Economic Growth and Reform:
Lessons from the United States and Japan

R. Glenn Hubbard
Chairman, U. S. Council of Economic Advisers
Airlie Center
Warrenton, Virginia
September 21, 2002

So near the anniversary of the tragic terrorist attacks on the United States, I appreciate this opportunity to address this distinguished group. I am even more gratified that Prime Minister Koizumi honored the United States on the anniversary. It is indicative of the deep mutual friendship between our nations, and of the great support Japan has shown the United States, especially during this past year.

Anniversaries are a time for acknowledgement and also for reflection. About a year ago, I came to discuss the prospects for reform and growth in Japan. The Japanese economy that had outperformed most industrialized economies over much of the past half century was experiencing its fourth recession since 1990. Japanese asset markets reflected this difficulty, with a decline in the Nikkei index of almost 30 percent since January 2001—and this was from a Nikkei already over 30 percent below its peak reached in March 2000. The United States was in the midst of a difficult period as well. The U.S. economy was struggling to recover from a recession that we now know was more severe and sustained than was expected or appreciated at that time. This recovery was set back by the attacks of September 11, which had significant economic, as well as human, consequences.

Even at that time, however, there were reasons for optimism in both countries. In Japan, plans were being made for tax reforms aimed at promoting investment, a strengthened commitment was made to address the non-performing loan (NPL) problem, and strategies were being developed to enhance competitiveness. These efforts promised to serve as a foundation for more extensive reform and policy initiatives to restore Japanese economic vitality and enhance economic growth. In the United States, meanwhile, reductions in marginal tax rates proposed by the President and legislated by Congress in May 2001 as a sound long-term tax policy demonstrated an added benefit of bolstering consumer spending and thus helping the economy to emerge from recession.

A year later, the U.S. economy's recovery is underway. Real GDP grew at an annual rate of 3.1 percent in the first half of 2002, and private sector forecasters anticipate the growth rate of GDP at just slightly below this rate in the second half of the year. The Japanese economy, too, has shown some signs of improvement. However, concerns remain. Some fear that U.S. stock market losses earlier this year and high-profile corporate scandals have caused investors to be more cautious, hurting global capital markets. Indeed, some commentators have argued that the combination of accounting scandals and equity price declines make the U.S. model of market-centered financial capitalism a less persuasive model for the rest of the world. Others have argued that government budget deterioration in the United States poses risks for the U.S. recovery and the global economy.

I do not share these views. Actions by markets, regulators, and policymakers for the United States have already improved confidence in financial markets, the recovery, and the allocation of capital. Likewise, President Bush remains committed to spending restraint. Our experience over the past year can serve as an example of how policies can improve the economy, and provide some perspective on the restructuring and reform agenda in Japan.

The United States

It is useful to begin with the broad setting for the United States economic outlook and policies. Over the long term, productivity growth is the most important determinant of growth and living standards. The structure of an economy, including the institutional and legal framework that support markets, is the key influence on productivity and thus on the sustainable rate of economic growth. Historically, the U.S. model is an undeniable success in this respect.

The deregulation of the U.S. economy beginning in the 1970s and 1980s was and is a tremendous source of economic flexibility and success in generating resources for our economy. Deregulation, along with reductions in marginal tax rates and victory in the Cold War, fueled a long boom in the United States that was interrupted only briefly during the early 1990s. In particular, the post-1995 boom in productivity growth in the United States stands out from other industrial economies. Many have attributed this productivity acceleration to the development of new technologies. While this attribution carries a grain of truth, businesses around the world can

all buy the same technology, so the roots of the U.S. advantage lie elsewhere. The U. S. model – a flexible, market system – provides rewards to entrepreneurial, private-sector investment that deploy these technologies in productive risk-taking. The preservation and support of these incentives is central to long-term productivity growth.

The recent behavior of inflation also bodes well for the long term. Inflation remains low and stable in the United States, with minimal impact on economic decisions such as the ability of businesses to plan for the future. The absence of inflation pressures also means that the Federal Reserve would have policy room in which to maneuver in the near term.

