Encouraging Growth and Stability

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Good Morning. It is a pleasure to be able to address this group again, especially at this crucial point for the world economy. Given the events of the past few weeks, it is surely the expectation that I talk about the recent financial turmoil, the steps that we have taken to address the problems, and what we can expect. I will do that. But since this will be my last opportunity to address this group in an official capacity, I would like to start with a somewhat longer run perspective. When significant government action is needed and sought, it is easy to forget the underlying market principles that have made our economy the strongest in the world. Despite the legislation passed last week to address the extraordinary circumstances that confront our economy, the President has not forgotten those principles and neither have I.

The key question is, "How do we ensure continued success and stability?" I believe that the two are related. The conditions that are positive for long-term economic growth also tend to reduce the influence of various shocks that would otherwise cause significant economic fluctuations. Some of my points will sound familiar to you, but I hope to provide some additional evidence mostly based on the U.S., but generalized sometimes to the G-7 and OECD countries.

The Historic Record

Table 1 shows the growth rate across the G7 countries from 1998 to 2008. The countries with the highest growth rates happen to be the English speaking ones: Canada, the United Kingdom and the United States. But I do not believe that it is language that sets these countries apart. Instead I think the practices and policies they have pursued have been conducive to growth, at least over this period. In particular, I will argue that flexibility in labor and capital markets, low taxes without too much progressivity, and openness to trade and investment across international borders are factors that favor economic growth. Some initial evidence on this point is provided by the "Ease of Doing Business Ranking", reported in the last column of table 1. The correlations are hardly perfect, but Canada, the U.K. and the U.S. are among the most flexible countries by this measure and Italy, with the lowest growth rate, is the least flexible.

Table 1

Real GDP Growth In G7 Countries

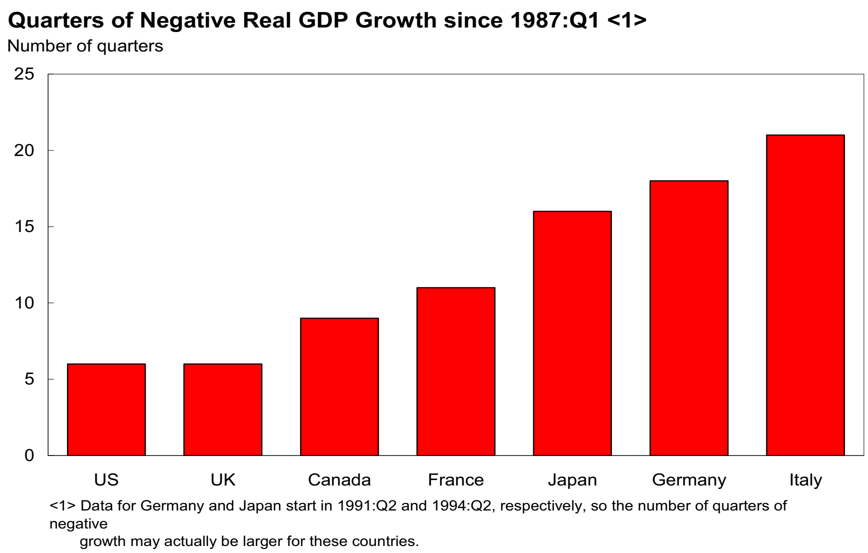
	Average Annual Growth Rate (1998:Q2 - 2008:Q2)		World Bank Ease of Doing Business Ranking
Canada	3.1%	Canada	7
UK	2.7%	UK	6
United States	2.7%	United States	3
France	2.1%	France	31
Germany	1.6%	Germany	20
Japan	1.5%	Japan	12
Italy	1.3%	Italy	53

Source: Country sources, World Bank

In terms of economic fluctuations, in addition to flexibility, openness and low taxes, I would add good fiscal policy and good monetary policy.

