Mr Hayami discusses the challenges for the Japanese economy

Speech given by the Governor of the Bank of Japan, Mr Masaru Hayami, at the Kisaragi-kai meeting on 27 July 1999.

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I. Introduction

It is a great privilege to be invited to the Kisaragi-Kai meeting to make a speech in front of this distinguished audience.

First, I will make use of this opportunity to discuss the current state of the Japanese economy. Then I will move on to the main theme – structural problems that have to be faced in revitalizing the economy. I hope that my view will give you some perspectives for the future.

II. Recent Developments in the Economy and the Outlook

Let me begin with the Bank of Japan's view on the current state of the Japanese economy and the outlook: Japan's economy, at present, has stopped deteriorating, and corporate sentiment has improved slightly, however, clear signs of a self-sustained recovery in private demand have not been observed yet. The following factors have combined to keep the Japanese economy from a further deterioration. First, active fiscal policy has been stimulating public investments as well as housing investments. Second, private firms have been reducing their inventories successfully helped to some extent by the development of final demand. Third, financial conditions are improving, as a result of the Bank of Japan's zero interest rate policy and the injection of public funds into major commercial banks. The buoyancy in the stock market since early spring and the improvements in corporate sector confidence shown in the *Tankan*, are based on the increased anticipation of better business and financial conditions in the future, as well as the current improvements in final demand, output, and inventories.

It is, however, uncertain at this stage whether the Japanese economy, is on the way to a self-sustained recovery as anticipated above. The reasons can be summarized as follows.

To begin with, I will address two factors that will have a negative effect on the future of the economy. First, the stimulus effects of public investment will fade out eventually. Second, the corporate restructuring efforts of individual firms will expose the macro economy to downside pressures. This is an example where what are rational strategies from the viewpoint of individual firms may have undesirable effects on the economy as a whole. With corporate restructuring, workers faced with harsh income conditions, reduce consumption spending, while firms save the resulting cash or make debt repayments, instead of reinvesting. This "paradox of thrift" may drive our economy into shrinkage.

Of course, there are factors that will work positively on the economy. The point is, however, whether these factors are strong enough to outweigh the negative ones mentioned above.

Let me discuss the positive factors in detail. First, corporate restructuring may bring about a recovery in corporate profits – and may push up stock prices in anticipation of such a recovery. For the recent corporate restructuring to have a positive effect, the profits recovery should boost firms' spending sufficiently to outweigh workers' saving.

The second positive factor is that the effects of the government's various measures to ensure the stability of the financial system and the Bank of Japan's monetary policy to ease financial conditions are permeating throughout the economy, improving household and corporate sector confidence somewhat. Furthermore, there is a possibility that this improved confidence will stimulate the spending attitude of consumers and firms. In fact, household consumption has held steady even amid the harsh income conditions. However, corporate expenditure is still weak, as is obvious from the

Tankan survey on business fixed investment plans. While financial institutions are improving their skill in risk management and striving for adequate lending margins, bank loans have not increased while demand for fund raising remains weak.

The third positive factor is a recovery in overseas economies, especially in Asia. Although China's economy is decelerating somewhat, Korea is now on a recovery trend. Thailand and the Philippines as well as Malaysia and Singapore are bottoming out gradually. These developments will facilitate Japanese exports and production.

The above arguments make obvious the following fact: if foreign economic factors are not considered, the recovery of the Japanese economy depends largely on when corporate behavior becomes active. The recent improvements in corporate sector confidence are good signs for the economy, but other economic indicators and fixed investment plans show no significant signs of economic recovery. Our judgment is that it is too early to say that the Japanese economy is on the way to a self-sustained recovery. Therefore, the downward pressure on prices will remain, although prices have been stable recently.

It is in view of such economic conditions as those described above that the Bank of Japan will maintain the current monetary easing stance and continue to firmly support economic activities until deflationary concerns subside.

III. Contained Dynamism of the Japanese Economy

A caveat regarding fiscal and monetary policies is that they are effective in managing the economy in the short run, but are not a panacea for all of the problems the Japanese economy faces.

This last decade of the 20th century has seen the Japanese economy experience its lowest growth since the end of the Second World War. Despite several economic stimulus measures from both the monetary and fiscal side, the response of the economy has been generally slow and we have yet to confirm any clear revival of economic dynamism led by private demand. Taking into account the weakness of private demand over the past ten years, it is perhaps natural to think that there might be something "structural" which has contained economic dynamism. If this is the case, it is difficult to expect a long-lasting recovery, if any, based solely on macroeconomic stimulus measures. Hence, to restore vitality to the Japanese economy in the medium term, painstaking efforts must be made to resolve each structural problem so as to enable the nation's economic potential to fully blossom. And such efforts are also necessary if both monetary and fiscal policy are to have their full effect.

