# Toshihiko Fukui: A tale of two cities in the eyes of a central banker

Remarks by Mr Toshihiko Fukui, Governor of the Bank of Japan, at Japan Society, New York, 6 January 2005.

*   *   *

## 1. Introductory remarks

It is a pleasure to address this eminent audience of Japan Society. Before I proceed any further, I would like to offer my deepest condolences to all the people affected by the earthquake in Indonesia and the tsunamis that followed it. Though we are far away in New York from the tragic events in the Indian Ocean, I hope that we could do everything within our capacity to help our sisters and brothers in distress.

Tsunami happens to be a word derived from Japanese, and Japan has in fact suffered from many tsunamis in the past. Though tsunamis are not necessarily made in Japan, I believe that we could share our experiences with the world.

The purpose of my visit to New York in this frigid season is to commemorate the 100th anniversary of the Bank of Japan's representative office. Some of you might feel disinclined to listen to me, as central bankers tend to harp on the same string. But I can assure you that my speech here will prove to be a lot warmer and more humane than the freezing air outside.

Ladies and gentlemen, the world economy is in fact a lot warmer than a year ago. This is true of Japan's economy too. Indeed, the fundamentals of Japan's economy have visibly improved during the past few years. The basis for renewed momentum is emerging in both the corporate and financial sectors, putting the current recovery on a stronger footing than the last two recovery phases in the 1990s.

The corporate sector has come a long way in its adjustment efforts to eliminate past excesses, and is working actively to devise new business strategies in this globally competitive environment. The financial sector, having made great strides in reducing non-performing loans (NPLs), seems better prepared to provide innovative services, going forward beyond this April when the blanket protection of deposits is removed. In a nutshell, Japan's economy has virtually regained health that it lost a decade and a half ago.

On the prices front, economic recovery has tended to slow deflation during the past few years. As productivity growth accelerates and unit labor cost (ULC) declines, however, linkages between economic growth and prices seem to be becoming a little tenuous in recent years. It is against this background that the core consumer price index is still registering a small decline in recent months, while the corporate goods price index is rising moderately.

Under the present circumstances, the Bank of Japan has two tasks to achieve simultaneously: first, put Japan's economy on a sustainable growth track by maximizing the new dynamism in our economy; and second, end deflation entirely. This is my New Year message to those who are particularly interested in Japan's economy.

As I said a few minutes ago, I have come to this city to commemorate the 100th anniversary of our New York office. I have learned that Japan Society will also mark its 100th anniversary in two years, meaning BOJ New York office and Japan Society are almost the same age. Actually, the general manager of our New York office 98 years ago - Mr. Eijiro Ono - was involved in organizing Japan Society. With this in mind, please allow me, for the moment, to talk about the early days of both Japan Society and the Bank of Japan's New York office, that is, the early 20th century.

Japan Society came into being in 1907 to promote friendly relations between our two nations. Many prominent leaders from both sides of the Pacific Ocean contributed to the establishment of this important forum. This was almost 50 years after Japan had opened its doors to the Western world, when Commodore Perry arrived on Japan's shores to seek diplomatic relations between our countries.

Japan Society was formed when our bilateral relationship was becoming closer, but sometimes tense due to the vagaries of international geopolitics in those days. As is often said, there was a bit of ambivalence in US-Japan relations.

On the positive side, the United States was most helpful in guiding Japan towards successful modernization. We especially owed a great deal to US assistance in the process of industrialization. Trade linkages between the two countries were growing stronger year by year.

At the same time, the downside of our deepening ties was emerging around the turn of the century. A rift appeared in parallel with the palpable increase in Japan's military power in the Pacific and Japan's surprising victory over Russia in 1905. Set against this backdrop, it was natural for the United States to see Japan as a rising power in Asia, with the potential to challenge US primacy in this geo-politically complex region.

Japan Society was born out of this delicate international context. It was expected to perform a dual function - that is, cultivating a mutually beneficial relationship on the one hand, while preventing possible misunderstandings from developing into confrontations on the other.

As I mentioned at the outset, the Bank of Japan was engaged in founding Japan Society. To say a few words on "pre-history," the Russo-Japanese war (1904-05) prompted Japan to tap international capital markets to secure the war chest. As part of this effort, the Bank of Japan decided to station an executive auditor each in London (1904) and New York (1905), two international financial centers, to supervise the issuance of foreign currency sovereign debts of Japan.

