

Masaru Hayami: Revitalization of Japan's economy

Speech by Mr Masaru Hayami, Governor of the Bank of Japan, at the Japanese Economic Research Center, Tokyo, on 29 May 2000.

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I had opportunities to speak on the structural problems facing Japan's economy and the medium to long-term issues which needed to be addressed. And, on each occasion, I emphasized that for Japan to achieve a full-fledged recovery, not only support from policy measures but also private sector vitality in the form of "creative destruction", were of critical importance. As Japan's economy has recently been showing clearer signs of improvement, we have witnessed earnest efforts toward structural reform being set in motion in various areas of the economy. Bearing in mind such a development, today I would like to talk about the issues which are considered important to Japan's economy at the moment.

1. Recent economic developments and structural adjustment

Current state of the economy

Let me start by giving our view on the current state of the economy. The improvement in Japan's economy is becoming distinct. And, recovery has been observed in some areas of private demand as witnessed by business fixed investment continuing to increase gradually. Looking back to around this time last year, it is true that some economic indicators had already begun to show signs of recovery. Such a recovery was brought about by an increase in public investment and favorable developments in overseas economies, and was far from being a self-sustained recovery led by domestic private demand.

To the contrary, the recent improvement has been accompanied by a recovery in private demand centering on a moderate increase in business fixed investment, and deflationary concerns have gradually subsided, although private consumption, which is a major component of private demand, still remains short of what one would call a recovery. Granted that private consumption is unlikely to return to the high growth of the 1980s because of the declining growth potential of Japan's economy over the long run, and given that consumer sentiment has been gradually improving, the key to the outlook for private consumption will be the impact of increased production and higher corporate profits on household income. With this in mind, we continue to carefully monitor the economic situation.

Business cycle and structural adjustment

While the economy is on a recovery path, we observe that structural problems have not yet been solved. Since such an observation leads to controversy over the relation between the business cycle and structural adjustment, allow me to elaborate a little.

It is not correct to say that the economy will never recover unless structural problems are solved. Needless to say, some kind of structural problems always exist at any point in time in any economy, and I do not deny that Japan currently faces extremely big problems. Moreover, it should be remembered that at the same time we also experience business cycles. On the other hand, it is not correct to claim that an economic recovery has nothing to do with structural problems. If structural reform does not proceed smoothly, economic recovery will lack strength, or big problems will remain unsolved even after the economy recovers substantially as evidenced by the situation in Japan after the bursting of the bubble. I think it true to say that economic recovery would be all the more robust if accompanied by the progress of structural reform.

The nature of structural problems may differ from time to time and from country to country, and it is not easy to come up with a clear-cut definition. Having said this, the current structural problems in Japan could be characterized as arising from the process of the economic system adapting to a new environment, in other words, it is a problem that has contained the dynamism of the Japanese economy. Indeed, changes in the economic environment in the 1990s such as the progress of information and telecommunications technology and the globalization of market economies had a substantial impact on Japanese firms in persuading them to change. The aftereffects of the bursting of the bubble can also be recognized as a structural problem in that they prevented firms and financial institutions from adapting to the change in the environment by eroding their financial strength.

Significant changes in the environment can make an existing economic system obsolete and reduce profitability of the corporate sector. Particularly when the magnitude of change is large and firms are uncertain as to how to adapt, many initially tend to be defensive in their response by reducing investment and employment, which only leads to further downward pressure on the economy. In the process of cost reduction, however, firms that recover profitability and discover ways to adapt to the new environment will gradually increase in number. Then, the way a firm overcomes structural problems itself will become a source of new growth. This is the stage where firms take the offensive in that they implement comprehensive reform of their management system geared toward the new environment and invest in strategically important areas or new businesses. Though even at this stage there will exist not a few firms which are still defensive, the overall picture is that the economy will recover as structural reform progresses. And, as the number of firms taking the offensive increases, the economy will eventually shift to a full-fledged recovery path.

Characteristics of economic recovery under structural adjustment

Currently, it is our judgment that Japan's economy is at the stage where the number of firms taking the offensive has started increasing, that is, the economy is moderately recovering parallel with structural adjustment. Let me point out some of the major characteristics of this recovery.

First, the recovery has been led by the corporate sector. In the 1990s, the prolonged recession and slow adjustment of employment and wages under the prevailing management system led to a substantial rise in the proportion of labor income to national income, which was one factor behind the deteriorating profitability of Japanese firms. Putting aside the effects of active monetary and fiscal policy as well as steady developments in overseas economies, the current recovery is, to a large extent, triggered by the earnest restructuring of Japanese firms with the aim of restoring profitability. Thus, with respect to the recovery of private demand, it seems natural that the corporate sector, which has regained profitability as a result of restructuring, should take the lead by increasing investment followed by the household sector as income conditions gradually improve. This is the development we are now witnessing.

