

"Study Group on Structural Changes in Flows of Funds in 21<sup>st</sup> Century"  
-- Interim Report (July 1999) --

(1) Motives and Purposes for Studying Fund Flows

Japanese Economy after Collapse of Economic Bubble

The economy has long remained unable to shift to private demand-led growth and bring its potential into full play.

Financial markets have reduced their pricing and risk-distributing functions. Even under excessive savings, the markets are short of risk capitals.

Growing Need to Pay Attention to Fund Flows

Structural Changes in Flows of Funds in 1990s

- Flow: A shift from a fund shortage to a fund surplus in the business sector  
The government sector's massive fund shortage
- Stock: Personal sector's financial assets worth more than ¥1,200 trillion.  
Outstanding government debt exceeding ¥500 trillion  
Growing need for combining the flow and stock

Increasing level of Interaction among National Economies and Financial Markets

- The liberalization of financial and capital markets and development of information and communications technologies have brought about an explosive expansion of cross-border financial transactions.

The effect of one country's economic policy on another country is no longer negligible.

Emergence of Society Comprising Less Children and More Aged People

- How will such society affect economic trends as well as savings and investment that represent flows of funds?

Financial system reforms, fiscal investment and loan program (FILP) reforms, and other reforms that could greatly affect the flows of funds



Viewpoints of Study Group

How should we view the structure of fund flows in the early 21<sup>st</sup> century at a time when the number of children is decreasing and aged people increasing?

What would be policy challenges to ensure efficient distribution of funds with a view to fully utilizing the potential of the economy?

What would be roles of the public sector in addition to market forces for efficient distribution of funds?

## (2) Fund Cycles and Economic Trends in Future and Sustainability of Public Sector's Fund-raising

### Future Economic Trends as Basis for Future Fund Cycles

When foreseeing structural changes in the flows of funds in the 21<sup>st</sup> century, we should make wide-ranging predictions on how economic trends and the investment-savings balance would be in the early 21<sup>st</sup> century.

i) A wide-range predictions on long- and medium-term growth potential as part of economic trends may be developed depending on how to estimate degrees of technological advancement with the workforce hardly expected to grow.

Need for structural reforms.

ii) Will private sector investment in plants and equipment remain high or fall to international levels?

The effects of the international capital cost convergence, information technologies, etc.

iii) How should we estimate the savings rate in the early 21<sup>st</sup> century when a more-aged society is set to emerge on the retirement of baby-boomers?

### Sustainability of Public Sector's Fund-raising

Regarding the public sector's investment-savings balance, considerable budget deficits are expected to remain even if potential growth is realized. We should seriously contemplate the effect of such budget deficits on the macroeconomic picture and their sustainability.

i) As for the public sector's debt, outstanding government debt is estimated at 120% of the GDP at the end of fiscal 1999. In terms of flow, massive annual budget deficits are expected.

We should further analyze the sustainability of the public sector's fund-raising. We should also specify the relationship between benefits and costs of administrative services and encourage the people to realize this relationship.

ii) As for the effect of budget deficits on the economy, we should consider the possible effects of budget deficits on global real interest rates amid the globalization of the economy and financial and capital markets. We should also consider the possibility of markets imposing risk premiums according to their assessment of budget conditions.

iii) As for the burden of government debt, we should consider the equality between generations and distribution of resources between the private economy and the public economy.

iv) Several issues on local government budget deficits (autonomy, self-responsibility, etc.)

### Public Sector's Fund-raising and Management of Flows and Stocks

We should consider the whole picture of the public sector's fund-raising operations including not only government and municipal bond issues but also FILP bonds and FILP agency bonds, which will be introduced in future.

- i) A growing need to implement a broadly defined debt management policy that covers not only government and municipal bond issues and FILP bond issues but also government guarantees, future pension payment burdens and other off-balance liabilities.
- ii) A need to consider how to realize and assess the public sector's fund flows and stocks and how to manage such stocks.

### (3) Efficient Financial Markets and Enhancement of Their Fund Distribution Functions from Viewpoint of Fund Flows

#### Realizing Status Quo

At present, Japan's financial markets have failed to fully utilize their risk-distributing and pricing functions. They are short of risk capitals even under the fund surplus. Factors behind such financial markets include the disposal of bad loans, the public sector's increased intervention, lending activities of financial institutions, and the end of the catch-up economy where all sectors have tried to catch up with western economies.

Financial institutions are shifting from fund intermediaries to risk intermediaries and pursuing the optimum size and qualitative changes for their credit risk management.

There is a view that the public sector's expansion of risk burdens as special measures to cope with the financial system crisis has distorted financial markets' pricing function.

