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27 October 1986

Japanese Capital: Still Flowing Freely to the United States [redacted] 25X1

Summary

Japanese investment managers continue to channel long-term funds into the United States, although reports indicate that high-yielding Australian and Canadian bonds are attracting some attention. We believe the availability of low risk financial instruments in the far larger and more liquid US financial markets will continue to attract Japan's big institutional investors, who are motivated by the need to recycle the proceeds from Japan's massive current account surplus and by the opportunities presented by Tokyo's ongoing deregulation of capital controls. [redacted] 25X1
[redacted] leading Japanese securities companies want to make large-scale investments in order to convince the Federal Reserve Board to grant them the status of primary dealers of US Government bonds. Although this long-term perspective suggests Japanese funds will continue to flow freely to the United States, developments such as higher oil prices or increased domestic demand in Japan could sharply reduce future investments. [redacted] 25X1

This memorandum was prepared by [redacted], Office of East Asian Analysis. Information available as of 27 October 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan, Northeast Asia, OEA, on [redacted] 25X1

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Large Capital Outflows Continue

Japan is the world's largest creditor with $130 billion in net long- and short-term foreign assets, and we expect capital outflows to increase slightly over the next six months. Yen appreciation, which is fueling a near-term expansion in the current account surplus, has helped supply the Japanese with funds to boost overseas investments (see figure 1). Japanese institutional investors, who were responsible for the bulk of the $65 billion net outflow of long-term capital during 1985, are clearly eager to boost their overseas holdings. Press reports indicate that trust banks and insurance companies--which together manage pension funds worth over $80 billion--are actively trying to move away from the heavy concentration on domestic investments that resulted from Finance Ministry regulations restricting capital outflows through the mid-1970s. 25X1

The Japanese Government also seems ready to facilitate growing foreign placements. In an effort to dampen criticism of Japan's massive trade surplus, officials in Tokyo have publicly emphasized that Japanese capital exports--the flip side of the surplus--play an important role by making up for saving shortages in other countries. Japanese officials have another reason for encouraging outflows--to reverse some of the appreciation of the yen that has occurred over the past year. To this end, the Finance Ministry has eased guidelines that in the past acted as a brake on offshore investment activities:

- The Finance Ministry now allows life and non-life insurance companies to put 30 percent of their portfolios--instead of the previous 25 percent--into foreign bonds. Trust banks will be able to expand their holdings of non-yen securities by the same percentage.

- The Ministry of Posts and Telecommunications--responsible for overseeing the huge postal savings system--has removed the 20-percent ceiling on investment in foreign securities by the postal pension fund. The respected financial daily Nihon Keizai Shimbun estimates the change will boost postal pension fund investments in foreign securities by over $7 billion dollars annually.

- Effective 1 October, foreign exchange banks can, within proscribed limits, convert yen funds into other currencies and use the proceeds to buy foreign bonds.

Finance Ministry officials believe, according to press reports, that the recent changes may gradually boost the foreign securities held by Japanese by at least $25 billion, a 50-percent jump in current holdings. 25X1

