

For release on delivery  
10:00 a.m., E.D.T.  
April 17, 1992

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

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I am pleased to appear today to discuss, as you requested, recent stock market developments in Japan. I think that it is useful to review these developments from a longer time perspective than just the past few weeks. I also will address the implications for Japanese banks and for the overall performance and prospects for the Japanese and world economies.

Japanese stock prices nearly tripled from the end of 1985 to the end of 1989. The reasons for this increase are not completely clear. It seems to have been fueled in part by the low interest rates associated with an expansionary monetary policy adopted by the Bank of Japan from February 1985 to December 1987. This initiative was directed at countering the contractionary effects on the Japanese economy of the doubling of the yen's exchange value against the dollar. Land prices in Japan also soared during this period, reinforcing the rise in stock prices because Japanese corporations are major land owners. While other world stock markets were also generally booming in the early part of this period, the Japanese market far outpaced those of other industrial economies.

Profits of Japanese corporations increased very strongly, 9-1/2 percent per year in 1987 and 1988, but stock prices rose at a much faster rate. As a result, conventional price-earnings ratios hit a peak of over 70 in August 1987, some 3 to 5 times PE ratios in other major markets. Even after adjusting for certain accounting differences (primarily with respect to depreciation allowances) and the prevalence of

War, the Japanese market see-sawed through most of 1991. Late in the year, however, amid growing anxieties over the slowing of economic activity in Japan, a rapidly worsening profit outlook, and recurring revelations of financial market improprieties, stock prices began a renewed plunge. From the end of October 1991 through April 16, 1992 the market fell a further 30 percent. This has occurred despite a significant easing of monetary policy.

This latest decline in Japanese stock prices brought conventional Japanese PE ratios down to the neighborhood of 30 or so, somewhat above that for the S&P 500 in the U.S. market. Doubtless, adjusted PE ratios for Japanese stocks are lower than this, and other valuation measures such as price-to-book value or price-to-free-cash flow are less elevated.

The Japanese stock market decline does not appear to have had important spillover effects on U.S. financial markets to date. Our stock market has been quite strong over the past year or so. In general, movements in price changes among major stock markets are only weakly correlated, because they respond primarily to developments in the home country, which have the greatest impact on profits. One exception to this pattern would be the consequence of major shocks, such as the 1990 oil price shock, which affect all the world's economies.

The decline in the Japanese stock market has not had any great effect on the yen/dollar exchange rate, either. That exchange rate has moved over a range of ¥ 123 to ¥ 142

per dollar over the past year and a half, a much narrower percentage range than, for example, the DM/dollar rate. Since the December-1989 peak of the Japanese stock market, the net appreciation of the yen against the dollar has been 8 percent.

The rapidly rising prices of Japanese land and equities, together with the huge appreciation of the yen from 1985 to 1987, made foreign land, equity, and bonds demonstrably attractive to Japanese investors. Yen-denominated debt rose sharply, against the increasingly valuable collateral, freeing funds to move abroad. During the 1986-88 period, Japan was a huge exporter of long-term capital, exceeding \$130 billion in each of those three years, on a net basis, far in excess of Japan's current account surpluses, which averaged over \$80 billion per year.

Despite increased gross demands for foreign currencies, the yen appreciated steeply against the dollar. Along with rising concern over market access abroad, Japanese manufacturers were led to undertake large direct foreign investments to expand manufacturing capacity in their foreign markets. Direct foreign investment outflows peaked at over \$45 billion in 1990. Similarly, rising yen-denominated asset values led to large-scale portfolio diversification abroad. *Long-term foreign portfolio investments by Japanese residents, including purchases of U.S. government and corporate bonds, averaged nearly \$90 billion per year during 1986-88, net of portfolio investments by foreign nationals in Japanese securities. The excess of long-term capital outflows over the*

current account surplus was balanced primarily by short-term private capital inflows, notably borrowing abroad by Japanese banks, which averaged over \$55 billion per year during the 1986-88 period.

This pattern of capital flows began to change during 1990 and was sharply reversed in 1991 as Japanese stock and land values peaked and eroded. Japan experienced net long-term capital inflows in 1991, the first year since 1980. A still positive but reduced rate of net foreign direct investment by Japan was more than offset by net portfolio and other long-term capital inflows. Japanese portfolio holders continued to purchase American and other foreign securities, though at rates far below those of 1986-89. These purchases of U.S. and other foreign securities were outweighed, however, by very large purchases by foreigners of Japanese securities. Stock purchases were particularly strong. The sharp decline in Japanese stock prices made equities seem more reasonably priced, and the decline in prices had apparently left foreign investors' portfolios underweighted in yen assets.