## Prospects and Measures for Development of Efficient Financial Markets

In order to develop efficient financial markets, Japan would have to enhance the markets' risk management, information service and governance functions. Japan would also have to shift to a market-based system to revitalize the economy and ensure its diversity. For the immediate future, particularly, Japan would have to expand the so-called "market-based indirect finance" and improve governance and other functions that are currently insufficient for the nation's financial markets.

The challenges to that end are as follows:

Recovery of markets' risk-distributing and pricing functions

A shift to a multi-channel system where a traditional funding channel via banks coexists with a new channel via the capital market

Establishment of "alternative investments" to give governance recommendations and information services to companies in their startup or reorganization stage

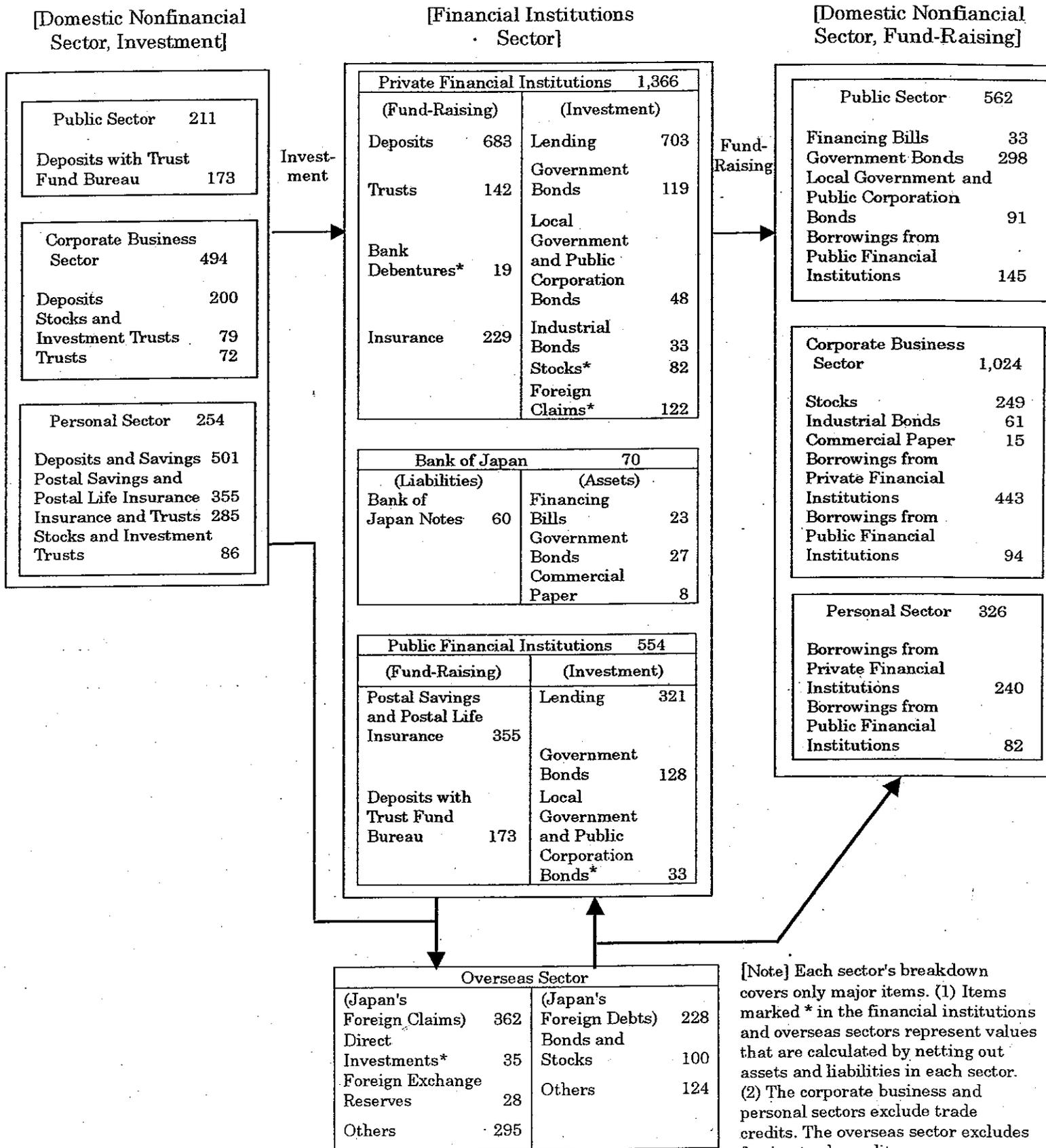
Development of institutional and system infrastructure for markets

Specific measures to develop efficient financial markets and enhance markets' fund distribution function

