The Financial System and Global Socioeconomic Changes

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I have a few comments on some recent changes in financial structure and also changes in the effects of monetary policy which perhaps need more discussion.

1. Socio-Economic Structure Changes: "Softnomization"

The industrialized countries - the United States, Japan, and Europe - attained modernization and industrialization after the Industrial Revolution. In recent years, their socio-economic structures have been changing in a way we call "softnomization".

In pre-modern times, people lived with nature's cycle - the "path of nature" or the "soft path".

The "path of mechanization and automation" or the "hard path", pursued in the process of modernization and industrialization has blessed mankind with material affluence. It also has brought about "global environmental problems and maladies to advanced nations, such as drug use and other urban crimes, and it has deteriorated the vitality and quality of the society.

"Softnomization" means a softening of the hard path, by seeking harmony between the "hard path" of modern times and the "soft path" of pre-modern times.

Today we see softnomization going and the quality and meaning of affluence is questioned in the affluent society, and we observe a shift of emphasis or change in priority from "quantitative enlargement" to "qualitative enhancement" in various fields, such as science and technology.

The economy is also softnomized. Reflecting the evolution in science and technology, there is now a shift from heavier and larger industries to smaller and lighter
ones. The quantitative expansion-oriented era, in which uniform commodities were mass-produced rapidly, is being replaced with a new era where personalities and sensibilities are given serious consideration. Emphasis is now put on producing diversified products in a limited quantity and supplying various services in order to meet diversified and high-quality needs.

Amidst the softnomization and service orientation of the economy, the concepts and statistics of the age of industrialization, which were geared to measuring mere good production, should be reviewed. For example, since improvement of productivity in service activities has been simply considered as a rise of market price in the System of National Accountants of the United Nations (SNA), the GNP figure of each advanced country has been less than the real GNP figure. Assuming that productivity in service activities is equal to that of manufacturing industry, GNP growth rates of the United States and Japan in the 1980s could increase by 2%. Recognition of improvement in productivity (or quality) in service activities could reduce the price index by this percentage figure which has been considered equivalent to a rise of market price.

Now in the United States, it is pointed out that, excluding foodstuffs and energy fuels, while the Consumer Price Index (CPI) is rising, the Producer Price Index (PPI) is falling. Thus these two figures are diverging from each other. This divergence may be mostly accounted for by the fact that PPI covers only the prices of goods, but CPI includes prices of services without sufficient adjustment for quality.

2. Changes of Financial Structure in Advanced Countries
Socio-economic change, such as softnomization, informationalization, service orientation, and internationalization have caused a fundamental change in the financial structure of advanced countries.

In 1929, industrialized countries were still in the process of industrialization, and business corporation required massive funds for their production activities, for which they depended on banks. In short, financing and producing were closely linked in this period.

Now, however, after the accomplishment of industrialization in developed countries, we see the generation of "structural excess money", which are massive funds exceeding those required for normal manufacturing activities. Such excess money moves freely and quickly beyond country borders and time zones among time, spot, and futures markets in currency, money, stock, gold, and crude oil.

I would like to explain the background of the generation of "excess money".

First, the development of softnomization and the shift from heavier and larger industry to lighter and smaller industry have brought about a reduction in corporate funds required for capital and inventory investment per production unit. The growth of the service industry is accelerating this trend.

Second, as industrialization matured, the retained earnings of corporations have growth. Large corporations have come to finance funds for production, sourced by depreciation and the growth of retained earnings. Owing to the relatively stronger bargaining position of corporations, they have diversified their methods of funding and
have become less dependent on banks for financing. Moreover, the corporations are further, aggressively, having portfolio investment, sourced from their surplus money.

Third, individual investors also have accelerated their profit-taking behavior by investing in equities and other instruments, and increasing their financial assets.

3. Changes in Effects of Monetary Policy

Banks have had to develop new fields of financing, resulting in aggressive lending for M&A or real-estate related activities. This might trigger a market crash as a consequence of unsuccessful LBOs. They have increased the risk of financial institutions, as is seen from the bankruptcies of Campeau and Drexel.

Now psychological factors such as "Omowaku" - speculation, or emotional expectation and political expectation - are more influential on the market that the supply and demand for money. This has brought about big fluctuations in stock prices and foreign-exchange rates.

The linkage between the flow of funds through banks and normal production and economic activities, has been weakened, and interest rates are directly affected by both international capital movement and fluctuation of foreign exchange rates. These have caused great changes in effects of monetary policy over business cycles, prices, and other economic activities.

Since the flow of excess money is not strongly linked with the usual production activities, its rapid shifts have little impact upon production activities. The largest difference between Black Monday in 1987 and the Great Depression in 1929 is that the
stock market crash on Black Monday hardly had effects on the real economy.

The linkage between the money flows and inflation rates also seems to be weakened. In addition, although it is necessary to make further examination, it seems to me that the linkage between monetary indexes and the real economy is weakened, except for the close linkage with sales of real estate, in which "excess money" is mainly invested.