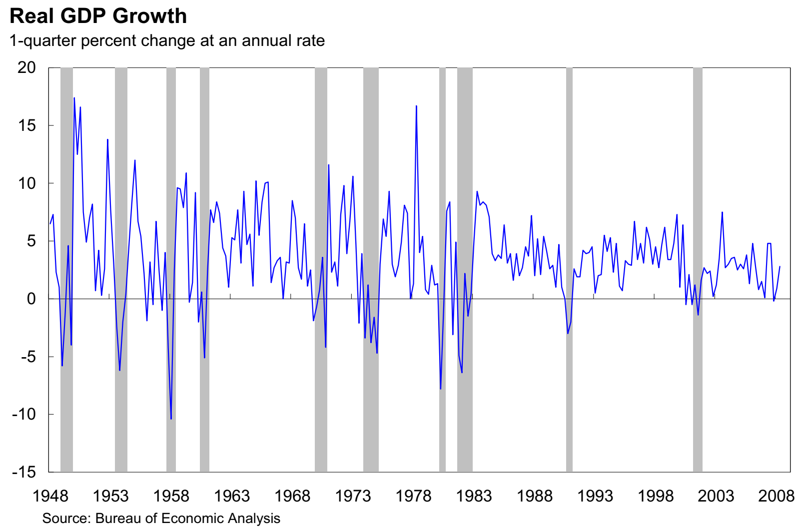
Chart 1 reveals that the same countries that have had the highest growth rates over the past decade have also tended to have the least pronounced short-term negative fluctuations as measured by the number of quarters of negative real GDP growth since 1987. The U.S. and the U.K. have had the fewest negative quarters, followed by Canada and France. Japan, Germany, and Italy have had a significantly greater number of quarters of negative GDP growth over the last twenty years.

Chart 1



It is also true, as seen in Chart 2, that the amplitude of GDP growth rates has decreased over time, at least for the United States. In particular, the large negative shocks to U.S. GDP that preceded 1983 are not present in the post-83 period.

Chart 2



I believe that determinants of growth relate to the underlying structure and fundamentals of the U.S. economy rather than to actions taken by the government. But government policies can enhance or detract from the environment in which private actors must operate. The knowledge that central banks have acquired over time has allowed them to control inflation without initiating destabilizing shocks to the economy. Fiscal policy, by preventing the public debt from growing too rapidly while at the same time providing appropriate and minimally distorting incentives, has become more effective over time. Countries that have allowed flexible labor and capital markets by adopting laws and institutions that establish default rights and intellectual property can also be an important contributor to economic growth and stability. Let us consider the aforementioned factors in more detail.

Labor Market Flexibility

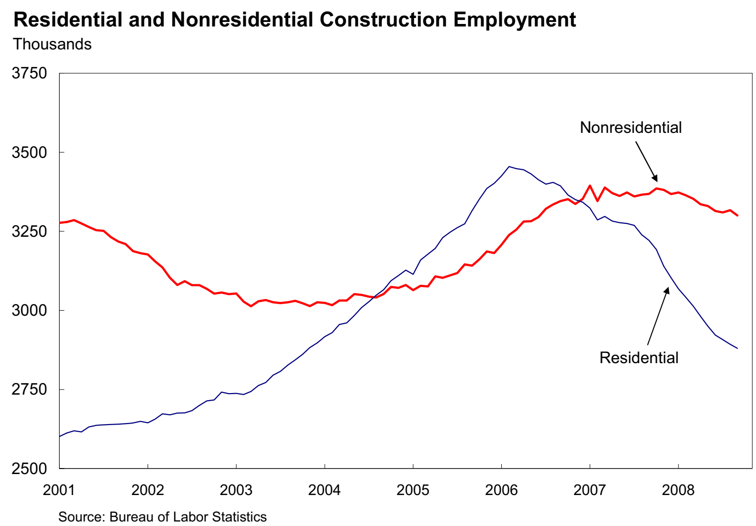
Some countries have policies that encourage more labor market flexibility than others. Other things equal, economies that allow more flexibility provide capital with a higher rate of return which attracts investment and raises worker productivity. Over the short term, mobility of labor is important so that when one sector is hit with a shock, workers can easily move from the adversely affected sector to those that are growing. Limitations on firing imply a reduction in the speed of adjustment of both expanding and contracting industries because they reduce the willingness of employers in growing sectors to take on freed-up labor.

