

# Masaru Hayami: Challenges for Japan's Economy - The Central Bank's Perspective

Speech given by Mr Masaru Hayami, Governor of the Bank of Japan, at the Keizai Club on 22 December 2000.

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## Introduction

We have just a week or so to go until the end of the year. I would like to present my own thinking on what has been achieved over the past year and what remains to be done. At the same time, I would also like to explain our basic stance regarding the conduct of monetary policy in order to deepen your understanding in this respect.

## 1. Three Features of the Current Economic Recovery Economic developments this year

### *Economic developments this year*

The first thing to be emphasized is that Japan has finally reached a stage where there are emerging signs of an economic recovery.

At the beginning of this month, GDP statistics based on a new calculation method (SNA93) were released. GDP growth on this new basis was -0.6% for fiscal 1998 but turned positive in fiscal 1999 (+1.4%) and the corresponding figure for the third quarter of this year stands at +1.5%. What should be noted in this connection is how private demand and public investment have contributed to this recovery trend.

When the Bank of Japan adopted the zero interest rate policy around two years ago, public investment for the first quarter of 1999 increased (+13.3%) compared with the previous year. In contrast, private demand such as household consumption and business investment declined (-2.0%) in the same period. However, this contrast has been gradually reversed during the last two years. In the third quarter of this year, public investment decreased (-4.1%) on a year-on-year basis while private demand grew (+1.1%). In other words, the gradual upturn in private demand is strengthening while the fiscal stimulus has turned negative.

Under these conditions, corporate profits as a whole are expected to record a double-digit increase for the second consecutive year. At the same time, employment and household income conditions are slowly improving, as demonstrated by the positive growth of wages since this spring and a slight decrease in the unemployment rate from its all-time high.

Some of you might not feel comfortable with my diagnosis of the present economic situation and we are fully aware that such a perception does exist. In our opinion, this perception typically reflects the very characteristics of the ongoing recovery phase.

### *'Polarization' of economic recovery*

The first feature of the ongoing recovery is that there remains considerable divergence among various sectors or segments of the economy regarding the pace of recovery, which is sometimes called 'polarization.' At present, for example, the corporate sector is showing a notable improvement while the household sector is being left behind. This is clearly reflected in the fact that business investment is markedly increasing although personal consumption remains lackluster. In other words, the recovery trend now underway is being driven mainly by the corporate sector with the household sector lagging. Moreover, the stark contrast between the IT-driven new economy and traditional old economy is also a case in point, and the contrasting picture between large manufacturers and small and medium-sized non-manufacturers is also often mentioned.

At this point, I would like to add further explanation of the sharp contrast between the corporate and household sector. In the corporate sector, the profit improvement is becoming more pronounced and business investment is on an upswing, though firms are not likely to immediately increase wages and hiring. This is because the corporate sector is attaching top priority to eliminating over-indebtedness

and reinforcing profitability under strong pressure from financial markets in this rapidly globalized environment. I assume this is the main reason why household and consumption-related firms do not feel any strong sense of a recovery at the present moment.

Vigorous restructuring and the resulting recovery in the corporate sector is a precondition for sustainable growth, but it is highly likely that improvements in employment and income conditions and personal consumption will remain slow for some time to come. However, if income distribution to the household sector is overly constrained as a consequence of aggressive efforts to pursue corporate restructuring, we will face a greater risk, at a macro level, of personal consumption falling, thereby jeopardizing the nascent recovery. In view of the above, Japan's economy seems to be precariously balanced in building the foundation for a sustainable upturn.

### ***Price developments***

The second characteristic of the present recovery phase is the continuing weakness of prices. Year-on-year growth in CPI and the GDP deflator has been negative. Under these circumstances, even if sales volume increases it will not likely result in any conspicuous increase in nominal sales. Lack of a clear sense of recovery among business managers also reflects such a factor.

Yet, we can detect some positive aspects in the current soft trend of prices. For instance, the expansion of new distribution businesses - often called 'category killers'- is offering considerable benefits to consumers through their bold pricing strategy. It is said that this new strategy, making extensive use of overseas networks in terms of procurement and production, is providing a new business model for distribution firms. Furthermore, rapid progress in telecommunications technology is also exerting downward pressure on prices, as is typically seen with PCs and IT-related goods.