Second, we observe polarization in various areas of the economy. For example, a moderate recovery of business fixed investment does not mean a uniform increase across the board. While those industries which produce basic materials are burdened with excess capacity and continue to restrain investment, those related to information technology, such as electric machinery, have increased investment substantially. Another example. In the labor market, we have recently witnessed the situation where new job offers have been growing at a double-digit rate on a year-on-year basis while the unemployment rate has remained high or even slightly increased. This signifies a widening mismatching of supply and demand in the labor market. Under the globalization of market economies and the progress of information and telecommunications technology, while workers with skills that firms need are in short supply, workers who have accumulated firm-specific skills under the traditional lifetime employment system are no longer in demand.

When economic recovery and structural adjustment proceed simultaneously, we often observe conflicting developments. Thus, to accurately grasp economic developments, it is extremely important not only to examine macroeconomic indicators but also to thoroughly understand the microeconomic movements behind such macroeconomic indicators.

2. **Movements toward structural reform**

Response to the aftereffects of the bursting of the bubble - declining financial intermediary function

Now let me turn to the earnest structural reform efforts being seen in various areas of the economy.

First, the problem of the declining financial intermediary function after the bursting of the bubble has begun to be resolved. It goes without saying that the aftereffects of the bursting of the bubble were one of the major factors responsible for making the 1990s a “lost decade” in Japan. The bursting of the bubble created the balance sheet problem. Indeed, the non-performing asset problem of financial institutions has reduced their risk-taking capacity and impaired the smooth circulation of money. In particular, behind the extremely severe recession from the end of 1997 to 1998 was a decline in confidence on the part of both the corporate sector and the household sector stemming from financial system instability and the deterioration of the financial intermediary function which has often been termed a credit crunch.

Since spring last year when the Bank of Japan effected the zero interest rate policy and public funds were injected into major banks to strengthen their capital base, public confidence in the financial system has been gradually restored, and we are observing a favorable impact on the economy. Furthermore, an important development which has not been observed for nearly half a century since the end of World War II, is that the financial industry is moving toward large-scale consolidation.

Last year, private consumption supported the economy in the midst of a decline in household income, which means a decline in the savings rate. This can perhaps be interpreted as households, which were concerned with financial system instability and increased their savings from the end of 1997 to early 1998, turning to loosen their purse strings. In this regard, the Survey on Lifestyle and Financial Behavior conducted by the Bank of Japan indicates that since spring last year not only has concern over the collapse of financial institutions subsided but also the number of respondents expressing worries about job security and earnings or refraining from spending has also gradually decreased. On the part of the corporate sector, responses to the Bank’s Tankan survey indicate that the improvements in the lending attitude of financial institutions and also their funding conditions have been gathering momentum. Moreover, the willingness of small and medium-sized firms to invest, which is mostly financed by bank borrowing, seems to have gradually strengthened, though up until now such investment has been contained within cash flow and has not yet led to an increase in bank borrowing.

Considering that the non-performing asset problem of financial institutions has not been completely resolved, and taking into account the excess debt of the corporate sector, we have not yet reached a point where we can say that the problem of the aftereffects stemming from the bursting of the bubble has been resolved. In addition, the continuous decline in property prices is another matter of concern. Furthermore, the consolidation of financial institutions is not merely a matter of size. The key to successful consolidation is to become more efficiently managed through a strategy of “selection and concentration”, and it will take more time for such consolidation to bear fruit. Nevertheless, at this moment, it should be noted, and welcomed, that amid the irreversible trend of financial globalization and the advance of information technology it is the initiative of the private sector, not that of the public sector, which will pave the way to the new economy.

Parallel with such moves on the part of major financial institutions, progress has been made in direct financing such as the establishment of MOTHERS on the Tokyo Stock Exchange in November 1999, followed by NASDAQ JAPAN established in early May at the initiative of the private sector and which will start operation in June. I have repeatedly emphasized that at the present time when structural adjustment is much needed, abundant domestic savings should be utilized to finance investment in the form of “risk capital”. And, I thus welcome that such markets have been inaugurated to fulfill an intermediary function for risk capital.

