
The Resurgence of the American Economy

The US Economy and Japan-United States Economic Relations

The resurgence of the US economy was one of the major global events of the last years of the 20th century. Along with other contemporary developments—the end of the Cold War, the further economic integration of Europe and the creation of the euro, and Japan’s “decade of decline”—it has had profound effects on the world economy. Whether the US recovery of the period turns out to be lasting or a transitory phenomenon is a critical question that will have a significant impact on the economies of other countries, including Japan.

The answer to this question will also have important consequences for the foreign economic policy of the United States, and especially for the its relationship with Japan. Continued strong performance by the US economy, and the increased self-confidence that springs from it, will reduce US concerns about the economic performance of Japan (and other countries). Hence, it will reduce the pressure that the United States places on them to alter their own economic policies (Bergsten and Noland 1993).

Indeed, the unique “Japan policy” conducted by the United States for a quarter-century, from the early 1970s through the middle 1990s (as described in chapter 1), now looks to have been largely a historical accident. The United States entered its own period of economic difficulty in the early 1970s, with a substantial decline in productivity growth and hence economic growth that led to a prolonged stagnation of real wages and incomes. The oil shocks, and the gasoline lines they produced,

revealed for the first time in the postwar period the deep vulnerability of the United States to external events. Double-digit inflation and a plunging dollar heightened national anxiety in the late 1970s. Along with the rise of Japan to global economic prominence, these forces drew the United States into a policy toward that country that was unique in US experience.

The intensity of this Japan-specific US policy accelerated sharply in the middle 1980s with the crisis in overall US trade policy that then developed (Kunkel 2001). The sharp increase in US budget deficits during the first Reagan administration, coupled with the rise in interest rates that was necessary to overcome the double-digit inflation of the late 1970s, produced a dramatic rise in the value of the dollar and record increases in the US trade and current account deficits, of which the largest share by far was with Japan. The huge dollar overvaluation, especially against the yen, drastically altered the politics of US trade policy—with a sharp rise in the number of industries seeking import relief and a sharp fall in the export interests that resisted such proposals. Key members of Congress opined that “the Smoot Hawley tariff itself would have passed overwhelmingly had it come to the House floor” at that time.

Under the leadership of his new secretary of the treasury, James Baker, President Reagan reversed his foreign economic policy to head off such a risk, with both the Plaza Agreement to drive down the dollar and a “tough” new trade policy to show Congress that he could be trusted to “defend American interests.” Japan—as the main surplus counterpart to the US deficits and the primary threat to US economic supremacy—was the chief target of these actions, and the unique US policy toward that country was ratcheted up further. This intensified pressure persisted for most of the next decade, through the Clinton administration’s effort on autos and auto parts, until it ran aground in the middle of 1995.

Clear evidence of a new US attitude toward Japan can be observed in the second half of the 1990s. As the US economy regained its competitiveness and noninflationary growth shifted into high gear in the middle of the decade, the United States—despite rapid increases in its trade and current account deficits—relaxed its attack on Japanese trade policies and even substantially scaled back its assault on Japanese structural rigidities. The United States—motivated especially by the onset of the Asian financial crisis, and by Japan’s huge fiscal and monetary policy errors—launched a renewed effort to influence Japanese macroeconomic and financial-sector policies in 1997-98, but even those initiatives waned as the decade came to a close. The new Bush administration in 2001 essentially maintained the policy toward its chief Pacific ally that it had inherited, if anything downplaying the economic issues even further relative to security concerns, indicating that the sense of renewed confidence continued despite the sharp slowdown in US economic expansion.

These changes in the US attitude were well founded. The focus of the early Clinton administration on Japanese trade policies, especially

concerning such products as semiconductors and automobiles, were based on “strategic trade theory” concerns that those policies could severely harm important US industries and even the entire US economy (Tyson 1992). When it turned out that the relevant US industries were doing quite well and in fact contributing substantially to the resurgence of the overall US economy, with at best modest help from the trade policy initiatives, the salience of such initiatives waned perceptibly. Even more important, the overall US economy surged dramatically, despite the absence of much help from these initiatives—indeed, when the Japanese economy as a whole was stagnating and thus *dampening* global growth. When it also turned out that the initiatives were likely to bear little fruit (as will be analyzed in chapter 5), they were dropped precipitously after the middle of 1995.

The renewed US attention to Japanese financial and macroeconomic policies in the late 1990s reflected a new and opposite concern: that Japan’s economic *weakness* could adversely affect the United States (and the world as a whole). There were widespread fears in 1997-98 that Japan’s relapse into recession, compounding and compounded by the Asian crisis, could jeopardize US and global economic growth. The severe structural weakness of the Japanese banking system, in particular (as will be described in detail in chapter 3), posed a threat to regional and even global stability.

Hence the United States, with increasing force and public criticism, sought major changes in Japanese fiscal, monetary, and banking policy. But the US and world economies subsequently accelerated, to their most rapid growth in 30 years, without much improvement in Japanese performance. Most of the East Asian countries recovered from their crises, despite continued weakness in the largest economy in the region. Thus the United States was able to throttle back its concerns about Japanese weakness in the late 1990s, as it had previously throttled back its concerns about Japan’s strengths in the earlier period. The world had clearly learned how to prosper despite a decade of stagnation in Japan, and US concern over Japan’s prospects increased only modestly, even with the sharp slowdown in US and global growth after the middle of 2000.

The strong US economic performance of the late 1990s simultaneously muted most of the domestic political pressure in the United States to restrict US markets for Japanese products. US economic strength, coupled with the strong performance of US exports throughout the 1990s—except for the period of the Asian crisis—dampened the pressure to open Japan’s market to US products even more. In particular, the steady reductions in unemployment to their lowest levels in 30 years greatly weakened the political impact of pleas for special help from the government *vis-à-vis* Japan.

Steel was the sole exception among major industries (see box 4.2). A series of antidumping actions were taken on steel in the late 1990s and

an import quota bill for steel did pass the House of Representatives in early 1999 (but was soundly rejected by the Senate and clearly would have been vetoed by President Clinton) (Hufbauer and Wada 1999). President Bush initiated an “escape clause” case for steel in early 2001 (Hufbauer and Goodrich 2001). But no other import restrictions against Japan were seriously considered, and the intensity of the US pressure on Japan to further open its markets—even for such previously “politically sensitive” products as semiconductors and auto parts—waned appreciably.

Even the sharp slowdown in US growth, and modest increases in unemployment (with much larger increases in *manufacturing* unemployment) that began in the middle of 2000, had generated very little protectionist or mercantilist pressure against Japan by the middle of 2001. To be sure, generalized antiglobalization pressures remained strong—as they had throughout the boom years of the late 1990s. Most of those pressures, however, were aimed at “low-wage countries” such as Mexico (in the NAFTA debate) and China (in the debate over its entry to the WTO and US granting of permanent normal trade relations), and at countries with allegedly low labor and environmental standards. Japan met none of these criteria, even in the view of those most aggressively against globalization.

In addition, the combination of the US economic slowdown and record trade deficits produced a surge of concerns in the middle of 2001 by US industry, labor, and agriculture over the adverse effect on US competitiveness of the continued strength of the dollar. Even there, however, the calls for remedial action were generalized and aimed more at the euro than, as in past periods, at the yen. There was even some sympathy for the weakness of the yen in view of Japan’s continued travails and its desperate need to find a vehicle to promote the recovery of its own economy.

This reduction in US pressure on Japan was particularly noteworthy in that one of the traditional sources of such pressure was increasing steadily, and in fact reached its *worst* position in history: the US trade and current account deficits, both globally and bilaterally with Japan itself (see figure 4.1). Historically, increases in US bilateral deficits have been the most accurate “leading indicator” of trade disputes with individual countries, especially Japan (Noland 1997a). The largest runups in those deficits have produced the most aggressive US attacks on Japanese economic policies in the postwar period: the import surcharge of 1971; the “locomotive” approach of the late 1970s, which sought major changes in Japanese macroeconomic policies to stimulate global growth and to reduce the US imbalance; and the reversal of Reagan policies in 1985, which produced the first “managed-trade” agreement (in semiconductors) and the infamous Section 301 authority for unilateral retaliation against countries (especially Japan) that did not open their markets to US products,

along with the Plaza Agreement, which produced a 50 percent depreciation of the dollar against the yen. Yet the recent escalation of US external deficits, to annual rates of about \$450 billion and 4.5 percent of GDP, coexisted with the significant *cooling* of tensions described above.