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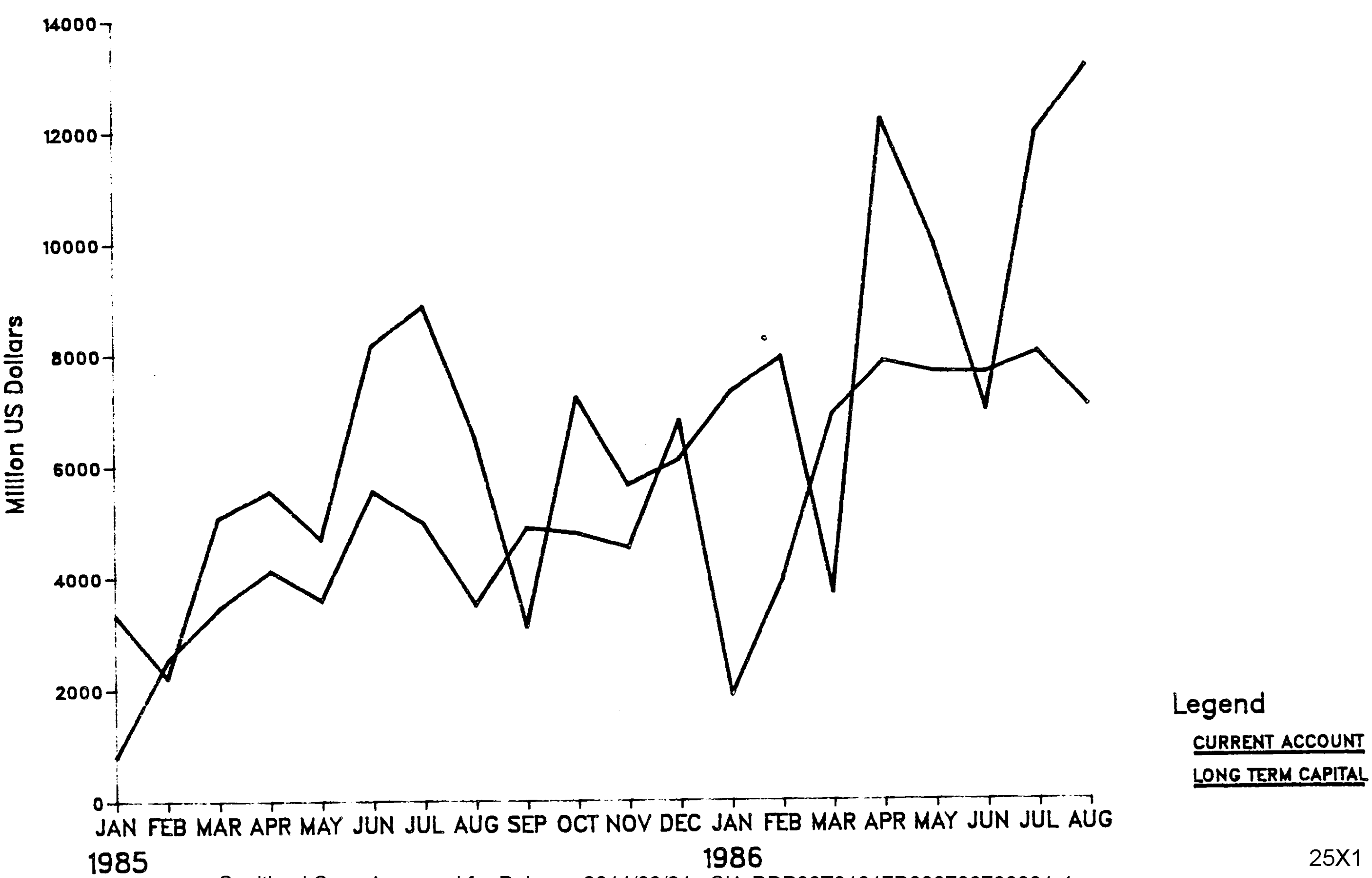
Figure 1

Japan's Current Account and Net Long-Term Capital Outflows, 1985–86



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Stable Flows: The Liberalization Factor

With Japanese assets large and likely to grow, the potential that shifts in placement will unsettle international financial markets increases. Japanese investment practices in the last year, however, suggest that despite exchange and interest rate changes, Japanese capital outflows have generally remained focused on the United States (see figure 2). Some industry analysts had expected Japanese investors to avoid US assets and to sell currently held bonds until the yen reached a plateau. In 1985, however, over 50 percent of Japanese net long-term capital outflows were invested in the United States--a sizable increase from the previous 30 percent share in the United States in 1984. [redacted] 25X1

Japan's financial liberalization program, which has been gaining momentum in the wake of the 1983 Yen/Dollar accord, is probably a major factor accounting for the emphasis on investment in the United States. In particular, it has improved the ability of investors to hedge against exchange and interest rate fluctuations, making overall capital outflows relatively stable despite swings in these variables:

- According to press reports, many investors are using "impact" loans to protect their portfolios. The loans, denominated in a foreign currency, allow the investor to take advantage of higher US interest rates while avoiding losses that could result from exchange rate changes.