In order to study this issue, our Institute has established the "Research Committee on Financial Structure and Policy Effectiveness" chaired by Mr. Ryuichiro Tachi, Professor Emeritus of Tokyo University and Former President of our Institute.

4. Calling for Structural Measures to Reduce "Excess Money"

Although "excess money" is not strongly linked with the real economy, massive and drastic shifts of excess money would make the world economic system unstable.

Amidst these changes in financial structures, policy coordination and cooperation among the monetary authorities of major industrialized nations have been closely established and they have shown great success.

Measures aimed at the factors which cause the structural change are called for, in addition to remedies to lessen the instability of the world economic system.

In the United States, a famous professor advocates equipping each market with instruments to prevent money from sudden and drastic movement. But I don’t think we can expect sufficient effect from such instruments and they might disturb the smooth flow of money.
In the global society there are some regions such as the Asia-Pacific and Eastern European areas that need massive funds for economic development, employment expansion, and improvement of the standard of living.

Structural measures are needed to reduce the total quantity of "excess money" through the recycling of private funds, which make the best use of "excess money" being criticized as a cause of the "money game" in developed countries.

5. Asia-Pacific Money & Capital Markets

Finally, I would like to add a few topics about the money and capital markets in the Asia-Pacific area, especially ASEAN countries.

ASEAN countries intend to promote export-oriented industries and actively seek to attract foreign corporations. In response, massive direct investment have been made by corporations of the industrialized countries. This has enabled the economies in this region to achieve remarkable progress.

However, their domestic industries are not yet fully developed. Their money and capital markets are also not fully developed for industrial development, although industrial development and finance are inseparable from each other.

The characteristics of the financial markets in detail in this region are as follows.

These ASEAN markets do not have long-term financial instruments, such as long-term credits, straight bonds, or convertible bonds, possibly due to the characteristics of the overseas Chinese concept on financing, namely, most of the bank loans in this area have rather short-term maturity. Foreign corporations bring money
for their initial investments from their own countries. They have difficulty in raising local money for operations. Therefore, they are obliged to renew local short-term money again and again, or raise dollar funds from Singapore. The markets have neither developed enough for investing profits, nor portfolio investments, in these countries.

Responding to this problem, the financial authorities of these countries have made extensive efforts to rapidly reform their financial markets, especially in the past year. Japan would like to cooperate in the development of the markets in this region. For this purpose, I have been exchanging views on financial markets with Finance Ministers, Central Bank Governors, and others in this area.

Long-term capital for industrial growth is indispensable, and there is a strong demand for this capital to promote the growth of domestic industries in this area. In order to bring about economic development in the Asia-Pacific area, and partly in order to shield financial markets of advanced countries from the destabilizing effects of "excess money", it is important to foster money and capital markets that will play an intermediary role for the "excess money" and other private funds of advanced nations.

Our institute and FAIR jointly inaugurated "The Committee for the Development of Money and Capital Markets" chaired by Mr. Tomomitsu Oba, former Vice Minister for Internal Affairs of our Ministry, in cooperation with financial authorities for each country in the area.

Investment in human resources is essential for the development of financial
markets. This year our Institute is launching a training program for high ranking officials of Asian governments and financial institutions, which is designed to bring the trainees to Japan and to send instructors there from industrialized countries, in cooperation with the Asian Development Bank (ADB). We have already appropriated this program in the Japanese budget proposal for fiscal 1990.

CONCLUSION

When accepting an Honorary Doctorate from Columbia University, Former Prime Minister Noboru Takeshita, in his acceptance speech, disclosed that he had been called the "stronger yen" minister. This is because during his first tenure as Finance Minister, the yen appreciated from 242 to 219 against the dollar. When he was appointed Finance Minister for the second time, the yen was 250 and it strengthened to 200 at that time. And after a meeting with President Ronald Reagan, he told the press that the yen level was in the hands of market forces, at which time the yen started to appreciate to less than 200, leading to an even stronger yen thereafter.

Today the yen was hovering somewhere in the 155-160 level and is even stronger than in those days. But the recent G7 meeting warned that the present yen level will have adverse effects on the world economic adjustment process. With this transition of the yen's level, I cannot help but feel the passing of four and a half years.

In the United States there are views that German money, which has maintained a major part of the world liquidity, will dramatically diminish, because West Germany is expected to invest large amounts of money to reconstruct East Germany. Hence, in
order to deal with matters such as the environment and the Latin American problems, more attention appears to be paid to the movement of Japan's money.

Regarding the recent depreciation of the yen, as seen in the G7 statement, we must pay careful attention to the concern about weakening the improvement in the trade imbalance and the shortage of international liquidity.

I sincerely hope that a world system with full freedom and vitality will be constructed through the cooperation of the United States, Japan and Europe and that global society will make further progress.

Thank you very much.