It must of course be noted that the persistence, and even the growth to record levels, of the external deficits had several *beneficial* effects on the US economy during the boom period of the late 1990s (Bergsten 2001b). The rising dollar, which was an important cause of the increasing deficits, and rising net imports themselves dampened import prices. This in turn checked prices of competitive domestic products and helped restrain inflation, perhaps by 1 percentage point a year (Rubin 2000). This reduction of inflation in turn helped restrain interest rates, perhaps by 1-2 percentage points. The net capital inflows that both caused and financed the current account deficit also further moderated interest rates and helped facilitate the sharp increases in investment that fueled the boom. The administration and the Federal Reserve could never publicly admit that they welcomed the trade deficits—though the administration did constantly extol the virtues of a “strong dollar”—but the deficits’ positive contribution to the strong performance of the economy undoubtedly limited their zeal for attacking Japan’s contributions to it.

Moreover, Japan’s share of the US global deficit fell sharply during the 1990s. Japan consistently accounted for about half of the US worldwide imbalance before 1992 (see figure 4.1)—partially explaining why the aggressive US trade initiatives of the earlier period were aimed so clearly in its direction. But that number fell steadily to about 20 percent in 1999. Moreover, in at least some time periods, China replaced Japan as the single largest counterpart of the US deficits.¹ Japan’s external surplus, though still sizable, in fact *declined* steadily in late 2000 and the first half of 2001, while the US deficit remained near record levels. Hence, another traditional source of Japan-US economic tension has moderated substantially during the past decade.

The reliability of this analysis—which suggests that the juxtaposition of US economic difficulties and strong Japanese performance explains much of the economic conflict between the two countries for a quarter-century—is complicated by the fact that there is no earlier period of comparable US economic strength after Japan had become a major global player and thus a serious competitor of the United States. The only prior period of prolonged US economic expansion in the postwar era came during the 1960s, when Japan was still regarded as a poor if rapidly developing country. Indeed, President John F. Kennedy, in seeking Congressional approval to negotiate the Kennedy Round of multilateral trade

1. The US data, however, clearly overstate the magnitude of its bilateral deficit with China (Lardy 1994; Hufbauer and Rosen 2000).

liberalization in 1961, cited as a rationale “the need for new markets for *Japan and the developing nations*” (italics added) (Preeg 1970). As we will see below, US industry in fact failed to recognize the rise of Japan (and Europe) by the end of that decade, and thus let its own competitiveness slip to a point that severely weakened the US economy for the next decade or so.

During the steady rise of Japan to global prominence in the 1970s and 1980s, however, the US economy was experiencing an extremely difficult period. Labor productivity growth dropped sharply, from the 3 percent annual rate of the first postwar generation to about 1.5 percent during the period 1975-95 (table 2.1), and overall economic growth declined correspondingly. Average unemployment in the United States exceeded 6 percent in the 1970s and 7 percent in the 1980s, in comparison with the 4.5-4.8 percent rates of the 1950s and 1960s and a “full-employment norm” of about 4 percent. Average real wages stagnated during this entire period, and actually declined for the lowest two quintiles of the labor force. Double-digit inflation became rampant in the late 1970s and early 1980s, and interest rates correspondingly soared above 10 percent.

This extended period of mediocre US economic performance correlates almost perfectly with the onset, and maintenance, of an extremely aggressive US foreign economic policy toward Japan—commencing with the “Nixon shocks” in the early 1970s through the Clinton Framework Talks that extended into the middle 1990s. The adoption and maintenance by the United States of a unique “Japan policy” in the economic sphere for more than two decades thus seems to have been primarily the result of an equally unique historical coincidence—an extended period of travail for the US economy, coupled with the dramatic rise to global prominence of the Japanese economy at the same time, exacerbated by the intense interaction between the two, including the very sizable aggregate imbalance in their trade positions throughout the period.

There is of course an alternative hypothesis: that it was Japan’s weak economic performance in the 1990s, rather than strong US results, that primarily induced (and politically enabled) the United States to relax its pressures on Japanese policies. That weakness has been evident both at the macroeconomic level and in the failure of much of Japanese industry to exploit high value-added areas of the “new economy.” This development (which will be analyzed in depth in chapter 3) is undoubtedly an element in the equation as already emphasized. Indeed (as was noted in chapter 1), a “bypass-Japan” mentality has come to influence parts of US industry, and is part of the thinking of some US authorities.

However, some of the leading firms in Japan’s dynamic internationally competitive sector—its Sonys and Toyotas—have maintained or even strengthened their global positions, even as Japan’s overall economy has suffered its “decade of decline.” There has been very little, if any, letup

Table 2.1 The growth of US labor productivity, the labor force, GDP, and the unemployment rate, 1960-2000
(annual growth rate, percent)

Year	Productivity ^a	Labor force ^b	GDP growth	Unemployment rate
1960	1.9	0.7	2.5	5.5
1961	3.7	0.2	2.3	6.7
1962	4.6	1.6	6.0	5.5
1963	3.9	1.9	4.3	5.7
1964	4.6	2.3	5.8	5.2
1965	3.6	3.2	6.4	4.5
1966	4.1	2.3	6.6	3.8
1967	2.2	2.4	2.5	3.8
1968	3.1	1.7	4.8	3.6
1969	0.5	2.6	3.1	3.5
1970	2.0	-0.2	0.2	4.9
1971	4.4	2.4	3.1	5.9
1972	3.3	3.6	5.3	5.6
1973	3.2	3.6	5.7	4.9
1974	-1.7	-0.3	-0.3	5.6
1975	3.5	0.6	-0.3	8.5
1976	3.6	3.6	5.2	7.7
1977	1.6	4.8	4.5	7.1
1978	1.1	3.7	5.7	6.1
1979	0.0	2.4	3.4	5.8
1980	-0.3	-0.3	0.0	7.1
1981	1.9	0.0	2.5	7.6
1982	-0.4	-0.6	-1.9	9.7
1983	3.6	4.0	4.2	9.6
1984	2.8	3.1	7.3	7.5
1985	2.0	1.9	3.9	7.2
1986	3.0	2.3	3.4	7.0
1987	0.5	2.8	3.5	6.2
1988	1.2	2.0	4.2	5.5
1989	1.0	1.5	3.5	5.3
1990	1.3	0.3	1.7	5.6
1991	1.1	-0.7	-0.2	6.8
1992	3.9	1.3	3.3	7.5
1993	0.5	2.1	2.4	6.9
1994	1.3	2.7	4.0	6.1
1995	0.7	0.3	2.7	5.6
1996	2.8	2.2	3.7	5.4
1997	2.3	2.2	4.4	4.9
1998	2.7	1.4	4.3	4.5
1999	2.5	1.4	4.1	4.2
2000	3.1	1.0	4.1	4.0
Averages				
1960-74	2.9	1.9	3.9	5.0
1975-95	1.6	1.8	3.0	7.0
1996-2000	2.7	1.7	4.1	4.6

a. Labor productivity is the output per hour of all persons in the business sector.

b. Labor force is the civilian labor force, age 16 years or older.

Sources:

Productivity growth: US Department of Labor, Bureau of Labor Statistics, <http://www.access.gpo.gov/usbudget/>. *Labor force growth:* US Department of Labor, Bureau of Labor Statistics, <http://www.access.gpo.gov/usbudget/>. *GDP growth:* US Department of Commerce, Bureau of Economic Analysis, <http://www.access.gpo.gov/usbudget/>. *Unemployment:* US Department of Labor, Bureau of Labor Statistics, <http://www.access.gpo.gov/usbudget/>.

of the pressure they have brought to bear on their US competitors and the US economy. Indeed, we will suggest below that this continued pressure—along with similar pressure from other foreign competitors—has been a major positive factor inducing the rising productivity and hence strength of the US economy during this period. Moreover, unlike the earlier period of Japanese weakness and US strength during the early postwar years, Japan is now a rich country whose per capita income, depending on market exchange rates, has at times considerably exceeded that of the United States.

The most directly international measure of Japan's economic prowess—its global trade and current account surpluses—in fact rose to record highs in 1993-94 and continued to exceed \$100 billion annually, even as they declined into the earliest part of the 21st century. These surpluses derived partly from Japan's economic weakness, both its stagnant domestic economy (which dampened demand for imports) and the periodic depreciations of its currency. But the surpluses also reflected the continued competitive strength of Japanese manufacturing. The persistent and growing strength of the United States provides a much more plausible explanation than Japan's weakness for most of the reduction in US pressure on Japan, though the latter was clearly a contributing factor.

Any projection of the future Japan-United States economic relationship—and especially any prescriptions for its conduct—thus must be rooted in a judgment concerning the course of the US economy for at least the next few years. (It must also be rooted in a parallel judgment concerning the Japanese economy, to which we will turn in chapter 3.) Renewed strong US performance, particularly with continued low levels of unemployment, would probably presage a continued lower level of US anxiety concerning Japan. This would not suggest a new era of "benign neglect," however, because the US external deficit will almost certainly require correction at some fairly early point, because politically sensitive and powerful US sectors will continue to face tough competition from their Japanese counterparts, and because Japanese *weakness* could cause as much (or more) trouble for the United States than Japanese strength—including for adjustment of the US deficit, because that would inevitably *add* to the pressures on the Japanese economy. Moreover, a relapse by the United States to its mediocre economic record of the 1970s and part of the 1980s, especially with rising unemployment, could trigger renewed aggressiveness toward Japan (and other parts of the world). Hence we now turn to an assessment of the outlook for the US economy.