The long-term capital inflow and current account surplus in 1991 were offset by large private short-term capital outflows. Japanese banks, whose capital positions were eroding with the stock market decline, moved to shrink their balance sheets by reducing both foreign assets and foreign liabilities; liabilities were reduced \$93 billion more than assets. The 1991 pattern of capital flows appears to have continued into the early months of 1992.

Some concerns have been expressed in the financial press about the implication for markets outside Japan of this reversal from Japan being a long-term capital exporter to a long-term capital importer. These concerns, while understandable, seem to me exaggerated. As long as Japan continues to run current account surpluses, it must, by definition, be an overall capital exporter. To the extent that Japan's global current account surplus is widening, the net increase in Japan's capital exports contributes to the supply of world savings, thereby, in effect, reducing pressure on interest rates in international credit markets.

To be sure, shifts in the composition of Japan's desired capital exports may cause some price adjustments in various asset markets. But these adjustments need not be terribly disruptive. Japanese investors hold, for example, only a small fraction, 2 to 3 percent, of outstanding marketable U.S. Treasury securities. Their holdings of U.S. equities are of even smaller magnitudes. While U.S. data indicate that Japanese investors sold, net, some \$20 billion in U.S. Treasuries in 1990, interest rates on these instruments nonetheless declined, as other investors, including U.S. investors, were willing to buy them. In 1991, Japanese investors were, in fact, small net purchasers of U.S. bonds and stocks. The big change in 1991 was in net purchases by foreigners of Japanese securities, particularly stocks, which were very large.

Implications for Japanese Banks

Reflecting the decline in the Japanese stock market and the adoption of Bank for International Settlements capital standards, Japanese banks have restrained their asset growth in both domestic and international markets in recent years. Whereas the domestic assets of Japanese banks increased at double-digit rates in the years 1985 through 1989, they increased only 8 percent in 1990 and were flat in 1991. The pattern is even more dramatic in terms of international activity. The international assets of Japanese banks almost quadrupled from 1984 to 1989, with their share of international assets of all banks rising from less than a quarter to almost 40 percent. In 1990 and 1991, however, the international assets of Japanese banks declined, on balance, and their international share fell back to less than a third.

The restraint in the overall asset growth of Japanese banks has been caused, in part, by their desire to exceed the minimum risk-weighted capital ratios in the Basle Accord on capital adequacy. In the past, asset growth at Japanese banks appeared to have been oriented towards accumulation of market share, in part fueled by a relatively low cost of capital as well as additions to capital resulting from large and growing unrealized profits on their equity portfolios. In the past two years these sources' support of the growth objective has disappeared; it appears that Japanese banks are focusing much more carefully on the profitability of their core banking

business. This shift in business priorities is likely to be a healthy development in the long run.

Japanese banks differ from those in some other countries, including the United States, in that they have been permitted to hold substantial equity positions in nonfinancial corporations. The appreciation of the value of these equity holdings buttressed the capital of Japanese banks. Investors in Japanese bank stocks, recognizing the value of these appreciating nontraditional bank assets, were willing to pay large premia to acquire shares of Japanese banks. These premia were above what might be expected based on the earnings of the banks from their banking business alone. To that extent, owning shares in banks took on some of the characteristics of owning shares in a mutual fund.

Bank regulators, in developing the Basle Accord, were well aware that the quality of Japanese bank capital resulting from unrealized gains in equity securities was inferior to capital derived from other sources. Because such capital was correctly judged to be subject to market risk, and because banks would in all probability be subject to a tax liability for capital gains if forced to realize such gains to bolster capital, the Basle Accord permitted only 45 percent of these unrealized gains to be counted as capital -- and, moreover, not as equity capital but only as Tier 2, that is, supplemental capital.