Since many structural problems stem from the supply side of the economy, resolving them requires that we send the appropriate signal and give the right incentives to the public. As evidenced by Reaganomics in the U.S. and Thatcherism in the U.K., supply-side policies would most likely be accompanied by various pains and require a long period until reforms take root among the public and bear real fruit. It is indeed for this reason that we need to reach an early consensus as to the nature of the structural problems in Japan and thus come up with the right prescriptions.

Some say that structural problems encompass a variety of issues, not only economic ones but also demographic, educational, and environmental ones. But, today, I will focus on three economic issues which are interrelated and have a particularly strong impact on Japan's macroeconomic performance: first, the delay in cleaning up the balance sheet of firms; second, changes in economic growth mechanisms under globalization; and third, the imbalance between savings and investment.

IV. Delay in Cleaning Up the Balance Sheets of Firms

The most immediate lingering structural problem is that we have not yet completed the disposal of assets and liabilities that ballooned during the bubble period. In the wake of the bursting of the bubble, we first saw the collapse of firms which had expanded their liabilities based on aggressive management plans, and then the accumulation of non-performing assets on the part of financial institutions. This, in turn, reduced the risk-taking ability of financial institutions by eroding their capital position, resulting in impairing the smooth circulation of money in the economy. In addition, a loss of credibility in the financial system triggered by the collapse of some financial institutions worried depositors and financial markets alike, and seems to have contributed to the economic deterioration witnessed during 1997 and 1998 through a worsening of household and corporate sector confidence.

The disposal of the non-performing assets of financial institutions has made considerable progress, at least from the accounting viewpoint, thanks to efforts on the part of financial institutions as well as capital injection into major banks using public funds. Needless to say, financial institutions must make further efforts, including the removal of non-performing assets from their balance sheets.

It should be noted that balance sheet erosion is not limited to firms which have already gone bankrupt and the financial institutions which extended loans to them. Although not on the verge of suspending business, not a few firms misjudged demand during the bubble period and made large fixed investments or launched new businesses which turned out to be totally unprofitable. These firms have only just been managing to repay the debt while suffering from worsening asset efficiency and a high debt ratio. The often heard cases of "excess capacity" and "excess debt" have been partly attributed to the business cycle, but fundamentally they should be interpreted in this context of the debt overhang from the bubble period.

There is little doubt that the delay in cleaning up corporate balance sheets lies behind the slow recovery of fixed investments despite extremely low interest rates. Indeed, there are cases where financial institutions have been obliged to be cautious in extending additional loans to firms lagging in improving their financial condition, even if they have new projects which are expected to be profitable. It is pointed out that this is partly because financial technology is not well developed in separating the risk related to a firm from that related to a project which the firm undertakes like in project finance. It thus seems unlikely that the Japanese economy will regain dynamism without an improvement in the balance sheets of the corporate sector.

V. The U.S. Experience – A Case of "Creative Destruction"

Often asked questions include: "How can the corporate sector scrap unprofitable businesses and obsolete equipment?" "Once the corporate sector has downsized unprofitable sectors, how will it lead to revitalization of the whole economy?" To answer these questions, it is perhaps instructive to look at the past 20 years' experience of the U.S. The U.S. faced such problems as dwindling productivity growth during the 1970s and 1980s and balance sheet adjustment from the late 1980s to the early 1990s. In solving these problems, the U.S. government, particularly since the Reagan administration, has played a supporting role by promoting deregulation which has led to intensified competition and industrial revitalization. In the private sector, U.S. firms reviewed their production and management processes, and made necessary strategic adjustments, which has been labeled "re-engineering".

Therefore, to look at developments in the U.S. is useful in considering not only the balance sheet problem but also the kind of structural adjustment which is conducive to increasing productivity and restoring economic dynamism to the Japanese economy.

Economic recovery in the U.S. since March 1991 has often been labeled a "jobless recovery" because it was not initially accompanied by a significant increase in employment and private consumption. However, this gradually changed to a full-fledged recovery with an increase in both fixed investment and employment, resulting in more than eight years of expansion until now. There are, admittedly, various views with respect to the future of the U.S. economy, but it deserves attention that the Schumpeterian process of "constructive destruction" has often been cited to have played an important role in its success to date.