- Fixed-rate currency and coupon currency swaps--exchanging the proceeds from debt in one currency for payment in another currency carrying either fixed or variable interest rates--provide other ways for investors to avoid foreign exchange risk in investments. For example, a Japanese insurance company that has invested in US securities might swap the dollar interest payments it is due for a guaranteed amount of yen at a future date.

- Finance Ministry permission, granted in November 1985, for banks and securities firms to trade financial futures contracts in the overseas markets also has enabled investors to hedge against fluctuating exchange and interest rates. For instance, a bank could use a futures contract for dollars to lock in a set exchange rate several months in advance. [redacted] 25X1

Trouble Ahead for US Assets?

Despite the public evidence [redacted] that indicates 25X1
that US assets remain a favorite of Japanese investors, some financial analysts believe their allure could fade. As a case in point, [redacted] 25X1
[redacted] the Japanese were shifting their investment portfolios from US dollar securities into Canadian securities in order to earn a higher rate of return. [redacted] 25X1

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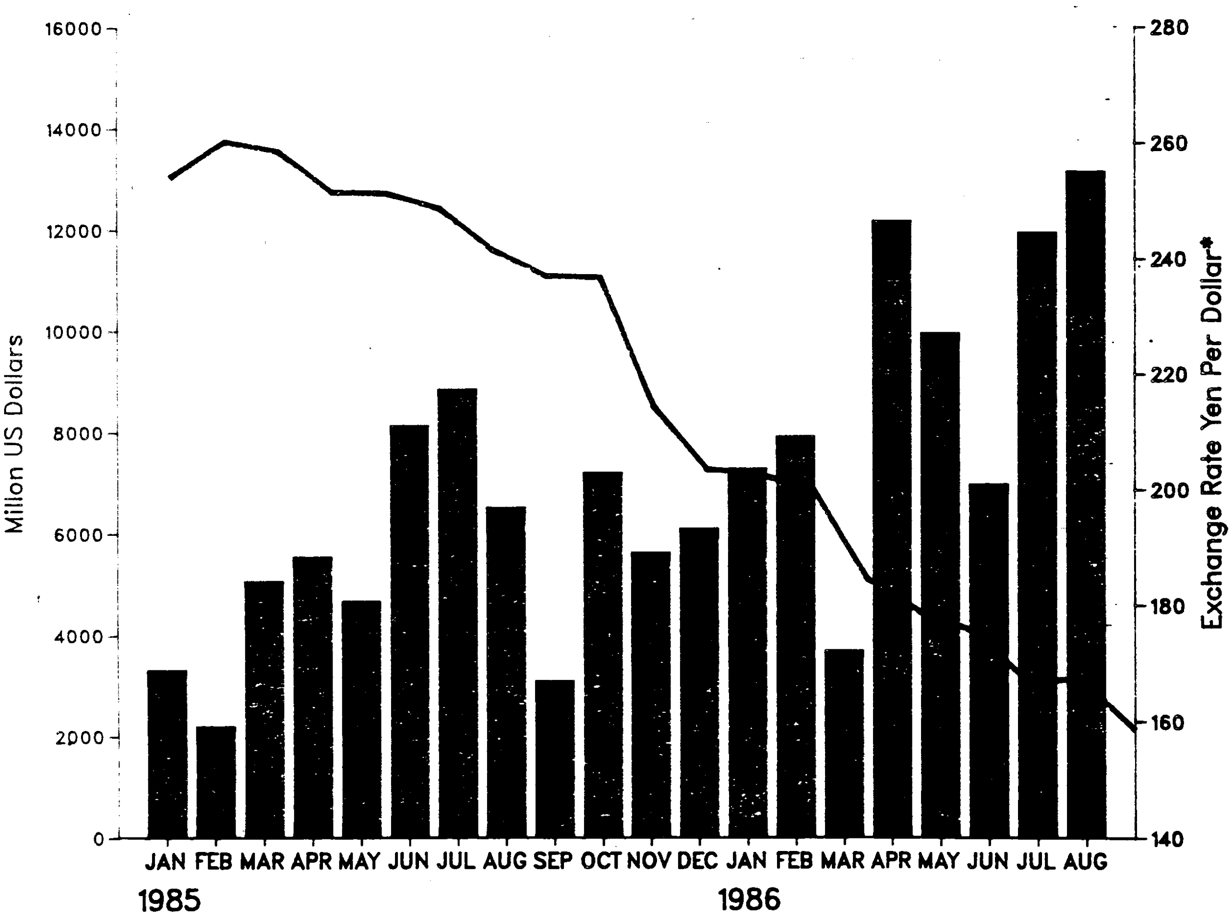
Figure 2