New phase of corporate restructuring

Second, efforts toward structural reform have also been made in terms of corporate restructuring, and I think we have begun to observe the result of such efforts. When talking about restructuring and the

results in the recent period, those in the business world say that they have been pursuing restructuring for a long time. I fully commend past efforts toward corporate restructuring, but what I would like to emphasize here is that the restructuring witnessed since last year is of a different nature compared with the past and such a tendency has recently become more distinct. In my view, past restructuring focused mostly on cost reductions, in other words, downsizing. To the contrary, current restructuring, though initially having a tendency toward downsizing, has shifted to focus on business content or reengineering, which means the restructuring of production and management systems which have been rendered inefficient. I believe that the restructuring of Japanese firms has truly entered a new phase.

Behind such a change in the focus of restructuring, those in the business world, as in the case of financial institutions, experienced a protracted recession and were faced with a very severe financial environment, particularly from 1997 to 1998. During this period, many small and medium-sized firms faced funding difficulties, and from the summer to the autumn of 1998 when financial and capital markets both at home and abroad were under stress due to such factors as the Russian crisis, not a few representative big Japanese firms also faced similar difficulties. Such an experience linked with changes in the accounting system, namely the consolidated and mark-to-market methods, brought about the recognition or a sense of crisis on the part of firms that Japan's traditional corporate governance including the main bank system and cross-shareholdings would not be viable for long and that for their own survival they should enhance their evaluation in the capital market through such measures as improved capital efficiency. All this seems to have triggered current full-fledged restructuring.

Current restructuring is different from past downsizing in its nature because firms are required more than ever to efficiently allocate resources and improve profitability. For example, since big firms engaged in the production of electric machinery and chemicals could not enjoy economies of scope any more, they concentrated on areas where they had the most edge, recently termed "areas of core competence" in Japan, and at the same time withdrew from or scaled down unprofitable business areas. And, among basic materials industries burdened with excess capacity, there have been movements toward consolidation including mergers and acquisitions and obsolete equipment beginning to be scrapped. Recent restructuring and consolidation in the corporate sector, including financial institutions, extends beyond the existing keiretsu and corporate group frameworks, and in some cases has proceeded globally with the involvement of foreign capital. Also, good use is being made of such new methods as mergers and acquisitions and the holding company format. Last year, mergers and acquisitions increased substantially and direct investment into Japan, which indicates foreign capital inflows, reached a record high 1.5 trillion yen on a balance of payment statistics basis, three times the prior-year level. Of course, it cannot be denied that the recovery of corporate profitability has been largely attributable to past restructuring, that is, downsizing centering on a reduction in labor costs. However, current restructuring can be expected to exert pressure on firms to withdraw from low profitability areas and concentrate resources on highly profitable and strategic areas such as investment in information technology-related areas. We continue to pay close attention to how the recent development will lead to the recovery of corporate profitability and competitiveness, and eventually the restoration of corporate vitality.

Possibility of an information technology (IT) revolution

Third, the IT revolution seems to have reached Japan. In the 1990s, with the improvement in productivity induced by the expansion of IT-related investment, the United States enjoyed prolonged expansion and price stability, although we observed such distortions as excessive consumption due to higher stock prices and a rising current account deficit. In Japan, we have recently witnessed a rapid increase in IT-related investment by semiconductor manufacturers. And, I feel that expectations are gradually emerging in Japanese business circles that a mega change which occurs only once or twice in a hundred years might have started in Japan. However, there still remains a deeply-embedded pessimism that Japan is more than ten years behind the United States in IT-related business areas and it is not easy even to catch up. To understand the coexistence of expectations and pessimism, let us examine discussions regarding how the IT-related revolution has been affecting Japan's economy.

One topic for discussion is the spread of IT-related investment in the corporate sector. In this regard, it is necessary to distinguish between investment by IT producers and that by IT users. It is true that IT-related investment in the United States has centered on the computer and telecommunications industries which have recorded the largest improvement in productivity. But it is also true that IT users in a wide variety of industries such as other manufacturing, financial, and distribution industries have improved productivity by way of IT-related investment, which has laid the foundation for the prolonged expansion of investment. In contrast, the current surge in IT-related investment in Japan seems to be at the stage where IT producers such as semiconductor-related manufacturers expand their investment in response to the worldwide expansion of IT demand. While they are important investments, the experience in 1995 and 1996 shows us that an investment boom is bound to be cyclical, which sometimes takes the form of large-scale stock adjustment. Therefore, it is important whether investment by IT users is sustainable. It is encouraging news that many firms are considering strengthening their production and sales systems by introducing supply chain management with the aim of information sharing among client firms as well as procuring materials through the Internet. In the Economic Planning Agency's Survey on Corporate Behavior published this April, many surveyed listed firms reported excess production capacity on the one hand, and a shortage of information-related equipment on the other. The future outlook for investment by IT users needs to be judged in relation to Japanese-style management. Here, I would like to point out that the spread of such investment to a wide area, including small and medium-sized firms, will be the key to the sustainable expansion of investment, and eventually to an improvement in productivity.

