

## **Toshihiko Fukui: Restructuring Japan's economy**

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, to the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 28 October 2003.

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The foundation for a gradual recovery in Japan's economy is being laid as the environment for exports and business sentiment have improved. This development occurs against the background of a cyclical rebound in global demand for IT-related goods as well as the progress of structural adjustment, including the improvement of corporate profitability.

Structural adjustment of Japan's economy is but halfway complete, and many issues remain to be resolved. Persistent adjustment pressures have weighed heavily on the self-sustaining recovery of domestic demand, which needs to be duly taken into account in the conduct of monetary policy.

Under such circumstances, the Bank of Japan will continue to firmly maintain its quantitative easing policy until the consumer price index registers stably zero percent or an increase year on year. We think it important to ensure that the current nascent economic recovery is put on a sustainable path. In this regard, on October 10, the Bank decided to take such measures as raising the upper limit of the target balance of current accounts in the interest of more flexible and timely monetary operations.

We need to put the issues facing Japan's economy, including structural adjustment, into a historical perspective that encompasses such issues as globalization and the maturity of Japan's society and economy. Hence, today I would like to look back upon the process of structural adjustment in the Japanese economy, and address current problems with a focus on three key concepts, "value added," "risk" and "sustainability."

### **I. The Path to Date of the Japanese Economy**

#### **A. High Economic Growth**

Let me start by reviewing the high economic growth period between 1955 and 1970. During this 15-year period, real GDP almost quadrupled with an annual growth rate of nearly 10 percent. Such high growth was only possible because of the potential endowed to Japan's economy as well as favorable historical and geographical conditions at that time.

Japan's endowment included a relatively high technological capacity and a diligent work force. Moreover, it was willing to absorb technology and culture from abroad. Japan's potential in this regard was evidenced by the rapid industrialization after the Meiji Restoration and the subsequent economic development.

In terms of historical and geographical conditions, it should be noted that because the Cold War put a number of countries under the influence of communism, Japan could continue to play the role of "the world's factory" in the market economies during the period from the late 1950s to the end of the 1960s. Furthermore, Japan increased its business fixed investment at a rapid pace because World War II had erased a large amount of domestic capital stock.

The period of high economic growth in Japan coincided with the baby boomers' entrance into the labor force. In fact, the labor force increased from about 40 million in 1955 to about 50 million in 1970. Furthermore, population growth around that time followed a bell-shaped curve, which led to a relatively light burden being imposed by the pension and other social security systems compared to other industrialized countries.

#### **B. Shift to a Floating Exchange Rate System and the Two Oil Shocks**

From the 1970s through the early 1980s, the Japanese economy experienced several major disturbances, including the revaluation of the yen triggered by the "Nixon Shock" and the subsequent shift to a floating exchange rate system, and the two oil shocks. In particular, the First Oil Shock combined with the excess liquidity of the time to produce rapid inflation.

In contrast, Japan managed to overcome the Second Oil Shock smoothly, perhaps we can say the most smoothly among the industrialized countries. Behind this was not only a timely macroeconomic policy response, but also the fact that Japanese industry, having learned the lesson of the First Oil Shock, actively improved energy efficiency. As a result of these efforts, Japan's economy became the least dependent on oil among the industrialized countries, and at the same time succeeded in making energy-efficient technology a new source of value added. This can be cited as a classic example of Japan turning a problem to be overcome into a source of strength by using its technological capability. The success of Japan's economy in overcoming the Second Oil Shock contributed relatively smoothly to raising its international reputation.

### **C. Stronger Yen and the Emergence of the Bubble Economy**

In the latter half of the 1980s, the Plaza Agreement triggered the large-scale correction of the strong U.S. dollar at the time, and Japan experienced a period of economic stagnation caused by the yen's appreciation. This stagnation, however, ended rather quickly, and, as is well known, what followed was economic expansion accompanied by asset price bubbles.

The coexistence of high economic growth and low inflation throughout this period suggested gains in productivity, and we observed widespread optimism that Japan had overcome the adverse effect of not only the oil shocks but also the yen's appreciation. In reality, however, many structural adjustments were simply postponed, in contrast to the period of the oil shocks during which a strong sense of imminent crisis had speeded the adjustment process.

