Trends in Japanese Household Portfolio: Flight to Safety, Setback to Investments

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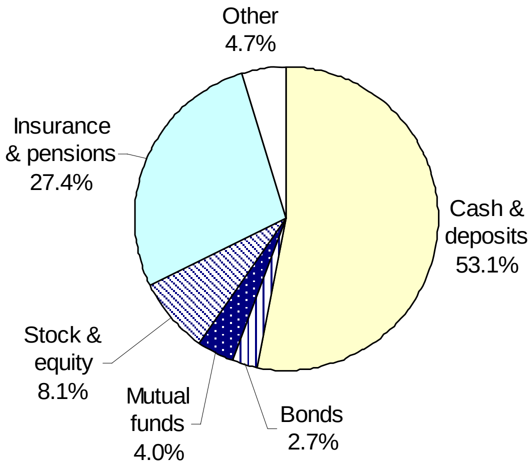
I. General changes in financial assets

According to the Bank of Japan's Flow of Funds Accounts, Japanese household financial assets fell below the ¥1,500 trillion level to stand at ¥1,467 trillion as of end-September 2008 after declining by ¥36.7 trillion in the third quarter of 2008. A breakdown of the decline into net inflows/outflows and evaluation gains/losses shows that ¥2.0 trillion was the result of net outflows and ¥34.7 trillion the result of evaluation losses. A breakdown of the evaluation losses shows that ¥25.0 trillion consisted of losses on shares and other equities while ¥8.5 trillion consisted of losses on mutual funds, both reflecting the impact of the financial crisis on asset prices. In the 12 months to end-September, the household portfolio declined in value by ¥89.8 trillion, 6.1% of the outstanding amount. Of this, ¥18.9 trillion consisted of losses on mutual funds and ¥66.8 trillion of losses on shares and other equities. These facts show that the financial crisis has had a significant impact on Japanese households even if we allow for the fact that the proportion of the portfolio held in savings and deposit accounts is higher than in other developed countries. This compares with a loss of 12.5% on the US household portfolio, where a higher proportion is invested in equities and mutual funds.

As Japanese society ages, the number of elderly households drawing down their financial assets is likely to increase more rapidly than the number of working households continuing to save. Before very long, this will tend to reduce Japan's savings ratio and, eventually, the outstanding amount of household financial assets.

In order to counterbalance this, the challenge facing Japan's financial services industry is to increase the overall return on these assets. At present, 53% of these assets are held in the form of cash and deposits (i.e., risk-free assets). The proportion of assets earning a low return is high by international standards. As has been pointed out for many years, households still need to shift more of their portfolio out of risk-free assets with a low return to assets with a high return, despite the losses they have suffered as a result of the financial crisis.

Figure1: Breakdown of Japanese household financial assets (as of end-September 2008)



Source: Nomura Institute of Capital Markets Research, based on Bank of Japan *Flow of Funds Accounts*

II. Specific changes in financial assets

Are there any signs that such a shift has taken place? It was thought that such a shift had begun in 2004 (e.g., as households increased their holdings of mutual funds). What impact has the financial crisis had on this?

During the last few years, the most important trend in household financial assets was an annual ¥10 trillion switch out of postal savings accounts into mutual funds and time deposits. Although outflows from postal savings accounts have eased since the Post Office was privatized in October 2005, this major trend is still intact.

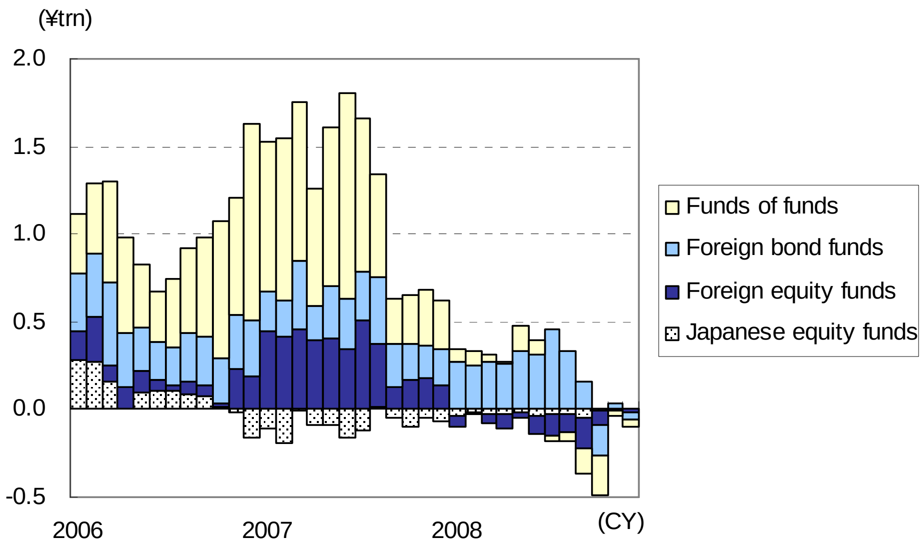
A large part of the outflows from postal savings accounts has been reinvested in bank time deposits. Net inflows to time deposits amounted to ¥4.5 trillion in the third quarter of 2008 and to ¥15.0 trillion in the 12 months to end-September 2008. These inflows have continued since the Bank of Japan ended its zero interest rate policy in July 2006 as Japanese depositors appear to appreciate the fact that they can earn a non-zero interest rate on their deposits, even if it is only 0.25% on a three-year time deposit.

Along with time deposits, mutual funds have seen net inflows every quarter since the second quarter of 2004, the figure for the third quarter of 2008 being ¥1.1 trillion. Mutual funds' main attraction for Japanese households was exposure to foreign bonds. The most popular types of mutual funds have been monthly distribution funds that invest either in foreign bonds or balanced portfolio. This is because they offer more attractive returns than deposits. From the beginning of 2007 to 3Q 2008, despite the financial crisis, households continued to invest in mutual funds that invest in foreign bonds as these funds were not affected by falling share prices. However, balanced funds and funds that invest in either foreign or Japanese equities saw a marked decline in inflows (partly as a result of falling share prices and partly as a result of the tighter sales regulations introduced at the end of September 2007), after having seen a large increase in inflows during 2006-2007. Since October 2008, however, mutual funds that invest in foreign bonds have also begun to see net outflows as a result of evaluation losses as the yen has strengthened by 15% or more.

Listed equities have seen continuous net outflows since the third quarter of 2006, the figure for the third quarter of 2008 being ¥0.1 trillion. In the 12 months to end-September, households suffered losses of ¥31.4 trillion, the largest amount since Japan's asset boom of the late 1980s turned to bust. However, since October, they have increased their purchases of equities on the view that these are now undervalued. According to data from the Tokyo Stock Exchange, households have turned out to be net purchasers for the calendar year 2008 as a whole.

The trend for households to shift out of postal savings into time deposits and mutual funds continued in the third quarter of 2008. What is noteworthy, however, is that the recent strength of the yen has even led to net outflows from mutual funds that invest in foreign bonds. In addition, the interest spread between Japan and foreign countries, which used to be the main attraction of such funds, looks like largely disappearing as monetary authorities are cutting interest rates. This is also likely to make these funds less attractive. The effect of the financial crisis to households' portfolio choices remains unpredictable.

Figure 2: Breakdown of net inflows to mutual funds (by type of fund)



Note: Data through end-November 2008
Source: Nomura Institute of Capital Markets Research, based on Investment Trusts Association, Japan