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"Asset Price Inflation in the 1980s: A Flow of Funds Perspective"

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During the 1980s, many industrial countries experienced a significant accumulation of debt, which was accompanied by a boom in asset markets and dramatic increases in asset prices. This paper adopts a flow of funds perspective in order to examine how and why financial resources were channeled almost exclusively to certain asset markets. It does so both by focusing on the microeconomic changes underlying the asset price and debt cycles and by examining where imbalances emerged, how funds were redirected toward certain asset markets, and why the process continued until price increases became unsustainable in some markets. Although similar patterns emerged in several countries, the paper looks particularly at the experiences of Japan, the United Kingdom, and the United States.

An important feature in all three economies was a declining demand for funds by traditional borrowers--corporations, governments, and, in the case of Japan, both. In all three economies, the financial system had to cope with a major redirection of funds to new borrowers. This shift in the demand for investment funds coincided with a shift in the types of financial assets demanded by savers, who moved increasingly toward trusts, pensions, and insurance. Thus, at the same time that borrowers were changing, the financial systems also had to create new instruments for savers, primarily households. Until new investments and financial instruments were developed, and consumers learned to evaluate them, funds were recycled in certain asset markets.

Country-specific factors meant that these financial market developments played out differently in each of the three countries. Changes in the behavior of borrowers and savers in Japan, for example, were accompanied by a large mismatch between saving flows and traditional investment opportunities, and Japanese asset inflation extended across both equity and real estate markets. In the United Kingdom, by comparison, asset inflation was largely confined to the real estate market, primarily because U.K. banks chose to fill the gap left by changing borrowing needs by taking advantage of the excess demand for housing that had accumulated during the earlier period of regulation, which provided a natural outlet for bank investment. In contrast to the other two economies, the changes in U.S. borrowing and saving patterns were accompanied by a major decline in the depository institutions' share of financial intermediary liabilities. Two major factors accounted for this decline: the Government increased its borrowing, and thus expanded the pool of marketable securities available to investors, and financial innovation permitted the securitization of traditional bank assets, such as mortgages. Thus, funds were redirected away from the corporate sector as savers moved into marketable securities and, unlike in both Japan and the United Kingdom, the resources available to the insured banking system for taking risks were limited. As a result, asset inflation was relatively subdued in the United States.

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