Sources of the US Economic Resurgence

Writing in the middle of 2001, after the sharp slowdown that began in the middle of 2000 and persisted for at least a year, it is clearly premature

to attempt a definitive analysis of the resurgence of the US economy in the late 1990s and its likely future course. During the second half of the decade, however, the US economy surprised most observers with the acceleration in its growth and job creation to unanticipated levels without triggering significant inflation. It has grown for almost 20 years, except for a very short recession in 1990-91, and for more than 10 years without interruption (despite the sharp slowdown from mid-2000 to at least mid-2001). There is a rising consensus on the causes of, and the future prospects for, this remarkable record—but nothing that could yet be called “conventional wisdom.”

In addition, it is worth remembering that no one foresaw the strength and sustainability of this US expansion. Even discounting the doomsayers and “American declinists,” some of whom saw Japan as dominating the world economy by now, there was no contemplation of anything like the magnitude and duration of the US rebound. It must also be noted that the United States, during all this progress, was still viewed by some as a “bubble economy” that could burst at any time, as Japan did a decade ago—and that the precipitate decline in the NASDAQ, along with the lesser but substantial declines in the broader market indices, provide at least modest support for that view. In addition, the large and growing external deficit suggests that, at some point, the dollar could fall sharply and cause substantial disruption, as it has on three previous occasions during the postwar period.

Even if no such immediate problems eventuate, it is also clear that the United States continues to face daunting economic and related social problems—such as low private savings, an inadequate primary and secondary education system, substantial income inequality, and an extended period of wage stagnation that only began to disappear in the later stages of the boom of the 1990s. Any temptation toward US triumphalism must thus be tempered by the shortcomings that could disrupt future progress in both the short and long runs. Nevertheless, the recent record is impressive, and we turn to a necessarily tentative analysis of its sources as a basis for attempting to judge the likely future course of the economy—with its significant, perhaps decisive, impact on US economic relations with Japan.

Three factors seem to account for most of the US resurgence. The first is the sharp pickup in labor productivity growth, from less than 1.5 percent annually during the period 1975-95 to about 2.5 percent in the second half of the 1990s, which in turn seems to derive largely from the commercialization of the new information technologies and the competitive pressures of globalization. The second major change is the structural shift of the federal budget from large deficit to large surplus, which produced part of the needed boost in national savings, enabling real interest rates to decline substantially and thus to promote private investment. There

are cyclical elements in both these shifts: productivity always picks up during an expansion, the expansion itself helps to strengthen the fiscal position, and both have faltered during the slowdown of 2000-01. Both productivity and the budget have clearly experienced substantial underlying improvement, however, even when all short-term factors are taken into account.

The third key element in the economy's improvement is the superb conduct of monetary policy during the past two decades by the Federal Reserve under the leadership of Paul Volcker and Alan Greenspan, which has quelled rapid inflation and then permitted the expansion to proceed without premature tightening of monetary policy. One additional result of these sea changes in fiscal and monetary policy has been the restoration of a high degree of flexibility for the future; monetary and/or fiscal stimulation can now be deployed to counter almost any significant deterioration in economic prospects or any abrupt crises, and thus is available to keep the expansion going even if it should be hit by negative shocks. Both types of stimulation were of course used promptly in 2001, with precisely this goal in mind.²

Increased Productivity Growth

Sustainable growth of course rests on increases in productivity of the economy (see box 2.1 for the relevant definitions and concepts). The underlying cause of the slow growth of the US economy from the early 1970s to the middle 1990s was the sharp slowdown in the growth of labor productivity to less than 1.5 percent a year from about 3 percent annually throughout the first postwar generation (table 2.1). With labor force growth at 1 to 1.5 percent a year, economic growth thus averaged only 3 percent. Such growth was adequate to bring unemployment below 6 percent for only 4 of those 20 years, and it averaged close to 7 percent during the two decades—far higher than in the previous quarter-century. Indeed, many economists believed as late as the middle 1990s that the US growth potential had dropped to annual rates of 2 to 2.5 percent.

Starting in about 1996, however, labor productivity increases rose sharply, to an average of 2.7 percent a year (table 2.1). Total factor productivity growth—the best single measure of the underlying efficiency of the economy—rose even more sharply (especially if the special computer sector is excluded) (CEA 2001). Economic growth thus rose sharply, to an average of 4.1 percent in the second half of the 1990s (table 2.1). Domestic demand growth averaged almost 5 percent annually during

2. Lindsey (2000) instead attributes “America’s 17-year boom” to deregulation, cuts in marginal tax rates, “supply-side” management of capital and labor, and a “revolution” in capital markets. These factors, especially deregulation, have undoubtedly contributed to the rise in productivity growth, but the elements cited in the text appear to be more important.

Box 2.1 Productivity concepts and definitions

Economists typically use two primary concepts of productivity: labor productivity and total factor productivity (TFP). Labor productivity equals real output per hour of work or per employee. It thus incorporates all contributions to output except for the quantity of labor itself. The three main components of labor productivity growth are capital deepening (i.e., increased investment), changes in labor quality (as firms substitute toward workers with more skills) and TFP—which includes everything else.

The growth of labor productivity plus the growth of the labor force equals output growth, at least during prolonged periods. At the same time, the increase in labor productivity equals the growth of real wages (and approximates the growth of per capita income). There is also a considerable negative correlation between growth in labor productivity and inflation. Hence changes in labor productivity are central to an economy's performance.

But we obviously want to know more about the underlying sources of growth in labor productivity, and this is where TFP becomes important. TFP is defined as real output per unit of all inputs and is essentially the amount of output growth not explained by the measured growth of capital and labor. It is frequently interpreted as a proxy for technology, which is important and certainly included, but TFP also picks up such phenomena as increasing returns to scale, reallocation from low- to high-productivity activities, and improvements in organizational structures and management techniques. It is thus the best aggregate measure of the total efficiency of an economy and must play a central role in any assessment of a country's underlying strength and improvement, especially during a period of rapid technological and management change (including due to globalization), such as that experienced by the United States in the late 1990s. (This description draws heavily on Steindel and Stiroh [2001]. See their excellent paper for more details.)

1997-99, and productivity growth accelerated *after* a half-decade of growth for the first time in the postwar period. About 16 million jobs were created in the 1990s. Unemployment declined steadily, to just above 4 percent by early 1999, and remained there until early 2001.

The comparison between productivity growth in the United States and in other countries in recent years is noteworthy (table 2.2). During the 1980s and the first half of the 1990s, labor productivity growth was slower in the United States than in every other G-7 country except Canada—and was about one half that of Japan. In the latter half of the 1990s, labor productivity growth was higher in the United States than in all other G-7 countries—especially including Japan (Gust and Marquez 2000).

The crucial questions, of course, are why productivity growth accelerated so sharply and whether that acceleration is likely to prove sustainable. Expert analyses diverge at this point. Gordon has argued that virtually all of the pickup occurred in durable manufacturing, including in the information technology sector itself, and that very little impact of the “new economy” could be seen “in the remaining 88 percent of the economy” (Gordon 2000, 50). Conversely, Jorgensen and Stiroh find that total factor

Table 2.2 Average growth rate of productivity in Group of Seven countries, 1981-99

Country, region, and productivity estimate	1981-89	1990-98	1990-95	1996-98	1996-99
Australia					
Labor productivity	1.45	2.37	1.79	3.52	3.12
Capital deepening	0.45	0.82	0.64	1.16	1.06
TFP	1.01	1.57	1.15	2.41	2.11
Canada					
Labor productivity	1.42	1.26	1.34	1.10	0.92
Capital deepening	1.31	0.96	1.08	0.73	0.67
TFP	0.14	0.31	0.26	0.69	0.27
France					
Labor productivity	3.41	2.12	2.26	1.86	1.61
Capital deepening	1.10	1.09	1.35	0.57	0.05
TFP	2.26	1.03	0.89	1.31	1.12
Germany					
Labor productivity	n.a.	2.13	2.26	1.96	2.14
Capital deepening	n.a.	1.09	1.22	0.91	1.06
TFP	n.a.	1.03	1.02	1.04	1.07
Italy					
Labor productivity	2.33	2.09	2.72	0.81	0.67
Capital deepening	0.87	1.18	1.36	0.82	0.82
TFP	1.45	0.88	1.32	-0.01	-0.14
Japan					
Labor productivity	3.12	2.48	2.89	1.64	2.07
Capital deepening	1.15	1.44	1.56	1.21	1.23
TFP	2.00	1.03	1.31	0.46	0.85
United Kingdom					
Labor productivity	3.37	1.72	1.78	1.60	1.47
Capital deepening	0.42	0.53	0.57	0.44	0.54
TFP	2.90	1.20	1.21	1.18	0.95
United States					
Labor productivity	1.59	1.78	1.47	2.42	2.57
Capital deepening	0.73	0.77	0.68	0.96	1.11
TFP	0.86	1.01	0.79	1.46	1.47
Of which, labor quality	0.34	0.39	0.42	0.32	0.31
OECD					
Labor productivity	1.31	1.43	1.02	2.26	2.30
Capital deepening	0.25	0.24	0.16	0.40	0.54
TFP	1.09	1.20	0.85	1.91	1.80

n.a. = not available.