There are a variety of measures of labor flexibility. One that is frequently used is the average job tenure in a country. The United States average job tenure is 4 years as compared with 8 years of tenure in the UK, which has the shortest tenure among EU countries. Other nations, including Germany, France and Italy averaged over 10 years of tenure in 2005 and some countries, like Greece, had nearly a 13 year average tenure.[1] Tenure is not a perfect indicator of job flexibility because average tenure can be low simply because there are many new entrants into a labor force. Still, average tenure gives us some indication of labor market flexibility.

It is also important to realize that churn is a major feature of our labor market. The JOLTS data (Job Openings and Labor Turnover Survey) reveals that in the typical month 4.6 million workers are hired and 4.5 million are separated from their jobs, implying that approximately 35 percent of the workforce changes jobs each year. By contrast, the average net change in jobs in the economy is 133,000 per month which is only about 3% of the number newly hired or separated.

The importance of mobility is well illustrated by recent declines in the housing market. When one sector is depressed, it is desirable to allow workers from that sector to move to other sectors that require essentially the same skills. As Chart 3 shows, in the period after February 2006, the residential construction industry lost jobs and has continued to do so for the past couple of years, but non-residential construction picked up those workers to some extent and employment in this sector has remained relatively strong. The ability of nonresidential construction to absorb labor from residential construction dampened the intensity of the construction decline and muted its effects on GDP growth.

Chart 3



Does this Matter? Chart 4 shows the relation of GDP growth to wage rigidity among the G7 countries as measured by the World Bank. The U.S., UK and Canada with the highest levels of GDP growth, also have the lowest amount of labor rigidity. Each of the other four G7 countries with more rigid labor markets has lower average GDP growth over the past decade. Of course, data points are limited, and there may be other reasons for the pattern that is observed, but the correlation that comes from simply lining up the data is notable.

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[1] Economic Survey of the European Union. Chapter 8. 2007. OECD.

Chart 4

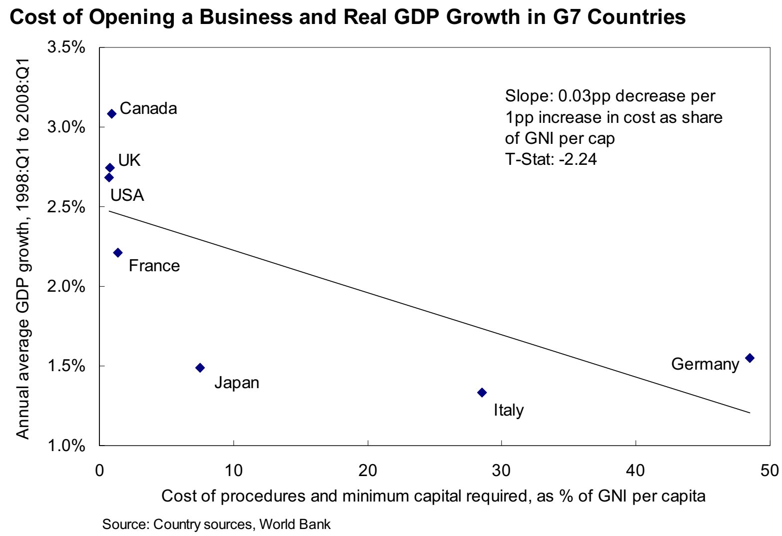
Source: Country sources, World Bank

<u>Unrestricted Capital Markets</u>

It is also important to allow capital to move to its most productive use and to avoid placing limitations on who can invest in various sectors. It is common, for example, for countries to prohibit foreign capital in particular, but even domestic private capital from investing in certain sectors that are maintained as government monopolies. Industries deemed to be strategic, like oil, transportation, communication, and direct media outlets are often off-limits to foreign investment.

