

Economic Growth and Reforms in the United States and Japan

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It has become commonplace to stress the difficulties facing the Japanese economy. I want to emphasize this afternoon the substantial opportunity Japan faces. During the 1980s, Japan enjoyed total factor productivity growth well above that of its G-7 cohorts and twice that of the United States. As is well known, during the 1990s, Japanese productivity growth fell by half while many in the G-7 experienced an increase in productivity growth. The difference was especially apparent during the second half of the 1990s as Japan grew at a rate of 1.5 percent per year while others such as the United States were growing at rates higher than 4 percent per year. The difference of these few percentage points is enormous. If, in 1980, an economy grew at an annual growth rate of 4 percent, it would have had its GDP doubled already – in 1997. In contrast, an economy growing at a 1.5 percent rate per year would have to wait until 2027 for a similar increase – a loss for the entire generation. Today, I want to use a short historical perspective to put the current economic picture in Japan and the United States in focus and discuss the reform agendas in both countries.

About a year ago, the Japanese economy 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 starting from a point already over 30 percent below the recent 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 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 has shaped my evaluation of how policies can improve the economy, and I think provides some perspective on the restructuring and reform agenda in Japan.

Indeed, recent proposals by the Japanese government suggest a commitment to reform. Last month, Prime Minister Koizumi met with President Bush and emphasized his desire for banking reform and then demonstrated his resolve by appointing a new cabinet. The Bank of Japan has just issued its own analysis of the non-performing loan problem, and an interim report on banking system measures by the Financial Services Agency is due out in a few days. The Japanese government has further indicated that it will outline a broad "anti-deflation" package later this month. I am optimistic about these proposals – Japan stands to benefit substantially if they are combined in a single broad agenda.

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 in advancing the economy and increasing 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 primarily 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-based 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.

After three consecutive quarters of negative growth in 2001, the U.S. economy has experienced three consecutive quarters of positive GDP growth. This year began with a rapid 5.0 percent growth rate in the first quarter followed by a 1.3 percent growth rate in the second quarter. These growth rates are 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 economy. 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 result has been solid growth in personal consumption expenditures and residential investment that are supporting the recovery.

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, 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 4.8 percent during the past four quarters – and quite rapidly during the first quarter. The Employment Cost Index measure of hourly compensation growth is 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.

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. Indeed, the current business cycle is somewhat different 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 decline by three to five cents for every dollar reduction in stock market 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 values – 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 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 recently. This year, the spot price of low-sulfur West Texas Intermediate crude topped \$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 recently hovered at the upper end of 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 legislation. The President now 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 pro-growth fiscal policy and structural reform. 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 recover this promise for the next generation, 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 aimed at controlling spending and long-run tax reforms that also provide near-term encouragement to investment, and structural reforms to improve functioning of capital markets and open up new possibilities for business activity and growth. This policy mix to revive the Japanese economy is an opportunity that also involves politically difficult decisions. In this context, the recent appointment of Heizo Takenaka as Minister of Financial Services as well as Economic and Fiscal Policy Minister is a significant step that suggests that the Japanese government is poised to deal with the troubled banking sector and corporate restructuring as a key component of its broad economic policy.

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 announcement 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.

The second parallel—albeit not direct comparison—is between the U. S. corporate accounting challenge and Japan’s non-performing asset problem. While the U.S. focus is on the quality of financial information regarding real performance, Japanese concerns center on both financial information and unlocking the potential of productivity in real assets. The Japanese government has outlined a comprehensive approach toward the financial sector that includes more accurate loan classification and sufficient provisioning, better capitalization of banks so they can recognize loan losses and dispose of bad loans, and better corporate governance of banks and borrowers. If the necessary reforms are implemented in Japan, productivity growth will increase (a benefit for the future), and will be reflected in asset markets as well (a boost in the present). 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 corporate statistics 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. This is not simply a phenomenon of the recession. Corporate return on assets has been well below its historical average, despite restructuring efforts by Japanese companies.

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 continue to, transform themselves in seeking to hold and extend 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 tend to be dependent on bank financing, and, without restructuring, unable to raise financing directly in capital markets. In particular, small firms, and domestically oriented firms of all sizes 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 weak incentive to participate in the restructuring of a borrower, preferring to defer realization of losses by continuing to roll over loans. 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 remaining 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. Definitive action is therefore required to reform the banking sector. Yet, some have been concerned that bank reform will result in short-term dislocations.

One reason is that investors want to be sure that the policies will be beneficial and will truly lead to reform of the banking sector. In 1999, the Japanese government agreed to a \$75 billion bank bailout that came without major strings attached. Three years later, many analysts suggest banks are now worse off, not better. Minister Takenaka realizes the importance of not spending public money simply to subsidize banks when he says: “Any policy to clear bad loans must come in concert with a more stringent evaluation of lending, fortification of shareholder equity and stricter corporate governance.”

A good plan is one that encourages an honest classification of NPLs, better provisioning for NPLs, higher quality of capital, and a combination of carrots and sticks that provide the proper incentives for bank managers and shareholders. A publicly funded capital injection based on and supporting these conditions can assure that the use of taxpayer funds contributes to a solution to the nonperforming loan problem, and is not wasted. Such a policy will help to resurrect the Japanese economy that had outperformed most industrialized economies over much of the past half century.