OECD = Organization for Economic Cooperation and Development.

TFP = total factor productivity.

Note: The sum of capital deepening growth and MFP growth does not always add up to labor productivity growth because of rounding errors. Measures of labor productivity, capital deepening, and MFP are those in Oliner and Sichel (2000), plus their estimated growth of labor quality.

Source: Gust and Marquez (2000).

productivity growth has tripled and that capital deepening has increased substantially as well. They reject Gordon's view and conclude instead that productivity growth has extended beyond information-technology-producing industries, which "could be interpreted as evidence of a new economy," and that the US economy "has undergone a remarkable transformation" and "may be recuperating from the anemic productivity growth of the past two decades" (Jorgensen and Stiroh 2000, 152, 160, 129).

Moreover, the US Council of Economic Advisers found through a series of industry analyses that "the spread of information technology throughout the economy has been a major factor in the acceleration of productivity" (CEA 2001, 33). Its studies showed "striking evidence of improvement" in wholesale and retail trade, financial institutions as a group, and some other components of the services sector. It concludes that "improved business practices and more-productive use of information technology have played an important role in the acceleration of productivity" (CEA 2001, 31).

An even more optimistic analysis has been offered by Greenspan (2000). Noting the "serendipitous emergence of a once- or twice-in-a-century surge in technology" and "the virtually unprecedented surge in innovation that we have experienced over the most recent half decade," he concludes that "capital deepening has surged during the past seven years and innovations, synergies, and networking effects have boosted significantly the growth of multifactor productivity." He rejects Gordon's view that the productivity increase has been narrowly based, arguing instead that "virtually every part of our economic structure is, to a greater or lesser extent, affected by the new innovations" and that "there is, with few exceptions, little of a truly old economy left."

Related to, but even more important than, the resolution of this debate over the breadth of the productivity pickup is its future outlook: whether it has largely been completed or, to the contrary, might still be at an early stage. The latter view has been espoused by Greenspan, who has stressed "the continuing acceleration of productivity" and that "credible evidence that the rate of structural productivity growth has stopped increasing is still lacking." Virtually all industries, in services as well as manufacturing, are now deeply into the process of applying the new technologies to their endeavors. Historically, it has taken surprisingly long periods to commercialize the new technologies of the day—which would explain the delayed payoff to the US economy and suggest that more, perhaps considerably more, might still be ahead.

Conversely, the official projection of the Council of Economic Advisers in early 2000 saw labor productivity falling from its pace of nearly 3 percent in the previous years (as then estimated) to an average of 2 percent for 2000-10 and slightly less toward the end of the decade (CEA 2000, 85). Gordon believes that the cyclical effect accounts for half a percentage

point of the productivity pickup and that further gains from computer investment are unlikely; indeed, he concludes that “the greatest benefits of computers lies a decade or more in the past, not in the future” (2000, 50).

But several careful analyses of the productivity pickup, some even taking account of the sharp economic (and thus productivity) slowdown of mid-2000 to mid-2001, conclude that there was very little cyclical contribution to the dramatic rise of 1995-2000 (Baily 2001; Basu, Fernald, and Shapiro 2001; CEA 2001). Even Gordon has acknowledged that “only a few years ago the consensus was that potential GDP was growing at a 2¼ percent annual rate (whereas) now the debate is whether that rate is 3½ or 3¾ percent . . .” (BPEA 2000; Baily 2001, table 2, summarizes and compares the remarkably similar conclusions of the major studies on this topic). Jorgensen and Stiroh, while noting that the sustainability of recent growth trends “hinges to a great degree on the prospects for continuing progress, especially in the production of semiconductors,” conclude that “upward revisions of growth projections seem a reasonable response as evidence accumulates of a possible break in trend productivity growth” (Jorgensen and Stiroh 2000, 184-85).

Gordon’s own suggestion that only half a percentage point of the recent growth upturn was cyclical leaves room for a significant upward revision of the potential growth rate. Even the earlier and lower CEA and other estimates of early 2000 would still see the economy growing at 3 percent annually. The chief author of the CEA analysis, taking into account the stellar productivity performance in 2000 as well as the downturn after mid-2000, and acknowledging that some of the pickup in productivity growth may have been temporary rather than structural, more recently has projected a sustainable economic growth rate of 3-3.5 percent (Baily 2001, 12). It thus seems likely that US growth has moved to a considerably higher plane and will provide a much stronger foundation for the country’s foreign economic policy, most notably toward Japan.

Globalization

The prospect for continued solid US expansion is strengthened by the even greater likelihood that globalization, the second major spur to the pickup in productivity growth, is still at an early stage. Most of this increased globalization of the US economy has of course resulted from the technological revolutions in transportation, communications, and the rest of the global infrastructure, although steady reductions in trade barriers have also been an important factor. Globalization plays an important, if often underappreciated, role in the US economic resurgence because its rapid onset in the United States has been a major spur to the competitive improvement of the private sector, by far the leading source of the productivity surge (Richardson and Lewis 2001).

The United States has in fact globalized extremely rapidly. The share of external trade in US GDP has almost tripled since 1960, increasing US openness to a level that approximates that of the European Union (as a group) and exceeds Japan (see figure 1.3). As a result, US firms realize that they are now competing in a truly global economy. Complacency permeated US industry after the extended economic expansion of the 1960s, the only postwar parallel to the present experience, because it still viewed itself as operating in a largely self-contained continental economy. Such complacency is of course nowhere to be seen at present. Indeed, US firms—whether in the tradable or nontradable sectors—continued to make constant efforts to expand their efficiency throughout the domestic boom of the late 1990s.³

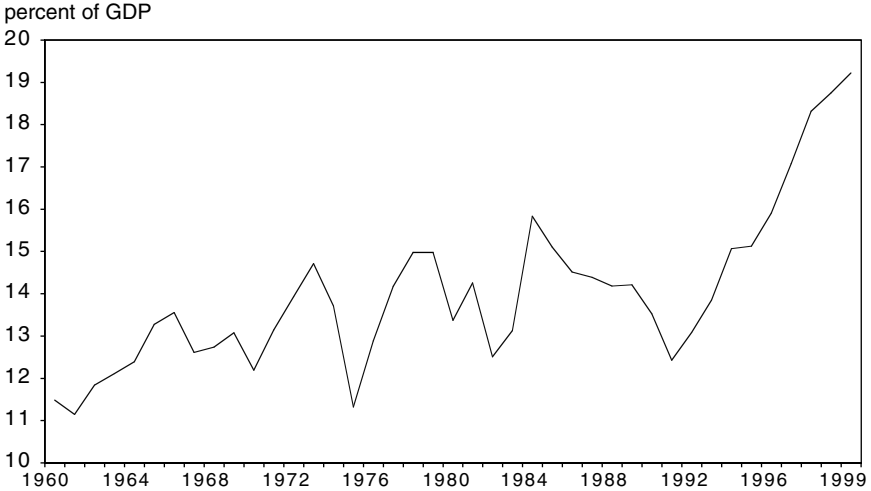
The competitive pressures of globalization have clearly improved the labor productivity of US firms. In addition, the antiinflationary impact of globalization—both its short-run effect through the stronger dollar and trade deficit, cited above, and its permanent impact through greater openness for the economy—accounts for part of the pickup of economic growth.

Most of this source of improved US growth is structural and likely to continue. It could even accelerate, because globalization is still at an early stage. Studies show that national borders still matter a great deal in determining international commerce, even between Canada and the United States—with their close geographic proximity, linguistic and cultural similarity, and free trade area for more than a decade (Helliwell 1998). Additional countries are participating effectively in international trade and finance. Competitive pressures from globalization are likely to increase rather than diminish.

The main risk to the outlook in this area is the political backlash against globalization. This has been especially manifest in the United States, blocking most further reduction of its own trade barriers (and therefore any serious multilateral liberalization) since 1994, despite the strength of the US economy. The Congressional split over the issue mirrors a fundamental split in public opinion, which is based largely on a deep division along educational lines between more- and less-skilled workers (Scheve and Slaughter 2001). A small but significant number of workers do in fact suffer substantial lifetime earnings losses from job dislocation in trade-intensive sectors (Kletzer 2001), and others fear that “there but for the grace of God go I.” Hence the backlash could escalate if unemployment were to rise, especially with the trade deficit at such sizable levels, and impede the continued expansion of globalization, which is otherwise quite likely and which has been so beneficial.

