Masaru Hayami: The US and Japanese economies - reflections of a central banker

Speech given by Mr Masaru Hayami, Governor of the Bank of Japan, at the 32nd Annual Joint Meeting of Japan-Midwest US Association and Midwest US-Japan Association, held in Tokyo, on 11 September 2000.

*   *   *

I am honored to be invited today to the 32nd Annual Joint Meeting of Japan-Midwest US Association.

As some of you may know, after having worked at the Bank of Japan from 1947 through 1981, I then entered the private sector where I spent about 17 years, during which time I often participated in meetings of business leaders from both the United States and Japan. At this Annual Joint Meeting, I am told that political and business leaders from both countries are going to discuss the problems that the world economy faces, including the IT revolution and globalization. Needless to say, I am looking forward to learning the results of the discussions.

Some ten to fifteen years ago, that is, in the late 1980s, one of the main topics at such conferences was economic and trade friction between the United States and Japan. Indeed, I chaired a small group established under the Japan-US Business Conference that discussed the resolution of disputes, which I found an important, but not an easy job. One of the advantages of serving as chairman was that I had the opportunity to visit a number of US cities, including Cleveland in the Midwest.

Fortunately, the economic and trade friction hotly debated at that time has been greatly alleviated, partly because the cause has been removed and also partly because misunderstanding on both sides has been resolved, which largely owes to the strenuous efforts made by those involved in solving the problems underlying the friction. However, I think it also reflects the fact that over the past ten years Japan's economy has stagnated while the US economy has revived.

Japan's economy saw the peak of the bubble about ten years ago. At that time, Japanese firms and financial institutions were expanding their global market share and were full of confidence. Many of you will remember a book entitled "Japan as Number One" written by a professor of Harvard University which was published immediately before the bubble hit the peak. In contrast, ten years ago the United States was suffering from twin deficits, a combination of huge budget deficits and the expansion of current account deficits.

But that was ten years ago. Now, the US economy has been enjoying its longest ever period of economic expansion. The unemployment rate has come down dramatically from 7.5% in 1992 to 4.1% recently. On the other hand, Japan's economy has experienced severe trials since the bursting of the bubble. Such contrasting development between the United States and Japan is most typically witnessed in the movement of stock prices. The current Nikkei Stock Average is a little more than 40% of what it was at the end of 1989, which happened to be its peak, while the New York Dow-Jones Industrial Average has risen four-fold during the same period.

Against this background, we Japanese have recently tended to become overly pessimistic about the medium- to long-term growth potential of Japan's economy. However, I believe that Japan's economy will be able to regain vitality if it firmly pursues economic reforms needed from a medium- to long-term viewpoint, as witnessed by the revitalization of the US economy since the 1990s.

To that end, we should learn lessons from past mistakes. At the same time, it is crucial that we steadfastly implement concrete reform measures while earnestly discussing how to revive Japan's economy. In view of the current boom of the US economy, it may be useful for US participants in this meeting to draw possible lessons from Japan's bitter experience which began when its economy was still in a good condition.

Bearing all this in mind, let me talk about two issues. The first issue is, in the context of the US-Japan economic relationship in the late 1980s, why did the bubble emerge and how did monetary policy affect the emergence of the bubble? The second issue is, though it might sound a little bit vague, to what extent do differences in economic and corporate management style, for example between the United States and Japan, affect economic growth?

Regarding the first issue, there are various factors behind the stagnation of Japan's economy in the 1990s. The emergence of the huge bubble in the late 1980s and its subsequent bursting in the 1990s was certainly one of the major factors. Although why the bubble emerged has not yet been fully analyzed, we can obtain a few common observations if we look back on the history of bubbles including the case of Japan.