The effect of the decline in the Tokyo stock market on the risk-weighted capital ratios of Japanese banks varies from



bank to bank, depending on the nature and overall importance of equity holdings at individual banks. In this context, the critical question is not the ability of Japanese banks to meet the Basle Accord's minimum requirement of 8 percent for the sum of Tier 1 and Tier 2 capital, but rather how much additional capital will banks need to raise and at what cost. Or, alternatively, how much will banks be induced to scale back their assets? A significant constraint on the asset growth of Japanese banks could be serious for nonbank borrowers in Japan, because of the heavy reliance of companies in Japan on bank credit and because capital market and other nonbank sources of funds are not as well developed in Japan as in the United States.

However, Japanese banks may choose to protect their traditional domestic business base and instead choose to pare back their loans to some of their newer customers, including those in overseas markets. Spreads and margins on banking transactions in these markets might in the short run increase somewhat as a major competitor scales back, just as such spreads narrowed when the Japanese banks expanded their activities. Over the intermediate run, however, the flexibility to lend by other banks and increased supply of credit from nonbank sources is likely to be sufficient to ensure that credit market conditions on a worldwide basis will not be substantially weakened by a scaling back by Japanese banks.

Macroeconomic Effects on the Japanese and World Economies

In addition to possible effects on credit availability in Japan, lower prices of Japanese stocks could affect Japan's real economy through their negative impact on the wealth of households, with attendant effects on private consumption expenditure and, in turn, real GNP. One important limiting factor, however, is that stocks constitute less than 10 percent of total household financial wealth in Japan. In addition, estimates from econometric studies suggest that in Japan the marginal propensity to consume out of wealth is relatively small.

There are additional reasons to suspect that actual impacts on consumption from declining equity prices could be even smaller in the present episode. Evidence from saving rates suggests that the expansion of household wealth during the recent stock market boom was not fully incorporated into household spending plans. In fact, the household saving rate had been on a downward trend in the 1980s. During the eight quarters since the Tokyo stock market turned down in early 1990, there has been little evidence of a shift in household expenditure to replenish the stock of savings; the household saving rate has remained well below its average of the previous decade. While consumption has decelerated with the recent slowdown in overall real growth, it has not been conspicuously weak.

Possible negative effects on consumption from lower equity prices could be compounded by additional declines in

prices of housing and land, which are mutually affected by developments in the stock market. Residential and commercial real estate prices have turned down in major metropolitan areas in latest surveys and have stopped rising as quickly in other parts of the country.

Negative effects of the stock market decline on investment in Japan could be more significant. The net asset positions of nonfinancial firms are affected directly by share-price declines. Lower stock prices also have substantially elevated the cost of issuing new equity, as well as increasing the cost of equity-linked methods of raising funds. In coming months Japanese firms will need to refinance a significant amount of previously issued convertible and warrant bonds. Of course, Japanese investors may be able to borrow through other avenues -- including a revitalized domestic corporate bond market -- but it is likely to be at substantially higher costs than in the past, which would tend to reduce Japanese international competitiveness. Japanese authorities have interpreted the recent deceleration of bank credit as arising from weak demand for funds. It is possible, however, in view of the deterioration of some Japanese banks' asset portfolios and the negative impact of the stock market decline on banks' capital, that tightening of credit could restrain investment.

Spillovers to business confidence also represent a potential risk to private investment from the stock market decline. Measures of business confidence have deteriorated steadily in recent months, and investment has been a weak

sector of final demand. Latest surveys of business intentions indicate that private investment may decline in fiscal year 1992 by as much as 5 percent, which would be the first decline since 1975, and a sharp reversal of rapid increases in private investment spending in recent years.

The recent slowdown in the Japanese economy has been reflected in reduced import demand and a widening external surplus. Reflecting the incorporation of some negative effects from stock market price declines that have occurred already, most forecasts project growth of domestic demand and GNP in Japan to be weak until the second half of this year, with some risk of further slowing if stock prices continue to slide substantially further. Accordingly, growth in Japanese demand for U.S. exports is not likely to be a particular source of strength for the U.S. economy in the near term. Nevertheless, even though Japan is the second largest export market for the United States, the separate contribution of the stock market decline to weaker Japanese demand for U.S. exports is not expected to be large.

In summary, the Japanese stock market decline is a significant development especially for Japan. It appears primarily to be a correction of the bubble in asset prices that was causing distortions to the Japanese economy with some spillover effects on the rest of the world. The Federal Reserve will continue to monitor closely developments in Japanese financial markets and their implications for our economy and markets. In my judgment the impact on the United

States from Japanese stock price changes to date are likely to be limited.