During this period, the environment surrounding the Japanese economy had already begun to change significantly. The Cold War structure had begun to be dismantled, as captured most vividly in the pulling down of the Berlin Wall, and the industrialization of emerging economies continued to move forward. As shown by these facts, the conditions surrounding Japan's economy began to undergo such sea changes as globalization and intensified competition.

These changes should have brought about the strengthening of corporate earnings power and the efficient reallocation of resources through active entry into and exit from markets and industries. Rising asset prices and overheated domestic demand, however, distorted various signals for economic adjustment and weakened investment discipline. Rather, a large amount of business fixed investment was made based on an excessively optimistic outlook for demand. In this, we can detect the source of the future problems, such as excess capacity, excess debt, and excess labor.

On the financial front, intensified global competition should have led to development of the market for financial intermediation, which would have supported the entry of companies into markets and industries and promoted more careful evaluation of the risk and return profiles of various projects. The latter half of the 1980s should have been a period during which financial intermediation progressed from a bilateral transaction basis to a market transaction basis.

The rise in asset prices, however, expanded bank lending using real estate as collateral, the classical bilateral transaction type of financial intermediation. When asset prices finally began to fall, expanded bank lending created the nonperforming-loan (NPL) problem, which has adversely affected the economy since the early 1990s. And households became quite hesitant to provide risk capital when they observed scandals involving securities companies and the large volatility of stock prices.

The birth rate declined sharply from 1.81 in 1984 to 1.54 in 1990, leading to the rapid graying of society. Of course, there are a variety of factors behind this. One of them seems to have been the rise in the number of women playing an active role in the workplace. With a great many companies still adhering to such employment practices as the seniority system, taking time off from work to raise a child often became a decision with serious consequences. Thus, the institutional set-up did not lend itself to checking the declining birth rate.

In spite of these demographic changes, the pension and other social security systems remained largely based on the bell-shaped population curve.

As far as the structure of public finance is concerned, both the United States and the United Kingdom made progress toward "a smaller and more efficient government" under severe economic conditions during the latter half of the 1980s. In direct contrast, Japan enjoyed an increase in tax revenues due to the overheated economy and higher asset prices, which led to a delay in reviewing the structure of public expenditure.

## **II. Restructuring Japan's Economy**

### **A. *Economic Stagnation since the 1990s***

Since the 1990s began, the end of the Cold War and the progress of IT have brought about an acceleration in the globalization of market economies. Under such circumstances, the Japanese economy has been put under very severe adjustment pressures on a number of fronts, including the deflationary impact caused by the bursting of the asset bubbles and intensified competition with emerging economies.

These adjustment pressures may be divided into three broad categories.

The first is the adjustment pressure that has emerged as the result of various excesses during the bubble period and their subsequent bursting. The problems of excess capacity, excess debt, and excess labor of the corporate sector as well as the NPL problem of financial institutions fall into this category. These problems have exerted downward pressure on domestic demand and adversely affected financial system stability.

The second is the adjustment pressure stemming from broad changes in economic conditions such as market globalization and domestic demographic changes. While preserving the high-cost structure created during the high economic growth and the bubble periods, Japan has begun to face intensified competition from neighboring East Asian economies, which have been growing at a fast tempo recently. The rapidly changing structure of the Japanese population has also suppressed expected future growth.

The third category is the adjustment pressure resulting from the need to overhaul the institutional infrastructure, including the legal system, the structure of public finance, and the pension and other social security systems, with a view to making the infrastructure more responsive to the needs of a mature society and economy.

### **B. *Progress in Corporate-Sector Adjustment***

Although many problems remain to be resolved, it should be noted that Japanese companies have been making steady, albeit gradual, progress in some areas. In fact, many companies have made efforts to reduce their debt overhang by restraining business fixed investment as well as cutting labor costs, in order to improve their earnings power.

The larger the original adjustment pressure, the greater energy and longer time these efforts will require. A reduction in investment and labor costs is indispensable for companies to recover their earnings power. If aggregated, however, such reduction will work to exert downward pressure on domestic demand and thus hinder the recovery of overall business conditions.

I think the efforts of companies to restructure their businesses have finally begun to bear fruit recently. Corporate profits have been increasing since last fiscal year. At present, the ratio of current profits to sales has approached almost its highest level since the bursting of the bubble. This implies that Japanese companies have been succeeding in lowering the break-even point by restructuring and adapting their business structure so that they can secure profits even when sales are sluggish.

