

Economic Policies for the United States and Emerging Markets
Remarks
of
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Assessing the Economic Outlook in the United States

It is useful to begin with the broad setting for the U.S. 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. As such, it suggests a number of implications for emerging market countries, a point I will turn to after first discussing the outlook in the United States.

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 must lie elsewhere—instead, in our flexible, market-based system that provides rewards to entrepreneurs and to productive risk-taking. The preservation and support of returns to private sector investment 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.

Regarding the near-term outlook, as the Administration does not prepare another official forecast until the next Budget, 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 contraction in 2001, the U.S. economy has experienced three consecutive quarters of positive GDP growth, including a peak so far of 5.0 percent growth in the first quarter of 2002. While growth slowed to 1.3 percent in the second quarter, this 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 of GDP. 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 enacted last spring provided valuable support for disposable incomes. Monetary easing translated into lower interest rates, supporting purchases of consumer durables as well as housing starts and mortgage refinancing. The upshot has been that growth in personal consumption expenditures and residential investment cushioned the recession and is now supporting the recovery.

GDP growth has also benefited from government purchases associated with enhanced homeland security and from inventory dynamics; the latter are estimated to have contributed 2.6 percentage points to GDP growth during the first quarter, and 1.3 percentage points in the second quarter. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide some further momentum. In contrast, there is little basis for expectation of dramatic aggregate demand growth stemming from the international sector.

However, the key to transforming recovery into robust growth is a revival in 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 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 have rebounded from recessionary lows. As reported in the National Income and Product Accounts, corporate profits have increased 14.2 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). 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.

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.

Another potential risk is increases in crude oil prices. Oil prices have risen roughly \$10 per barrel since the beginning of this year. 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 risen above 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. It is true that growth and the fiscal position are tightly linked. However, the causal direction is the reverse: 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 cost of 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 possibilities as well. An important recent development for the long-run growth outlook was the passage of Trade Promotion 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, 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. And all of this is built on a solid foundation of our institutions, notably free and flexible markets, and respect for the sanctity of contracts and the rule of law. Together, this constitutes a “pro-growth agenda” for the United States.

Extending Pro-Growth Policies to Emerging Market Economies

The pro-growth policy agenda being advanced in the United States is also relevant for emerging market countries. Discussion often centers on actions that the global community, working through the international financial institutions, might take to improve financial market conditions in emerging market economies.

This puts the cart before the horse. To see why, it is useful to begin with the central observation that economic growth is the key to creating jobs, improving living standards, and lifting people out of poverty. But economic growth does not appear like manna from heaven. Instead, good policies are needed to get growth—indeed, proper policy choices are essential for support from international financial institutions to be useful in the first place. The central economic policy issue for emerging market countries is not how to use international financial institutions to provide economic assistance. Instead, the central issue is to ensure that policies promote higher sustainable economic growth.

A clear lesson of research on the determinants of growth is that of humility. We are far from knowing how to solve the problem of development. One reason is that the problem is at least somewhat different for every country. The research literature—and our experience—shows that the circumstances of each country matter greatly. Even so, four general policy prescriptions can be seen as overwhelmingly important for fostering economic growth and improving living standards. These should be essential components of a pro-growth policy.

First, is that the rule of law is an essential underpinning of growth. By this, I mean not just law and order—though this is important—but also the sanctity of property rights, and the ability to make and enforce contracts. Individuals must have confidence that the government will

not intervene in legitimate private transactions, by expropriating property, favoring debtors over creditors, or advantaging one sector of the economy over another in legal proceedings..

The financial sector provides an important example. Efficient financial intermediation is vital for economic growth, but the banking sector cannot function without the rule of law. Research has found that reforms that strengthen credit rights, contract enforcement, and accounting practices boost financial development and thereby economic growth. A breakdown of the rule of law impedes even the normal mechanisms for recovery from a crisis; for example, exporters cannot take benefit from a depreciated exchange rate if they cannot get trade finance. Good governance is also necessary for encouraging and safeguarding the private capital flows that help to promote growth and prosperity in emerging market economies.