3. Baily notes that “intense global competitive pressure helps companies looking for ways to cut costs and raise productivity” (2001, 33).

Figure 2.1 Investment as a share of US GDP, 1960-99



Note: The figure represents gross private domestic investment as a share of GDP.

Source: US Department of Commerce, Bureau of Economic Analysis.

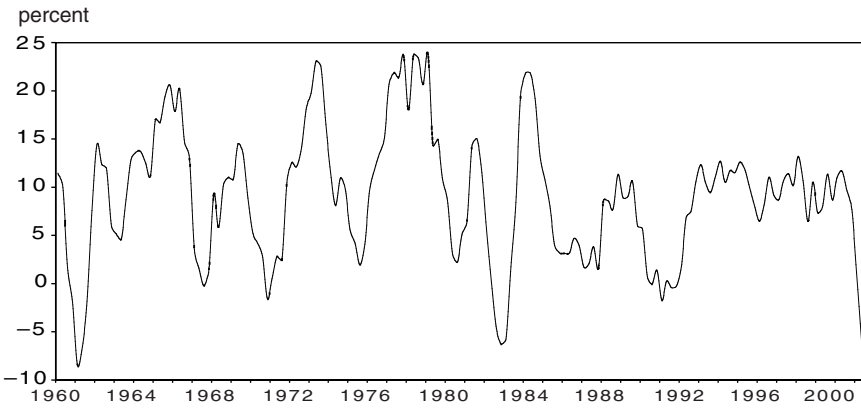
Savings and Investment

As noted above, capital deepening has been an important component of the sharp pickup in US productivity growth. Economic expansion requires increased investment, as well as more efficient investment, and US investment as a share of the economy rose substantially during the 1990s (figure 2.1). Indeed, real business outlays for equipment and software grew at double-digit rates for an unprecedented period of almost 10 years (figure 2.2).

Many of the competitiveness studies of the 1980s and early 1990s called for major changes in US tax and other policies to induce more investment (Competitiveness Policy Council 1992). The main change that actually occurred was the dramatic reversal in the budget posture of the US government, which took considerable pressure off the financial markets and left US interest rates considerably lower than they otherwise would have been. This presumably spurred a great deal of the pickup in private investment that has now been recorded.

The budget reversal, the second major source of the economic resurgence of the 1990s, is perhaps as remarkable as the pickup in productivity growth. The federal deficit reached almost \$300 billion (4.7 percent of GDP) as recently as fiscal 1992. It was transformed into a surplus of almost \$240 billion (almost 2.5 percent of GDP) in fiscal 2000. Hence the budget improved by an average of 1 percent of GDP a year for 7 years—a pattern of achievement in the United States that we will be proposing for adoption

Figure 2.2 US investment in nonresidential equipment and software, first quarter of 1960 through second quarter of 2001 (percent change from four quarters earlier)



Note: The data for nonresidential equipment and software were calculated by multiplying chain-type quantity and price.

Source: Department of Commerce, Bureau of Economic Analysis.

by Japan in chapter 3. The latest projections for the next decade cumulated to a unified surplus of more than \$4 trillion before the tax cut of early 2001, about half linked to Social Security and the other half outside that context. The outgoing Clinton administration in fact projected a total elimination of the national debt (still close to \$3.5 trillion) by 2012, although the tax cut has now eliminated that possibility, and many experienced observers doubted that such a cumulation of budget surpluses would ever take place in any event.

The direct impact of this swing in the federal budget position is of course to increase total national savings. During the same period, however, personal savings dropped considerably—from 8.7 percent of GDP in 1992 to 2.4 percent in 1999.⁴ Some of this decline presumably reflects the sharp rise in asset prices during the same period, notably for equities and real estate, and does not indicate as much of a “real” decline as the official figures suggest. But national savings, as recorded in the national income accounts, have risen very modestly (about 2 percentage points of GDP) during a period when national investment has climbed sharply,

4. There has traditionally been an inverse relationship between public and private savings in the United States, with surprisingly small changes in their sum (net national savings). That relationship broke down in the 1980s, however, when both public and private savings declined. There had thus been some expectation that a reduction in public dissavings would *not* be offset by lower private savings but, at least to date, that has not occurred (at least in the recorded numbers).

requiring a large increase in net capital inflows from abroad. These two phenomena—low private (and hence national) savings and a rapid buildup of obligations to foreigners—are among the underlying problems that could threaten continued good US performance. They do not detract, however, from the major contribution that budget correction made to the record of the 1990s—and they in fact suggest that such a record might never have been compiled in the absence of such extensive fiscal improvement.

Monetary Policy

A third key contribution to the US economy in the 1990s was stable and effective monetary policy. The Federal Reserve took virtually sole responsibility for eliminating the inflationary excesses of the 1970s—needing in fact to counter the huge budget deficits of the 1980s, as well as the legacy of the oil shocks and excessively easy monetary policy in earlier periods—and had achieved most or all of its goal of restoring stable price expectations by the early 1990s. It remained vigilant on that front, however, tightening policy in 1994 and again in 1999-2000, when it feared that demand pressures were again outrunning supply and raising a threat to the low-inflation environment it had created so successfully.

The Fed's other major contribution to the US economic success of the 1990s was its willingness, for most of the decade, to let unemployment decline to a steady succession of new 30-year lows without taking restrictive countermeasures. Few US economists, as recently as 5 years ago, believed that price stability could be retained if unemployment fell below 5.5 or even 6 percent.⁵ Most central banks, including most previous Feds, and most monetary economists would probably have tightened money far sooner than the Greenspan Fed. Chairman Greenspan had enormous faith in the productivity revolution that was taking place, however, as described above. He in fact believed that the official productivity data substantially underestimated actual developments (Davis and Wessel 1998), and thus pursued an approach that succeeded spectacularly in achieving both lower unemployment and continued price stability.

Future Risks

The US economic resurgence of the past decade thus rested on a sharp acceleration of productivity growth, driven primarily by the commercialization of new technological innovations and fundamental improvements

5. The most notable exception was the late Robert Eisner. Robert Solow also envisaged "experimentation" to see how low unemployment could fall without igniting price pressures.

in fiscal and monetary policy. However, the economy slowed sharply from the middle of 2000 to at least the middle of 2001; GDP growth dropped from 5-6 percent to about 1 percent. Hence new uncertainties arose about the outlook. Moreover, we know that the United States faces important risks and weaknesses, in both the short run and more structurally, with two particular vulnerabilities: the level of the stock market, even after the declines from the highs of early 2000, and the exchange rate of the dollar.

This book is of course about the medium-term to long-term economic relationship between Japan and the United States. Thus we are concerned about short-term swings in the two economies only to the extent that they alter our analysis of the underlying situation and hence the outlook over a longer horizon. The main lessons from the US turndown of 2000-01 for our purposes seem to be twofold: that both the rate of change and composition of the downshift closely resemble the typical US slowdown throughout the earlier postwar period, and that most of the causes of the slowdown seem to have been largely or wholly (or even more than wholly) reversed by the middle of 2001. Hence the evidence at the time of this writing in the middle of 2001 provides no reason for us to amend our basic optimism about the underlying strength of the US economy, even if future growth turns out to be less robust than the remarkable performance of 1997-99, and thus about the presence of a strong foundation for the US side of the Japan-United States economic relationship in the foreseeable future.

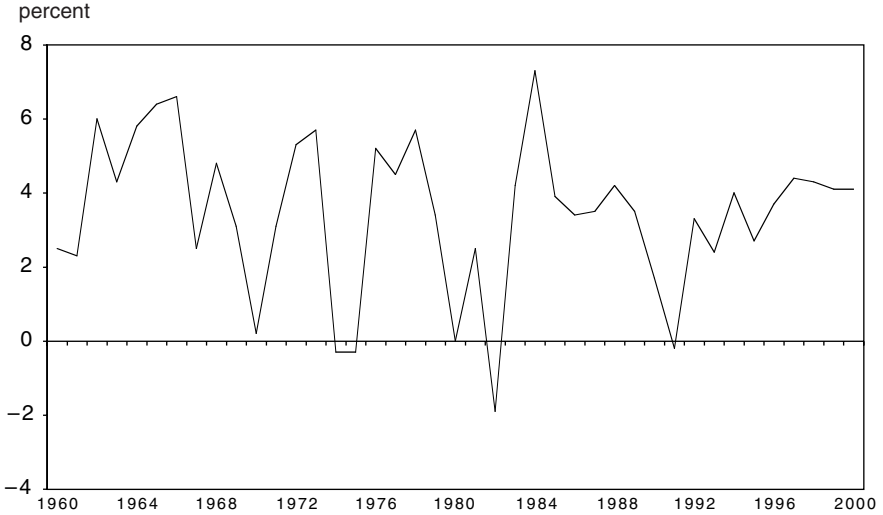
The United States typically experiences V-shaped cycles, with sharp declines in growth followed by rapid recoveries back to (or at least toward) the pre-slowdown rate (figures 2.3 and 2.4). In the latest case, growth dropped from an annual rate of 5.3 percent in the four quarters ending in June 2000 to 1.2 percent in the four succeeding quarters. This decline of 4 percentage points ranked near the middle of the 10 significant slowdowns experienced by the US economy during the postwar period.⁶

Likewise, the composition of the latest slowdown looks quite typical. The "contribution" of private consumption and equipment investment was quite similar to their "contribution" in the nine previous downturns. Inventory declines and falling government spending played a substantially larger role, partially offset by stronger than usual other investment (Baily 2001, table 8). All in all, there is no reason to believe that recent events carry any unusual implications for the long run.