IT can be utilized by the corporate sector which is called B-to-B, that is, business to business, and also by the household sector which is called B-to-C, that is, business to consumer. Another topic for discussion is how Japanese firms will respond to the situation when IT is introduced to the household sector. The IT revolution in the United States in the 1990s substantially enhanced productivity through the enhancement of operational processes as personal computer networks were introduced to the corporate sector. Japan was behind the US in this regard, which is perhaps one of the reasons behind the "lost decade of the 1990s". Some features of Japan's corporate system were said to be related to this delay. As you may remember, up until the 1980s, Japanese-style management, as represented by keiretsu transactions, the main bank system, and lifetime employment, had been regarded as superior in terms of information sharing among related parties through long-term relationships. In contrast, since the US-style big business model was vertically integrated and susceptible to sectionalism, it had been considered inferior to the Japanese system in processing information. However, any management system should be evaluated in relation to the technology available at the time. The Japanese system is no exception and it has been found to be not necessarily superior on all accounts when the cost of transmitting and processing information is dramatically declining due to the rapid progress of information and telecommunications technology. Rather, the merits of the Japanese system led to a lack of incentive to actively introduce IT for cost reduction purposes. In addition, while firms must review existing transaction styles and reduce workers to take full advantage of the benefits of IT, the Japanese system tends to make it difficult for firms to implement such changes. Furthermore, it should be noted that the 1990s was a period during which Japan had to face the aftermath of the bursting of the bubble and also that it has been difficult to create "venture businesses" in the cultural and social climate of Japan. Considering that all this has constituted constraints for Japanese firms to introduce IT, the IT revolution has widened the gap in competitiveness between the United States and Japan.

The recent move toward full-fledged restructuring and increase in investment by IT users can be seen as evidence that Japanese firms have begun to be aware of various problems related to IT. The foundation for venture businesses to be created and flourish is finally being laid as symbolized by the "bit valley", and partly due to such development the number of newly established firms as a whole has been gradually increasing since last summer. The use of IT in the corporate sector has just started in Japan. Even though the corporate sector in Japan lags behind that in the United States in the use of IT, there is a piece of good news for Japan. The next ten years are regarded as a period during which IT will be actively used by consumers, and not only personal computers but also IT-related electrical appliances and mobile phones will be used as IT terminals. Japanese firms have traditionally had a competitive edge in such areas as electrical appliances and mobile phones, and indeed they are the front runner in such areas as the utilization of mobile phones as information terminals. Regarding the

business-to-consumer area, the United States is yet to construct a plausible business model, and there is still a lot of uncertainty about the future. Notwithstanding this, it is important that even though the relative position of the United States and Japan may not be reversed, the possibility has emerged that Japan can fully compete with the United States in the IT field. These developments also seem to have had a positive impact on firms in enabling them to regain vitality.

3. Escape from the lost decade

Remaining tasks

Compared with my July 1999 speech in which I said that the dynamism of the Japanese economy had been contained, the developments that I have described today indicate that such dynamism has eventually begun to be re-ignited. However, this is far from saying that all structural problems inherent in Japan's economy have been solved.

For example, regarding the balance sheet problem of financial institutions, while the financial system has indeed escaped from instability, the problem is not yet fully resolved as I previously remarked. The excess debt problem on the part of firms has yet to be completely solved. Furthermore, as a result of firms putting more emphasis on capital efficiency, for a while they will continue to reduce assets with low profitability. In this regard, the Bank of Japan's March Tankan survey showed that major manufacturing industries expected the ratio of ordinary profits to sales for the current financial year to be around 4 percent, which is about the past average. We may be able to say that profitability indices on a flow basis have recovered to the average level of the past. However, profitability indices on a stock basis such as ROE and ROA have remained substantially below the level in the 1980s, which is a different aspect of what I referred to as a "decline in capital productivity" in my speech last summer. Under such circumstances, while investment will be made in highly profitable new areas such as the IT-related field, asset reduction will continue in existing low profit areas in order to raise ROE and ROA. According to the Economic Planning Agency's Survey on Corporate Behavior, about half of listed firms responded that it would take more than two years for their real estate, buildings, and production facilities to return to appropriate levels.