A pro-growth fiscal policy is centered on discipline in the size of the government. Extensive research has documented the poisonous effects on growth of large and growing state control of the economy. While the state should provide essential public services and ensure a social safety net, it should not enter into areas more efficiently handled by the private sector. Too often, excessive state control limits the ability of the private sector to develop the financial capacity for growth, leading to larger-than-necessary public sector spending and thus the need to raise corresponding revenues.

The problem is that most taxes distort economic activity and thus impinge on growth. The key is to finance government in the most efficient way. But efficiency can run into the problem of practicality. Faced with widespread tax evasion, governments might be tempted to turn to inefficient tax schemes that impose broad costs on the economy, such as the “financial transactions tax,” in which a tax is levied on withdrawals and/or deposits from bank accounts, including clearance of checks and payments of loans. The adverse incentives of this tax are obvious, in that it drives activity off the books. By reducing financial intermediation, the tax first destroys the base of transactions from which it was designed to pull revenue, and then, since intermediation is crucial for growth, the tax lowers growth and thus the overall tax base with it. Empirical research suggests that deadweight losses of these taxes in some emerging market countries are 20 percent of the revenue collected to as much as 40 percent.

Trade taxes can be similarly attractive to a government, because the activity to be taxed is localized at a relatively small number of ports and freight yards. But import tariffs shield domestic industries from competition and thus lower efficiency, while raising costs for domestic firms that rely on imported components.

In addition to paying heed to efficiency, fiscal policy must be sufficiently flexible that a surplus can be run in good times and a deficit in bad times. But a particular value for the primary surplus is not an end in itself—economic growth is the end. To this end, it is vital that the measures involved are as sustainable as the need—revenues based on one-off asset sales cannot be the basis for macroeconomic stability. Similarly, decisions made at different levels of government must not work at cross-purposes.

Effective monetary control is vital for economic growth. Individuals cannot form expectations for inflation without effective monetary policy—the resulting uncertainty depresses

investment and growth. For monetary policy to be effective, it must be centralized—provincial quasi-monies such as we have seen in Argentina are simply an alternate route to inflationary financing of a profligate government sector. Moreover, it is difficult to have effective monetary control without a functioning banking sector—quantitative credit limits as opposed to market-based price signals from interest rates lead distortions in investment decisions that hinder growth.

Central bank independence is a useful feature, particularly if this institutional separation helps the central bank to be seen as credible and free of political interference—indeed, there is a good deal of research associating this with preferred outcomes for inflation and thus growth. But in the end, policy implementation is what matters—policymakers must make good decisions for both monetary and fiscal policy.

Policies that foster openness and competition enhance growth. Such policies raise productivity growth, which allows for increased wages and thus incomes, as well as higher profits to fuel investment and job creation. Policies that raise productivity growth, including policies that spur competition, are those that directly increase a nation's standard of living.

A body of economic research indicates that the privatization of state-owned enterprises can raise productivity growth. Many emerging-market economies have made a good deal of progress in this regard. An important caveat, however, is that it is not enough simply to privatize. It is just as essential to ensure domestic competition in the industries with privatized firms, since otherwise this could simply replace a public monopoly with a private one.

Similarly, flexible labor markets are important for growth. For example, provisions that hinder firms from adjusting their labor force have been found to reduce employment—the opposite of the intended effect of policies meant to make it more difficult for firms to lay off workers. And the costs of such policies are mainly borne by those already on the margins of society such as the poor and young.

Integration with the global economy spurs competition and raises productivity. Even in emerging market countries that already benefit greatly from foreign investment, more can be done to remove barriers to investment, from the bureaucratic obstacles to those that delay import of components at the port of entry. For example, Mexico has made great strides in encouraging foreign direct investment, starting with the 1993 Foreign Investment Law that greatly reduced restrictions on foreign investment in Mexican firms, and followed by further opening in 1996. As a result, foreign investment has more than doubled as a share of GDP, from 1.5 percent before 1993 to 4 percent in 2001.

The United States has a major role to play in this regard. The recent passage of Trade Promotion Authority provides a way forward for future trade agreements such as those being negotiated in the Doha Round under the auspices of the World Trade Organization, and for bilateral and regional initiatives such as the Free Trade Area of the Americas and the free trade agreements being discussed with a number of countries, including Chile and Singapore.

