The Big Splash

By Susumu Kato

Wholesale prices are down about 10% over the last year, but the value of assets, including stocks, bonds and land, and even gold and paintings has gone up sharply. In early 1986, the government sold part of its NTT (Nippon Telegraph and Telephone Corporation) stock at slightly under ¥1.2 million per share. Shortly afterward, the price of these same shares was more than ¥3 million per share, and even today it is holding at more than twice the offering price. Land prices in downtown Tokyo have also soared with strong demand for office space, and this has now become a major social and political issue. Likewise, there are scenes of housewives clutching fistfuls of money as they go to the gold dealers to buy gold, Japanese purchasing famous paintings for record prices at international auctions, and many other signs of conspicuous consumption and excess liquidity.

There is another side to the coin, however. Steel, shipbuilding and other industries have been hard-hit by the yen's appreciation, and the resultant plant closures and layoffs have cast a recessionary pall over many areas and sown the seeds of public anxiety.

Today, companies and individuals alike are earning a far better return on the trading of money as a medium of exchange than they are on the production and sale of goods. This is just one facet of the excess liquidity permeating Japanese society. However, the economy has its own corrective mechanisms, and these have worked to correct this aberration by pulling the real rate of return on money (interest) down to the same level as the real rate of return on production (the real economic growth rate). Because the consumer price index increase is zero, it is only natural that the official discount rate should have been drawn down until it now approximates the real growth rate (approximately 3%). Excess liquidity was generated in the process.

Seen in another light, today's excess liquidity may be said to have its origins in the combination of the cheap dollar, cheap oil and cheap money. As the dollar fell from its overvalued perch following the September 1985 Plaza Accord, this sparked a chain reaction pushing down both oil prices and interest rates. The dollar has depreciated over 70% against the yen, dollar-denominated oil prices have fallen to less than half of their previous highs, and interest as shown by the official discount rate has also been halved.

Changing flow of goods and money

These major changes have altered the flow of goods and money and changed the relative prices of goods and money (nominal prices and interest). For example, as the yen's exchange rate jumped from an average of ¥222/$ in fiscal 1985 to an average of ¥160/$ in fiscal 1986 and oil prices slipped from a fiscal 1985 average of $27.30/barrel to a 1986 average of $13.80/barrel, Japan's import bill for mineral fuel resources plunged to ¥5.2 trillion in fiscal 1986—a saving of more than ¥7 trillion from fiscal 1985. While there is much talk about the recession in exports, the competition from imports, unemployment and all of the other problems accompanying the yen's appreciation, it should be noted that Japan recorded a ¥15 trillion surplus in its fiscal 1986 current account, which was ¥3 trillion more than in fiscal 1985.

This surplus capital availability combined with the shift from investment in capital equipment to investment in money markets, as demonstrated by the lower interest rates, and the result has been today's excess liquidity. Since it is impossible to rigorously define excess liquidity, this does not show up in Bank of Japan statistics. The best we can do here is to look at how much Marshallian k (the ratio of money supply to nominal GNP) has deviated from trends. The money supply may be defined as M_2 plus certificates of deposit (CDs) and this is shown in seasonally adjusted data. The Marshallian k is estimated as showing a gradual rise over the long term, from 0.7 in 1970 to about 0.95 at present. Of course, the actual Marshallian k is a more ragged line, with peaks above the trend and troughs

A display board of stock prices in Tokyo

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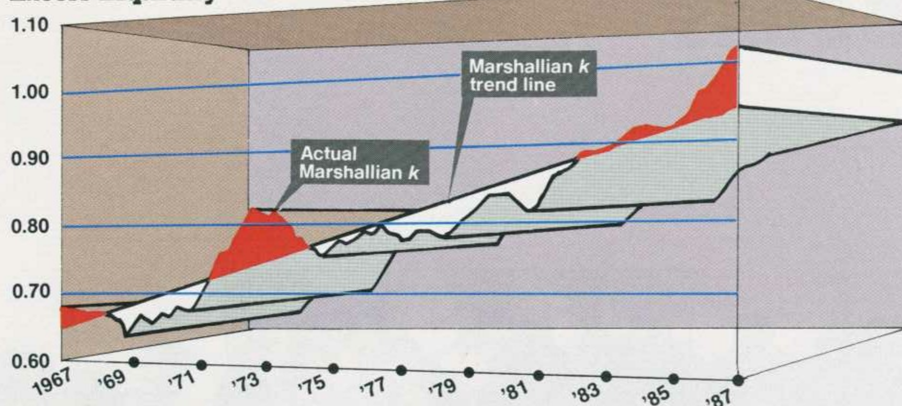

Sources: Ministry of Finance and Economic Planning Agency

below the trend line. When the actual figure is above the trend, we speak of excess liquidity, and when it is below the trend line money is tight.