One common observation is that it is inevitable that a bubble will emerge if public expectations become extremely bullish for some reason. And, borrowing the expression of Fed Chairman Greenspan, "irrational exuberance" prevails nationwide when a bubble emerges. However, intensification of bullish expectations alone is not enough for the emergence of a bubble, for it has to be financed, which is another common observation. As a matter of fact, during the bubble period in Japan, the activity of financial institutions had become extremely aggressive and interest rates had been kept low for a long period of time.

Now, in the aftermath of the bursting of the bubble, we hear various questions and criticisms such as "Why did the Bank of Japan maintain monetary easing for a long period?" There were a couple of reasons behind the delay in monetary tightening at that time. Above anything else, prices had been very stable. Furthermore, Japan had a sizable current account surplus, reaching 4.2% of GDP in 1986. And this strengthened the prevailing argument that Japan should continue monetary easing and expand domestic demand to reduce the external surplus, which was another reason for the delay in raising interest rates. The United States advocated that Japan's current account surplus should be reduced through the expansion of domestic demand, but such an argument was widely discussed in Japan as well.

The basic condition of the current account balance of a country is fundamentally determined by the trend of the net balance between savings and investment which reflects demographic and other underlying factors. Economic theory tells us that it is hardly possible for monetary policy to affect such a basic condition of the current account balance. Nevertheless, in reality, not a few advocated the erroneous argument which was not warranted by economic theory. I think this was partly because some support was given to a misconception that microeconomic problems could be solved simply by macroeconomic policy. In other words, there existed the mistaken notion that such problems as trade friction between the United States and Japan could be solved by monetary policy.

Looking at the booming US economy while reviewing the experience of Japan's bubble period, I cannot help but feel some difficulty in judging the arrival of the new economy, in other words, the difficulty in differentiating between "irrational exuberance" and "rational exuberance."

Most central banks would perhaps say "no" to the question as to whether monetary policy could prevent the emergence of a bubble. But, I think they would say "yes" to the assertion that monetary policy can play a very important role in maintaining a stable macroeconomic environment. As we have seen in the discussion based on the misconception about a reduction in the current account surplus, I strongly believe it is important for both policy makers and business leaders to understand and share some kind of basic logic in terms of macroeconomic theory for the conduct of sound economic policy.

Let me move on to the second issue I want to address which is to what extent differences in economic and corporate management style, for example between the United States and Japan, affect economic growth.

Against the backdrop of prolonged economic stagnation in recent years in Japan, there has been growing recognition that we should further incorporate into our system the US style management which emphasizes market-oriented economic management and shareholder-oriented corporate management. Simply put, regarding economic management, competition should be further intensified. The relaxation and lifting of regulations should be promoted. The financial system should be shifted from one led by banks to one led by the capital market. And, on the corporate management front, corporate governance should put more emphasis on shareholders. Needless to say, employment adjustment should be more drastic.

From time to time such an argument goes to the extreme that further development of Japan's economy cannot be expected unless we completely shift from Japanese style to US style management. I think this is overly pessimistic because Japanese style management is not something which never changes, but is rather something which has evolved in response to changes in the economic environment.

Of course, I am not saying that current Japanese style economic and corporate management has no problems. Indeed, I often mention the importance of structural reform, and am sometimes criticized for going beyond my position as central bank governor by making too strong a statement on the subject.

Nevertheless, I strongly believe Japan needs structural reform. First of all, let me emphasize that the growth potential of the economy can be increased largely by improvements on the supply side, that is, achieving steady productivity gains, rather than the short-term boosting on the demand side. For example, if we compare the productivity of workers in 1998, the figure for Japan was about 40% lower than that for the United States based on purchasing power parity in the IMF's World Economic Outlook, and about 30% lower when based on the actual exchange rate. Of course, if the sole objective is higher labor productivity, it can be achieved by investing a huge amount of capital and raising capital per worker. But, in this case, capital productivity and return on capital would decline. Furthermore, growth driven only by the huge investment of resources would eventually reach a limit.

For sustainable growth, we need to establish an indigenous mechanism that promotes growth by combining labor and capital in an optimal manner under given prices and which generates innovation in various fields.