One frequently used measure of the free flow of capital is the cost of opening a new business. Chart 5 illustrates that countries in which it is relatively cheap to start new businesses also had the highest levels of growth during the past decade.

Chart 5



Excessive regulation is another impediment to the free flow of capital. It may be much easier to establish new regulations than to de-regulate once those rules have been put into place. Regulation, or at least its opposite—deregulation—seems to be associated with growth.[2, 3]

Taxes

Let me turn to taxation. Because it is the after-tax returns that matter to investors of all kinds, tax rates are an important ingredient in determining investment and therefore economic growth. This is true both for physical and human capital. In the context of human capital, it is progressivity of tax rates that matters most since it is the difference between wages on high human capital jobs and wages on low human capital jobs that creates the incentive to invest in human capital. As a result, an economy that imposes too progressive a tax rate structure will weaken incentives to invest in human capital, and human capital is a major component of growth in most countries. There is evidence to support this view. In some recent work reported in a publication of the Hoover Institution, Hanushek, et. al find that when a significant fraction of the

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[2] Crafts, Nicholas, "Regulation and Productivity Performance," *OXREP* Vol. 22 No. 2, 2006.

workforce does not have the requisite skills to perform in a technologically advanced society, production suffers.[4]

A problem that has plagued the United States is the pervasive and stubborn achievement gaps that exist across demographic groups. Despite the relatively open nature of the U.S. educational system, it remains true that 80 percent of high school graduates within the top quintile of the income distribution go directly to college, while only about 50 percent in the bottom quintile do.[5] The top panel of chart 6 shows that enrollment rates of the bottom income quintile continue to lie below the average for the population

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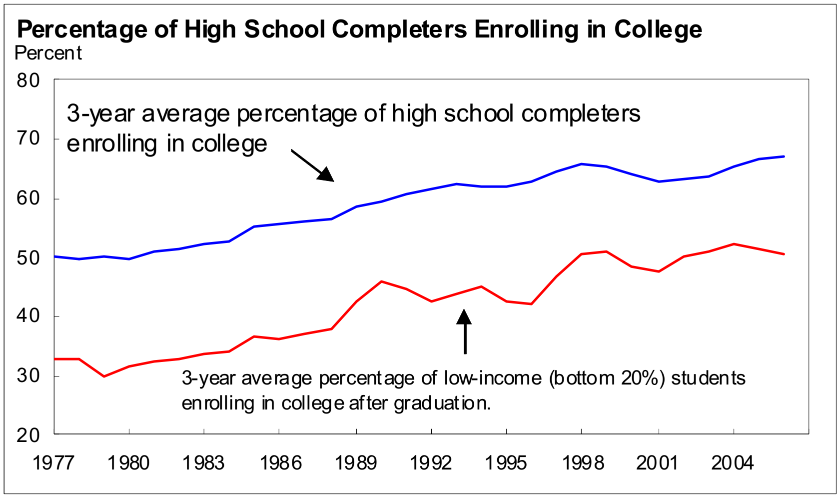
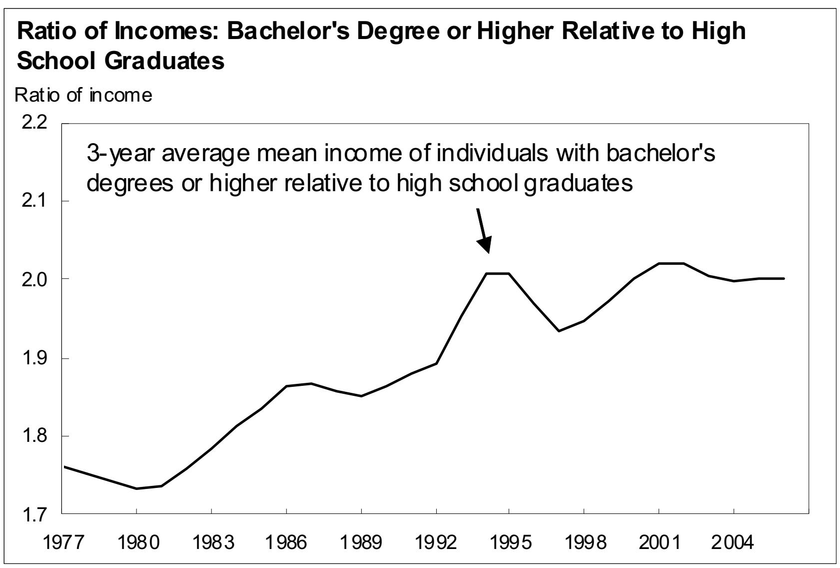
[3] Jayaratne, Jith and Philip Strahan, "The Finance-Growth Nexus: Evidence from Bank Branch Deregulation," Federal Reserve Bank of New York working paper, #9513, June 1995.

