Impediments to Growth in Japan

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Having given numerous presentations over the past year on the Japanese economy, I hope I am not at risk of wearing out my welcome in audiences like this one. This is especially true because the problems that face Japan have been well diagnosed for many years. However, I continue to believe that thoughts from friends can be useful to Japan, especially those that help to bolster the important reform efforts of Prime Minister Koizumi.

The revitalization of Japan in the post-war period is one of the world's true growth miracles, with real GDP increasing at an annual rate of 9.6 percent from 1955-1970. Japan also outperformed the industrial economies over the more recent past, growing at an annual rate of 4.3 percent from 1970 through 1990. In contrast, OECD growth (excluding Japan) averaged only 3.3 percent. It is in no small part this great potential that renders Japan's economic performance over the past decade extremely disappointing. Output growth for the decade ending in the fourth quarter of 2001 averaged an annual rate of 0.8 percent (far below potential), creating a huge output gap that translates into a lost opportunity for improving living standards in Japan. Poor economic performance also limits Japan's important role on the global stage and poses a drag on the global economy.

Reviving 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 been taken in Japan and call attention to those steps that remain to be carried out. Three actions remain the key

to reform and revitalization: (1) stopping deflation, (2) reviving the financial system and putting the collateral behind the non-performing loans in the hands of private market participants, and (3) structural reform. I will leave the third issue to other colleagues in the administration, and spend the remainder of my remarks on the first two issues. By way of a preview, some preliminary congratulations may well be in order in the efforts to counter deflation. With regard to the reallocation of resources involved in the resolution of the non-performing loans, additional necessary steps remain to be taken.

Stopping Deflation

Deflation is an economic cancer that eats away at the productive and entrepreneurial sectors of an economy. While each of us as an individual benefits 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.

With this diagnosis in mind, many commentators have envisioned a sort of "grand bargain" to revive the Japanese economy. Such a bargain would be between the Bank of Japan and the government, whereby the Bank of Japan would provide an accommodative monetary policy in exchange for implementation of a tough-minded reform agenda on the part of the administration. Are we in fact seeing the first steps of such a "grand bargain" on the part of the Bank of Japan? Since moving to a quantitative easing policy in March of last year, the Bank of Japan has eased policy four times, upping the target for reserves on deposit at the Bank of Japan (current account balances at the Bank of Japan) in August, September and again in December. Most recently, the Bank of Japan announced late in February that it would increase its purchase

of long-term Japanese government bonds (JGBs) to ¥1 trillion per month and vowed to provide sufficient liquidity to the financial system as the end of the fiscal year approaches.

Over the past year, current account balances held at the Bank of Japan have quadrupled from an average of ¥5 trillion to the current level of ¥20 trillion. The results of this easing of monetary policy have been apparent, with the monetary base up 32.6 percent year-over-year in March. However, growth in M2 plus CDs is disappointing – up only 3.7 percent year-over-year in February (data for March will be released on April 10).

Some commentators have portrayed the latest policy changes as ineffective, until recently arguing that the consumer price index data show that Japan is still "mired in deflation." Some caution is in order given the famous long and variable lags implicit in monetary policy, especially with the bulk of the easing coming in only the past three months. Nonetheless, the increase in Tokyo consumer prices in March, the first increase in seven months, is a positive development.

Because asset prices are forward-looking, they are an avenue to achieve a more immediate read-out of the ultimate impact of monetary policy. A standard analysis, for example, would be that in the face of a significant monetary easing, one might expect an increase in long-term bond yields due to an increase in expected changes in the price level. And there is some indication that price expectations, as reflected in JGB yields, have responded to BoJ easing measures, although there may be other reasons for the rise in JGB yields since early November. Still, the evidence is consistent with a current and expected easing of monetary policy, the Bank of Japan has taken a first step and should be encouraged to continue its current policy, and do more if necessary, until consumer prices do respond. The Bank of Japan has begun to deliver on its side of any possible "bargain."

Non-Performing Loans and Corporate Restructuring

The key to understanding the issue of financial and corporate revival is to understand that the non-performing loans (NPLs) in bank portfolios are only a symptom of the underlying problem. The real problem is that capital is not being allocated to its most productive uses. If banks continue to roll over loans to firms that have no hope of turning a profit, fewer scarce financial resources are available to those firms that can turn a profit. Understanding and solving the non-performing *loan* problem requires understanding and solving the non-performing *asset* problem. Indeed the two are mirror images.

A few numbers illustrate the crux of the problem facing the Japanese economy and corporate sector. The simplest starting point is to look at productivity. After averaging 2.0 percent in the 1980s, multi-factor productivity growth in Japan fell to 1.3 percent for the 1990-95 period and tumbled to 0.5 percent for the three years ending in 1998. Obviously, the impact of this decline is felt in the corporate sector. The non-financial corporate sector's return on assets, using the latest Financial Statements Statistics of Corporations from the Ministry of Finance, stood at 2.7 percent in the fourth quarter. This is above the recent trough of 2.0 percent, but well below the historical Japanese average of 4.0 percent.