Turning to the near-term outlook: As the Administration does not prepare another official forecast until the next Budget early next year, I would like to walk through the expected mechanics of the current recovery and how recent data affect economists' forecasts of the recovery.

After three consecutive quarters of negative growth in 2001, the U.S. economy has experienced three consecutive quarters of positive GDP growth, peaking at 5.0 percent in the first quarter of 2002. While growth did slow to 1.1 percent in the second quarter, the rate is consistent with the now-familiar mechanics of the present economic recovery. The starting point for upward momentum is the legacy of aggressive monetary easing by the Federal Reserve during 2001. Over the course of that year, the Fed cut its target federal funds rate eleven times, lowering the target from 6.5 percent to 1.75 percent, with the most recent reductions occurring in December 2001. Given the well-known lags in monetary policy, these reductions will continue to provide stimulus throughout the remainder of 2002 and beyond.

Among components of final demand, solid consumption growth continues to provide the foundation of continued strength in the growth. Indeed, as is well known, the household sector has been a source of strength in final demand over the course of the recession and recovery. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress last spring provided valuable support for disposable incomes. Substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. The upshot has been solid

growth in personal consumption expenditures and residential investment that are supporting the recovery.

In addition, growth in GDP has benefited from government purchases associated with enhanced homeland security and short-run inventory dynamics; the latter are estimated to have contributed 2.6 percentage points to GDP growth during the first quarter, and 1.4 percentage points in the second quarter. These factors are likely to continue to contribute a bit in the near term, while there is little basis for expectation of dramatic aggregate demand growth stemming from the international sector.

Inventory investment contributed to the economic slowdown, but by early in 2002, the pace of inventory decline slowed, providing a significant boost to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide momentum.

However, the key to transforming recovery into robust growth is the pace of business fixed investment. Only with robust business investment will labor markets firm and the economy return to robust job creation. The recently passed "Job Creation and Worker Assistance Act of 2002" contains provisions to reduce disincentives to investment – specifically, 30 percent expensing. Businesses are permitted to deduct immediately 30 percent of the cost of new qualifying business investments undertaken in the three years starting on September 11, 2001. Moving toward faster capital-cost recovery – in the extreme, full expensing of investment outlays – represents an important step toward fundamental reform of the U.S. tax code.

In addition to being sound long-term tax policy, these provisions provide valuable support for an investment recovery. Moreover, the interest rate environment remains favorable and the corporate profitability appears to be improving. As reported in the National Income and Product Accounts, profits from domestic operations have increased 14.1 percent (not annualized) during the past three quarters. The gain in profits is partly accounted for by very modest growth of unit labor costs. Productivity grew 4.9 percent during the past four quarters (a period that includes recession and recovery) – and quite rapidly during the first quarter. The Employment

Cost Index measure of hourly compensation growth was stable at about four percent, allowing profit margins to expand. Given the stronger fundamentals, investment should recover, something that has been hinted at by recent evidence on orders for durable goods and surveys of purchasing managers' intentions.

Of course, there are risks to this outlook. For example, the decline in equity prices since the end of May – reflecting shifts in the equity risk premium and concerns over, among other things, profitability and the quality of financial data – represents a clear loss of household wealth through direct holdings and 401(k) and retirement plans. Indeed, the current business cycle is somewhat unique in this regard. During a typical cycle, household balance sheets are relatively stable, while flows of personal income suffer and subsequently recover. In contrast, during the current episode personal income – especially disposable personal income, supported by the tax cut – has held up quite well, while household balance sheets have suffered.

Weakness in household balance sheets has raised concerns over the durability of the recovery. As is well known, consumption tends to lose three to five cents for every dollar of lost wealth. In addition, investment also falls because of the higher cost of capital. Combining these effects, a *permanent* loss of, for example, 20 percent in stock-market value – together with other macroeconomic interactions in a standard model, including any offsetting action by the Federal Reserve – would reduce the level of real GDP by roughly 0.6 to 1.0 percentage point after one year. While this is a significant impact, it would not overwhelm the upward path of the recovery. Moreover, the reduction in GDP would be a transitory event, with GDP returning to its former path after three years or so.