[4] Hanushek, Eric, Dean T. Jamison, Eliot A. Jamison and Ludger Woessmann, "Education and Economic Growth," *Education Next,* Hoover Institution, vol.8, no. 2, Spring 2008.

[5] The Condition of Education 2008. National Center for Education Statistics. U.S. Department of Education.

Chart 6





The bottom panel of Chart 6 shows that in the United States, the ratio of income of college graduates to high school graduates has risen over time (although it has flattened out recently). College is a more valuable investment today than it was 30 years ago.[6] These high rates of return have drawn people into college. Now, almost two-thirds of students enroll in

[6] Source for college enrollment data: Current Population Survey (CPS), October Supplement, 1975–2006; published in The Condition of Education. 2008. National Center for Education Statistics. U.S. Department of Education. Source for earnings data: Current Population Survey. Released by Census on March 15, 2007 and available at http://www.census.gov/population/www/socdemo/educ-attn.html.

college after high school – see the upper line of the top panel of Chart 6. Even among families with low incomes, the increase in the rate of college enrollment has been quite substantial (the lower line of the same chart).

Human capital is key, but it is also important to adopt tax policies that promote investment in physical capital. Capital deepening and efficiency gains have been important productivity raising factors. Between 1995 and 2005 increases in the quality and quantity of the U.S. capital stock accounted for a little over one percentage point per year in productivity growth.[7] Capital deepening makes workers more productive and leads to higher wages in the long run. Productivity and compensation often diverge temporarily, but grow together one-for-one over the longer run.

Average annual productivity growth fell for most G7 countries between 1990 and 2005 but the U.S. showed consistent increases in productivity growth over this period.[8] Whether this can be attributed to differences in the tax treatment of capital is questionable, since the United States is in the middle of the pack in terms of its taxation of capital. But there is suggestive evidence from the OECD countries that high rates of taxation are impediments to growth. As Chart 7 reveals, there is a tendency for countries that tax capital at very high rates to experience lower growth than those that tax at low rates.

