

Sakuya Fujiwara: Recent financial and economic developments in Japan and the euro area

Keynote Speech by Mr Sakuya Fujiwara, Deputy Governor of the Bank of Japan, at the Fourth Paris EUROPLACE Financial Forum, held in Paris on 27 November 2000.

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Introduction

Ladies and Gentlemen,

It is my great honor to be given this opportunity to speak again at this Paris EUROPLACE Financial Forum. I also understand that this is a forum, where exchange of views among distinguished participants of different experiences is of special importance. Therefore I reserve the right to ask for your opinions on such interesting topics as recent developments in capital markets and the impact of information technology in the euro area.

Now, with respect to my duty today, I have three topics in my mind. First, I will discuss Japan's economy and the challenges it faces. Then, I will turn to recent developments in the euro area, a subject which is of particular interest to myself. Here, I dare to introduce my observation on the economic structural reform recently underway in the euro area. And last, I will briefly touch on enhanced interrelations between the euro area and Japan.

1. Japan's economy and the challenges it faces

Compared with a year ago, when I gave a speech at this forum last year, Japan's economy has shown notable improvement. The recent economic recovery is mainly driven by the corporate sector, where we witness the increases in production and corporate profits. Against such background, business fixed investment has been increasing, especially in the IT and telecommunications fields. Although the pace of recovery remains sluggish in the household sector, positive developments are observed in employment and income, reflecting the recovery of business activity. In sum, Japan's economy is recovering gradually, with business fixed investment continuing to increase.

At the same time, however, we cannot ignore the fact that Japan has yet to solve structural problems in the economy. In this context, Japanese firms and banks continue to suffer from balance sheet problems, the aftereffects of the bursting of the bubble in the 1990s. And, while the world economy, especially the United States, has registered high growth by exploiting the benefits of new technology supported by salient entrepreneurship as well as the vibrant capital market, Japan has somewhat lagged behind in its ability to adjust itself to such new environment. With a nascent recovery now underway in Japan, constant efforts are necessary to continue to tackle the remaining structural problems head on, which in turn should be the prerequisite for sustainable growth.

Important progress has already been observed, though, in the financial sector. Bank capital base has been strengthened by the injection of public money. There has also been a progress in reinforcing safety nets. On top of that, the consolidation of financial institutions, especially large ones, is in progress, something which Japan has never experienced since the end of the World War II. I sincerely hope these changes will beef up the profitability and competitiveness of financial institutions, thereby enhancing the efficiency and stability of the financial system as a whole.

Meanwhile, ongoing corporate restructuring process may exert downward pressure on the economy in the short run. But I believe this should facilitate efficient allocation of resources to high-growth industries, contributing to sustainable growth in the long run.

To accelerate such structural change, determined efforts on the part of policy makers are also important. Such efforts should include deregulation, tax reform and improvement of accounting and

legal systems. The Bank of Japan, as a central bank, must contribute to ensuring a stable macroeconomic environment through appropriate monetary policy measures, which will form the basis for creative and future-oriented corporate activity. In addition to this, the Bank of Japan assumes important responsibilities in improving the financial market and payment system infrastructure. The start of real-time gross settlement of fund transfers and government bond transfers from the beginning of next year is one of such efforts.

2. Dynamism of the euro area economy

When I think about structural reforms in the Japanese economy, I always think of the experiences of the euro area economy on this front.

Today, nobody doubts the importance of structural reform, but it is difficult to achieve a social and political consensus as to the most practical approach. Reform is accompanied by pain, and also takes a long time to bear fruit. But once the direction is set, reform calls for further reform, thereby generating autonomous momentum. Developments in the euro area economy have considerable implications and are encouraging to us. I realize it may sound too simplistic but the essence of reform lies in market integration.

I say this because market integration leads to intensified competition. In the euro area, mergers and acquisitions are a driving force for corporate restructuring and industry reorganization. This increase in M&A, which started from around 1997, was no doubt sparked by the introduction of the euro. In addition, firms are being forced to change their management strategy so that they can survive amid global competition and keep up with technological innovation. Indeed, firms are increasingly aware that efficient management and higher profitability are more important today than ever, and such recognition is evident in recent M&A examples. These days firms are not expanding their business fields, but rather streamlining businesses that they have little competitive edge in, and beefing up the ones that are strategically important.

Market integration in the euro area has also brought about dynamic changes in the economic infrastructure, including transportation, electric power, telecommunications, and finance. In the area of finance, some examples of positive developments include the creation of new payment systems, such as TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer), the rapid expansion of capital markets, and the merger and integration of stock exchanges. In addition, the euro area has begun to review tax systems and labor practices.

Amid the sea change of market integration and the introduction of the euro, deregulation and market infrastructure consolidation are being seen. And the private sector is making the most of resources, so to strengthen competitiveness. Thus, market integration accelerates momentum for competition, and in turn stimulates momentum for reform in other areas of the economy and finance. I believe that every economy has the potential for growth. The problem is how to realize such potential. Structural reform seems to be a trigger in this regard.

I know that some are skeptical about the euro area economy. Such voices often argue that the weak economy is the reason for the weak euro. For example, they say that structural rigidity of the euro area economy, or the difference in productivity between the United States and the euro area, has induced the massive outflow of capital to the United States thus causing the euro to weaken.

The mechanism behind exchange rates is very complex, and as a central banker, I ought not to make any careless remarks on this delicate subject. However, I have to say we should not hastily assume that the weak euro merely reflects a weak economy. Capital outflows across the Atlantic could be the result of intensified global competition that has stimulated various types of strategic alliances across the border.

Integration of the European markets and the introduction of a common currency are historically the most remarkable events since the collapse of the Bretton Woods system nearly thirty years ago. As such, they can be characterized as part of a project which has the potential to dramatically change the

landscape of the world economy. With this in mind, I will continue to keep a close watch on economic developments in the euro area.

3. Interrelations between the euro area and Japan

Lastly, I would like to give my view on interrelationships between the euro area and Japan, focusing on capital flows. As I have mentioned, in the euro area, monetary union has triggered various kinds of structural change, bolstering the development of the overall economy. The impact is so large that it has affected not only the euro area itself, but also Japan.

An example of the effect is direct investment. Direct investment from western Europe to Japan soared more than tenfold in a year, from about 100 billion yen in 1998 to over 1 trillion yen in 1999. Investment from France was especially large, which reflects the capital collaboration that was seen in the automobile industry. Direct investment from Japan to the euro area is also on the rise. The increase in direct investment will promote the reallocation of management resources, technology transfer, and competition, resulting in boosting both economies.

The increase in capital flows between the two economies is well evidenced in portfolio investment. In 1999, Japan's portfolio investment in the euro area exceeded that in the United States. Japan's foreign portfolio investment in France, Germany, the Netherlands, and Luxembourg, the four euro area countries for which individual data are available, totaled almost 5.6 trillion yen in 1999. On the other hand, Japan's portfolio investment in the United States was 1.4 trillion yen. This is rather noteworthy, because, in international capital markets, the United States, with its huge current account deficit, absorbs a lot of funds provided by the euro area and Japan. Despite such a situation, capital flows between the euro area and Japan are surging, and both economies are growing more interdependent in international capital markets.

In the increasingly integrated global market, the euro area and Japan are becoming more and more dependent. I hope today's forum will contribute to bringing the two economies closer, and serve as an opportunity to enhance communication between the private sector of the euro area and that of Japan. I know this forum will be a success.