### **C. *Search for New Business Models***

Japan's proximity to rapidly growing East Asia has an interesting implication from the viewpoint of the corporate response to changes in the global environment. On one hand, such proximity exerts a strong impact on competition and prices through the inflow of less expensive imports. On the other hand, it strengthens the competitiveness of domestic industries rather quickly.

Although Japanese companies are significantly handicapped by higher labor costs compared with companies in East Asia and other emerging economies, many export items, such as electrical machinery and transportation equipment, still maintain strong international competitiveness, and the trade surplus remains. Behind this, Japanese companies have been producing high value added by creating new business models through a combination of their own technology, quality control expertise, the production capability of East Asian economies, and the ability in terms of design to respond to consumer needs in various countries.

In the domestic market, including the nonmanufacturing sector, new business models have emerged in which overseas production and distribution channels are consolidated. Some of the products created under such new business models are beginning to attract consumers and gain market share.

#### **D. Institutional and Legal Measures**

It should be noted that institutional and legal measures have been taken, which allow active entry and exit as well as intensified consolidation of the corporate sector.

For example, in dealing with the bankruptcy and reconstruction of companies, it is important to make use of market discipline and create a framework that maximizes the interests of all concerned, while retaining the value of companies on a going-concern basis to the greatest possible extent. In line with this view, enactment of the Civil Rehabilitation Law and other adjustments to the legal framework have been effected, and legal procedures expedited. In the area of corporate law, revision has been undertaken to help firms reorganize more easily.

For financial system stability, various safety nets, such as the establishment of a framework for injecting public funds into financial institutions, have been improved in light of the difficulties that we have faced since the 1990s.

#### **E. Current Economic Situation**

Progress in restructuring seems to be having a positive effect on the current economic situation.

As I stated at the outset, the foundation for a recovery is now being laid. Corporate profits have been increasing, and business fixed investment has shown signs of improvement. Exports are once again on the rise, particularly in the IT-related goods area. Uneasiness surrounding the financial system has also subsided compared to some time ago.

Some argue that if prices started falling, corporate profits would be squeezed due to the downward rigidity of nominal wages, and there would be a high probability of a deflationary spiral emerging. Actual experience, however, reveals that Japanese companies have adjusted nominal wages rather flexibly and increased profits. Private consumption remains flat, with the decrease in household income being offset by an increase in the propensity to consume.

I believe that an autonomous adjustment mechanism in Japan's economy has been functioning. This fact has significant implications for the conduct of macroeconomic policy.

### **III. Key Issues and Outlook for Japan's Economy**

#### **A. Structural Issues**

The Japanese economy still faces a number of structural issues, which it is striving to overcome. These may be summarized as follows.

The first issue is the reallocation of economic resources to improve the efficiency of the economy and foster the development of leading industries for the next generation. This may be a necessary process of dealing with the legacy of the bubble economy and strengthening the underlying business structure. But, at the same time, it may create a problem in that the domestic capital equipment of Japanese companies will become obsolete relative to that of other major countries. Thus, once Japanese companies recover their earnings power to a certain extent, their next challenge will be to make their capital equipment more productive through new investments.

Many Japanese companies have also reduced labor costs by restraining the hiring of new regular employees. Such labor restructuring tends to put an undue burden on the younger generation, and entails the risk that the vitality of the economy might be impaired if the situation persists and the younger generation's willingness to participate in the labor force diminishes. Thus, it is imperative to enhance labor market flexibility not only at the level of individual companies but also through the entire economy, and expand job opportunities for the younger generation.

The second key issue is the reactivation of the financial intermediary function. This includes overcoming the NPL problem and improving the infrastructure of market-based credit intermediation. Although steady progress has been made, there still remains a fairly long way to go before we feel

confident that the NPL problem is fully resolved. The complete removal of blanket deposit insurance is still being postponed. Market-based credit intermediation, which can function as a substitute or complement for bank lending, has not yet fully developed.

The third issue is to redesign various systems so that they adapt to the needs of a new age. In particular, it is an urgent task for Japan to reform various systems, including the social security systems, the national tax system, and the relationship between the central government and local governments.

Redesigning these systems tends to raise the conflict of interest problem among generations. During a high-growth period such as that experienced in the past, a compromise solution to this problem can be found relatively easily as the economy is expanding. Recently, however, it is increasingly difficult to resolve the conflict based on the premise of economic expansion.