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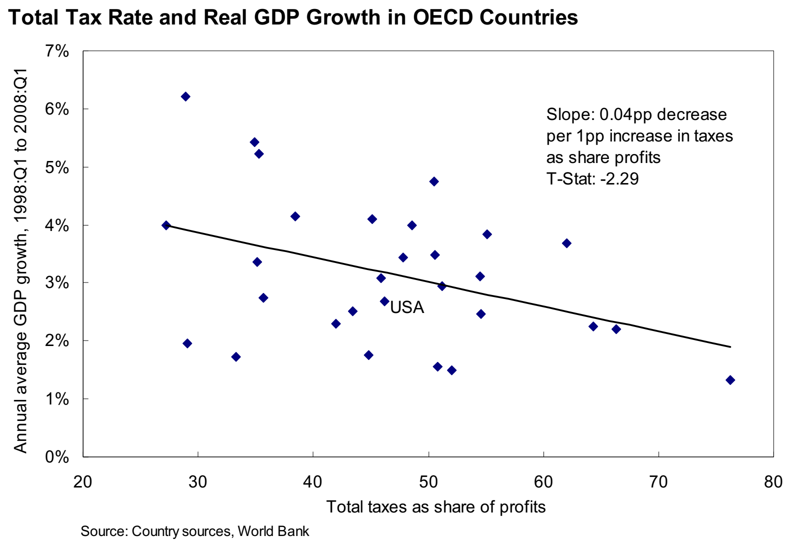
[7] *Economic Report of the President*, 2007, page 50.
[8] *Economic Report of the President*, 2007, page 59.

Chart 7



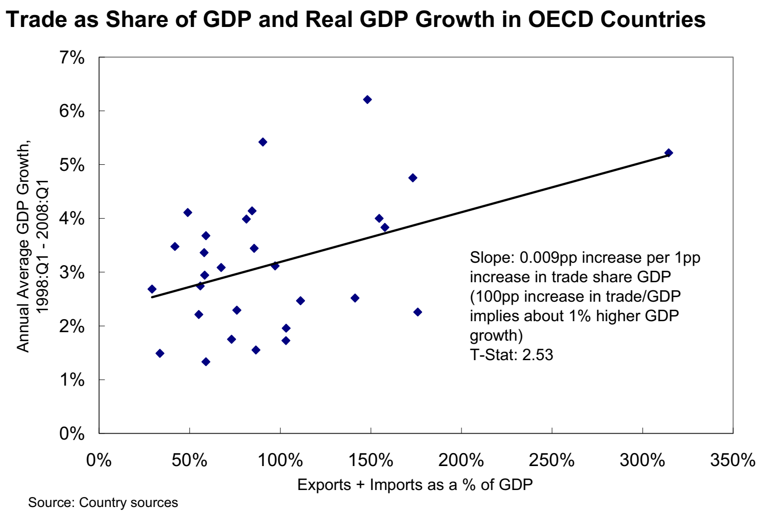
In a recent NBER study, Djankov, et. al., examined 85 countries and found that a 10 percentage point increase in the effective corporate tax rate reduced aggregate investment by about 10 percent and entry by new firms by about 17 percent.[9] These adverse effects of taxes on investment suggest an avenue through which high taxation is likely to impede growth.

Openness and Trade

The world has become more interconnected over recent decades. That trade is a force for good is one of the basic tenets of economics and is not controversial among economists. But it is certainly controversial among non-economists. Indeed, there is a growing tide of protectionism as people fear that their jobs will be lost to competition from cheap labor abroad.

But the view that trade shifts production towards goods in which countries have a comparative advantage is not only fundamental to economics, it is sound logic. Higher national income results when factors are reallocated from less efficient sectors to more efficient ones. Additionally, trade allows access to new technology and information and provides for additional sources of imitation so that new products and new techniques can be introduced to boost native productivity. And for smaller countries, the ability to sell in a global market may allow economies of scale in production that would not be present were producers limited to selling in the domestic context.

