

ECONOMIC GROWTH AND REFORMS IN THE UNITED STATES AND JAPAN

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Good afternoon. I am grateful to Prime Minister Junichiro Koizumi and Minister of State for Economic and Fiscal Policy Heizo Takenaka for the opportunity to speak with you about prospects from structural reform for economic growth, living standards, and Japan's role on the global stage. I believe those prospects are significant and promising. At the same time, I do not diminish the significant political effort that achieving them will require.

It has become commonplace to stress the difficulties facing the Japanese economy. I want to emphasize today the substantial opportunity Japan faces. During the 1980s, Japan enjoyed total factor productivity growth well above that of its G7 counterparts, and twice that of the United States. As is well known, during the 1990s, Japanese productivity growth fell by half while many in the G7 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.

Despite struggles with forces of recession and the economic consequences of terrorism and geopolitical risk, the Japanese and U.S. economies have experienced

recoveries. For the third quarter of 2003, both Japan and the United States grew faster than expected, with real GDP expanding in the two economies at an annualized rate of 1.4 percent and 8.2 percent, respectively, though questions about the sustainability of growth at this pace remain.

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 economic growth 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 must lie elsewhere. *The U.S. model – a flexible, market-based system – provides rewards to entrepreneurial investments that deploy these technologies in productive risk-taking. The preservation and support of these incentives is central to long-term productivity growth.*

Following a brief recession in 2001, the U.S. economy has staged a substantial recovery. While the pace of GDP estimated growth at a rate of 8.2 percent for the third quarter of 2003 is not sustainable, many private-sector economists believe that GDP growth of at least 4 percent (at an annualized rate) may be expected over the next four quarters. Monetary and fiscal policy have played an important “risk management” role, enabling the recovery of profits, domestic demand, and employment. The starting point

for the upward momentum is the legacy of aggressive monetary easing by the Federal Reserve over the 2001-2003 period. Given the well known lags in monetary policy, this easing will continue to provide stimulus to the economy throughout 2004.

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 President George W. Bush and passed by Congress in 2001 provided valuable support for disposable incomes and consumer spending. 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 a strong recovery also requires a continued rebound in business fixed investment. With robust business investment, labor markets will firm, and the economy's pace of job creation will improve. Investment incentives passed in 2002 and reductions in the taxation of dividend and capital gains tax rates, passed in 2003 have offered important policy support for the investment recovery. Looking ahead, moving toward faster capital-cost recovery – in the limit, full expensing of investment outlays – remains a substantial step toward fundamental reform of the U.S. tax code.

There is little reason to believe that policy support for the recovery will be removed over the next year. The Federal Reserve correctly focuses its attention on its objective of low and steady inflation. Absent inflationary pressures, the Fed is unlikely to raise its federal funds rate target over the next several months. The economic support provided by the Bush tax cuts is also likely to remain in place for the foreseeable future as long as President Bush is reelected.

Most important for the U.S. economy is the continued strong performance of productivity growth. Many economists believe that structural productivity growth could be 3 percent per annum or higher. While many factors contribute to this robust pace of

productivity growth, the flexibility of American businesses and financial markets and vibrant markets for entrepreneurial capital play especially important roles.

Of course, there are risks to this outlook, including geopolitical concerns, the possibility of increased protectionism among major economies, and concerns over the stability of the foreign-exchange value of the dollar. Another potential risk is increases in crude oil prices. A sustained increase in oil prices of \$10 per barrel would be expected to lower GDP by 0.25 to 0.50 percent after six months to one year. Larger increases pose a more substantial risk.

Some commentators have focused 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 little 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 over the medium term, 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, and toward this end reform of the Social Security and Medicare programs is important. 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.

To summarize, the U.S. economy has faced serious challenges during the past few years. 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 Japanese economy – the world’s second largest – has entered a recovery. Higher export demand, reflecting in part the vigorous upturn in the United States, is the key contributing factor to the near-term outlook. In addition, the combination of export growth and a rebound in profits has fueled an investment recovery. Some worrisome signs remain, however, including stagnant nominal growth, continuing solvency questions for financial institutions, and the negative consequences of likely tax increases for domestic demand. Against the backdrop of the fledgling recovery, it is important to recall that the postwar revitalization of the Japanese economy is one of the outstanding episodes of 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. The administration of Prime Minister Junichiro Koizumi has embraced this theme.

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 presence of reform-minded officials 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. Likewise, the new leadership at the Bank of Japan continues to offer an opportunity to reassess the course of monetary 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. The nationwide effort to raise accounting standards and the announcements 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 nonperforming 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.

This is important: The nonperforming asset problem has had a corrosive effect on productivity growth – and hence long-term growth prospects – in Japan. Poor lending decisions have not only kept many money-losing firms in business, but have depressed the creation of new businesses in the sectors in which the weak firms are most significant. Recent economic research corroborates the sharper decline in productivity growth in these sectors. 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. 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. Instead, the nonperforming loans remain 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 continue to account for a greater share of nonperforming loans.

These observations are sobering, but also suggestive. Even in the near term, Japan is in a good position to make better use of information technology – and other technological developments – in many industries. After all, technical expertise is excellent, and industrial relations are stable. A leading indicator of Japan's productivity potential is the presence of the weak second tier of firms that have remained subsidized or overregulated.

Better productivity performance will follow more efficient allocation of capital and labor, and this reallocation will be enhanced by the expanded presence of entrepreneurs. But, to flourish, these entrepreneurs need access to financing. Japan does not lack domestic savings to be invested; the banking system is not allocating the savings well.

