rising throughout the 1970s. From 1955 through 1979, the average per annum velocity of circulation increase was a relatively stable 3.4%. In Japan, except for the brief period of excess liquidity in 1972-73, the velocity of circulation was generally declining (the per annum average for 1974 through 1985 being a 2% decline). Although there were differences in the trends as a result of differences in the Japanese and American financial, social and other systems, trends were generally stable in both countries.

This situation changed sharply, however, going into the 1980s. In both Japan and the United States, there was a conspicuous slowing of the velocity of circulation. It is clear that velocity of circulation is closely related to economic trends overall, and when the economy is in recession nominal GTD slumps to reflect the sluggishness in real growth and prices. By contrast, the rate of increase in the money

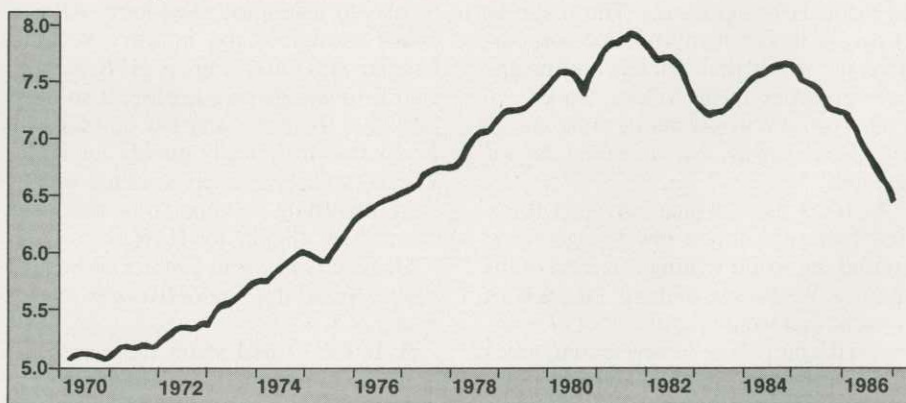
supply is slowed less because of the easing of monetary policies. As a result, the velocity of circulation slows. Yet in the 1980s, events seemed to violate this law. Monetary policy has been consistently easy since 1980 in Japan and since 1982 in the United States, and the Japanese and American economies have gone through a minor economic cycle without moving off easy-money policies. In both countries, although the velocity of circulation did experience an upward blip starting in second-half 1983, this was both shorter lived and less vigorous than the increases in the recoveries of the 1970s. As a result, it failed to sop up the excess liquidity and the accumulation of savings and other assets proceeded apace. This excess liquidity has in turn been cited as a primary cause of the strong bull markets in Kabuto-cho, Wall Street and other bourses

worldwide, as well as the soaring land prices in Tokyo and other Japanese urban centers and the many other ways that asset prices have skyrocketed.

One of the reasons cited for the longevity of this excess liquidity situation is the lower profit expectations from real-asset investment. With the lower velocity of circulation, asset selection preferences have shifted from real assets to financial or paper assets.

With the two oil crises, Japan's real economic growth rate slipped to 4% or so. Corporations sought to adapt to this era of slower growth by moving to slimmer and trimmer operations. More recently, the yen's rapid appreciation has engendered an export slump and sluggish domestic demand, eroding profit expectations from real assets overall and resulting in a relative heightening of ex-

