

Remarks on Economic Growth and Reform in Japan  
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In the wake of the tragic attack on the United States, I appreciate this opportunity to address the METI conference by videotape. Now more than ever it is important that global economic policy focus on enhancing prospects for growth through reform.

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 relative to the OECD average (excluding Japan) of 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 of 1.4 percent from 1990-2000 (far below potential) has created a huge output gap that has translated into declining living standards in Japan and a drag on the global economy.

**Reasons for Long-term Optimism**

Even with recent experience as a backdrop, I see cause for optimism. For some time there has been a broad consensus on the economic and financial problems facing Japan and how to approach them. An essential element of a solution is a redirection of non-performing assets in the corporate sector toward more productive uses, and this redirection will require the associated restructuring of the financial sector. The problems with the Japanese economy are not beyond fixing, and indeed many of the necessary initial steps have been taken. What remains are the essential—and politically difficult--decisions that will produce an incentive structure to encourage the necessary corporate and financial restructuring.

My long-term optimism on Japan's situation reflects two observations. First, many steps have been taken to put in place a transparent and more market-friendly environment in Japan. These steps are enhanced by the Koizumi administration's sound decision to focus on a reform agenda, giving the administration unprecedented public support that will be needed in the coming months. Second, the United States in the 1980s faced some of the same set of circumstances as Japan. After some missteps, the U.S. government and private sector effectively dealt with restructuring issues, and the private economy emerged stronger and more vibrant. In my remarks, I offer an economist's analysis of the current problems facing Japan, using the U.S. policy experience -- both its mistakes and successes -- to provide some suggestions on how best to push ahead the restructuring and reform agenda.

### **Challenges—Improving Corporate Performance**

Most analysis of restructuring in Japan focuses on the financial side – in particular the problem loans held by Japanese banks. There are seemingly endless discussions over the magnitude of the non-performing loans (NPLs). I do not believe these discussions are always productive, as they can deflect attention away from the real problem, the non-performing assets (NPAs) in the corporate sector. Fortunately, the Japanese administration has explicitly drawn the link between financial and corporate restructuring. This link is crucial. Understanding and solving the NPL problem requires understanding and solving the NPA 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 3.2 percent in the second quarter. This is above the recent trough of 2.0 percent, but well below the historical Japanese average of 4.0 percent. Leverage is also quite high in Japan. Although it has declined in recent years, the debt-to-equity ratio still amounts to 277 percent, roughly seven times as great as in the United States.

The same data reveal that there is a clear difference between large manufacturers and both smaller manufacturers and all non-manufacturing firms. Indeed, the large manufacturing firms in Japan are world-class competitors who have and are continuing to transform themselves to hold onto their position—companies like Toyota and Honda come to mind. Not surprisingly, it is these large manufacturers who have moved away from bank financing to direct financing, for these firms the share of bank debt to total liabilities has fallen from 24.9 percent in the fourth quarter of 1986 to current levels of 16.1 percent. However, other firms that have yet to undergo substantial restructuring are still dependent on bank financing, which in part explains the NPL problem for the banks. In particular, domestically oriented firms such as construction, real estate, and trading account for 54 percent of the NPLs as of March 2000, and it is these very same firms who have not been forced by the pressure of international competition to restructure.

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) with debt-to-equity ratios approaching 100

percent. However, spurred by deregulation and reform, the corporate sector was transformed, 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, with a debt-to-equity ratio of 55 percent. Capital that was devoted to this sector was allocated more efficiently 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.

Japan stands at crossroads similar to the United States in the 1980s, and U.S. experience offers some lessons for policies. We now know, perhaps not surprisingly to economists, that incentives really do matter. As I noted earlier, large Japanese manufacturing firms have and are continuing to transform themselves, but other Japanese firms are lagging. The question is why are they lagging -- the answer is incentives. The larger firms face the international competition that provides the incentive for transformation. The domestically oriented firms lack this crucial incentive. A legal and regulatory framework that provides incentives for restructuring is needed, and Japan has gone a great distance in providing that framework. Over the past five years, significant strides have been made, in particular the enabling of the holding company structure, allowing for stock options and stock swaps, improved accounting standards, and the new Civil Rehabilitation Law bankruptcy regime. All of these steps improve long-term fundamentals. What remain are some additional steps and the will to use the framework that has been put in place.