This conclusion is reinforced when the causes of the slowdown are disaggregated. There were four key factors, each of which subtracted

6. Baily (2001, table 7). All but one of these other declines produced negative growth in at least two consecutive quarters, and hence a recession as conventionally described. The latest fall did not do so because the starting base was so high, higher in fact than in all but one of the earlier periods.

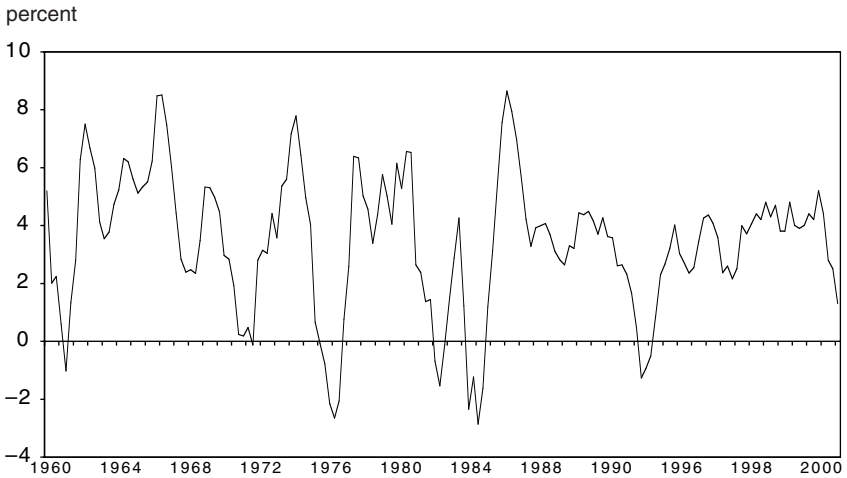
Figure 2.3 Annual growth of US GDP, 1960-2000



Note: Real GDP annual growth rate.

Source: US Department of Commerce, Bureau of Economic Analysis.

Figure 2.4 Quarterly growth of US real GDP, first quarter of 1960 through second quarter of 2001



Note: Real GDP growth, from the same quarter of the previous year.

Source: US Department of Commerce, Bureau of Economic Analysis.

roughly 1 percentage point from growth: the rise in world energy prices in 1999, the increase of 150 basis points in short-term interest rates by the Federal Reserve in late 1999 and early 2000, the wealth effects generated by the fall in the stock market, and the timing impact—positive for growth in 1999, negative in 2000—of the Y2K phenomenon. Each of those elements had changed substantially by the middle of 2001: world energy prices had dropped back to their long-run trend level, the Fed had *reduced* interest rates by 275 basis points and thus far more than offset the previous hikes, the broad equity indices (though not the NASDAQ) had recovered to within 10 percent or so of their historic highs, and the Y2K effect had dissipated. These causes of the slowdown were quite traditional and suggest that it is likely to follow the traditional US cyclical pattern, including a fairly early and reasonably solid recovery. This likelihood is reinforced by the income tax cut legislation of early 2001, which is projected to inject another 1 percent of GDP at an annual rate into the economy in the second half of the year and some continuing stimulus thereafter on an ongoing basis.

The Pessimistic View

There is, however, an alternative view of the slowdown of 2000-01 that has more worrisome implications for the long run (Makin 2001). This view emphasizes two interrelated phenomena: the possibility of continued reduced levels of private investment, especially in the high-technology sector, and the risk of a sharp fall in consumption stemming from the negative wealth effect caused by the sharp decline in the equity markets and the historically high level of consumer debt. Roach puts the view succinctly: an “American-style L” will produce growth of only 1.5-2 percent during 2001-03 as “the earnings recession deepens and labor cost-cutting intensifies . . . (so) the noose will slowly tighten on the saving-short, overly-indebted, and wealth-depleted American consumer” (2001).

The fundamental fear of this school of thought is that the exuberant investment boom of the late 1990s, which accounted for one-third of total US growth as opposed to its typical share of one-sixth (Makin 2001), left the US economy with substantial overcapacity. Hence investment will remain depressed for several years, both dampening economic growth in the short run and dropping productivity growth well below its late-1990s rates.

Such a sustained fall in investment would have two additional effects. One would be continued downward pressure on profits and hence on equity prices, reducing the prospects for an early rebound to their previous levels and possibly presaging further substantial declines. The other is upward pressure on unit labor costs, as output falls while unemployment levels remain relatively unchanged at first, but which shortly produces layoffs and higher unemployment.

In turn, these forces coalesce to trim consumer demand, the main bulwark of the economy throughout the first four quarters of the 2000-01 slowdown. Rising unemployment translates into slower growth of incomes. Stagnant or lower equity prices would sustain or worsen the wealth loss. The historically high levels of consumer debt would become more salient. Consumption weakness would join investment weakness in slowing the economy, perhaps through an extended period of stagnation (or even stagflation), if not outright recession.

There are of course responses to all these concerns. As noted above, the fall in investment during the 2000-01 slowdown was about the same as in the typical postwar recession—which usually ended in a sharp V-shaped rebound. It is true that household equity wealth fell by \$5 trillion from its peak in early 2000 to early 2001—but this came on the heels of a rise from \$8 trillion to \$18 trillion from 1995 to 2000, a huge gain whose impact is likely to swamp that of the partial retrenchment.⁷ Despite the rise in unemployment in early 2001, housing sales hit record levels, and automobile sales remained strong. The interest rate and tax cuts were of course intended to stimulate and reinforce precisely such effects.

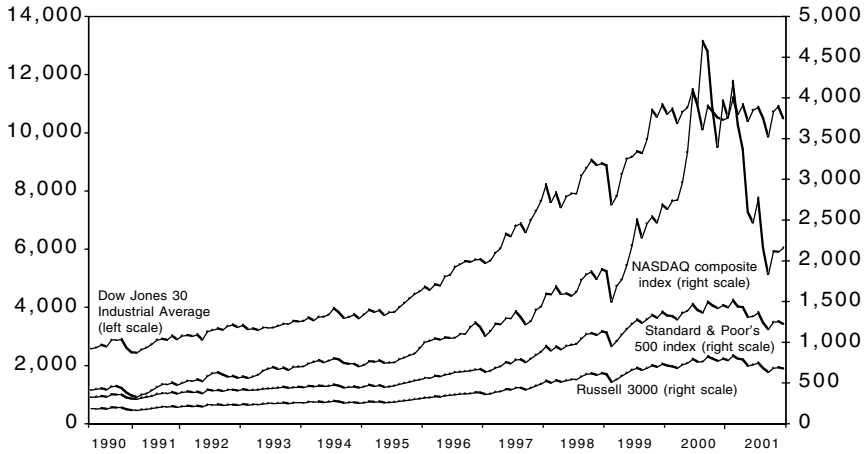
Key Uncertainties

Whatever one's view of the short-run prospects for the US economy, there clearly remain several key uncertainties. Most important, it is unclear at this juncture whether productivity growth will rebound to the 2.5 percent level, or even anything close to it, when overall economic growth picks up again. The sharp rise of 1996-2000 could turn out to have been a one-shot jump in the *level* of productivity, rather than a lasting increase in its *rate*. We simply will not know until the slowdown that began in the middle of 2000 has run its course and the short-term negatives cited above have disappeared.

Likewise we must acknowledge that many observers, especially outside the country, continue to view the United States as something of a "bubble economy"—even after the substantial correction in the equity markets that took place in 2000 and early 2001. To be sure, stock market valuations—especially for the high-technology NASDAQ, but even for the Dow Jones Industrial Average and the broader indices—reached very high levels by historical standards by early 2000, with price-earnings ratios that were roughly double their historical averages. There was thus widespread concern that a sharp correction, as in Japan in the early 1990s, could create a sharply negative wealth effect that would slow the economy sharply

7. Lettau, Ludvigson, and Barczi find that "unsustainable, or transitory, changes in wealth have little influence on consumer spending" and that even *permanent* movements in wealth mainly act contemporaneously and "bear little relation to *future* consumer spending" (2001, 19; italics in original).