Among the possible factors underlying the recent move in equity markets are a global rise in the equity risk premium and U.S.-specific concerns over the quality of reported corporate earnings. In this regard, the United States took quick steps to ensure that financial reporting met sufficient standards of transparency and accountability. The President outlined a ten-point plan to improve corporate responsibility and provide incentives for prompt, clear disclosure of relevant economic information. Congress recently complemented this effort with the Sarbanes-Oxley bill, which the President supported and signed into law on July 30.

It is important to recognize the link between economic diagnosis and policy response. A central lesson of the long boom in the United States has been the reliance on private markets to allocate capital. By improving the information available in capital markets, investors will be better able to pursue their desired combinations of risk and return, and equity market valuations will reflect investment opportunities better.

The quick and decisive action to improve market functioning stands in contrast to the experience during the savings and loan (S&L) and banking crisis in the late 1980s. The early handling of this crisis by regulators was a costly mistake. Regulatory forbearance and the lack of prompt corrective action made a large problem much worse, even in the absence of legal and regulatory impediments to restructuring.

Another potential risk is increases in crude oil prices. Oil prices have risen roughly $10 per barrel recently. The spot price of low-sulfur West Texas Intermediate crude has risen above $30 per barrel for the first time since February 2001, while the OPEC basket price index (which includes both high- and low-sulfur crude oils) has remained within OPEC's target band of $22-$28. A sustained increase in oil prices of $10 per barrel would be expected to lower GDP by about 0.25 to 0.50 percent after six months to one year. Larger increases pose a more substantial risk.

Some commentators focus on the return of U.S. federal budget deficits as a risk to economic recovery; indeed, in the minds of some, proposals to *raise* taxes become necessary. Despite essentially no empirical evidence that moderate changes in budget surpluses are related to long-term interest rates, proponents of this view argue that increasing the budget surplus is the key to faster growth. In reality, these concepts are linked. However, the causal links are reversed – a stronger economy produces higher revenue and larger surpluses.

At present, the budget is on track to return to unified surplus in the middle of the decade, with the near-term shortfalls reflecting primarily the combined influences of recession, the need to prosecute the war on terrorism, and the demands of homeland security. In this setting, the greatest economic risk associated with the budget is failing to prioritize national needs and control the growth of spending. Spending discipline limits the need for growth-reducing taxes in

the present and future. Pro-growth tax policies that lower marginal tax rates and reduce the tax on productive risk-taking are good long-run policies to build budgetary resources over the long-term. Economic growth is a direct consequence of millions of individual decisions to produce, save, and invest. Any added tax burden today would be a step in the wrong direction.

Of course, there are upside wild cards as well. An important recent development for the long-run growth outlook was the passage of Trade Promotional Authority (TPA) legislation. Having signed TPA into law, the President has the authority to pursue an ambitious agenda of agreements to enhance global free trade, with benefits in the United States and the world economy.

To summarize, the U.S. economy has faced serious challenges during the past year. The policy response has been an aggressive monetary easing paired with advances in fiscal policy and structural reform. In the former, U. S. tax policy has focused on long-run fundamentals – lower marginal tax rates, faster capital cost recovery as incentives for investment, and recognition of the need for spending restraint. Structural reforms have focused on the role of increased transparency and accountability in financial reporting in providing improved performance of capital markets.

Japan

The postwar revitalization of the Japanese economy is one of the outstanding episodes in modern economic growth. Unfortunately, over the past decade, Japan’s economic performance has been disappointing and represents lost opportunities to improve living standards. Better economic performance would also enhance Japan’s important role in the world and provide an additional strong engine of growth for the global economy.