This marked the formal inception of our New York office. Since then the New York office has played a significant role in establishing solid relationships with the US financial authorities and banking communities.

Japan Society saw its membership ballooning from 250 at the end of 1907 to over 1,300 at the end of the 1920s. But in the dark 1930s when military tensions between our two nations escalated, its activities were severely constrained. Similar hardship fell upon the Bank of Japan, leading up to the temporary closure of our New York operations in 1941, following the US government's decision to put a freeze on Japan's assets in America. Japan Society also virtually stopped activities in 1942.

The rebirth of Japan Society following World War II began around 1946 and became active when Mr. John Rockefeller the 3rd became President in 1952. It is a testament to his foresight that he rebuilt Japan Society, which contributed greatly to bringing our bilateral relationship back on a viable path towards friendship and mutual respect. In a similar vein, the Bank of Japan re-opened its New York office in 1950.

## 2. Financial sectors in the US and Japan

Having reflected on the history of Japan Society and the Bank of Japan, I am becoming more uncertain whether I am speaking as a central banker or simply as a friend of yours. Being a careered central banker, however, I should perhaps begin to focus on the developments that have taken place in the financial sectors of both our countries.

It is often pointed out that Japan is different from the United States. This view is voiced not only in Japan but also in the United States. Some argue, again on both sides of the Pacific, that Japan is a unique country. I am always amused to hear it, because every country is different, and every country is unique in my opinion, just like everyone in this room is unique. There is always a Japanese way of business like there is an American way of business, a French way, an Italian way, and a Chinese way. In fact, such diversity makes the world very rich, in the same way as we enjoy Japanese food, Chinese food, French food, Italian food, and American hot dogs and hamburgers.

As far as financial business is concerned, however, I think there are a number of similarities between Japan and the United States. By this, I mean not only a growing similarity in terms of financial businesses in recent years, but also plenty of similarities in terms of financial developments in history as well. I am referring to not just rosy episodes but also painful experiences.

### *United States*

From the 1970s through the 1980s, the US financial system weathered several seismic difficulties. Failures of Franklin National Bank in 1974, Penn Square Bank in 1982, and Continental Illinois National Bank in 1984 are particularly memorable. The Latin American debt crisis in 1982 put enormous strains on US money center banks. Over-stretched investment boom was one of the culprits for the Savings & Loans (S&L) debacle in the late 1980s.

In the wake of traumatic experiences in the 1970s and 1980s, the US regulatory framework was revamped to better prepare for future contingencies in the financial system. The enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991 marked a watershed in the regulatory context.

In the 1990s, deregulation for financial business progressed, prompting large-scale consolidation among US financial institutions such as the mergers of Chemical Bank and Chase Manhattan Bank (1996), Travelers Group and Citicorp (1998) and Chase Manhattan Bank and JP Morgan (2000), to name just a few examples. According to a study by Finance Ministry and Central Bank Deputies of the Group of Ten (G10), the United States accounted for nearly 55% of the merger and acquisition (M&A) activities in the financial industry during the 1990s, centering heavily on the banking sector.

This trend to consolidation continues in the 21st century. US banks' stronger earnings and capital base have given a further boost to consolidation, including the creation of a financial colossus by JP Morgan Chase's recent marriage with Bank One (2004). Primary motives behind the current wave of consolidation are revenue enhancement by synergy as well as its stability through product and geographic diversification, in addition to cost savings through economies of scale. Increased competition and stronger pressure from shareholders accentuate the urgency of revenue enhancement for many financial institutions.

***Japan***

Looking back on the past two decades, Japanese financial institutions have followed their US counterparts at least in terms of lending sprees. During the euphoric period of the mid- and late 1980s, Japanese banks expanded their balance sheets disproportionately, aided by sharp rises in share and real estate prices. Their aggressive investments overseas, particularly those in the United States, galvanized serious debate as to whether Japanese financial institutions would end up dominating the global financial landscape. It was in this period that a number of Japanese banks, including regional banks, rushed to New York to open up new offices.

