

November Capital Market Flows

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Executive summary

November capital flows were characterized at an international level by outflows, on the one hand, from the weaker to the stronger economies (i.e. from emerging countries to developed countries) and on the other hand from Japan and US towards Europe. The measures the Japanese government will have to take in a near future to solve the banking problems may even contribute to increase the outflow from Japan. In Japan, individual investors seem to be willing to take advantage of the actual undervaluation of stocks, and this could be good news for the JREITs.

International regional capital market flows

Emerging countries: Capital outflows

The “flight to quality” expected after the terrorist attack on the WTC has become reality. The resulting capital outflow concerns South and Central America, Eastern Europe and some Asian countries (especially Muslim countries like Indonesia). This movement has for example affected the creditworthiness of Argentina which debt has been downgraded partly by S&P to “Default”.

US: Capital outflows

Capital outflows from the US are mainly due to a decrease of the investors’ confidence in US assets. The NBER (National Bureau of Economic Research) has officially declared that the US economy entered in a recession in March. Even if the confidence in a recovery next year is said to be growing among US economists and investors, the hard data to support this impression is lacking and capital outflows, on the contrary, are tangible:

- ✓ The last few weeks have seen the sharpest one-week sell-off in US Treasuries since 1987. This has left 10-year yields at 80 basis points above the low reached in early November.
- ✓ In Asia, the Chinese and Taiwanese authorities have begun to sell US dollars.
- ✓ In the framework of its Corporate Governance Investments Active Management CalPers has allocated 1.3 billion dollars to investments in European corporations.

Japan: Capital outflows conditioned partly by the government policy

According to a survey carried out by the Ministry of Finance between the 5th and the 9th of November, as domestic investments into foreign bonds and stocks represent respectively 1.6 trillion yen and 14,1 billion yen, foreign investments into Japanese bonds and stocks account only for approximately 163.2 billion yen and 14.1 billion yen, showing a clear unbalance between the

capital inflow and the capital outflows from Japan.

The factors explaining this outflow are mainly related to the concerns of the Japanese government's ability to solve the bad loans problem and to take the country out of recession. Those concerns are strongly expressed by western rating agencies and international organizations:

- ✓ MOODY's has announced that the BoJ alone cannot rapidly solve the NPL problem,
- ✓ Fitch has downgraded Japan's creditworthiness from AA+ to AA citing a list of economic and structural problems that "threaten to worsen unless the government takes drastic measures". The rating agency offers also an alarming assessment of what it regards as the true size of the non-performing loan problem, which centers on 87 trillion yen of the so-called watch list.
- ✓ Observers pointed out that FSA's special inspection of Japanese banks would result in some banks being undercapitalized.
- ✓ OECD (organization for Economic Cooperation and Development) said that Japanese economy was expected to be particularly weak in the second half of this year and next, contracting about 1% in 2001 and 2002

This outflow could worsen depending on the decision of the Japanese government of whether to buy foreign assets in order to weaken the yen against the dollar. This measure, up to now flatly refused by the Japanese government, seems now to be "under consideration", as the BoJ has little room to use interest rates or quantitative monetary policy to counter deflation. Besides, this measure finds an active supporter in the person of the chief secretary of the Democratic Liberal Party who has announced, during an interview to the *Nihon Keizai Shinbun*, that he sees as being favorable an increase in the yen against the dollar exchange rate to 140 yen in order to improve Japanese economic situation.

In principle, this would drive down the value of the yen against dollar, increasing the competitiveness of Japan exports and discouraging imports to Japan. Thanks to higher import prices, price should rise, slowing the five-year deflation of Japanese consumer prices. Nevertheless, certain analysts nurture doubts on the significance the effect of this measure could have, arguing that even assuming a favorable impact on the exports, the exports are only a 10th of Japanese GDP, and a 10% improvement in Japanese exports worldwide is not sufficient to drive Japan out of the recession.

Continental Europe: Net capital Inflows

Due to the investors' diffidence into US assets and Japanese banking system "a shift of funds towards the banking sectors in Europe has started to be seen" (Hidenao Miyajima at FRC of Nomura Securities).

Moreover, this inflow should intensify in a near future as the European Union agreed on the 26th of November to reduce the cost of cross-border transfers in euros from 2003 after defeating opposition from a number of member states led by Germany. This measure is representative of the strong intention of the European Commission to ease the financial regulation and should contribute to make the region more attractive, both for the foreign and the European investors.

On the contrary other easing measures could potentially stimulate capital outflows from Europe:

- ✓ Growth of private pensions and new measures allowing funds to invest more overseas,
- ✓ Relaxation of restriction on offshore investments,
- ✓ German plan giving greater freedom to a new class of pension funds by allowing them to invest exclusively in equities and to place as much as 30% of their investments outside the Eurozone.

Regarding this last point one can also argue that having to guarantee that investors get back at least their principal investment, pension funds are likely to be relatively conservative and to eschew currency risk by investing mainly in Eurozone bonds.

Domestic flows of funds

Individual investment towards Japanese blue chips has surprisingly increased. In September 2001, while the institutional investors were selling off Japanese stocks, the investments from individuals have reached more than 150 billion yen.

According to Tsubasa securities 2001 survey, 76% of the individual investors want to invest in stocks. Investments in JREIT stand at the 9th position after companies stocks, foreign currencies deposits, postal deposits, companies stocks and mutual funds, public and corporate bonds, individual pension funds, and Life insurance.

Asked about the reasons for wishing to hold shares and stocks funds, “because I am not satisfied with low interest rates” and “because shares are undervalued now” accounted respectively for 59% and 56% of the responses. Most of the individuals have also said that they were prepared to take risks related to capital losses if the yield is commensurate.

More than one half of the investments into JREIT come from individual investors. The reason why this investment has the favor of individual investors is not only its yield. In a context of economic depression, the JREITs answer also to the individual investors needs of stability. Favorable market conditions for JREITs have generated capital inflows into the office property sector, which have pushed the prices up and the yields down.