In contrast to the pressure to restructure from international competition, the undercapitalized banks that have made loans to weak borrowers 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 the banking sector as a whole is not better off. As the Minister for Financial Services Heizo Takenaka commented in the fall of 2002: “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 nonperforming loans, better provisioning for nonperforming loans, 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. In this regard, I am concerned about recent Financial Services Agency proposals for “pre-emptive” capital rejections. A successful recapitalization of Japanese banks should use market signals to determine which banks merit support. Banks that can attract financing at arm’s length at reasonable terms as part of their recapitalization might be given higher priority. Such a policy will help to resurrect the Japanese economy that had outperformed most industrialized economies over much of the past half century.

Private-sector analysts have estimated that cleaning up banking sector losses could eventually cost Japanese taxpayers about four percent of GDP, substantially greater than official estimates. 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. (Banking-sector losses are but a small part of taxpayer exposure, as some researchers estimate that losses to taxpayers from the government's Fiscal Investment and Loan Program could eventually exceed 15 percent of GDP.)

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. Despite some encouraging steps, the Government of Japan has not implemented a reform plan that would call a halt to poor credit allocation by banks. By delaying deposit insurance reform, even the worst banks continue to be able to attract financing and support weak borrowers. While a series of government agencies has been created to assist banks with the disposal of nonperforming loans, none has done much to restructure troubled borrowers. The recently created Industrial Revitalization Corporation of Japan has an explicit mandate to restructure troubled borrowers, but the jury is out on its effectiveness.

While banking reform is required to facilitate successful restructuring and raise overall productivity, the nonperforming loan problem cannot 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.

Monetary policy alone, of course, cannot fundamentally alter Japan's long-term growth prospects. Economies grow and prosper because of the productivity and innovation of businesspeople and workers. At the micro level, it is encouraging to see corporate restructurings and banking reform proceed, and rejuvenating the process by which capital is allocated lies at the heart of improving Japanese economic performance.

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.

The clear sign that monetary policy remains too tight is the continuing deflation and expectation of deflation in Japan. *Deflation is not an abstract enemy of monetary economists. It can be an economic cancer: High real interest rates and mounting real debt burdens in a deflating economy sap business performance and tax entrepreneurship and dynamism.* The high real returns from holding cash further retard willingness to hold riskier, more productive assets. Deflation also weakens consumer spending by leading households to postpone purchases.

Contemporary discussions of Japanese monetary policy in Tokyo and Washington center – wrongly, in my view – on currency interventions. While anecdotal evidence seems to indicate that recent Japanese currency interventions have been unsterilized – thereby contributing to monetary expansion – the data are not so clear. In any event, a strategy of monetary expansion through a series of ad hoc unsterilized interventions is not the best way to advance the reflationary policy Japan needs.

Bank of Japan Governor Toshihiko Fukui has commented on several occasions on the need to restore a reference price level in Japan. The Bank of Japan could define the price level gap it wants to make up, and announce that it will undertake any and all measures to achieve it. The precise tactics are less important than articulating the strategy. But follow-through will be essential. Stop-and-go policies toward operating targets should give way to more aggressive expansion by the Bank of Japan.

A sustained, credible monetary expansion in Japan to restore price stability may well weaken the foreign exchange value of the yen in the near term (consistent with the objective of the ad hoc interventions). But a monetary policy aimed at restoring a stable price level importantly will reduce the many effective tax burdens deflation exacts from

the private economy. The longer-term effect on the yen's value is ambiguous because of a vigorous, recovering Japanese economy may, all else equal, see a stronger recovery.

A popular reading of the G7 Finance Ministers' communiqué in Dubai is that exchange rate policy is at the center of attention. An alternative reading – which I prefer – is that the communiqué emphasizes that the major economies of the world should adopt policies that promote economic growth, importantly including domestic demand growth.

This reading is consistent with President George W. Bush's emphasis on the promotion of economic growth in the United States, in the G7, in emerging economies, and in the poorest economies. It is in the economic interests of the United States – as well as Japan – for Japan to return to price stability and economic growth. The applause for a global recovery requires more than the U.S. hand clapping. Pro-growth policy in Japan is important.

Japan and the United States are allies and friends in values, national security, and commerce and finance, and our leaders have a close relationship. In economic policy, a zero-sum game of currency intervention can give way to a positive-sum game of Japanese reflation and global recovery.

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. In the United States, the pro-growth tax policy of 2001-2003 both helped to speed the economic recovery and improve incentives for productive risk-taking, saving, investment, and long-run growth. Reports that Japanese tax reform plans focus on the need to reduce 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 is 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 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 Prime Minister Junichiro Koizumi's reform and recovery agenda.

In the near term, tax increases pose a threat to a sustained recovery in consumer spending. In particular, new household tax and social security burden hikes, on top of tax increases already set for next year may render optimism on consumer spending short-lived. On the corporate side, increased pension burdens reduce profit growth and, likely, hiring, further weakening consumer sentiment.

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 believe Japan can and will pursue this opportunity to cure the woes of recession, nonperforming assets, and deflation through the Koizumi administration's reform agenda. I also believe the role that U.S. corporate reform and pro-growth tax policy has played in aiding financial markets and the recovery can provide useful input to the policy debate in Japan. Both countries share agendas in national security and international commerce and finance.

Let me close on an optimistic note. In the United States, near-term prospects for economic growth remain bright, as accommodative macroeconomic policy is allowing the economy to grow fast enough to eliminate the output gap arising in the recent recession. Long-term growth is supported by the economy's flexibility and resilience. *In Japan, too, short-term growth prospects can be improved with appropriate accommodative policies. The large cumulative output gap suggests significant possible noninflationary growth in the near term. Over the longer term, possibilities for productivity growth can be improved through more efficient allocation of capital and a greater role for entrepreneurial firms.*

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