With regard to the additional steps, the bill pending on the Commercial Code needs to be passed as quickly as possible. The ability to use stock swaps must be provided to foreign firms so that they do not have to set up domestic subsidiaries to participate in mergers and acquisitions.

The fiduciary responsibility of money managers toward shareholders should be further clarified. The U.S. experience suggests that a statute like that contained in the Employee Retirement Income Security Act (ERISA) and the associated “Avon Letter” from the Department of Labor can help clarify what is expected of pension fund money managers. Finally, consolidated tax treatment, currently under study, should move forward expeditiously so firms can offset profits in one subsidiary with losses from another subsidiary. Procedures for foreclosing on collateral should be simplified. Finally, portable pensions will help boost labor market flexibility. These “finishing touches” will certainly enhance the restructuring environment.

### **Challenges—Improving the Health of the Financial Sector**

However, these finishing touches may not prove sufficient, precisely because of the unique incentives faced by Japanese banks and their troubled borrowers. The smaller manufacturers and the non-manufacturers in Japan are much more dependent on bank financing, the heart of the problem. A bank faces a much weaker incentive to participate in the restructuring of a borrower, preferring to hide any losses by continuing to roll over loans to borrowers, especially in an environment of low interest rates. A bank’s shareholders are not likely to demand action on problem loans, especially if the bank’s shareholders are the owners of the troubled company. Similarly, a firm’s shareholders are not likely to demand action if they are the owners of the bank. A poorly capitalized bank has no interest in resolving its problem loans, because a true resolution will result in a markdown of the value of the loan and a further decline in capitalization. To avoid regulatory scrutiny, poorly capitalized banks struggle to keep loans current, papering over the problem in the misplaced hope for a reversal of fortune. Often, banks face the wrong incentives for handling the problem.

A lever is needed to force action on the part of the banks, and here again the U.S. experience is illustrative. The important lessons of the Savings and Loan (S&L) and banking crisis in the United States are the danger of regulatory forbearance and the need for prompt corrective action. The differences between the approaches of the Federal Deposit Insurance Corporation (FDIC) for the banks and Federal Savings and Loan Corporation (FSLIC) are very instructive. The early handling of the S&L crisis by FSLIC was a costly mistake of U. S. economic policy. Forbearance and the lack of prompt corrective action made a large problem much worse, even in the absence of legal and regulatory impediments to restructuring. The point is that a conducive restructuring environment is not enough, as I mentioned earlier there are good reasons to suspect that banks and their borrowers, left to their own devices, are unlikely to undertake restructuring voluntarily.

With this in mind, the question of current Japanese policy is brought to the forefront. The Financial Services Agency (FSA) has targeted the NPLs of the major banks in its reform proposals, a limited but nonetheless helpful first step. In addition, the FSA has proposed a new framework for workouts, based on the principles of the International Federation of Insolvency Professionals (INSOL). I look forward to the details of this new framework. However, it is important that banks *use* the new legal and regulatory framework to confront their problem loans. Problem loans should be identified on the basis of future cash flows and realistic assessments of the value of collateral and guarantees. The resolution of problem loans must not just involve debt forgiveness, the operations of firms must be restructured. Naturally such an exercise will involve recognizing losses by both the banks and the companies, but this is key to moving capital to its most efficient uses. The current practice of “evergreening” -- banks extending new loans so that companies can service old loans -- should come to a stop. The practice will come to a

stop with the meaningful implementation of prompt corrective action. In particular, the FSA should consider increasing the capital adequacy ratios that trigger automatic corrective action. Finally, based on U.S. experience, it is not clear that bank mergers can bring about the needed downsizing of balance sheets. Closing insolvent institutions should remain a viable option.

### **Navigating the Challenges Posed by Restructuring**

To my thinking, the negative economic consequences of restructuring have been overstated. Admittedly, the short-run effect will be contractionary. However, the experience in Texas and elsewhere has demonstrated that a quick resolution of a debt overhang problem can result in a rapid recovery of economic activity. It is hard to overestimate the positive economic effects of resolving uncertainty. Japan has seen this most recently with the Mycal bankruptcy. On the day of the bankruptcy announcement, the equity markets in Japan soared despite the negative developments associated with the attack on the United States. If the debt overhang is not resolved real estate and other asset markets become illiquid until the overhang is properly addressed, depriving economic agents of useful price signals and incentives. Moreover, consumer sentiment and spending are restrained as workers try to hedge against potential job losses. A quick resolution lets markets operate, providing the fuel for increases in economic activity. A slow resolution leads to paralysis and stagnation. In this regard, the recently announced expectation by the Japanese administration that it will likely take seven years to cut NPLs in half is very problematic. The U.S. experience with the Resolution Trust Corporation (RTC) between 1989 and 1991, when assets were restricted to sell for no less than 95 percent of appraised value, is telling. The RTC was not truly effective until after 1991, when this restriction was eased.