The weak trend of prices can be explained under the supply and demand framework. With regard to the demand side, downward pressure on prices stemming from weak demand is markedly receding unlike in the first half of last year when Japan's economy was on the brink of falling into a deflationary spiral. On the other hand, downward pressure on prices arising from supply-side factors such as technological innovation, the streamlining of distribution channels, and deregulation is increasing. This downtrend caused by supply-side factors is not necessarily a new phenomenon. Indeed, if we look at technological innovation, it is proceeding much faster in the United States than in Japan. However, given that Japan has various industrial sectors less exposed so far to competitive pressure, we cannot disregard the possibility that the impact of technological innovation and economic globalization might become stronger. In addition, as the current recovery is still gradual with a substantial output gap lingering, we are aware that downward pressure on prices has not been entirely subsided.

As factors stemming from both the supply side and demand side affect prices in a complex manner, it is also becoming more difficult to grasp an accurate assessment of price developments. The Bank of Japan has paid special attention to whether the downward trend of prices is aggravating the economic situation through suppressing nominal income such as corporate profits and wages, thereby inducing a further decline in prices. In other words, the Bank has been watchful of the possible risk of a deflationary spiral. To make a correct judgment on this point, it is necessary to examine not only the development of price indexes, but also the underlying supply and demand balance as a whole, corporate profits and earnings, and the like.

At present, corporate profits are increasing and income conditions of households are gradually moving toward an improvement. In highly promising sectors, the declining prices of goods are helping to revitalize corporate activity. Considering these phenomena, we judge it unlikely that current weak prices will translate into a deflationary spiral.

### ***Financial Developments***

The third feature of the present recovery is the slow growth of monetary aggregates and bank lending.

In a normal recovery phase, new risk-taking activities increase against the background of positive interaction between the real and monetary side of an economy. However, this pattern does not seem to hold in the current situation because the financial system, still plagued by non-performing loans, is not sufficiently robust to propel the recovery of the real economy.

I hasten to add that I do not mean to say that any severe financial constraint is acting as a drag on real economic activity. This can be confirmed in our TANKAN survey, which shows that while the number of small and medium-sized companies that feel the lending attitude of financial institutions is 'severe' is

still more than those who think it is 'accommodative,' the figure is decreasing. As for large companies, the number of firms that feel the lending attitude is 'accommodative' has been exceeding those who think it is 'severe' since around September 1999. In light of these results and other micro-level information on corporate financing, corporate funding conditions as a whole seem to be steadily easing.

Yet, the pace of easing in this regard remains slower than warranted by the extremely low level of interest rates. Without the resolution of financial system problems, we will continue to be susceptible to adverse side-effects on economic and financial conditions, whenever a problem in financial institution management surface. We have recently witnessed the successive failure of Japanese life insurance companies and credit cooperatives, and such incidents tend to put the household and corporate sectors on the defensive.

In connection with the financial conditions just mentioned, I would like to briefly explain the recent trend of monetary aggregates in Japan. Over the past several years, the highest growth of monetary aggregates was recorded in 1998 when Japan was suffering economic deterioration and financial system instability. M2+CDs, the typical measure of monetary aggregates, was growing by roughly 5% at that time, but gradually slowed to 3-4% in 1999 and further declined to the 2% level this year.

Undeniably, this monetary development does not fit well with the normal pattern in which economic recovery leads to higher monetary growth through robust corporate activity. However, there are several reasons for the recent downtrend of the monetary aggregates.

First, although corporate cash flow remains plentiful thanks to recovering profits and restructuring effects, expenditures such as business investment are lower than this level. Second, until last year, there was a widespread tendency on the part of the corporate sector to hold precautionary liquidity on hand amid prevailing concern over financial instability. But such accumulation of liquidity on hand has peaked due to the effects of various policy measures aimed at restoring financial stability materializing, and more companies are striving to slash both external borrowings and cash on hand in order to improve balance sheet efficiency bearing in mind their market evaluation such as credit ratings. Thus, it might be possible, for the time being, that the growth rate of monetary aggregates will further dip despite improving corporate profits and abating anxiety over the financial system. This paradoxical development regarding monetary aggregates is also one of the salient features of the current recovery phase in the sense that its root cause is associated with problems in Japan's financial system.

