# U.S.-Japan Relations

It is a great pleasure to be here today with so many old friends in such handsome surroundings. In meetings over the past two days, this conference has covered in some depth a great many of the most critical issues facing the U.S. and the Japanese economies. It has explored the nature of our countries' mutual interests in banking, securities, and related financial markets. It has had a look at issues raised by the ways in which both our economies function in a global and regional context. And it has not lost sight of the macroeconomic and regulatory environment in which our two economies play major roles.

What I would like to do, therefore, is to stand back and examine with you some of the reasons why I believe the U.S.-Japan economic and financial nexus is so critical and why I attach so much importance to continuing the superb relationship we at the Federal Reserve Bank of New York have enjoyed over the years with our counterparts in the Bank of Japan.

I go back a long way in my interest in Japan—to my days in the Navy in 1959 when I first visited the country. I have, in fact, spent much of my professional life working in one way or another with Japanese financial institutions. In the late 1970s, I had the good fortune to serve as chairman of the University of Chicago's Center for Far Eastern Studies.

As President of the Federal Reserve Bank of New York, I again have an opportunity to contribute actively to deepening U.S.-Japan relations, this time in an official capacity. My involvement focuses on the cooperative efforts that characterize relations among central banks. While these cooperative efforts have many dimensions, they take their most tangible form in the coordinated operations undertaken in the foreign exchange markets.

Remarks by William J McDonough, President of the Federal Reserve Bank of New York, before the Japan Society, New York, New York, October 22, 1993

As you know, the Federal Reserve Bank of New York operates in the foreign exchange markets on behalf of both the Federal Reserve System and the United States Treasury Department. At the same time, we act as agents for foreign central banks in these markets. In the course of our daily work, we routinely confer with our colleagues around the world. Our ties with our counterparts in the Bank of Japan are among our closest. I certainly don't have to underscore to this group the nature or importance of the dollar/yen relationship.

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But much more than the foreign exchange markets binds the Japanese and U.S. economies together. We are all well aware of the trade linkages that have engaged our two economies for decades. Japan currently accounts for almost 18 percent of U.S. merchandise imports, while the United States accounts for about 20 percent of Japan's merchandise imports.

These market shares, however, although roughly equivalent, apply to markets of rather different size, resulting in the chronic imbalance that has characterized our two countries' bilateral trade position over the past decade. The fact is that for some time now—the past ten years to be exact—the United States has run, on average, a $45 billion annual merchandise trade deficit with Japan. Last year the deficit reached $50 billion.

Why have these imbalances been so persistent, and are they sustainable? The answers to these questions are not simple. Even very large swings in exchange rates have not qualitatively altered the problem. Such persistence suggests that fundamentally the trade imbalance is rooted in the different structures of our two economies and the different traditions of our people. In particular, I cannot help but cite the high savings rate in Japan compared with that in the United States.

While our two countries have had their share of differences over the years when it comes to trading issues, there is no denying the importance each of us attaches to access to the other's markets. Our two economies are simply too large and too important for each of us to strive for anything less than full and free access, over time, and sooner rather than later.

I would be remiss in failing to cite the considerable efforts our countries have undertaken—and continue to undertake—to seek mutually acceptable solutions to overcoming obstacles we face in achieving that goal.

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For example, the Clinton administration places a very high priority on the successful outcome of the Framework agreements announced in July by our two countries.

Under these agreements, our two countries have pledged to undertake bilateral talks on market liberalization in five principal areas over the next six to twelve months. The areas covered include: 1) increasing Japanese government purchases of foreign computers, supercomputers, satellites, medical technology, and telecommunications; 2) expanding trade in such sectors as autos and auto parts; 3) seeking reform of Japan's regulated industries, including insurance and other financial services; 4) harmonizing foreign direct investment and access to technology in both countries; and 5) implementing and monitoring existing U.S.-Japan trade agreements.

In terms of market access, the Framework agreements contain no specific numerical goals for increasing Japanese imports. Under discussion, however, are various ways for the two countries to evaluate progress in measuring market access and encouraging Japan to reduce its overall trade surplus.

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Japanese official institutions and private creditors, for example, hold roughly 25 percent of all foreign-held U.S. government debt and about 3.5 percent of total U.S. government debt. These figures, I should note, take account only of direct sales to Japan. They do not account for sales of U.S. government debt through third countries, such as might take place in London and the Euromarkets.