- Creation of risk money and enhancement of financial intermediary functions (development of collective investment schemes, etc.)
- Coping with the effect of markets' institutionalization on the markets and their participants, and ensuring the market order
- Development of know-how for new financial services including venture capital, and mergers and acquisitions
- Development of safety nets (systemic risks and institutional responses. Special measures and moral hazard.)
- Roles of public sector (roles of policy-based finance and public sector, effects of FILP reforms on the flows of fund)

## Japan's Flow of Funds

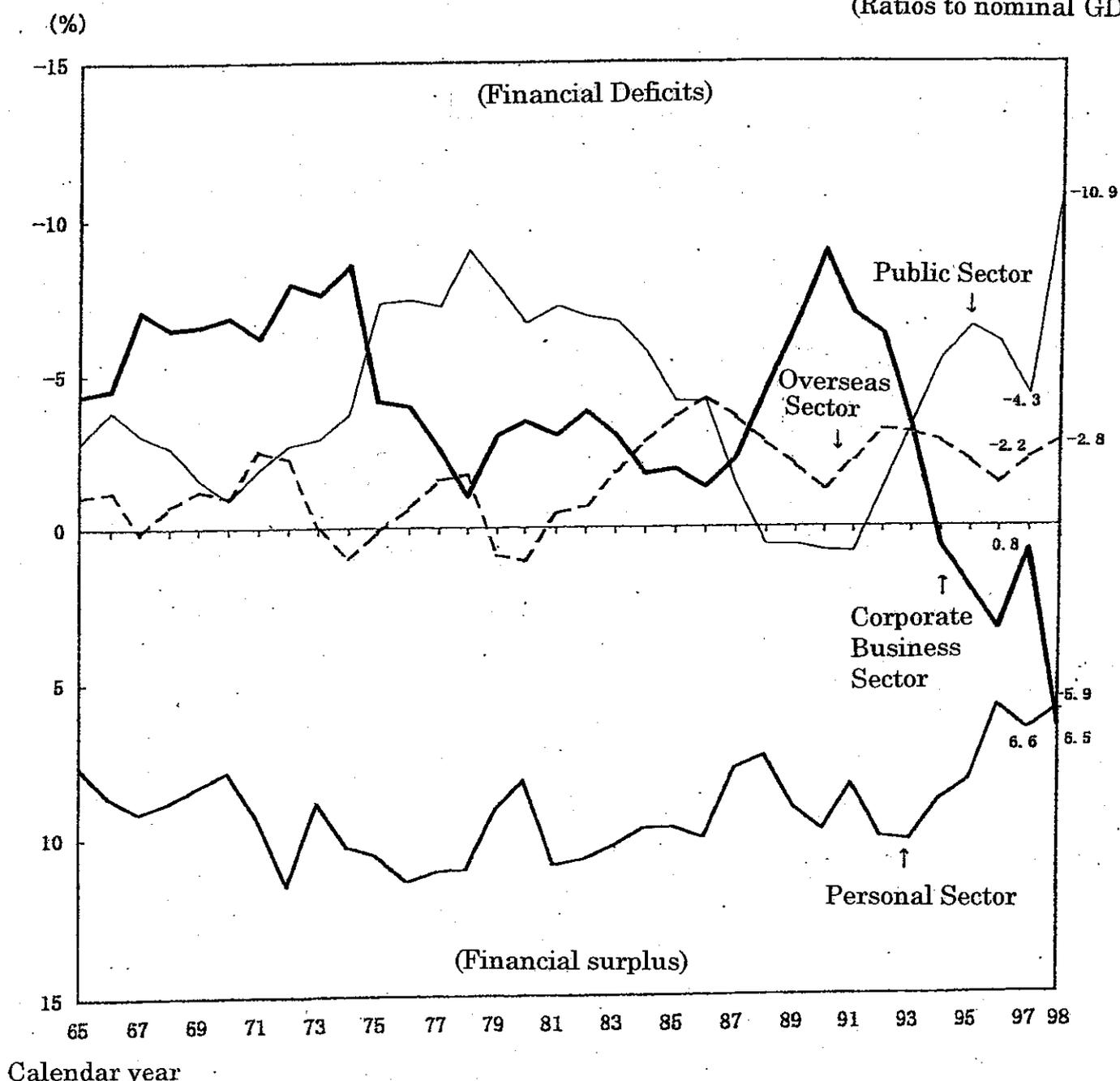
(Outstanding values at end of December 1998, in trillions of yen)



(Source) "Flow of Funds Accounts" Bank of Japan

# Changes in Sector-by-Sector Financial Surplus or Deficits

(Ratios to nominal GDP)



(Note) Figures for 1998 are preliminary.

(Source) "Flow of Funds Account" Bank of Japan

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