## **2. Challenges for the Japanese Economy**

### ***Structural problems and implications of a gradual recovery***

The three characteristics of the current economic recovery I just mentioned are closely linked to long-standing structural problems in Japan's economy -- the disposal of non-performing loans created by the bursting of the bubble -- and the necessary response to economic and financial globalization and technological innovation. Thus, with those structural challenges in mind, I would like to think about the future course of Japan's economy.

Since this October, the Bank of Japan has started to release "Outlook and Risk Assessment of the Economy and Prices." This report, to be published twice a year, presents a baseline scenario of Japan's economy for the coming one to two years as envisaged by the Bank's Policy Board members, and also gives their assessment of various risk factors. In the first report published in October, the Bank judges that "Japan's economy will continue to trace a gradual recovery mainly led by private demand," but "because of various structural adjustment pressures, including balance sheet problems and continuing restructuring at firms and financial institutions, expansion of the economy is unlikely to be vigorous."

Two important messages from this are worth mentioning.

First, Japan's economy at present is in a preparatory stage for sustainable future growth. Structural adjustment has a variety of implications. On a macroeconomic level, such adjustment includes further utilization of competitive mechanisms, deregulation and the review of existing regulations, and reform of the industrial structure. As for individual corporate management, on the other hand, adjustment means shareholder-focused corporate governance, employment adjustments, and personnel relocation, all of which calls for a re-examination of the social and economic system. This process is

inevitably accompanied by pain. In addition, the persistent burden of non-performing loans on corporations and financial institutions cannot disappear overnight, and should thus be alleviated by value added generated by economic activity each year.

In a nutshell, although structural adjustment requires considerable patience, it is an inescapable challenge if we are to return to sustainable economic growth. Hence, from this viewpoint, the pace of economic recovery is likely to remain slow for the time being. Nevertheless, we must remain fully committed to resolving various structural problems and not just seek higher growth in a myopic manner.

At the same time, however, I would like to stress another essential point, which is the fact that it is difficult to strengthen resilience to adverse external shocks, given the slow pace of recovery, which will very likely remain the case for some time to come. Therefore, we must closely watch the world economy and developments in international capital markets. I will revisit this later in relation to the conduct of monetary policy.

### ***IT revolution***

I would now like to turn to the issue of how to respond to the substantial changes commonly referred to as the IT revolution in light of the implications for structural problems.

The two major problems I have described - the disposal of non-performing loans and reform of economic structure - have long been pointed out since the bursting of the bubble. With respect to the reform of economic structure, its future direction has not been clear for some time, namely it has been difficult to identify areas or leading industries which are likely to support future growth. However, it gradually became clear recently that how to respond to rapid changes in the area of telecommunication and how to utilize fruits resulting from such changes are important questions to be tackled.

Since I am not an expert on IT, I would just like to give my comments from the viewpoint of economic growth, which is obviously a concern for central bankers. There are two points.

First, considering that technological innovation has an enormous impact on the socio-economic fabric as a whole, the IT revolution currently underway might be comparable to the Industrial Revolution in Britain or the quantum leap of the US railroad industry. What is common in these two cases is the large-scale migration of labor to the leading industry exhibiting higher productivity. In Britain during the Industrial Revolution, this employment shift was mainly seen from agriculture to the textile industry. As for the dramatic growth of the railroad industry in the US, it is well known that the numbers working in the railroad and steel industries increased dramatically. Furthermore, among the 14 million increase in the work force in the non-agricultural sector over the past five years in the US, nearly a half can be attributed to an increase in service-related industries, reflecting the rapid growth of IT. Of this seven million increase, three million was seen in such areas as software design and the provision of temporary staff.

As such examples typically illustrate, structural adjustment does not stop at referring to management reform at an individual firm level, but can be regarded as a process through which production factors such as labor, capital, and land are shifted to more efficient fields.

Second, technological advancement has much broader implications than the mere expansion of high-productivity sectors and substantial increase in employment. The essence of the IT revolution is that it triggers a rise in productivity of the economy as a whole, while at the same time inducing profound changes in various entities including corporations and governments.