Both countries actively participate in each other's equity markets. Moreover, U.S. and Japanese securities firms seem to have roughly equal representation in each other's markets, although this assessment may not take full account of some of Japan's acquisitions of and minority investments in U.S. securities firms in the late 1980s. In terms of foreign direct investment, however, Japan, which had holdings of some $100 billion in the United States at the end of 1992, has invested far more in the United States than the roughly $26 billion the United States has invested in Japan.

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The dramatic increase in the presence of Japanese banks in the U.S. markets over the past decade has taken place in a broader context of an overall explosive growth of Japanese banks in the international markets. This growth has been driven by such macroeconomic considerations as Japan's expanding role as an international trading and investing country and net changes in dollar exchange rates.

At the same time, however, changes are taking place in the nature of our financial relationships. Some of these changes can be traced to the falloff in Japan's equity markets beginning in the spring of 1990 and the piercing of the Japanese real estate bubble at about the same time.

The loss of wealth stemming from these developments has obliged Japanese banks, which have held significant equity stakes in industrial companies for some time, to slow the growth of their balance sheets, in some cases rather dramatically. (Today, limitations on Japanese banks' equity investments in industrial com-

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panies are very similar to those prevailing in the United States.) The shrinkage in their balance sheets has inevitably begun to alter the dominant role these banks have played over the past decade in intermediating credit worldwide.

U.S. banks, by contrast, have begun to see their profit margins grow over the past two years as they reap the benefits of a low-interest-rate environment and measures taken to control expenses in the wake of the LDC debt crisis and the falloff in real estate values. U.S. banks today have improved their capital ratios and diversified their earnings, and are working off their problem loans. Overall, they are looking better than they have in many years.

Finally, the financial linkages between our two economies embrace our macroeconomic relationships as well. In these relationships, both our countries have much work ahead of us.

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The Japanese economy currently is in recession, largely reflecting declines in private investment and net exports, despite growth in the first quarter. With domestic demand weak, import growth has slowed, and the current account surplus has widened, inviting pressures for protection and acting as a drag on world growth.

The Japanese government's announcement on September 16 of a new expenditure package of some 6 trillion yen, coupled with the fiscal stimulus measures put in place earlier in the year and the cut in the official discount rate on September 21, can be expected to support the resumption of modest growth next year. Inflation continues to be subdued.

In the United States, I am pleased to say, we have finally begun to address our fiscal imbalance. There will, however, be a health plan for next year that will have to be financed in a credible way so as to avoid hemorrhaging on the fiscal front.

Our efforts to reduce our fiscal deficit have been aided by low inflation, the outlook for which remains reasonably good. Long-term interest rates have finally come down and are now at their lowest levels in nominal terms in roughly two decades. While growth has been more sluggish than we might have hoped for, the bene-

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fits provided by the declines in long-term interest rates have made possible record refinancings in our bond and mortgage markets, lowering costs for a wide spectrum of borrowers, including state and local governments as well as households, and leading to a recent pickup in housing.

Like a number of other industrial countries, but excluding Japan, the United States has reached the point at which the level of its public sector debt and its persistently large budget deficit are such that fiscal policy is no longer available as a tool of macroeconomic policy. If fiscal policy is unavailable to address some of the social needs that now confront so many of our economies, inflation must remain under control, largely because of its regressive tax aspects. Therefore, in the current environment, price stability is critical not only for the classic reasons but also because it takes on a social importance as well.

This brings me to my last point and that has to do with the structural problems the U.S. and the Japanese economies face. As mature industrial societies, our countries share a number of problems in common having to do with such issues as care for the elderly, health benefits for all our citizens, investment in education, and attention to the environment. The success we have in addressing these problems will affect our ability to compete and prosper in the next century. In the United States we are just beginning to deal with these issues. In Japan, there are signs of change beginning to take hold, including the possibility of more flexibility in labor practices.

As both our countries begin to improve the efficiency of our economies and the welfare of our citizens, I believe it is absolutely critical that we, as the two wealthiest economies in the world today, work together in making choices that may—more often than we might like—be politically difficult. In my view, our common goals are so obvious we simply cannot afford to allow our cooperation to lapse or to permit ourselves the luxury of tending single-mindedly to our own gardens. We each share major responsibility for the future of the global economy in which we live, and I, for one, welcome the opportunity to work together with my counterparts in the Bank of Japan and elsewhere in the government to contribute however I can to further the goals of our mutual interests and concerns.