In some respects, the situation in Japan is similar to what was faced in the United States and the United Kingdom, in the 1980s. Policies put in place by strong leaders such as U.S. President Reagan and U.K. Prime Minister Thatcher helped encourage the necessary restructuring, laying the groundwork for rapid growth in both economies over the past decade. In the non-financial corporate sector, by the mid-1980s the return on assets for large firms in the United States fell as low as 0.9 percent (after-tax). However, spurred by deregulation and reform, the corporate sector was transformed and returns on assets surged, as employment fell

and balance sheets improved from a deleveraging. Gains in manufacturing have been truly impressive. Returns on assets for these firms stood at 5.9 percent in 2000. Capital that was inefficiently devoted to this sector was allocated elsewhere. The job losses in manufacturing were more than made up by job gains in other sectors, with the U.S. economy enjoying the longest economic expansion in its history.

If the problem is as straightforward as I describe, why has more progress not been made in Japan toward resolving the problem? The answer, as I emphasized in Japan this past December, is incentives on the part of bank management, bank regulators, and the political process. Bank managers are loath to force a loan customer into restructuring as it reflects poorly on past management decisions. Bank regulators are often unwilling to force banks into action, since such a move would call into question past regulatory practice. Finally, the political process may find it difficult to take tough actions that disadvantage key constituencies.

Of course, there are always reasons to be offered other reasons for delay and forbearance, most prominently the argument that foreclosure and restructuring must wait for a more supportive macroeconomic environment. Waiting for such a fortunate circumstance is a mirage: The macroeconomy will not meaningfully recover until capital is allocated to its most efficient uses. This has been Japan's experience for the past decade. Proponents of the "wait for recovery" view also claim that moving capital from struggling firms to more productive firms will depress asset prices, adding insult to injury and further depressing economic activity.

In this regard, I have a surprising story: The opposite is true. Rapid restructuring likely will lift asset prices, which will buoy economic activity. Rational market participants are fully aware of the assets that need to be reallocated – for example the real estate held as collateral that must be sold when firms are restructured. Prior to actions toward restructuring, asset prices are

low because forward-looking markets take into account the large supply of distressed assets that will be made available once restructuring begins. Asset prices do not rise until the sales actually begin, when market participants can be sure that the supply is starting to be worked off. Empirically, this can be seen at both the firm level and in the aggregate data, in Japan, the United States, and other countries as well.

To begin, let me examine both the U.S. experience and the Nordic banking crises for evidence that restructuring bolsters prices and economic activity. At the firm level, the United States has witnessed many successful corporate restructurings, where firm values rose as soon as markets believed restructuring would take place. For example, this is precisely what happened when Mellon Bank restructured by spinning off its problem assets into Grant Street Bank – in three months, Mellon's share price was up 10.5 percent as compared to a 2.5 percent increase in the S&P 500 index. In the three months after Humana announced the separation of its hospital and health plan operations, its share price rose 32 percent compared to a three percent increase in the S&P 500. Finally, in the three months following Scott Paper's decision to undertake a serious restructuring by bringing in its first outside chief executive in 115 years, its share price rose 41 percent compared to a less than three percent increase in the S&P 500. In each case, markets did not reward the restructuring until the restructuring took place. It would have been pointless to wait until prices rose before beginning the restructuring, as it was the delay in restructuring that kept prices depressed.

The same can be seen in more aggregate data. Let me start with Texas in the late 1980s and early 1990s. Some will argue that the Texas experience – while an easy example - is not relevant for Japan. Now, the problems in Texas certainly never threatened the payments system in the way that the banking problems in Japan have. However, in another sense, the problems in

Texas, when Texas is treated as its own economy, were in fact at least as large as those faced by Japan. In Texas, 844 banks and savings and loans failed, the resolution of these institutions cost $80 billion, or 21 percent of annual Texas gross state product. In Japan, public funds allocated to financial crisis resolution are estimated to amount to 12 percent of GDP, with only a fraction of these funds actually spent. Japan has some way to go before its resolution costs compare to those in Texas.

The prices of the assets of the failed banks and thrifts in Texas remained depressed for years, as markets were well aware of the large overhang of distressed assets that needed to be liquidated or resolved. Prices did not rise until the first sales took place. For example, loans at the first auction in Dallas sold for 21 percent of book value. At the next auction, loans sold for 62 percent of book value. The same story was seen in San Antonio, where at an initial auction loans sold for 18 percent of book value while at the second auction loans fetched 36 percent of book value. The lesson is clear: Holding assets off the market in the hopes of a price rise is self-defeating.