For example, Chairman Greenspan of the US Federal Reserve has repeatedly taken up the subject in his speeches. The IT revolution is enabling companies to grasp their production lines and consumer needs on a real-time basis. Moreover, it also makes it possible for them to slash precautionary buffers such as inventories, funds, and workers, a point Chairman Greenspan emphasizes when discussing the benefits of the IT revolution. In short, the improved efficiency of information processing has reduced uncertainties for corporate management, thereby enabling the transfer of resources to more productive uses. This, in his view, is the main benefit of enhanced productivity at the macro level created by the IT revolution.

In Japan, discussions are likely to mainly focus on the past development and performance of individual IT-related companies, although there are also various new directions being seen. For instance, some companies are introducing so-called 'supply chain management' aiming at centrally

controlling all planning, procurement, production, distribution, and sales not only for themselves but also for their clients. It will be interesting to see how this new system, just one example of recent new directions, will evolve.

This reminds me of what J. Schumpeter, a great academic economist, wrote. He saw the process of economic development as 'creative destruction.' As a driving force for economic development, he propounded a movement which he called 'new combination,' which comprises five elements: new products, new production methods, new markets, new resources, and new organizations. To borrow his terminology, the most visible changes which we are currently witnessing in Japan are in the field of 'new products,' though such signs of change are also being seen in the other four areas.

### ***Conditions for successful utilization of IT***

Next, I would like to spell out the fundamental conditions through which we can pursue structural adjustment of the whole economy, aided by technological innovation in the IT sector.

First, labor mobility needs to be enhanced. As I explained in the examples of Britain and the US, successful structural adjustment presupposes the smooth reallocation of labor to more productive areas. Recently, part-time jobs and temporary workers have increased substantially, which is assessed as improving the mobility of labor markets. However, mismatching between supply and demand in labor markets is still considerable, and, under such a situation, more efforts are required to eliminate the obstacles to labor mobility.

Second, it is necessary to rebuild the financial system and revitalize market functions. In this connection, Schumpeter put great emphasis on the role played by 'bankers' in promoting his 'new combination.' In a contemporary context, 'bankers' in a Schumpeterian sense can be interpreted as the 'financial system' as a whole which includes banks as financial intermediaries as well as financial and capital markets. To nurture new industries and businesses, a sound and robust financial system through which capital and risks are efficiently allocated is pivotal.

The desirable financial system framework varies across time and countries. It cannot be set as a fixed goal to be pursued. Nevertheless, what I would like to stress is that it is important for the financial system to foster and embed a culture that credit including deposits, loans, security investments, and derivative transactions is provided with constantly taking account of the risk-return relationship.

Third, various institutional obstacles to innovative activities should be removed along with the strenuous pursuit of deregulation. In this regard, various efforts by the private sector and government have been bearing fruit. However, there are not a few points to be examined such as whether institutional frameworks like accounting rules, taxation, and the legal system are compatible with the new era. Viewed from this perspective, many attempts at utilizing IT are conducive to creating an environment in which corporations and individuals find it easy to bear risk. At the same time, this has an important bearing on facilitating structural reform in Japan. In that sense, I think that the degree of prevalence of IT revolution in the economy can be a measure of the progress in the structural adjustment in Japan.

## **3. Role of the Bank of Japan**

### ***Conduct of Monetary Policy***

Given the above, what role should the Bank of Japan play as a central bank in promoting structural reform of Japan's economy?

We cannot expect much progress in structural reform when inflation or deflation is developing. The aim of monetary policy is to contribute to the sound development of the economy through the pursuit of price stability, which is the biggest contribution a central bank can make toward accomplishing structural adjustment. In this context, I would like to briefly discuss some challenges facing the conduct of monetary policy.

The Bank of Japan lifted the zero interest rate policy last August. This decision signifies "a small adjustment to the degree of monetary easing" in line with the improvement of the economy as I mentioned at the outset, and that the Bank has not changed its stance to support economic recovery through keeping accommodative monetary conditions.

Looking at various risks surrounding the current economy, because the pace of recovery is still gradual, we need to pay due attention to the possibility of a downswing due to adverse external shocks or the rekindling of deflationary concerns.

While the risk factors which the Bank has been paying attention to were explained in detail in the "Outlook and Risk Assessment of the Economy and Prices," let me highlight two points which I am especially focusing on at the moment.