With respect to corporate restructuring and the IT revolution, there is no knowing how they will lead to an improvement in corporate profitability and increase in investment. Even if higher profitability and larger investment were realized, there is a possibility that the polarization seen in the economy might become, albeit temporarily, more apparent. For example, while there are industries regaining profitability supported by restructuring and IT demand, not a few firms will be left behind in traditional and domestic demand-oriented industries. In this regard, public utilities, which have experienced a series of deregulatory measures, continue to suppress investment, and small and medium-sized wholesalers and retailers who are susceptible to the effects of the distribution revolution have been slow to exhibit a business recovery. Regarding employment, there is a possibility that while demand for workers who have skills compatible with the new era increases, demand for workers who lack such skills declines. In this context, the unemployment problem might become an issue. These negatives can be termed the "shadow of structural reform".

Since it is difficult to forecast the impact of IT on corporate profitability and growth, we should bear in mind that there may be large swings in the stock market which tends to strongly respond to a variety of forecasts. In fact, strong expectations last year for the growth of IT-related industry led to a substantial increase in the prices of IT-related stocks. On the other hand, while the improvements in Japan's economy is becoming distinct, IT-related stocks in Japan have recently been bearish reflecting the worldwide correction of IT-related stocks. These swings are unavoidable to some extent when the market is trying to identify growth industries and the key firms which lead such industries. The swings in stock prices will reveal promising new technologies and firms which incorporate these technologies, and nurture them. The Bank of Japan continues to pay due attention to stock price developments, and, in so doing, we think it important to calmly identify the meaning and background of stock price fluctuations.

Furthermore, a declining birth rate and aging society present a long-term challenge to Japan's economy. For example, with respect to the high savings rate of the private sector in Japan, I have often remarked that the lack of consensus among the public as to how future pensions and medical fees should be funded has restrained consumption through anxiety about the future. In this regard, the introduction of a nursing care system from this year is certainly a step forward, and I hope this system will take hold.

“Creative destruction” revisited

When the economy recovers, as is now happening, it might well be the case that efforts for structural reform might be neglected due to a sense of security. In addition, when the shadow of structural reform becomes conspicuous, for example in employment, calls to reverse such reform and pressure for additional macroeconomic policy measures such as the expansion of aggregate demand are very likely to intensify. However, there is no doubt that structural reform has contributed to the current economic recovery, and we should not forget that remaining structural problems must be solved to achieve sustained economic expansion in the future. Structural problems cannot be solved solely by macroeconomic policy measures such as monetary and fiscal policy. Now that financial and capital markets are highly globalized, any attempt to wipe out past problems by generating inflation will never be successful. Let me emphasize again that it is private sector vitality in the form of “creative destruction” that can solve these structural problems. And, as the US experience shows, private sector vitality will gradually absorb the adverse effects of structural reform.

In this “era of metamorphosis” as represented by the current IT revolution, there exists considerable uncertainty about the future. From another angle, we can say that it is an era where innovation can lead to business opportunities. Under such circumstances, the role which the public sector should play is to prepare a market environment which is conducive to nurturing innovation. One thing is the stability of the macroeconomic environment. In this regard, it is the responsibility of the Bank of Japan to maintain stable macroeconomic conditions through price stability. Other important roles that the public sector should play are to promote deregulation and improve the taxation and legal systems so that firms and households can take appropriate risks more easily and operate more flexibly.

As such, it is my view that the role of the public sector in this era of metamorphosis should be to focus on preparing an appropriate market environment. In this regard, we should learn from the US experience where the early Clinton administration advocated the “information super highway” plan, but which was later dropped in favor of preparing an environment conducive to encouraging the IT revolution led by the private sector. In Japan, triggered by severe economic conditions in 1997 and 1998, we have seen efforts toward preparing an environment suitable for economic rebirth, including enactment of the Economic Revitalization Law. As we move toward a full-fledged economic recovery, the role of the public sector and economic policy should be flexible so as to be able to remain consistent with an era of metamorphosis. In this regard, it is necessary to examine the role of public investment, the level of which is said to be very high among industrial countries, from the viewpoint of fiscal deficits as well as whether such investment is in line with the current era of metamorphosis.

In July 1999 when I spoke on structural problems in Japan's economy, there were more pessimistic views about Japan's economy than today. On that occasion, I said I was proud of Japan's high quality labor force, technology, and management skills which had created a big economic power from the ruins after the war, and emphasized the need of “creative destruction”. And now, after almost a year, I am quite encouraged to find that signs of a recovery have been increasing. I hope the current favorable developments will gather momentum and that the day will soon come when Japan's economy returns to a full-fledged recovery path led by the private sector. Let me conclude my remarks by saying I hope that the 1990s will be revaluated as the ten years which laid the foundation for the prosperity of the next generation.