## **B. *Importance of Creating Value Added***

Although these issues are not easy to overcome, let me offer a few comments regarding the key to the solution.

The first is the need for Japan to strengthen its ability to create value added in various areas. Of course, creating value added is not limited to the economic problem, but also includes more comprehensive concepts such as cultural and political activities. Here, I would like to focus my remarks mostly on value added related to the economic problem.

As a country becomes richer and the people's standard of living improves, labor costs tend to rise. For continued economic prosperity, it is thus vital whether or not Japan can create high value added comparable to the increase in labor costs. In addition, the nation's total population is expected to start declining from around 2006 and hence we cannot expect much contribution from the population front to future economic growth. This is an added reason why raising the capacity to create value added is such a pressing item on the agenda.

This agenda must be achieved in the context of globalization. Globalization means that the division of labor proliferates globally. In this regard, we must ask ourselves seriously in what area Japan should play a role in creating value added.

With the advancement of the IT revolution, the costs of obtaining and duplicating information across borders have been significantly reduced. Thus, producing similar items will not yield high value, which naturally leads to limited profit opportunities. At the same time, precisely because of the advance of IT, if unique items are somehow produced, they can easily be spread globally. Under such circumstances, it becomes very important to produce things unique to Japan or things that only Japan can produce.

I believe that Japan has sufficient capability to continue creating unique items, at least in the economic area, and is equipped with several advantages.

Since World War II, Japanese manufacturers have applied their advanced technologies exclusively to nonmilitary rather than military use. This has been one of the major features distinguishing Japan's application of advanced technology compared with the United States and European countries.

There is no country other than Japan that is more enthusiastic about applying advanced technology to every corner of daily life. Examples include not only automobiles, home appliances, ticket vending machines and passenger gates, but also mobile phones with Internet and photographic functions and digital cameras.

In the context of emerging economies with large populations, people's lives are increasingly affected by new technologies such as IT as their economies develop. In this regard, the technologies developed and applied to daily life in Japan may make large contributions to emerging economies.

This may be particularly applicable to the case of East Asian countries, which are geographically close to Japan. Japanese consumers are said to be among the most demanding in the world. If we can effectively combine Japan's technology and expertise, which are approved in the demanding domestic market, with the production capability and local consumer demand in East Asian countries, geographical proximity as well as historical and cultural linkage with Asian countries will likely work to Japan's advantage. We have already seen some signs of such a combination materializing.

Let me digress a little and touch briefly on a serious question of whether the world economy from the 21st century onward is sustainable in view of the energy and environmental problem. Recently, strong

interest has been expressed with respect to the development of recyclable energy and the restraint of carbon dioxide emissions. Considering the size of the economy and the tempo of growth in Asia, it is highly likely that Asia will be the first region to face squarely the question of whether or not the global economy is sustainable.

Measures to deal with the energy and environmental problem should not be considered simply in terms of costs. From the viewpoint of maintaining the sustainability of the global economy in the future, these measures are in themselves a source of value added. As I mentioned earlier, the experience of overcoming the Second Oil Shock allowed Japan to find a new source of value added in energy efficiency and environmental protection technology. I am confident that we can make use of such value added in a variety of areas.

As long as there remain issues to be resolved and needs to be addressed, we have infinite opportunities to create value added.

### **C. *Risk-Resilient Financial Intermediation System***

My second comment concerns the need to provide a framework sufficient to support private economic agents in their efforts to find and develop these opportunities. In this regard, dealing with risks involved in economic activity is an extremely important issue.

Since it is impossible to fully forecast the future, economic activity to produce value added will inevitably entail uncertainty. When adequate measures for dealing with the uncertainty are in place, economic agents can launch forward-looking plans with confidence. Creating value added and managing risks are in fact two sides of the same coin.

The framework for the diversification of risks among economic agents has been developed as fundamental infrastructure for economic development. For instance, modern corporate law, based on the idea of limited liability of shareholders, can be regarded as the framework that enables risks pertaining to economic activity to be absorbed by a wide range of economic agents. Undoubtedly, these systems have played an important role in supporting economic development in many countries in the modern era.

In the coming age in which risks pertaining to economic activity will grow as globalization advances, financial intermediation systems will play a very important role in constructing a framework for the efficient diversification of risks and their absorption by the overall economy.