The first is the development of the world economy in general, and the US economy in particular. While the US economy has been expanding at an above-potential rate, its real GDP growth for the third quarter of this year (+2.2%) is slower than the previous high-growth path of four to five percent. The deceleration of the US economy per se has been considered desirable for ensuring sustainable growth, as far as it is leading to a soft landing. However, at the same time, the slowdown of the US economy might have an adverse impact on Japan's economy, including indirect effects channeled through the Asian economies that are heavily dependent on exports to the US. We should remain vigilant as to whether the economic slowdown in the US will affect sustainable growth of the world economy.

The second risk to be noted is the continuous volatile movement of stock markets in and outside of Japan. If falling Japanese stock prices dampen the sentiment of the business and household sectors or undermine the risk-taking capacity of financial institutions and corporate entities, the recovery could be hampered. At present, the trend of increased corporate profits has been maintained, and there seems to be few signs of adverse effect on the real economy. Needless to say, however, we remain watchful of stock market developments and their potential ramifications.

### ***Monetary Policy and Structural Reform***

As I have discussed, the Bank of Japan, closely watching various risk factors, is determined to conduct monetary policy in an appropriate and flexible manner with the aim of supporting the nascent economic recovery and preventing the Japanese economy from falling into a deflationary spiral.

At the same time, I would like you to understand that monetary policy is no panacea, and cannot be a substitute for needed structural reform. Needless to say, over the long haul the source of economic growth should be found in the full realization of private sector vitality with the support of various innovations. In pursuing structural reform, both policy efforts and corporate endeavors to directly address structural problems are imperative.

In that sense, as I mentioned, we need to continuously re-examine our social and economic system and reduce uncertainties and anxieties surrounding various economic activities to the extent possible, thereby creating an environment in which risk-taking is facilitated.

As the central bank of our country, the Bank of Japan provides a variety of banking services, the quality of which affects the course of Japan's economy. Therefore, we are willing to contribute to the reform of financial systems by improving the functioning of financial markets and payment systems. Currently, we are striving to introduce RTGS -- real-time gross settlement -- which will start on January 4th next year. At the same time, we are also exploring the possibility of adopting electronic systems to carry out operations related to treasury funds. I hope that these assiduous efforts will bear fruit in building an efficient and stable financial system.

### ***Concluding Remarks***

In reviewing economic developments in Japan, I have presented my view of the challenges facing us and the basic stance concerning the conduct of monetary policy.

Now that we are close to the dawn of the twenty-first century, let me wind up my speech with a brief overview of the economic developments of the past century.

Over the past 100 years, annual growth has averaged 3.3% in the US and 1.9% in Britain. Both nations experienced two world wars and several smaller ones. On the economic and financial fronts, they both experienced rampant inflation and deflation, as well as severe financial disruption. And, it was some twenty years ago that the decline of their national power was debated. As for the recent five years, however, both the US and the UK have achieved average growth of 4.4% and 2.8%, respectively, both of which figures are one percentage point higher than the average growth for the

whole 20th century. This is an eloquent demonstration that even mature economies can expand vigorously if they are successful in rejuvenating the dynamism of the private sector.

In contrast, the average growth rate of Japan's economy for the past 100 years is 3.9%. The figure for the last 50 years is 5.8%, and for the last five years, 1.4%. As such, the recent prolonged low growth rate has provoked a pessimistic view with respect to the medium- to long-term growth capacity of Japan's economy. However, I think one does not need to be that pessimistic. As is evident from overseas examples, as far as an economy is an embodiment of human activities, the track of the economy will be shaped depending on how we judge the prospects for the economy and how we act on such judgement.

As I mentioned today, it is true that Japan's economy has been preoccupied in dealing with the aftermath of the bursting of the bubble in the past ten years and thus might have not adapted appropriately to changes in the environment surrounding the world economy as represented by the term 'globalization.'

Therefore, if this was the case, what is necessary is to share a recognition, among ourselves, that we cannot escape the pressure of global competition. With such a shared view, the specific content of structural adjustment which awaits to be tackled will emerge spontaneously. I strongly believe that if the private sector takes the initiative in structural adjustment with the government's support in laying the ground for such efforts, Japan's economy will regain robust growth.

I mentioned that the roles of the Bank of Japan in relation to structural reform are to make efforts to realize economic stability as well as to improve banking services of the central bank itself. I would like to conclude my speech by emphasizing that the Bank will bear these two roles in mind and continue to make the utmost efforts for the development of Japan's economy.

Thank you very much for your kind attention.