However, success tends to breed excess. The burst of speculative bubbles in the early 1990s left awful damages on the balance sheets of Japanese banks. At the same time, another adjustment pressure was imposed on the industrial side of Japan's economy. That was a competitive pressure that the rapid industrialization of China and other Asian economies posed to labor-intensive industries in Japan. In other words, both lenders and borrowers were hard hit by these structural shocks to an unprecedented degree.

This was the beginning of the abysmal spiral in which Japanese banks were trapped as an economic downturn and non-performing loans (NPLs) fed on each other. The bulk of NPLs forced a drastic shakeout of Japanese banks' businesses, both domestic and international. I presume many of you still remember the "exodus" of Japanese banks from downtown New York in the late 1990s. This withdrawal en masse drove several famous Japanese restaurants in New York out of business, which was an international spill-over from the Japanese financial problems.

After a decade-long hardship, however, a silver lining has finally emerged on Japan's financial horizon. Progress has been made over the past years in resolving NPL problems. Structural adjustments in domestic industries seem to have run their course in view of the fact that a number of corporate businesses are posting record high profits, together with the lowest leverages during the past two decades. Improvements in corporate profitability and balance sheet adjustment have in turn enabled banks to reduce loan-loss provisioning.

Being freed from "capital constraints," Japanese banks are becoming more proactive in strengthening their viability through consolidation and strategic alliances. Consequently, the number of large city banks has dwindled from 9 to 4 during the past 4 years. Corporate culture in the banking industry is also undergoing a number of profound changes, as symbolized by the ongoing take-over bids for UFJ Bank by two rival mega-banks.

Foreign capital has also played a meaningful role in this revitalization process. Carving out new business opportunities such as M&A advisory, distressed debt transactions and private wealth management, foreign financial institutions are providing the Japanese market place with good stimuli.

Against this backdrop, Japanese banks and other financial services companies have begun to develop new business models, like providing a variety of non-conventional products and distribution channels that were unthinkable a decade ago, when the parochial turf war within the financial industry was all the more important.

### *Japan and Asia*

With their non-performing asset problems receding, Japanese financial institutions are shifting their strategic focus to profit enhancement, including reinforcing their business outreach overseas. This change is especially notable in Asia where opportunities for new financial business are opening up saliently. A new economic dynamism is unfolding in the Asian region. I refer to the vertical division of production processes whereby Japan and the rest of Asia are becoming increasingly inter-dependent through the trade linkages based on their comparative advantages.

In contrast to such close trade linkages, financial linkage in this area is still weak. As is widely known, however, Asia is abundant in both savings and investment opportunities. Linking savings with investment is the key role of finance. If savings are channeled into investments within the region, that will increase the scope of finance, thereby enhancing efficiency of capital allocation. In this regard, sharing closer time zones is a huge advantage for financial institutions in Asia. I hope that Japanese financial institutions will take advantage of this strategic potential to cultivate a new business horizon.

The successful marriage of savings and investments within Asia will have global policy implications, too. The more efficient allocation of capital in Asia, the greater demand for goods and services in savings-rich Asia, and consequently the smaller imbalances in the global payment balances.

Let me remind you that development of Asian economies has been made possible by its free access to the global market place, in particular US markets. This is evident not only by recent history of emerging economies but also by the history of Japan hundred years ago. Throughout history, not only consumers but also industries in the United States have benefited from growing trade and investment in Asia. Both the United States and Asia have therefore a common interest in keeping our economies open to international flows of goods and capital. I hope this economic reality will continue to provide a basis for US involvement in Asia, on which benefits accrue to all countries.

At this juncture, let me add a few words about US-Japan relations by highlighting the fact that Japan is located at the west end of the Pacific Ocean, where the United States has a crucial stake. For this geographic reason, it is quite natural that Japan has long been the gateway for US engagement in Asia. I hope this will lay the groundwork for the plus-sum nexus of economy and finance between Asia, Japan and the United States.

## 3. Closing remarks

Now, the clock tells me that I should conclude my speech. At the beginning of 2005, the US economy is growing steadily. Japan’s economy is regaining momentum after 13 years of stagnation. It is my pleasure to see our two economies expanding at this historic juncture, when both the Bank of Japan’s New York office and Japan Society are marking their centennials. I am sure this relationship between us will flourish for the next hundred years after we shared much wisdom in the preceding hundred years.

Thank you very much for your attention and I wish you a very happy New Year.