Under such circumstances, we have to deal with the following three agendas.

First, the allocation of resources should be reviewed in light of changes in the economic environment and resources should be invested in more productive areas. In this way, resources would be more efficiently utilized. For example, labor and capital need to be reallocated from the public to the private sector, from low growth to high growth industries, and from less efficient to more efficient firms. Such redistribution would certainly be accompanied by pain, but without it we cannot expect the steady development of Japan's economy.

Second, the legal, tax and accounting systems, some of which are outmoded and can be an obstacle to innovation, should be reviewed. While I recognize that it is never easy to review any system, which inevitably entails conflict of vested interest, we should know that we will not be able to take advantage of the power of innovation unless systems are reviewed in response to changes in the economic environment.

Third, what we really need to see is the emergence of innovators. Changes in the economic environment will create a variety of opportunities for making profits. Transforming such opportunities into profitable businesses cannot be achieved through a mechanical process. It can only be achieved if innovators are allowed to pursue their entrepreneurial abilities to the full.

These three agendas boil down to the problem of how to improve the ability of the economy and society to cope with various changes. Such an ability is always needed, but, when technological innovation and economic globalization are rapidly progressing, economies and societies that can respond to such changes have a considerable competitive edge.

I think the fact that the United States has recently recorded higher growth than Europe and Japan reflects a greater ability to cope with changes which can be characterized by flexibility and diversity. At a recent conference sponsored by the Federal Reserve Bank of Kansas City, Fed Chairman Greenspan emphasized that the flexible US labor market had contributed to recent high economic growth, by noting the seemingly paradoxical situation of low unemployment despite many layoffs.

From these viewpoints, we definitely observe the seeds of changes in the recent development of Japan's economy. Let me give you some concrete examples of such change.

First, the reform of systems is proceeding rapidly. For example, a number of changes have been made in the area of accounting, including mark-to-market valuation, more adequate pension liability accounting, and the review of the relationship between subsidiaries and their parent companies. And, importantly, the level of disclosure has been greatly improved. By accurately showing the performance of a firm, these changes put strong pressure on corporate managers to pursue restructuring and higher profits.

Second, corporate managers have become increasingly aware of return on capital.

Third, the mentality of employees has changed. Japan’s labor market, which is characterized by lifetime employment and the seniority-based wage system, used to be perceived by many as lacking flexibility. However, recently we have seen gradual changes in the market as large-scale employment adjustment has begun to be observed.

Fourth, reform of the financial system has been proceeding. Since the autumn of 1998, a legal framework for the smooth dissolution of failed financial institutions has been established and public funds have been injected into major banks to strengthen their capital base. Although there remain a lot of things to be solved, the condition of Japanese financial institutions has significantly improved thanks to the restructuring efforts on the part of financial institutions.

Related to these positive developments, direct investment into Japan has substantially increased in recent years. In the past, inward direct investment was much smaller than outward direct investment. In fact, it was only 200 million dollars in 1996. However, it has been on a rising trend, amounting to 12.8 billion dollars last year. I have great expectations for a continuing increase in direct investment from abroad as it would stimulate Japan’s economy through the transfer of managerial resources and business expertise.

Before closing, if I may summarize, firstly, a stable macroeconomic environment is a prerequisite for sustainable growth, and in this regard, monetary policy plays a very important role. Second, to raise the economic growth rate over the medium to long run, structural reform affecting the supply side of the economy is indispensable. I think that the contrast between the US and Japanese economies during the past ten to fifteen years exactly proves this point.

Let me conclude my remarks by quoting the following prayer for “Serenity“ by Dr Reinhold Niebuhr which I cherish whenever I face challenging issues as Governor of the Bank of Japan:

> God grant me the serenity to accept the things I cannot change, The courage to change the things I can; And the wisdom to know the difference.

Thank you very much for your kind attention.