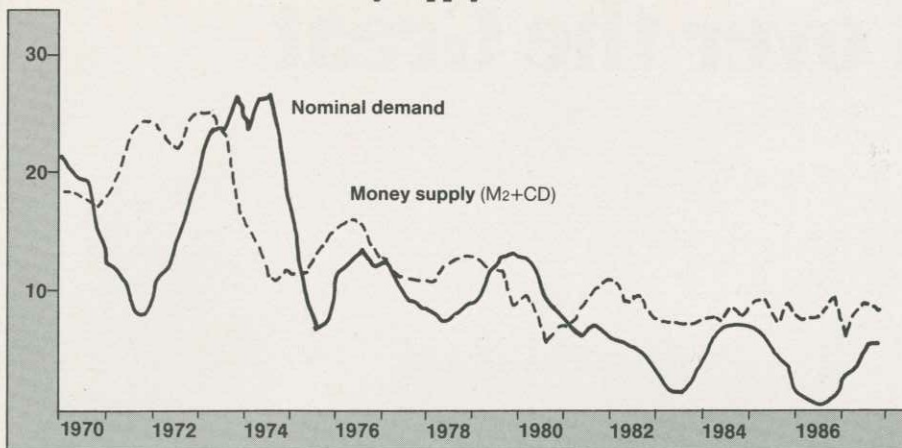
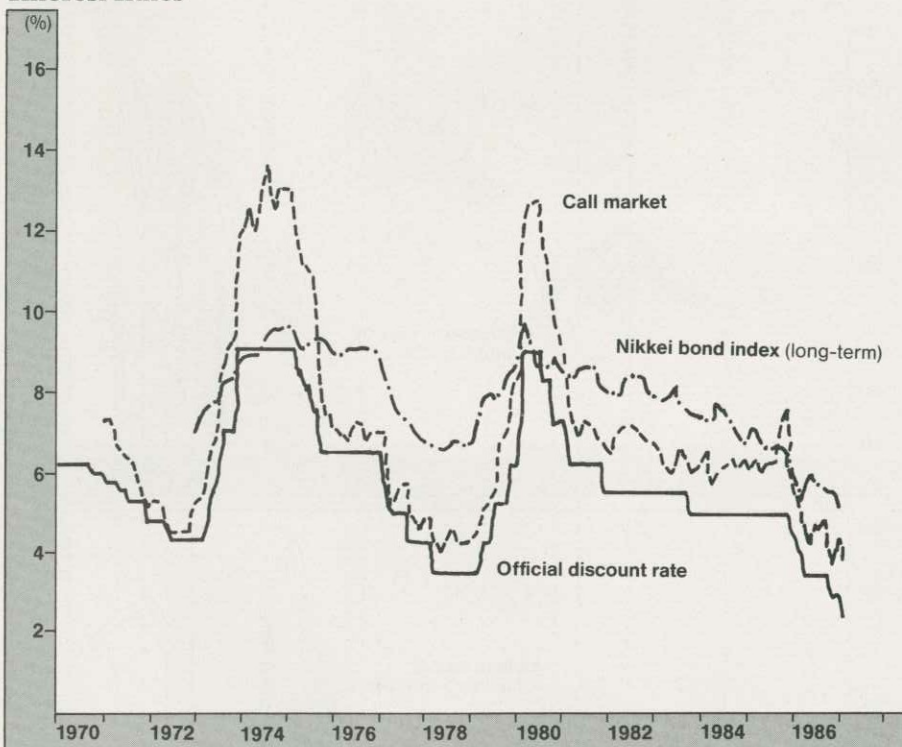
U.S. Velocity of Circulation (nominal demand+M1)



Japanese Velocity of Circulation (nominal demand+M2+CD)



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Nominal Demand and Money Supply (% increase from previous year)**Interest Rates**

pectations from financial assets. Thus the great flocking to play the money game. Although the corporate balance between savings and investments has remained healthy even during the recession, the ratio of real assets to financial assets has gone steadily down. Companies are raising funds on money markets not for capital investment but for financial investments. Substantiation for this thesis is found in the fact that the velocity of circulation is conspicuously slower in the corporate sector than in the household sector.

Supply-side contributions

While these are the main factors accounting for the excess liquidity on the

demand side, they have been complemented on the supply side by the revolution in financial services. The banking revolution accelerated rapidly in the United States in the mid-1970s, and it has made itself felt in Japan in the 1980s. Among the more conspicuous manifestations of this revolution in Japan are the greater diversity in bond issues as the government expanded its offerings, the increasing popularity of compound-interest instruments such as maturity-designated time deposits, money market certificates, certificates of deposit and the deregulation of interest rates on large-denomination time deposits. With the mounting pressures from within Japan and overseas, deregulated-interest instruments came to account for a sharply

higher percentage of the money supply (M_2+CD), growing at over 50% per year and climbing to 15% as of the end of 1986. The money supply has thus become more sensitive to interest rates with the coexistence of regulated-interest and deregulated-interest instruments. It was in these circumstances that monetary easing permeated the economy, creating a relative acceleration in the rate of increase in the money supply.

Easy money to continue

With the convergence of trends on the supply and demand sides, there was an increase in liquidity. Normally, with active international capital flow, excess liquidity would flow overseas, the currency would be depreciated on exchange markets, and, as a consequence, the economy would expand and there would be an increase in the velocity of circulation. Yet this time, the United States has also pursued easy money policies to accommodate the collapse in the price of oil and its massive fiscal deficit. As a result, there was a spiraling effect with easy money in both Japan and the United States. Looking at the money supply on the credit side, M_2+CD increased approximately ¥29 trillion in 1986, of which the increase in domestic credit creation accounted for ¥34 trillion and the decline in the money supply because of outflow was ¥7.2 trillion (versus ¥3 trillion in 1985).

What is the outlook for this excess liquidity? While there are a number of factors affecting the velocity of circulation of money, the most watched ones today are: (1) the United States economy; (2) the Japanese economy, and especially the questions of how strongly the government will step up its expenditures to stimulate the economy and what changes, if any, will be made in the tax system; and (3) the prices of oil and other commodities.

The U.S. economy is expected to be a neutral or moderately positive factor (accelerating velocity of circulation slightly), the Japanese economy to be moderate positively, and commodity prices neutral. Thus, assuming there is no fundamental change in the monetary authorities' basic easy-money stance, there will probably be an easing of the rate of decline in the velocity of circulation. Although there are a number of other important variables, including the question of timing and changes in the scale of capital outflow, there is little likelihood that the excess liquidity will get much worse. However, while it will not get much worse, neither is it likely to abate in the near future. ●