While Japan’s difficulties are not the mirror image of those in the United States, it is interesting to note that the same mix of policy responses might support recovery in Japan: aggressive monetary action to address deflationary pressures, fiscal policy oriented around controlling spending and long-run tax forms that also provide near-term stimulus, and structural reforms to improve capital market functioning. This policy mix to help revive the Japanese economy will involve politically difficult decisions. In this context, the role of the United States

should be to acknowledge the steps that have already been taken in Japan and call attention to those steps that remain to be carried out.

I believe that recent U.S. experience is relevant to these economic policy challenges in Japan. Consider the parallels to the U.S. corporate accounting challenge. First, Japan is also addressing the importance of improved corporate governance and more transparent accounting. On the heels of revisions to the Commercial Code in May, the Japan Business Federation has announced its intention for the first review of its corporate governance guidelines since 1996. This coincides with the nationwide effort to raise accounting standards and the recent announcement that some firms plan to provide voluntarily CEO certification of financial statements as a means to raise investor confidence. In short, both the public sector and private sector are undertaking efforts to provide greater transparency and accountability in the corporate sector.

The second parallel – if not direct comparison – is Japan's non-performing asset problem. While the U.S. focus is on the quality of financial information regarding real performance, and Japanese concerns center on both financial information and returns to real assets, they share the common feature of highlighting the importance of using markets to allocate (and reallocate) capital efficiently. Learning from the challenges to restructuring is something best done in a dialogue between friends rather than in isolation. That is one reason I am particularly interested in the prospects for the Asian Pacific Economic Cooperation (APEC) conference on "corporate restructuring" this summer.

The dedication to economic fundamentals in Prime Minister Koizumi's vision has great potential for reward. If the necessary reforms are implemented in Japan, productivity growth will increase, and will be reflected in asset markets as well. Likewise, as we also know from the experience of the United States and other economies, without reform, market-driven benefits to the Japanese economy will not materialize.

The crux of the problem facing the Japanese economy and its corporate sector may be summarized by examining a few pieces of data. The simplest starting point is to examine Japan's productivity, which, after averaging 2.9 percent in the 1980s, fell to 0.7 percent for the

1990-95 period, and has been averaging 1.3 percent since. Obviously, the impact of this decline is felt in the corporate sector. The nonfinancial corporate sector's return on assets, calculated using the latest Financial Statements Statistics of Corporations from the Ministry of Finance, stood at 2.5 percent in the second quarter. This is above the recent trough of 1.8 percent in 1998, but well below the historical Japanese average of 4 percent.

These same data reveal that there is a clear difference between large manufacturers and the remainder of manufacturing and non-manufacturing firms. The large manufacturing firms in Japan are world-class competitors who have, and are continuing to, transform themselves in seeking to hold their competitive positions. Not surprisingly, these large manufacturers can and have moved away from bank financing to direct financing. For these firms, the share of bank debt in total liabilities has fallen from 37.4 percent in the fourth quarter of 1986 to current levels of 26.5 percent. Instead, the NPLs are concentrated in those firms that are not, and without restructuring cannot, go directly to capital markets. In particular, domestically oriented firms in construction, real estate, and wholesale and retail trade are increasingly accounting for a greater share of NPLs, which had already accounted for 57 percent of the NPLs by September 2001.

In contrast to the pressure to restructure from international competition, the undercapitalized banks that have made these loans have a weaker incentive to participate in the restructuring of a borrower, preferring to defer realization of losses by continuing to roll over loans to borrowers. A poorly capitalized bank has only a weak interest in resolving its problem loans, because full information about the extent of the trouble could result in the realization of insolvency and loss of bank equity. To avoid regulatory scrutiny, poorly capitalized banks can struggle to keep loans current, papering over the problem in the misplaced hope for a reversal of fortune. In short, banks can often face the wrong incentives for handling the problem.

For this reason, there is a role for policy to improve the working of capital markets in this setting. The Financial Services Agency (FSA) has targeted the NPLs of the major banks in its reform proposals, a helpful first step. In addition, the Japanese Bankers Association and the Keidanren have proposed a new framework for out-of-court workouts, based on the principles of the International Federation of Insolvency Professionals (INSOL). However, it is important that banks use the new legal and regulatory framework to confront problem loans.