How the non-performing assets should be disposed of remains an open question. In the economy of textbooks, it should make little difference whether the banks acquire the collateral behind the loans and dispose of it or the borrowers undertake the restructuring, perhaps spinning off the assets. However, in practice, given the incentive problem facing banks and their borrowers, it makes sense to involve a third party such as Japan's Resolution and Collection Corporation (RCC). The RCC currently is in possession of some ¥29 trillion in bad loans. These should be liquidated quickly. Again, lessons can be drawn from the U.S. experience. The RTC was so successful in part because it was mandated to contract with private asset management and disposition firms, it was recognized that it would be wasteful to have the RTC try to develop its own expertise. The RTC was also innovative, for example using securitization to create markets for non-traditional assets such as commercial loans.

It is clear that some of these lessons have been learned in Japan, where reform proposals call for securitization powers for the RCC. However, some aspects of the RCC's operation suggest that other lessons have not been fully adopted, especially with regard to the RCC's role in participating in restructuring. Because some of its loan portfolio is still current, the RCC is self-financing at this point in time, removing any sense of urgency. The agency should not seek to become a key player in corporate workouts; its role should be limited to rapid purchases and equally rapid sales. The example of the Korean Asset Management Company (KAMCO) is worth following. Through September of last year, KAMCO had acquired the equivalent of ¥12.3 trillion in bad loans and distressed assets and quickly resolved them, using innovative techniques such as joint ventures with foreign companies. The RCC should move with similar speed.

The Koizumi administration's desire for a detailed NPL agenda by the end of the month has led to some recent proposals that call for more aggressive purchases of NPLs by the RCC.



Indications that these proposals are also calling for equally aggressive sales by the RCC would be encouraging.

Any large purchases of non-performing assets by the RCC would require increased funding, a real obstacle in light of Japan's current fiscal situation. Here again, the proposals of the Koizumi administration are headed in the right direction. Abolishing or privatizing the special public corporations could free up resources that can be put to better use. The initial response of the ministries involved, offering to eliminate 5 of the 157 entities, was disappointing. Prime Minister Koizumi's determination to press ahead on public sector reform is encouraging. In addition, the administration has signaled an end to old-style public works spending that propped up ailing companies in sectors such as construction, the very same companies that account for the lion's share of NPLs.

Relief is also possible on the revenue side. A reduction in the generosity of allowances and exemptions from the income tax could allow for a lowering of marginal tax rates that would improve the incentives for working, saving, and investment. In the same vein, the high marginal tax rate on a second-earners income should be reduced. The relatively high tax on land transactions (four percent) and the postponement of inheritance taxes for land kept in agricultural use have also distorted the efficient allocation of resources. Fiscal reform can be combined with increased funding, allowing a reinvigorated RCC to eliminate the debt overhang, reduce uncertainty, and provide a dramatic boost to activity.

Finally, funding could be provided by the monetary authorities, either directly through purchases of bonds issued by the RCC or indirectly through purchases of Japanese government bonds that would effectively offset private market purchases of RCC bonds. The two approaches would have roughly equivalent effects, but the first approach might be much less transparent in

terms of the transfer from taxpayers. Using the monetary authority to fund the RCC, perhaps avoiding the political process, might mean that bank management and shareholders do not share fully in the burden of write-downs and restructuring. In addition, financing through the monetary authority should not allow the RCC to avoid rapid sales of the assets it acquires from the banks.

### **Conclusion**

Any solution to the present Japanese stagnation requires a rapid restructuring of the corporate and financial sectors. Changes over the past five years have made this restructuring possible, at least in a legal sense and the leadership of the Koizumi administration in its current reform proposals is impressive. Thus much of the hard work has already been done. All that remains is to ensure that troubled borrowers, and their banks, face the correct incentives. Once these incentives are in place the recovery is likely to be rapid and long lasting.

Thank you.