It should be noted that under such slogans as "re-engineering" and "strengthening core competence," many U.S. firms have sold off or scrapped unprofitable sectors and concentrated management resources on profitable ones while taking full advantage of information technology. Such efforts have been responsible for a rise in their stock prices and laid the ground for further expansion in business areas where they had advantages via such methods as mergers and acquisitions. At the same time, many new firms specializing in “high technology” have grown rapidly with the spread of the Internet against the backdrop of across-the-board large increases in investment in information technology to improve management efficiency. In addition, it helped the economy that those who lost jobs due to corporate downsizing were smoothly reallocated to such growth areas as software and other services, including medical and nursing care, in a highly mobile labor market.

With all these factors combined, industrial structure in the U.S. has dramatically changed over the past 10 years. The 50 years’ history of U.S. industry since the Second World War shows that the companies in major industries remained more or less the same during the 1950s and 1970s, including the “Big Three in the automobile industry,” and the big oil and steel companies. However, when comparing the 1990s with the 1970s, a number of firms specializing in “high technology,” which were not even established 20 years ago, are now listed among the major firms representing U.S. industry. This simple fact is deemed symbolic of the process of “creative destruction”.

What about the situation in Japan? In the 1950s and the 1960s, the textile industry and heavy industries such as steel and chemicals developed as leading industries. In the 1970s, the rise of the automobile and electronics industries substantially changed the lineup of major firms. However, since the 1970s, there have been no substantial changes.

I hasten to add that I am not saying that the Japanese economy cannot grow unless new firms are created. There is no doubt that many existing major firms are actively pursuing the development of new technology. Indeed, in this context, we can find examples of major firms in the U.S. which have undergone a dramatic transformation from what they were 20 years ago. Having said this, recalling Shumpeter’s belief that the function of an entrepreneur in the true sense is not so much to manage as to create a company, I cannot help but feel slightly disappointed that we have not yet seen the creation of many new companies which can lead the Japanese economy. A main driving force behind the buoyant development of the U.S. economy has been revitalization through intensified competition, and, if I may add another factor, “a culture of risk taking”. In Japan, while existing firms should concentrate their management resources on business areas where they have a comparative advantage, new industries or groups of new firms should emerge to create jobs, thereby achieving growth balancing the old and new. What is important in the process is that capital stock such as equipment and technology and management resources such as human resources be liquidated and reallocated to be fully utilized in growing new business areas.

VI. Changes in the Economic Growth Mechanism under Globalization

The second structural problem Japan has to face is that as globalization progresses and the shareholdings of foreign investors increase, Japanese corporate managers have come to pursue higher rates of return rather than expansion. At the same time, rates of return in those industries which had been protected by regulations have been forced to decline. Together, these developments have put heavy adjustment pressure on the existing industrial structure.

A. Management Pursuing Higher Rates of Return

A recent survey by the Economic Planning Agency shows that Japanese corporate managers have clearly changed to now emphasize higher rates of return. Since economic stagnation continues and hardly any increase in sales is expected, it is natural for corporate managers to pursue both higher return on assets (ROA) and higher return on equity (ROE). In addition, major Japanese firms used to rely on unrealized gains on shares as a buffer for the unexpected, and were able to remain profitable on the whole even if substantial losses were incurred in some areas. But, with the stagnant economy and sluggish stock prices, it became difficult to continue to depend on such unrealized gains, and this also seems to be partly responsible for the recent change in attitude of corporate managers who now emphasize rates of return over the short term.

The data show that the ROA of Japanese firms was an average 7.8 percent during the 1980s, but declined to 5.1 percent in the 1990s.[1] While this was partly due to the business cycle factor, it is true that the profitability of Japanese firms has been on a declining trend.

B. Changes in Economic Growth Mechanisms

One factor behind the declining profitability of Japanese firms is that their balance sheets still carry a huge amount of assets, either idle or underutilized, which is the negative legacy of the bubble period. A second factor is that since Japanese firms have long adopted a management style with an emphasis on maintaining employment, labor's relative share inevitably rose during the long recession, thereby squeezing capital's relative share, which translates into declining profitability. And, a third factor is that as the economy becomes more globalized, those Japanese industries, which had hitherto been protected by various measures such as regulations, are now forced to accept a declining rate of return, leading to the imminent need for large-scale adjustment of their industrial structure.

Given the efforts made by firms, the first two factors may be mended over time. The third factor, however, seems to stem from the substantial and irreversible structural changes that the Japanese economy is currently experiencing.