This relationship between asset sales and economic recovery can also be seen in the experience of other economies as well. The Nordic banking crises of the early 1990s are arguably the most applicable for Japan. In all of these cases, the crisis was so widespread that the payments system was at risk, and the size of the crises relative to GDP rivals estimates of the current problem in Japan. In Finland, recapitalization costs of the government are estimated to have amounted to 11 percent of GDP. Costs in Norway and Sweden were smaller, at eight and four percent of GDP, respectively. One reason for the disparity in costs is the difference in speed with which the problems were resolved. Sweden is held up as a model of rapid resolution, but in all three economies, economic activity was quickly revived. Two years after the establishment

of Securum, Sweden's main asset management company, real GDP growth had rebounded from an annual rate of –1.4 percent to an annual rate of 3.3 percent. Within five years, Securum had disposed of 98 percent of its assets. Activity also rebounded in Finland, where government recapitalization costs were higher. In the year after the Arsenal asset management company was founded, real GDP growth rebounded from an annual rate of –1.2 percent to an annual rate of 4.6 percent. In contrast, Norway did not use the asset management company approach to dealing with the problems in its financial system, rather the Government Bank Insurance Fund recapitalized financial institutions but insisted on capital write-downs, the replacement of management, and cost cutting. This decisive action mostly took place in 1991 and paid large dividends—real GDP grew at 3.3 percent in 1992, well above the 2.1 percent growth rate recorded in 1990. It is worth noting that in all three of these Nordic economies, monetary policy was accommodative while the restructuring was underway.

Recent events in Japan also confirm the lesson that prices will not recover until true restructuring begins. The stock market has clearly rewarded announcements of restructuring. Let me list a few concrete examples. The bankruptcy of Mycal pushed the Nikkei up 4.1 percent in September of last year, and most recently the Nikkei surged 5.9 percent on March 4 with the news of the Sato Kogyo bankruptcy. Markets will reward the news that banks are really addressing their problems. By the same token, markets will punish continuation of the flawed strategy of propping up failing firms.

With this clear lesson and especially clear examples in mind, what should one make of recent governmental efforts in Japan? The RCC should not be a vehicle for recapitalizing the banks through inflated purchase prices that reward bad decisions and weak provisioning. Rather, the RCC should be willing to take some risks on individual loan purchases. What is key is that

purchases are made and that the assets are put in the hands of private market participants. The RCC must not become a warehouse of bad loans, it must act as a nimble middleman that quickly moves troubled assets from bank balance sheets into the hands of those who can undertake the necessary restructuring. In this regard, I look forward to the promised public disclosure of the Financial Services Agency's round of special inspections. I hope that these inspections signal the end of regulatory forbearance and the beginning of a hard-nosed, realistic evaluation of bank assets.

In a similar vein, I do not understand the need for new restrictions and tighter supervision of short selling of equities, particularly when they are introduced before market participants and the exchanges have their systems in place to ensure compliance. This can only distort the valuable signals sent by the equity market, reducing liquidity and dulling the positive reception that true reform measures would receive. Some have compared the equity markets to gambling casinos. In fact, market participants risk their wealth on identifying both the productive and unproductive firms. This informed identification based on millions of informed opinions is extremely valuable and should not be diluted with misguided regulations that seek short-term results.

Tax Policy and the Reform Process

A review of impediments to growth in Japan gives me the opportunity to turn from thoughts on the need to avoid regulatory forbearance and promote quick disposal of troubled assets to an analysis of a topic that I have studied over much of my professional career. Prime Minister Koizumi has called for a major tax reform agenda to be prepared by the end of June, and I have spent time with those involved in preparing various tax reform proposals. Reports

that the tax reform plans focus on the need to lower tax rates and broaden tax bases are a promising development.

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 easy to think of tax reform as a sensible "long-run" policy. But tax policy can 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 significantly exceed those of spending changes – Kenneth Kuttner and Adam Posen estimate that, for Japan, the economic multiplier on tax changes is almost three times as large as 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, other things equal, raise asset prices and thereby facilitate structural adjustment.

Income taxes present significant opportunities for lower rates and broader bases. The Japanese tax code identifies ten different types of income, 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 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.

The 1998 reduction in corporate tax rates – which moved Japan to parity with most other industrialized nations – is a good step in this regard. The planned introduction of consolidated taxation in the 2002 fiscal year is also quite welcome. To facilitate corporate restructuring, firms must be able to offset losses in one subsidiary against profits in others. Viewed from this perspective, the proposed two percent surcharge for those firms using consolidated accounting discourages restructuring.

Tax reform efforts also appear to be focusing on the inheritance and gift tax as well as the land registration tax. A significant 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 is particularly unhelpful.

Looking over a long horizon, there is little doubt that 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.

Thank you, and I look forward to your questions.