Japan: Exchange Rate and Net Long–Term Capital Outflows, 1985–86



*Monthly (

[redacted] 25X1

We are skeptical that the Japanese will diversify away from US assets soon, despite the higher interest rates offered elsewhere. We believe Japanese investors value the low risk of US assets. For many of the larger Japanese investors, such as insurance companies, the longer maturity offered by some US Government securities continues to make them attractive as instruments for covering long-term liabilities. We expect the poor performance of the Australian economy--because of low world commodity prices and a heavy government debt burden--will also be a major deterrent to increased Japanese investment in Canberra's financial markets, as will the small size of Australian as well as Canadian and New Zealand financial markets. [redacted] 25X1

In our view, long-term goals will also encourage Japanese institutional investors to continue focusing on the United States. [redacted] several top 25X1 Japanese securities firms plan to make a major effort to win the US Federal Reserve Board's blessing as primary US Treasury bond dealers. [redacted] their goal is 25X1 to become major players in the US primary securities market by 1990, a goal that is also publicly espoused by Japanese securities firms' executives. 25X1 The strong showing of the Japanese in the $9 billion US Treasury 30-year bond issue on 8 May--the Japanese bought an estimated two-thirds--appears to bear out this assertion. As a result, we also give some credence to the [redacted] prediction that US Treasury securities 25X1 investment will continue to compose over 60 percent of all Japanese overseas investment through the end of the decade. [redacted] the 25X1 Japanese are increasingly interested in US real estate as well. For example, [redacted] Japanese banks plan to invest as much as $5 billion in US property 25X1 during 1986. [redacted] 25X1

But Anything Can Happen

With Japan's current account surplus likely to top $80 billion this year, we expect Japanese capital to continue to flow to the United States at roughly the present levels in the coming months. Several factors, however, could cause the magnitude of Japan's capital outflows to change over the next year:

- A major increase in domestic demand in Japan--admittedly unlikely, unless Tokyo loosens its fiscal policy--would mean that more capital would be needed in Japan for investment, driving up interest rates and making investors more likely to keep excess funds in yen assets.

- A sudden run-up in oil prices and thus in Japan's energy import bill would soak up some of the proceeds from Japan's trade surplus, leaving less for the Japanese to invest abroad. [redacted] 25X1

More likely, however, are several developments that would encourage Japanese investors to send more funds to the United States:

[redacted] 25X1

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- A cut in Japan's discount rate. This likely prospect could easily widen the US-Japan interest rate differential and, as such, encourage additional capital flows to the United States.

- Heightened expectations of the yen depreciating against the dollar at a later date. This view already is the conventional wisdom among Japanese financial institutions, [redacted] If others come to share it, the result 25X1 could cause Japanese, hoping to benefit from exchange rate changes, to invest money in US markets.

- A worsening of the Third World debt crisis. Lower commodity prices or higher international interest rates affecting developing countries could drive Japanese into heavier investment in the safer OECD markets. Between 1982 and 1984, largely in reaction to the LDC debt crisis, Japanese banks reduced the Third World share of their medium- and long-term foreign loan portfolios from 54 percent to 50 percent [redacted] 25X1 25X1 25X1

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