One might say that all of this well known, but that it constitutes an agenda for the long term, not for consideration when a country faces financial or economic crisis. Indeed, in such

times, discussion often focuses on the fiscal measures a country can take service debt without resort to inflationary finance that would undermine macroeconomic stability. A responsible fiscal policy is necessary for a country to emerge from a crisis, but this is not sufficient for ensuring sustainability. Instead, measures aimed at promoting higher sustainable economic growth are fundamental to ensuring debt sustainability over the medium-term.

One way to approach this is to consider the ratio of debt to GDP, which is of course widely used to indicate the sustainability of a country's macroeconomic program. A policy agenda focused only on the numerator—on fiscal policy—is flawed, even in the short run. An economy can face the prospect of a financial crisis on account of a near-term liquidity problem. But it can equally well face pressure if market participants develop the belief that the medium-term program is not sustainable. It does not matter if a country has dollar reserves or a stand-by arrangement sufficient to cover its obligations for a year or more. Risk spreads will widen and interest rates will rise today if potential creditors see that slow growth will make it impossible to service debt for any reasonable set of fiscal measures. Of course, this market reaction only forces a country further away from a sustainable path.

A pro-growth policy agenda is thus essential for both preempting crises and responding to them—it is essential to look as well at the denominator of the debt-to-GDP ratio. And just as in the United States, the main causal direction is from growth to the fiscal balance and not *vice-versa*. A stronger economy is thus the appropriate target for policy, not a particular value for the fiscal balance per se.

Considerations for Sovereign Debt Restructuring

Of course, even with the best of intentions, there will be circumstances when sovereign borrowers will be unable to honor their commitments. For example, external negative shocks such as a rise in oil prices, the depreciation of a competitor's currency, or a global economic slowdown, can leave a sovereign without the resources to meet its obligations even with implementation of appropriate pro-growth policies. A restructuring of the debt profile may be the policy to promote sustainable growth. It is thus important to have a framework in place to handle the situation.

The contractual approach, involving clauses in debt contracts that encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious, but orderly, restructuring of unsustainable sovereign debt is the essential first step to addressing sovereign debt restructuring. A set of model clauses can encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious but orderly restructuring. Contractual modifications could include: 1) collective representation clauses to structure discussions within creditors; 2) collective action and sharing clauses to deal with possible holdout creditors; and, 3) exit consents to encourage participation in exchanging old debt instruments for new ones.

It would also be useful to develop a way to address disputes across instruments, either through the clauses themselves or a separate mechanism. For example, this might be done through formation of a sovereign debt dispute resolution forum to address the complexity of financial instruments. Such a forum would be one way to bring together debtors and all classes

of creditors, allowing development of a restructuring plan to proceed jointly with all relevant claimants. Participation in the forum could be voluntary. This forum is similar to that proposed by IMF First Deputy Managing Director Anne Krueger in the context of a statutory approach to sovereign debt restructuring. The contractual and statutory approaches could be complementary and investigated in parallel.

One consideration that is relevant for both the contractual and statutory approaches to sovereign debt restructuring is the possibility that creditors and debtors lack incentives to come to the table in a timely fashion to begin a restructuring process. A way to address this would be to provide incentives that would help avoid IFI lending into unsustainable situations. Access incentives would not place a rigid quantitative limit on the use of IMF resources, but would instead provide incentives for countries to curb access and enter negotiations to restore sustainability. These incentives would reinforce the important idea that official financing should be complementary to restoring private-sector growth.

It is important to keep in mind that the rationale for an IFI program is to restore sustainable growth. This can only be accomplished by reviving the private sector. Economic growth allows both an improvement in the well-being of the people in the country and a greater ability to repay creditors. IFI funding thus should help to restore the creditworthiness of—and ultimately, creditor flows to—the private sector. The pro-growth agenda I discussed is fundamental to this goal. Thus IFIs should emphasize such an agenda in their programs.

In so doing, it is important to remember that the reason for reforming the restructuring process is to encourage the private sector growth and private capital flows that have benefited emerging market countries and have the potential to lift the poorest economies from poverty.