The special inspections conducted by the FSA from October to March were an initial step in using a regulatory lever to force action. Most important, the inspections were market-based, and forward looking involving 149 large corporate bank loan customers who had experienced significant changes in stock prices and/or external credit ratings. Most of these borrowers came from the weak construction, real estate, and wholesale and retail trade sectors. Of the loans examined, almost 60 percent were downgraded, with roughly 30 percent newly classified as "in danger of bankruptcy or below." The FSA has called for banks to dispose of newly emerging NPLs over a three-year time period, and now has called on banks to dispose of one-half of these loans in the first year and 80 percent after two years. The FSA is also calling for permanent, on-site inspectors at the major banks. I hope that these inspections and permanent inspectors signal the end of regulatory forbearance and the beginning of a hard-nosed, realistic evaluation of bank assets.

Problem loans are best identified on the basis of future cash flows and realistic assessments of the value of collateral and guarantees. The resolution of problem loans will lead to better economic performance if not limited to debt forgiveness, but rather focused on restructuring the operations of firms. Naturally, such an exercise involves recognizing losses by both the banks and the companies, but this is key to moving capital to its most efficient uses. Alternatively, some have argued that bank mergers might serve as a mechanism for triggering a restructuring of NPLs. Unfortunately, based on U.S. experience, bank mergers alone are unlikely to bring about the necessary downsizing of balance sheets. Closing insolvent institutions should remain a viable option.

Deposit insurance reform with limits on coverage is an important factor in assuring market discipline on banks. Recent discussions on postponing or modifying the scheduled Japanese deposit insurance reform demonstrate that there is still much concern about the readiness of the Japanese banking system to take this step. But I encourage you to take the steps that would reform and strengthen the banking sector so that limited despositor guarantees can be introduced without disruption.

By contrast, continuation of the full guarantee will not give banks the correct incentives when making loan decisions. If a bank is nearing insolvency, it has the incentive to play a dangerous game when deciding to offer a risky loan—heads, the bank wins and tails, the tax-payer loses, as the government is ultimately responsible for the bad loan. Delaying the elimination of the cap on deposit insurance simply allows more time for insolvent institutions to take risks and experience losses, thereby ultimately increasing the costs of resolving the problems in the financial system.

These policies focus on the role of banks in providing incentives to improve the allocation of capital in the economy. However, other steps can complement this effort. Planned legislation for a further revision of the Commercial Code would modernize corporate governance. Access to stock swaps by foreign firms would facilitate restructuring by making it unnecessary to set up domestic subsidiaries to participate in mergers and acquisitions. The fiduciary responsibility of money managers toward shareholders could be further clarified. The U.S. experience suggests that a statute like that contained in the Employee Retirement Income Security Act (ERISA) and the associated "Avon Letter" from the Department of Labor can help clarify what is expected of pension fund money managers. Procedures for foreclosing on collateral should be simplified. Finally, portable pensions will help boost labor market flexibility. These additional measures will certainly enhance the restructuring environment.

Halting deflation is another important element in reviving growth in the Japanese economy. While each of us as an individual may benefit from falling goods prices as long as our income does not change, deflation wreaks havoc with business balance sheets, reducing production, incomes, and employment. In Japan, deflationary pressures exacerbate structural difficulties in reallocating capital, aggravating the non-performing loan problem by increasing the ranks of non-performing assets warehoused in the banking system. Japan has experienced deflation for three consecutive years and deflation now appears to be entrenched in expectations.

During the past year, the Bank of Japan had undertaken steps to increase current account balances ("reserves"), but expansionary policy appears to be losing its momentum. The signs of this easing of monetary policy had been apparent, with the monetary base up 36.3 percent year-over-year. Yet, after peaking in April, monetary base growth has decelerated to 26.1 percent.