Let me elucidate on this third factor. Looking at the Japanese economy from a long-term perspective, we observe the following pattern. There is no doubt that the automobile and electronics industries have been one of the engines supporting post-war economic development because of the rapid increase in their productivity. By exposing themselves to international competition from an early stage, these industries have remained at the highest technological level globally and enjoyed high profitability through exports. Wages in these industries were raised in line with increased productivity. And, such an increase in wages permeated to other domestic industries with lower productivity, thereby improving the standard of living for the nation as a whole. If industries with low productivity try to pay the same wage as those with high productivity, the prices of products and services in these industries inevitably have to be raised. The existence of various regulations and traditional business practices have contributed to making such price increases possible without much difficulty.

As the economy became further globalized in the 1990s, the traditional pattern has undergone a tremendous change. What triggered the change was that firms in leading industries have expanded production overseas and conducted operations on a global scale while paying close attention to the difference in costs at home and abroad. As a result, Japanese workers who had enjoyed high wages when compared internationally have become exposed, directly or indirectly, to global competition. In addition, globalized firms which focus on cost performance have pressured their domestic subcontractors and service providers to reduce their prices, thereby threatening the profitability of domestic industries which had not been operating in a competitive environment. Furthermore, with the increase in travel overseas, Japanese consumers have become conscious of the difference between domestic prices and those abroad. These factors, combined with the progress of deregulation, have created a situation where domestic industries which used to be protected from competition find it increasingly difficult to secure profits just by raising prices as they used to do. Thus, the traditional growth mechanism whereby even low productivity industries could maintain a certain level of profitability has apparently become unsustainable.

Since the trend toward globalization is irreversible, it seems that time alone will not resolve this third factor responsible for declining profitability. Hence, it should be regarded as one of the most difficult structural problems facing the Japanese economy. In the U.S., such factors as technological innovation in telecommunications and intensified competition stemming from deregulation are said to have played an important role in improving productivity. Crucial for Japan's economic future is how to raise the productivity of industries which have not operated in a competitive environment. The process

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[1] Based on "Financial Statements Statistics of Corporations by Industry, Quarterly" compiled by the Ministry of Finance.

of "creative destruction" is deemed unavoidable to a certain extent. In this regard, we need to carefully monitor what happens to employment in the process.

VII. Savings and Investment Imbalance and Shortage of Risk Capital

As may have become already clear, keys to restoring dynamism to the Japanese economy are the growth of new industries and firms as well as the simultaneous revitalization of investment. In this context, one might well ask why a country with one of the highest per capita GDP figures in the world and ample household savings totaling 1,300 trillion yen finds it difficult to revitalize domestic investment. This brings us to the third structural problem: the savings and investment imbalance.

A. Decline in Capital Productivity

It is rather ironic that as economic globalization progresses and cross-border capital movements become free, Japan has become an increasingly uncomfortable place for capital to stay because of its high level of capital accumulation. With slow growth in the labor force, Japan has accumulated capital through aggressive fixed investment since the high growth period, which substantially raised the amount of fixed assets per unit of labor. In fact, in the incessant pursuit of economic development since the end of the Second World War, Japan has become a capital rich country, even more so than the U.S.

We should be proud of the fact that, through such capital accumulation, Japan's per capita GDP is among the highest in the world. At the same time, we should be mindful of the fact that the amount of fixed assets necessary to produce the same GDP has been increasing, that is, the productivity of capital has been declining. Declining productivity of capital means that the expected return has been declining, which is consistent with the downward trend of ROA. From an investor's viewpoint, this is the same as saying that capital is not efficiently employed in Japan, which might make investors both at home and abroad hesitate to invest in Japanese companies. Hence, if Japan increases investments only in existing areas to raise labor productivity, it will lead to a further deterioration in capital efficiency. Therefore, Japanese firms are currently facing a difficult challenge to expeditiously dispose of the negative legacy from the bubble period while at the same time exploring new business areas with high profitability and reallocating such resources as capital and labor to them.

B. High Savings Ratio

The imbalance between savings and investment is not a problem stemming exclusively from the investment side. The household savings ratio (on SNA basis) was more than 20 percent in the mid-1970s, but declined to around 10 to 15 percent by the end of the 1980s. The future prediction at that time was generally based on the following life-cycle hypothesis: When Japan becomes an aging society in the 1990s, older generations will reduce their savings and the household savings ratio will further decline, eventually resulting in the disappearance of Japan's huge current account surplus. However, the reality is that the savings ratio stopped declining in the 1990s and the prediction at that time has turned out to be wide of the mark.