As the figure shows, the Marshallian *k* has been well above the trend line in the 1971–74 period of excess liquidity and again in the present period from late 1985 until the present, indicating that both of these periods were times of excess liquidity. For what it is worth, the ratio of deviation from the trend line for the Marshallian *k* can be calculated at 10% for the previous peak in the October-December quarter of 1972 and only about 6% in the current peak of the January-March 1987 quarter, indicating that we are not yet in an extreme situation. At the same time, the deviation rate for the April-June quarter was 7%, which translates into about ¥25 trillion. However, with the recent increase in deregulated-interest instruments that are not included in M_2+CD, the estimates here tend to be on the conservative side, and this figure of ¥25 trillion in excess liquidity should be taken as a minimum.

Main investment targets

The next question is where people are investing all this excess liquidity. Looking at sector-by-sector capital balances, the surplus in individual capital is offsetting the deficits in the governmental and corporate sectors, and the excess that is not absorbed there goes to bloat the excess in the finance sector and flows overseas to offset deficiencies there. In effect, the excess capital in the individual sector goes, temporarily, into the financial sector as the individual purchases life insurance, invests or saves, and that in the corporate sector also goes into the financial sector in the form of *tokkin* or other funds. Following this, both go from the financial sector to financial assets, real estate, commodities or other investments.

Looking at the stock market, the Nikkei average has been abnormally bullish, jumping ¥9,000—or more than 70%—in the year up to the end of March 1987. With the sharp expansion in *tokkin* funds and investment trusts, the demand has far exceeded supply for stocks, and stock prices have climbed steeply on sharply higher trading volumes. Average daily trading volume on the Tokyo Stock Exchange (TSE) First Section was 450 million shares in fiscal 1985 and 840 million shares in fiscal 1986. In March 1987, trading volume was 1.42 billion shares daily.

Bond issues have been down from fiscal 1985 levels, with an effort to reduce the issue volumes of national bonds as the government tries to balance its budget and shake off its heavy dependency on deficit-financing bond issues, falling to only ¥25.47 trillion in government and other public bonds issued in fiscal 1986. While there has been strong growth in convertible bonds, bonds with warrants and other private-sector bonds, the total for fiscal 1986 was ¥4.5 trillion, only ¥2 trillion more than in fiscal 1985.

It is impossible to calculate a figure for investment in land, since the statistics make no distinction between purchases to meet current demand and speculation. All that can be done is to estimate from land prices. The main distinguishing feature of the current rise in land prices has been that it has been centered on downtown Tokyo and other commercial sites, and that land prices have gone up reflecting the greater productivity of land resulting from Japan's shift to more international and information-intensive uses.

According to land prices published by the National Land Agency, Tokyo commercial sites went up 79% and residential sites 93% in the year to July 1987, while in the Osaka area the figures are 20% for commercial sites and only 6% for residential sites. In the last period of excess liquidity (1971–74), land prices soared throughout Japan, but this time the increases are limited to the Tokyo area, where land has greater investment value.

Outlook for the future

Given the nature of the excess liquidity sloshing around in Japan, it is possible to conceive of three scenarios:

Scenario I: Greater excess liquidity

In this first scenario, the triple-decker combination of a cheap dollar, cheap oil and easy money continues to feed money into the financial markets and liquidity continues to expand. One of the assumptions for this scenario is that U.S. fiscal and monetary policy do not change and the twin (fiscal and trade) deficits show no appreciable decline, with the result that the dollar continues to slip. Yet as shown by the fact that the United States has recently raised its Federal Reserve rate, this is not likely. Something has to give.

Scenario II: A sudden drying up of excess liquidity

In this scenario, conditions are abruptly reversed as oil prices leap higher, the dollar appreciates and interest rates rise. With this about-face, the Japanese economy turns inflationary, the trade surplus shrivels up, and people rush to invest in goods, thus drying up the flow of money into financial markets. This is, in effect, a return to the conditions that prevailed in 1980 right after the second oil crisis. While this is incompatible with the changes that have taken place in the Japanese economy over the last few years, there is nonetheless a very real possibility that events in the Middle East may spark another period of soaring oil prices, and this scenario may be closer to the truth than most people would like to believe.

Scenario III: Soft landing

This seems the most likely in light of current economic trends. Because policymakers in both the United States and Japan are reluctant to see the dollar depreciate much more or to allow further inflation in the United States, it is probable that there will be a gradual change in the flow of money. Even though there will be no basic change in the excess liquidity situation, since there are huge financial resources available and a general unwillingness to invest in production facilities, the trend will be toward a drying up. Now that Japan has become the world's largest creditor nation and Tokyo stands on a par with New York as a major money market, it will expand and develop in accordance with actual rather than speculative capital demand. ●