Moreover, growth in M2 plus CDs have also been disappointing --- up only 3.5 percent year-over-year in August. Experience in other countries suggests that large and sustained increases in the money supply are necessary to overcome deflation. The Bank of Japan can and should pursue bolder monetary easing to end deflation. This would be consistent with the Bank's own framework, announced in March 2001, to target the quantity of money and achieve price stability. But we should also recognize that monetary policy cannot solve all of Japan's problems alone. It will work best as a part of a comprehensive program aimed at revitalizing the Japanese economy.

Japan also faces the critical medium-term challenge of consolidating its fiscal balances. Within the context of a credible and transparent medium-term consolidation plan, tax reforms in Japan-coupled, for example, with a spending constraint—can help increase the incentives for growth. As discussed earlier, the pro-growth tax policy of 2001 both helped to speed the U.S. economic recovery and will improve incentives for productive risk-taking, saving, investment, and long-run growth. Reports that Japanese tax reform plans focus on the need to address distortions in the tax system, broaden tax bases, and lower marginal tax rates are a promising development for Japan and the global economy.

It is essential that Japan's economy return to healthy rates of growth in order to meet the needs of an aging population. In this sense it is important to think of tax reform as a sensible "long-run" policy. Tax policy can, though, also support the necessary quick action on banking and corporate restructuring that is needed to restart growth. Prudent tax changes can lead to better functioning capital markets and make important contributions to the process of structural adjustment. (Such contributions exceed those of spending changes: Kenneth Kuttner and Adam Posen estimate that, for Japan, the economic multiplier on tax changes is significantly larger than the economic multiplier on expenditure changes.) Transactions taxes and taxes on dividends and capital gains are capitalized in asset values. A move to a broader tax base with lower rates on capital income and transactions would raise asset prices and thereby facilitate structural adjustment.

Income taxes present significant opportunities to reduce tax rates and broaden the tax base. The Japanese tax code identifies ten different types of income, for example, each taxed at a

different rate. In particular, interest income, capital gains, and dividends are all taxed at separate rates. The net effect of this disparity gives debt financing an advantage. In addition, longer-term capital gains on property are taxed at one-half the rate of short-term capital gains, providing an incentive to delay transactions. This asymmetry hinders the promotion of deep and well-functioning asset markets, markets that will be key in Japan's restructuring process. Equalizing the effective tax rate on all returns to equity is good tax policy. Lowering the effective rate will aid asset market performance.

Tax reform discussions have also touched on the inheritance and gift tax as well as the land registration tax. An important element for Japan's revitalization is that the real estate market – a particularly important asset market – operate with as few distortions as possible. That is, the transfer of the collateral behind problem loans must be as quick, transparent, and seamless as possible. In this environment, a registration tax as high as five percent on real estate transactions reduces real estate values and inhibits restructuring.

Looking over a long horizon, broadening the income tax base and lowering income tax rates will help to stabilize tax revenues as the needs of an aging population begin to mount. Although statutory marginal income tax rates are close to those in the United States, the many allowances have made for a relatively narrow base -- 15 to 20 percent of all employment income tax earners pay no tax. A calculation by the OECD indicates that the combined exemptions and allowances at the local and national level have reduced income tax collections by ten percent of GDP (without taking into account behavioral effects of tax policy).

Strengthening the tax system is good economic policy, especially for Japan in the current environment. A more unified treatment of income, both for households and businesses, and treating land like any other asset to reduce the tax drag on asset values and transactions will help to solidify and advance the other planks of the Prime Minister's reform and recovery agenda.

With all of these planks in place, the outlook for Japan will improve. The lessons are clear, both from a historical perspective and from current events: Markets have and will continue to reward forward progress – action – on the Japanese reform agenda.

Lessons

In previous visits to Tokyo over the past year, I have been optimistic about Japan's ability to cure the woes of recession, deflation, and nonperforming loans through a strong reform agenda. I remain optimistic that the Koizumi administration can meet its pledge to move forward with policy reform. And I believe the role that U.S. corporate reform and pro-growth tax policy has played in aiding our financial markets and recovery can provide useful input to the policy debate in Japan.