Companies and other economic agents diversify risks stemming from economic activity by combining various means of financing. Financial institutions make judgments about how to provide the best financial services by examining the profitability and risk of economic activity. If such judgments together with those of investors are eventually revealed in market prices such as lending rates and bond yields, economic activity will be disciplined and the efficient allocation of resources achieved.

For the efficient reallocation of resources in an economy as a whole, the financial intermediation system must be capable of appropriately evaluating profitability and risks, and such evaluation must be duly reflected in lending rates and credit spreads.

When an economy is experiencing high growth, financial institutions need not pay much attention to the ability to evaluate profitability and risks, because risks can be absorbed rather easily through larger revenues if these institutions maintain a certain volume of assets. Market financing may tend to remain as the secondary source of funding.

When an economy moves to a new stage with an intensified competition and metabolism, we commonly observe the active entry and exit of companies as well as the transformation of business models. Under such circumstances, the financial intermediation system must be equipped with a strong capability to deal with risks, and needs to contribute to improving the power to create value added through the efficient allocation of resources. Toward this end, financial institutions will be severely tested in their ability to evaluate credit risks, develop new financial services, and manage risks. In addition, it is vital to develop market-based financial transactions, which enable a variety of investments to be evaluated by multiple investors.

### **D. *Fairness***

My third comment concerns the need for fairness. This is the key concept for resolving conflicts of interest in the reform process of various systems by balancing benefits and burdens.

In the process of reforming such systems to adapt to economic maturity, we cannot avoid a conflict of interest to a certain extent. When economic growth is decelerating, it becomes increasingly difficult to avoid such a conflict.

For example, pension system reform is a kind of agenda that inevitably creates a conflict of interest among generations. Individual economic agents tend to focus on their own benefits and burdens rather than the adverse effect on the economy due to the delay in reforming the system. This makes it difficult to forge a consensus for the necessary reform.

Under such circumstances, we need to be aware of the question of whether or not the fairness between benefits and burdens is maintained when we try to reach nationwide agreement on the revision of the social security system, tax system and other economic systems.

In addition, a blueprint needs to be developed showing what kind of society and economy Japan aims at, and a consensus must be obtained. Then, we must strive to effect policies consistent with the blueprint.

#### **IV. Concluding Remarks**

Before concluding, allow me to mention three points that need to be borne in mind when conducting monetary policy in light of the issues faced by the Japanese economy.

First, maintaining price stability, which is the fundamental mission of the Bank. Economic agents will pay increasing attention to the problem of uncertainty stemming from global economic activity. In this regard, it is important to make price stability an anchor for the economy and remove the largest impediment to people's activity to create value added. Bearing this in mind, the Bank continues to work to overcome deflation, which is the most pressing item on the agenda.

Second, maintaining financial system stability. The meaning of financial system stability has evolved over time. During the high growth period, the convoy system was the norm, in which the primary objective was to prevent exit from the industry by restricting competition among financial institutions. Now, financial institutions are required to perform efficient funds intermediation, while strengthening their ability to evaluate profitability and risks as well as improving their risk management capability through competition. Systemic risk must be contained. Thus, both active risk-taking and financial system stability are necessary.

The financial system in Japan is still on the path to revitalization, and the risk-taking capability of financial institutions is not yet sufficient. Financial institutions need to accelerate their efforts by April 2005 when the blanket guarantee of deposit insurance will be completely lifted. In light of the various demands of the new era, the Bank aims to enhance prudential policy as well as the conduct of on-site examinations and off-site monitoring.

The third issue is how to improve the financial market. In the new economy in which companies compete in creating value added, it is necessary to understand the needs of the time and the evaluation of one's own business model from the "signals" transmitted by various markets. The market mechanism serves as an "antenna" and enforces discipline, which is indispensable for the Japanese economy's future prosperity.

Looking at this from a financial standpoint, financial institutions need to strengthen their risk-taking ability. At the same time, we require a framework in which the optimum allocation of resources is realized through the markets.

The Bank aims to contribute actively to this end. Since lending by financial institutions is an overwhelming part of the financial intermediation channel, it is both pragmatic and effective to start developing new credit markets, including a market for asset securitization. Accordingly, the Bank has already begun to implement concrete measures along this line.