"Financial Vulnerabilities in the United States"
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The new American administration will be less willing to give lectures to Japan on its economy. What looks like American triumphalism is really just a result of things happening in one place before they happen in another. Japan and the US share many common problems.

Japan's financial system is half-and-half: half of the system is socialized, the other is private but embarrassed by bad loans in the system. The public side of the system has zero risk taking. The system is not sustainable because of this lack of risk taking.

The US economy is losing momentum. There are two views on this phenomenon:

The optimistic view says that there will be a V-shaped recovery. Meanwhile, the realistic view (which I hold) says that recovery will be saucer-shaped; the circumstances in the tech industry are reminiscent of other times when businesses have over-invested. If you look at the numbers, it looks like a manufacturing recession. Capital goods orders and shipments are way down.

The US government did not warn the public about the downturn because it occurred during the presidential election. The Clinton administration did not want to hurt Gore's chances by announcing bad news. Meanwhile, Bush found that if he talked about a recession he was accused of trying to cause a recession, so he stopped. And Alan Greenspan stayed out because he didn't want to influence the election. Then the Florida vote recount worsened the chances for the Fed to move quickly.

If you look at productivity and output of non-farm business, the new economy proves to be real. Yet, however new the economy, it is still subject to regular economic characteristics—specifically the business cycle. Information technology (IT) contributions to productivity improvements are cyclical: the more you use IT, the more productive you will be. In essence, it is a new economy but an old paradigm.

The high tech sector includes computers, software, telecommunications, and the services that accompany those fields. This sector accounted for 5% of US employment and 8% of

GDP. Using nominal figures, however, high tech accounts for 5% of nominal GDP, which means that there have been significant price reductions. Power is going up; price is going down. So tech's real contribution is higher than its nominal contribution. The sector is, therefore, seeing lower profits compared to its contribution to the economy.

The stock market exaggerates. It plays a story out into the future. Prices today reflect a discount on people's expectations of future earnings. In March 2000, high tech accounted for 32% of the market's value. It was a bubble and it collapsed.

Technology's capacity didn't really take off until the introduction of two things: network software and the Internet. There were, however, three elements of the boom in capacity that are unrepeatable:

1. Building the first website – everybody is on the web now. But you can only build your first website one time. It took hard work and plenty of hardware and software. And the first time is the most expensive.
2. Y2K – in fixing the Y2K bug, software developers also did a top to bottom scrubbing of their software product. Plus, users had to purchase new hardware to run the new and improved software.
3. Broad band – allowed data to be sent almost simultaneously. But the technology got overbuilt and people are starting to realize it. Nortel's stock, for example, fell by more than 30% in two hours. There was premature capital investment in broad band.

I am pessimistic about growth because we are taking the leading sector out of the US economy. The transition will kick out 1% of GDP growth for about two or three years at a minimum to a number of around 2 or 3%GDP growth per year.

There is still enormous public trust in Greenspan's ability to prick the bubble. But we will need tax cuts to boost after tax returns for businesses. Profit margins of US non-farm businesses were no better than they were during the 1970s, our lost decade. Profit growth has been zero for the last five years.

The business community has been making dumb moves—borrowing too much. Businesses have increased their debt by 20% without profit growth. There is a financing gap, which equals capital spending minus internally generated funds. This number has gone from $50 billion in the 1980s to $100 billion in the 1990s, to $250 billion last year. This trend represents the dark side of deregulated financial markets.

Companies were buying back their own stock at inflated prices, using borrowed money. A tax cut will remove some of this burden and create incentives.

Americans have been selling their stocks because they saw the bubble. But foreigners (from Europe and the Middle East) have been getting burned on US equities. Now foreign investors are shy.

The stock market has two types of wealth effects. The first boosts consumption, so it is associated with who owns the stock. This effect propels faster GDP growth. The second affects business corporations. If stock prices go up, a business's worth goes up too. Businesses are then able to go public at higher values than was initially put in the venture. Consequently, they become wealthier, can more easily borrow, and add divisions to the company. When this wealth effect reverses, however, watch out!

If you look at household debt burden, you wonder why anyone could possibly question tax cut or rate cuts. But President Bush will have to compromise on the amount of the tax cut. Households will become worried if people start getting laid off; the government must act preemptively.

The NASDAQ composite index fall looks a lot like the recent drop in capital goods orders and shipments. This is an important indicator for consumer sentiment. I see the NASDAQ continuing its downturn and bottoming out at around 1800 to 2000. The true blow out has not happened yet.

What does all of this mean for Japan? More nastiness. There will be fewer orders for Japanese products. Meanwhile, businesses will be re-assessing capital equipment orders based on the US story. The ensuing reduction in orders will hurt capital equipment producers. The Japanese government should switch from public works spending to tax cuts. Also, stop using the word “restructuring”—it scares people. Call it “modernizing” or something. Half of the Japanese population is scared of losing their job—this is crazy.

Asia exports electronics; and here there will be a bloodbath. The financial crisis has not ended. I am particularly worried about Korea, as their recovery was “too easy, too fast” as my Korean friends say. The *cheabols* were not reformed. Elsewhere in Asia, China will have WTO adjustments to contend with.

Latin America is not doing so well either. Brazil, which matters most, received 25% of all FDI into emerging markets. President Fox, of Mexico, the other important country, has inherited a mess and must bring down the public's expectations. President Bush will do what he can to support Mr. Fox.

Can Europe save the rest of the world? Probably not. They are doing well, but they can only support the other regions.

I wanted to talk about the problem of non-performing assets in the US and Japan. Deregulated financial sectors lead to extremes because people try to outperform rate of returns. People go to extremes and over-finance. Once, say, a real estate project goes up, it becomes easier and easier to fund projects with similar plans and valuations start to sink. The first entrants win, while the last entrants lose big. We call this phenomenon in economics *the fallacy of composition*. Fancy spreadsheets gave this fallacy an air of scientific respectability. If the problem is big enough, it can take down a few banks.

The US established the Resolution Trust Corporation (RTC), which initially got a lot of bad press. After four years, however, it had solved the NPL problem and became a hero. The courts deferred to the RTC in repossession cases on behalf of national public policy. Finally the press got the story. Rather than read *The New York Times*, Japanese may do better using JETRO to get information about what is really going on in other countries.

Japan should go full speed ahead with rehabilitating funds, but the public needs an upside. The process will move more slowly in Japan because there are no pension funds like there are in the US. Japan needs fresh equity in troubled businesses, which will require shareholders to be diluted. But if they are to write off loans, bankers will need equity. Otherwise, owners of troubled companies won't do anything. It would be like a never-ending game of poker with an ever-increasing ante.

This is an intermediate approach, but Japan needs fresh equity from venture capitalists. Otherwise, the socialized portion of the financial sector will get bigger and stifle growth.

In terms of timing, Japan should start articulating the plans now, but execute them later when the US is out of its slump (in about two years). You should liquidate the losers and mark-to-market the rest.

The tax cut in Japan has not worked yet because the public is still afraid of unemployment. I recommend getting rid of the consumption tax (a holiday for two years) and the capital gains tax. You should push selective tax cuts to help business formation and consumption.

-The RIETI editorial department is responsible for this article.