It does not seem plausible to argue that a high savings ratio, that is, lower consumption than otherwise, is entirely due to national traits of the Japanese who regard savings a virtue. For example, surveys by the Prime Minister's Office and the Bank of Japan suggest that many older people are concerned about their future livelihood and that they have reduced expenditures because of rising uncertainty regarding the pension and social welfare system. An increase in such uncertainty is also seen among younger generations. People, young and old alike, seem to have been cutting back on expenditures and increasing savings in self-defense to prepare for future uncertainty.

One could say that we are caught in a "double savings" situation: In an aging society with a declining birth rate, older generations are saving more from their pensions in preparation for future nursing care needs, while younger generations are actively saving in fear of receiving less from their pensions in the future. Thus, if the household sector considers it necessary to save more and domestic investments are losing attractiveness, the economy will inevitably see an expansion of the fiscal deficit and current account surplus.

To avoid such a situation, it is important to give the public a clear image of the future framework of the pension system so as to reduce uncertainty as well as to establish a social framework for looking after the elderly. In view of the fact that caring for the aged can be a business opportunity in the U.S. and Europe, we should make good use of private sector vitality to create businesses in such areas as social welfare.

C. Shortage of Risk Capital

In addition to the high savings ratio, another marked characteristic of household savings behavior in Japan is the high proportion of savings held in low risk assets such as bank deposits and postal savings. A comparison of the composition of household assets between Japan and the U.S. according to flow of funds accounts statistics shows that: cash and deposits comprise 55 percent of total assets in Japan, but only 11 percent in the U.S.; and, while the figure for stocks is 7 percent in Japan, it is 43 percent in the U.S. These figures vividly highlight the difference in risk-taking attitude of the household sector between Japan and the U.S. It seems that U.S. capital markets, which tend to promote venture businesses, are supported by such household behavior to no small extent. In Japan, despite the strong propensity for safe assets, it cannot be denied that how to make firms and financial products attractive for investment purposes will warrant study.

I stated earlier that capital productivity in Japan is low and thus not attractive for either domestic or foreign investors. This refers only to the overall trend of the economy thus far. If we closely examine each individual firm and project, there must potentially be many investment opportunities with an appropriate combination of risk and return. There should not be much difference between Japan and abroad in that even a small firm will be able to become a big success if it takes advantage of technological innovation in telecommunications and deregulation. In fact, we may detect some seeds of new business opportunities in the recent buoyancy of the stock market. To germinate such seeds, it is deemed necessary to encourage new entry to the market through deregulation which leads to intensified competition and the revitalization of industries, and to create a variety of financial products through which the abundant savings of the household sector can be smoothly channeled as risk capital to investments in new businesses.

VIII. Concluding Remarks

The Japanese economy now stands at a crossroads as to whether it can move onto a self-sustained recovery path. Needless to say, a stable macroeconomic environment is important for the smooth progress of structural adjustment. We are fully aware that monetary policy is expected to play an important role under such circumstances. With these considerations in mind, we will maintain current monetary easing until deflationary worries subside.

Having said this, the three structural problems discussed here are determined by supply-side factors, and cannot be dealt with only by demand stimulus measures from the monetary and fiscal side. For example, in addressing the corporate balance sheet problem, to what extent firms tackle the allocation of management resources will depend critically on the way corporate governance is being implemented. Regarding the changes in growth mechanisms under globalization, whether new firms emerge to bring innovation to the productivity of existing domestic-oriented industries will depend on how regulations and traditional transaction practices change and how the capital market functions. As to the savings and investment imbalance and the provision of risk capital, much may depend on the future of pension, insurance, and taxation systems.

Since these supply-side measures work on the incentives of firms and households, it thus often takes time for effects to materialize unlike measures working on the demand side.

Even if it takes time, I am not pessimistic about the future of the Japanese economy. We should be proud of Japan’s high quality labor force, technology, and managerial ability which enabled the post-war economic recovery. Such economic potential is still intact. I believe that dynamism will be restored to the Japanese economy if, with appropriate supply-side prescriptions, industries revitalize themselves through the transformation of existing firms or the creation of new ones in a competitive framework conducive to increasing risk-taking activity.

In fact, the government has been examining various measures to tackle unemployment and industrial revitalization. And, in the private sector, we can observe some signs of future changes such as the increase in business affiliations and mergers and the review of business areas. By promoting structural change, the Japanese economy will undoubtedly exhibit the potential to transform itself into an economy with vitality and high productivity.

In coming up with specific supply-side prescriptions, cooperation between the private sector and the government is essential in discussing such problems as how to guide incentives for firms and households in a desirable direction and how to minimize moral hazard. I sincerely hope that my speech today will contribute to discussion on the very important problem of structural reform.