Figure 2.5 US major stock indices, January 1990-June 2001



Note: Monthly data.

Source: <http://finance.yahoo.com/m1?u>.

or even push it into prolonged recession—and many of those concerns have lingered even after the more subdued effects of the market declines of 2000-01.

The stock market, particularly the high-flying “Internet stocks,” had certainly corrected substantially by early 2001 (figure 2.5). The broad averages had dropped by 10-20 percent from their peaks, and the NASDAQ had fallen by 60 percent. Moreover, it could be argued that higher-than-historic stock valuations are justified by several factors: the lower inflation of the past half-decade; the reduced volatility of US economic performance, with only two quarters of recession during the past 19 years; the sharp reduction in the risk premium as half the population, and many of its most conservative institutions, have now become equity investors; the reduction in capital gains taxes to their lowest levels since 1941; and the sharp drop in the costs of buying (but also selling) stocks.

We have no intention of trying to predict the future course of the US stock market, especially writing at a time when the short-term outlooks for both the economy and the market itself are so unclear. Most important for our purposes in this book, however, even a renewed sharp decline in the stock market would not be likely to derail the US economy. The substantial improvement in productivity growth, even if it is not fully sustained, clearly suggests that the United States is *not* a bubble economy. The US financial system exhibits few of the weaknesses that translated market declines into economic declines in Japan (as will be described in

chapter 3). Any bubble is clearly limited to the equity markets, with few counterparts in the real estate and other markets that have exacerbated equity declines elsewhere. Even the sharp market decline in 1987, when the Dow Jones Industrial Average fell by 22 percent in one day—more than it fell in the full year after reaching its all-time peak in early 2000—did not weaken the economy substantially.

Econometric models suggest that changes in household wealth, from either equity or housing sources, produce changes only 3-6 percent as great in personal consumption expenditures (Ludvigson and Steindel 1999; Davis and Palumbo 2001). Moreover, housing wealth exceeded equity wealth in the aggregate portfolios of households as recently as 1995, and its continued steady growth has offset a considerable portion of the recent decline in equity values.⁸ The consumption effect of the sharp fall in equity prices took over a full percentage point off GDP growth at annual rates in the first half of 2001, but the continued increase in housing wealth offset about half that impact (“Why Consumption Holds Up,” *Macroeconomic Advisers’ Economic Outlook*, 15 May 2001). Moreover, monetary policy à la 1987 and 2001 could be and has been deployed to counter the effects of such a shock on the economy—in contradistinction to the monetary policy conducted by the Bank of Japan during Japan’s slump (as will be discussed in chapter 3).

One crucial difference between the United States in 2000-01 and Japan in 1990, in terms of possible stock market overvaluation, is structural and works to the advantage of the United States. The US market is supported by institutional investors, including pension funds and mutual funds, and by the personal savings of wealthy individuals. By contrast (as will be described in chapter 3), the Japanese market was largely supported by money borrowed from the banking system, either directly or through real estate projects. When the stock-land bubble burst in Japan, the banks were left with nonperforming loans to companies that had invested in real estate. The stock price declines thus hit Japanese banks directly by depreciating their own stock portfolios. Because the unrealized capital gains of banks counted as tier II capital in meeting their Basel capital-adequacy ratios, the stock price declines destroyed much of their capitalization. This would not happen in the United States in the early 2000s, even if the stock market crashes, in light of its stronger banking system; the absence of any significant real estate bubble; and the lesser overvalu-

8. Both equity and housing wealth equaled about \$8 trillion in 1995. Stock market wealth soared to \$18 trillion in 1999, after which it dropped to \$13 trillion in early 2001, while housing wealth climbed to \$11 trillion during that same period. Virtually all of the swing in equity wealth effects on consumption from early 2000 to early 2001 were accounted for by swings in the NASDAQ, but there is no evidence that these swings have a disproportionate impact on the economy (“Why Consumption Holds Up,” *Macroeconomic Advisers’ Economic Outlook*, 15 May 2001).

ation of the equity markets themselves, especially after the corrections that have already occurred.

As was noted above, another potential threat to sustained and substantial US recovery is the possibility that private investment will remain depressed for a prolonged period because of the excessive capital spending and resultant overcapacity in the telecommunications sector, and perhaps the information technology sector more broadly, during the exuberant boom of the late 1990s. It is certainly true that such overcapacity exists and that new capital spending in these sectors is likely to be subdued for a while. It is also true that the sizzling pace of investment in them was a major factor in the rapid growth of the late 1990s, explaining much of the rise in the rate of expansion above the long-term sustainable norm of perhaps 3 to 3.5 percent.

However, telecoms account for a very small share of the total US economy. Information technology as a whole, depending on how broadly it is defined, accounts for a minor percentage as well. The “old economy” continues to represent the great bulk of the overall picture. Moreover, as was noted above, it is the increased *utilization* of the new technologies by traditional sectors that seems to have provided much of the pickup in productivity growth and hence overall expansion of the economy. Depressed telecoms and/or information technology sectors could slow US growth during the next few years, and could certainly keep it from resuming the peak rates of the late 1990s, but need not block a reasonably rapid recovery. They also should of course bounce back in the medium run and resume making a positive contribution to the broader economy.

Yet another potential depressant for economic activity is the low level of personal savings, and associated high level of household debt, that has come to pervade the economy. It has been argued that these patterns will inevitably be reversed, as households seek to restore their balance sheets and reduce their debt, and a modest turn in this direction in fact occurred in early 2001. This would be good for the economy in the long run, for it would enhance total national savings and reduce the country’s reliance on foreign capital (and hence the current account deficit). In the short run, however, it would presage a fall—perhaps a sharp one—in consumer spending that could weaken the single most important component of the entire economy and thus produce slower growth. If the net savings balance of the private sector were to revert to its historical mean during the next 3 years, annual GDP growth could be limited to about 1 percent through 2006; even a fall of half in the private-sector deficit would hold growth to about 2 percent a year during that period (Godley and Izurieta 2001).

Such fears have of course been expressed for many years, because personal savings has dropped steadily since the early 1990s, but consumer spending has remained extremely robust, even since the downturn that began in the middle of 2000. Most observers believe the chief reason is the

sharp and, until recently, steady growth in household wealth generated by the dramatic rise in equity values and the steady, substantial increase in housing values. These wealth increases, which are not counted as “savings” in the national income accounts, have swamped the declines in household savings out of current income throughout the past two decades.

Including capital gains in income, the imputed “personal savings rate” has exceeded 10 percent of disposable income throughout the past two decades; exceeded 20 percent for most of that period; and reached 44 percent at the height of the bull market in 1999 (before of course turning sharply negative in 2000) (Lusardi, Skinner, and Venti 2001). Simply including *realized* capital gains produces an “adjusted personal savings rate” of 9-12 percent throughout the 1980s and 1990s, with considerably less volatility (Peach and Steindel 2000). These increases in household *assets* have been greater than the simultaneous rises in household liabilities (debt), so the hypothesized “need to restore balance sheets” is much less compelling.

Moreover, total national savings have risen as the decline in government dissavings via the federal budget has been greater than the fall in private savings. Hence the situation is sustainable *unless* there were to be a substantial and lasting decline in equity prices and/or home values. The possible risk to the economy then reverts primarily to the earlier question of whether a further substantial decline in the equity market is likely.⁹

The other chief risk is that the large shortfall in the capacity of US domestic savings to finance total national investment could be shocked from the other side of the equation, its external dimension. It is this shortfall that requires the United States to import capital from the rest of the world, currently at the rate of almost \$4 billion every working day (to finance the United States’ own large capital outflows as well as the current account deficit). The *net* capital inflow of about \$2 billion daily in turn defines the level of the current account deficit, which has risen to about \$450 billion.

The final threat to sustained US expansion in the future is thus the exchange rate of the dollar. The US external deficit is already well above 4 percent of US GDP. It rose at an annual rate of about 50 percent for the 3 years 1998-2000 before leveling off with the slowdown in the economy (and hence the demand for imports). US net foreign obligations approximate \$2 trillion, which is only 20 percent of GDP, but has been rising at 20-25 percent a year. The external deficit has reached levels that have proved to be unsustainable in other OECD countries—and in the United States itself in earlier periods (Mann 1999, forthcoming 2002).

9. Peach and Steindel note that “a truly massive decline in the market value of household assets would be required to bring the ratio of aggregate debt to financial assets back up to levels associated with the economic downturns of the early 1980s and early 1990s” (2000, 4).