As of March 2002, official estimates put NPLs at ¥52 trillion (\$418 billion), or about 9 percent of total assets. Private sector analysts have estimated the actual figure to be at least twice that amount. Indeed, the fact that private sector analysts do not readily accept official reports suggests that special inspections of all financial entities should be done to increase faith in the banking system. If the results suggest that the higher estimates are closer to being correct, bank provisioning must be increased substantially.

There are already some indications of the potential need for greater provisioning. The FSA conducted special inspections of 149 distressed borrowers that concluded in April 2002 and indicated ¥5 trillion more in troubled loans than originally thought and a need for ¥2 trillion additional loan loss provisioning. 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 special inspections and the assignment of permanent inspectors signal the end of regulatory forbearance and the beginning of a realistic evaluation of bank assets.

This approach highlights the importance of doing a thorough job of examining banks balance sheets and ensuring that banks are adequately provisioned and capitalized once the information is known. One way to encourage stricter asset assessments would be to use a discounted cash flow method similar to that employed in the United States; this is, in fact, what the Bank of Japan has suggested on its report on the bad loan problem. In this approach, the probability of recovering loans is based on the borrower's future, rather than past, profitability. This technique would force banks to set aside more reserves for loan losses. Currently, for risky loans, Japanese banks set aside about five percent of a loan's book value in reserves, whereas U.S. banks set aside about 20-30 percent using the recommended accounting method. The Mycal bankruptcy was a dramatic illustration of the need for higher provisioning. Most banks had set aside reserves of only five percent and found that their losses were about 50 percent. Adopting an appropriate provisioning method would give Japanese banks a better cushion in the event of future financial distress.

There are long-run benefits to ensuring that the banking reform is properly funded as well – a lesson learned during the U.S. savings and loan crisis of the 1980s. In 1987, the U.S. government passed the Competitive Equality Banking Act to deal with poorly managed savings institutions. This measure was woefully underfunded, however, and, as a result, restructuring was limited. The situation did not improve automatically with the initial formation of the Resolution Trust Corporation (RTC) in 1989 to manage the disposal of the bad loans. At first, the RTC was fearful of depressing markets and thus slow to act. Between 1989 and 1991, when assets were restricted to sell for no less than 95 percent of appraised value, the RTC merely warehoused bad loans. The combination of poor funding and the lack of definitive response depressed the value of the underlying assets – real estate – especially in the southwestern United States. Once the RTC was given the power needed to take definitive action in 1991, the result was decidedly different and the crisis abated by 1995 – one year ahead of schedule. Property values rebounded. Loans in a Dallas auction in October 1992, for example, sold for 62 percent of book value, up from 21 percent roughly a year earlier. Still, delays and inadequate initial funding meant the entire price tag for resolution was \$150 billion, about seven times the originally estimated cost in 1982. Proper funding and definitive action lead to a healthier banking sector and can improve asset values.

Getting bad loans off the books and improving banks' balance sheets is only a start. Bank reform must also involve changes in the way banks do business, with increased incentives for banks to allocate credit to productive sectors. An essential part of this is for shareholders to insist on improved bank management and monitoring of loan portfolios—the incentive for shareholders to insist on this should come from having them bear part of the cost of the clean up. Here it is useful to examine the Nordic experience, where banks receiving government funds in Sweden and Norway were required to dismiss management, close branches, and write down equity values. As a result, Nordic financial sectors returned to profitability, though the crisis did not subside until one to two years after definitive action was taken. Aggregate asset values rebounded as well as Finland's HEX stock price index increased by 236 percent over a 17 month period and Sweden's AFGX share price index increased by 130 percent over a 16 month window.

While banking reform is required to facilitate successful restructuring and raise overall productivity, the NPL problem should not be handled in isolation from other problems, particularly deflation. Deflation harms consumer and business confidence, preventing productive lending and investment from taking place. Monetary policy can therefore be a useful lever in moderating the negative short-term effects from banking reform. Banking reform without accommodative monetary policy will be much more difficult.

Accommodative monetary policy was an integral part of the financial recovery plan in Finland, Sweden, and Norway. Once definitive action was taken, monetary policy was eased to ensure the restructuring was successful. It is noteworthy that the country that employed the most aggressive monetary easing, Finland, was also the country that resolved their problem the fastest.

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 in April. Yet, since this peak, monetary base growth has decelerated to 21.4 percent. Moreover, growth in M2 plus CDs have also been disappointing --- up only 3.3 percent year-over-year in September. 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. But we should also recognize that monetary policy cannot solve all of Japan’s problems. 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. 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.

While tax reform’s a sensible “long-run” policy, 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. 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.

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.

I remain hopeful that the other planks in the government's plan will help end deflation and reform the banking sector. It is necessary to maintain a comprehensive approach toward the banking sector including – more accurate loan classification and sufficient provisioning, better capitalization of banks so they can recognize loan losses and dispose of bad loans, more rapid corporate restructuring and redeployment of assets into productive sectors, and better corporate governance of banks. Accommodative monetary policy is a key ingredient in this effort to smooth the short-term adjustment effects brought about by restructuring.

With all of these planks in place, the economic 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

I continue to be optimistic about Japan's ability to pursue this opportunity to cure the woes of recession, deflation, and nonperforming loans through the Koizumi administration's strong reform agenda. I also 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.

Thank you very much. I look forward to your questions and comments.