If foreign investors become unwilling to fund this US need for foreign capital at current prices, the most likely result will be a substantial depreciation of the dollar. A dollar fall of 20-25 percent could cut the external deficit roughly in half and return it to sustainable levels, for at least a while, at about 2-2.5 percent of GDP. Such a dollar decline would tend to take place primarily against the euro and against the yen, which are severely undervalued against all currencies as of this writing (Wren-Lewis and Driver 1998, updated 2000).

Because markets tend to overshoot, there could be a temporary dollar depreciation in excess of the "needed amount." Even a decline of 20-25 percent, however, would tend to increase the price level by 2 percentage points or so, because every fall of 10 percent in the trade-weighted dollar pushes up prices by about 1 percent. Such a depreciation would increase nominal interest rates by at least as much, and probably considerably more, as investors insisted on higher real rates to offset their fears of further depreciation of the currency and as the Fed raised rates to limit the inflationary risks from additional depreciation itself. These two developments would also tend to drive the stock market down. Moreover, this "triple hit" on the economy could not be countered by an easing of monetary policy without risking even further currency depreciation. These adverse effects would of course be more certain if they occurred while the US economy were still near full employment.

The concerns about the future of the US economy thus come full circle. The boom of the late 1990s, and at least some of the dramatic jump in productivity growth that was its most encouraging feature, relied heavily on sharp increases in private investment and relatively low levels of inflation and interest rates. Those crucial elements of the US economic resurgence were greatly facilitated by the strong dollar and the rising external deficit which, for all the problems they were building up for the longer run, played a central role in the success story.

It is quite possible that the economy could resume substantial growth, in the 3 to 3.5 percent annual range, without such dollar strength, because the slowdown of 2000-01 brought interest rates to much lower levels and further dampened the risk of inflation. Likewise, domestic savings could (and, in the long run, certainly should) replace foreign capital in supporting a substantially larger share of US private investment (though the lower level of domestic spending that would result would slow growth for at least a transition period). But the external imbalances could greatly complicate the adjustment to a new equilibrium, and even leave the economy with less long-run growth than now seems likely.

A substantial fall in the dollar is inevitable unless all economic history is repealed. But a "soft landing" for both it and the US economy, which would spread the depreciation over an extended period of time and thus minimize its adverse impact on the economy, is quite possible, for three

reasons. One is the underlying strength of the economy and its likely continued growth, if at somewhat reduced rates, as was described above—which is presumably the chief reason that the dollar remained so strong after the middle of 2000 despite the fall in US growth, interest rates, and equity prices. This strength should attract continuing sizable investments into dollar assets and prevent any free fall of the currency. Second, neither Europe nor, especially, Japan (as will be discussed in chapter 3) is likely to exhibit a highly dynamic recovery that would suddenly attract a flood of investment inflows away from the dollar.

The third mitigating probability is concerted sterilized intervention by the Group of Three (G-3) if necessary to slow the pace, and perhaps even to moderate the extent, of the inevitable slide in the dollar.¹⁰ In light of their own economic circumstances, neither Europe nor Japan would want a sharp appreciation of its currency, any more than the United States would want a free fall of the dollar. Hence this would be one of those relatively rare cases where the national interests of the G-3 are likely to coincide and thus pave the way for effective cooperative action. It is of course still possible that the authorities could fail to act in a timely manner, or that they could be overwhelmed by the markets even if they tried. But both the economics and politics point toward a gradual adjustment of the dollar—which would still have substantial, but considerably lesser, costs for the United States—rather than a crisis collapse and a substantial disruption of US economic growth.

Conclusion

Despite the slowdown that began in the middle of 2000 and the uncertainties about the future that have resulted, the United States enters the 21st century with an economy in its best shape since the Second World War. Economic expansion has continued almost uninterrupted for almost 20 years. More than 33 million new jobs have been created during this period. Domestic demand grew at almost 5 percent annually for the last 3 years of the 1990s. Both productivity growth and investment have been unprecedentedly strong for prolonged periods. The unemployment rate has approximated 4 percent, a 30-year low, since early 1999. Core inflation remains little above 2 percent.

This performance rests on firm foundations. Labor productivity growth rose sharply during the second half of the 1990s, to about 2.5 percent a year and, with the labor force rising at least 1 percent annually, would

10. Frankel and Dominguez (1993) and Catta, Galli, and Rebecchini (1994) make the case that sterilized intervention can be effective if conducted skillfully. That view is supported by the three G-7 interventions of the past 6 years: to weaken the yen in 1995, to strengthen the yen in 1998, and (less clearly) to strengthen the euro in 2000.

if resumed support steady economic expansion of about 3.5 percent a year (with the usual cyclical fluctuations around trend).¹¹ The private sector is continuously strengthening its performance, driven by the information technology revolution—especially the broadening and deepening application of this technology throughout the old economy—and the competitive pressures of globalization. Hence a faster rate of productivity growth is likely to continue, even if it turns out to be not quite as rapid as in 1996-2000.

In addition, the prospects for economic policy are strongly supportive of future expansion. There is scope for further monetary easing if the economy were to require it. The continuing surpluses in the federal budget, even after the tax cut of 2001, suggest that further tax cuts or other fiscal stimulants are available if needed.

To be sure, there are important risks. The stock market could experience another substantial correction. Private savings could rise, perhaps in response to an equity fall, and dampen consumer spending for an extended period. Investment could remain depressed, at least in the high-technology sectors. The exchange rate of the dollar could depreciate sharply and substantially. Most important, the acceleration of productivity growth in the late 1990s could turn out to be unsustainable, or even a one-shot episode. Any of these developments, or especially several coming in tandem, could dampen growth by 1-2 percentage points for 1-2 years, or even for the long run. They are unlikely to derail the prospects of steady, sustained growth for the foreseeable future, however, if at a lesser rate than in the recent boom period.

This optimistic outlook does not imply, by any means, that the United States has overcome all its economic (and related social) problems. During the two decades before the middle 1990s, the real incomes of large parts of the US population had stagnated or even declined, and income inequality had increased substantially. These trends had begun to be corrected in the late 1990s, but we cannot be sure that the reversals will continue or how far they will go. Moreover, as was noted, private savings have fallen to very low levels, and presumably will increase at some point—with a corresponding slowing of consumer demand. Despite some progress and much effort, the primary and secondary education systems remain inadequate to prepare many Americans to compete in a global economy. Partly as a result, there exists a substantial backlash against globalization, which could make it difficult for the United States to expand further (or even maintain) the openness to the world economy that has been so important to its success—especially if the inevitable temporary

11. In its May 2001 projections for the US economy during the coming 10 years, the Congressional Budget Office—which estimates its numbers on the conservative side due to its focus on drawing implications for the government budget outlook—assumes expansion of 2.4 percent in 2001, 3.4 percent in 2002, and 3.1 percent during the next 8 years (CBO 2001).

slowdowns in growth produce substantial increases in unemployment while the trade deficit remains large.

Our conclusion, however, is that the US economy is likely to maintain much of its renewed strength for the period of time that is relevant for the topic of this book—the next 5 to 10 years. It is not a bubble economy that is likely to implode, even if the stock market and/or the dollar exchange rate were to experience the substantial declines that are quite possible for both. It continues to face several severe underlying problems, but they have not impeded the recent revival and most are en route to improvement. Indeed, US performance could strengthen further if the information technology revolution itself, the commercialization of the new technologies, and globalization—three of the key factors in fostering the sharp increase in US productivity growth—turn out, as was suggested above, to be in their early stages. US policy will of course need to remain supportive for such continued progress to eventuate, particularly at the macroeconomic level of fiscal and monetary affairs, but also to maintain open markets and continue down the path of globalization more generally.

This optimistic prognosis for the US economy augurs well for its economic relationship with Japan. US economic troubles during the 1970s and 1980s, coupled with Japan's dramatic economic successes, were a key factor in the development of widespread concerns (and even paranoia) in the United States about the "threat from Japan." These concerns in turn provided much of the basis for decisions by a series of administrations and Congresses to develop, and attempt to implement, a unique "Japan policy" that would reduce the perceived threat and contribute positively to US recovery.

As was traced earlier in this chapter, the propensity to pursue this anomalous Japan-specific policy may have been largely a historical accident born of the coincidental juxtaposition of prolonged but temporary US economic weakness and Japanese ascendancy. The US concerns and resultant Japan policy then waned sharply, as the US economic resurgence gathered strength in the late 1990s (and as Japan weakened). Continued US economic strength should provide a firm foundation for a more normal, and more healthy, Japan-United States relationship in the years ahead.

In chapter 7, we will attempt to draw out in some detail the implications for Japan-United States economic policy of this outlook for the United States. Before doing so, however, it is necessary both to take a similarly close look at Japanese economic prospects and to appraise recent economic relations between the two countries. We turn next to these issues.