Chart 8

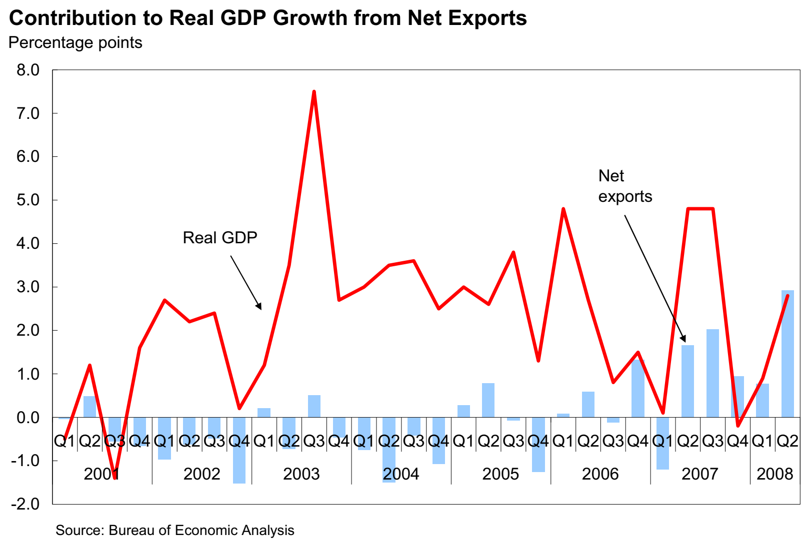


As can be seen in Chart 8, there is a positive relationship between trade as a percentage of GDP and average growth rates among OECD countries. Although there are many reasons why this relationship may hold that do not relate directly to openness, the evidence again suggests that countries that engage in more trade enjoy faster growth.

Chart 9 shows that the increase in net exports has been a major factor that has contributed to GDP growth over the last year and a half. In fact, in the most recent quarter the increase in net exports accounted for over 100 percent of total GDP growth. This is perhaps the strongest testament to the importance of trade, even to the most developed economies.

[9] Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *NBER* working paper #13756, January 2008.

Chart 9



The major policy implication is that free trade agreements are important to growth. The evidence supports economists' a priori views. Recent research shows that on average, free trade agreements increase trade in goods and services between signatories by about one third after 5 years and by more than double after 15 years.[10] Despite difficulties in the Doha round of the world trade talks, there have been some successes, including increases in the number of bilateral and regional free trade agreements.

Although much of the discussion in trade talks is about manufacturing and agriculture, these tend to be relatively small parts of developed economies and most of the gains from trade involve liberalization of trade in services. For example, financial, insurance, transportation and storage, telecommunications, express delivery and business services generate 68 percent of world GDP,[11] but account for just under 20 percent of global trade.[12] The prospective gains

[10] Baier and Bergstrand. Do Free Trade Agreements Actually Increase Members' International Trade. Journal of International Economics (2007) p. 72-95.
[11] World Bank, World Development Indicators, 2006.

from services liberalization are enormous, estimated at around a half a trillion dollars per year in the United States,[13] as compared with under $20 billion for complete liberalization of agricultural and manufacturing.[14] Developing countries also stand to benefit greatly from global liberalization of trade in services. China and India could gain an estimated $105 billion and $12 billion per year respectively. For China, this would amount to about 4 percent of GDP, and for India close to 2 percent.[15]

One obvious concern is that the opening of trade creates winners and losers. While economies may benefit on net from liberalization, some individuals whose jobs are highly specialized may find themselves losing from increased interaction with other economies in the world. There are programs to deal with trade adjustment and to assist in the training and relocation of workers whose jobs are lost to trade, but such programs are far from perfect, and implementation remains difficult.

The other side of the trade linkages are the investments that have become more intertwined.

Table 2

Average FDI as a % of Investment for 14 OECD Countries*	
1992	3.30%
1997	7.60%
2002	13.20%
2007	17.60%

*US, Australia, Canada, Finland, Germany, Italy, Japan, Netherlands, Spain, Sweden, UK, Turkey, Mexico, Korea.

[12] World Trade Organization trade statistics, 2005.
[13] Brown, Deardorff, and Stern, "Computational Analysis of Multilateral Trade Liberalization in the Uruguay Round and Doha Development Round", RSIE working paper 489, 2002.
[14] Anderson, Kym, et al, "Global Impacts of the Doha Scenarios on Poverty", World Bank Policy Research Working Paper 3735.
[15] Brown et. al. (2002).

As can be seen in Table 2, FDI was only 3.3 percent of a country's total investment in 1992, and was 17.6 percent in 2007. Although these ratios move around from year to year and are sensitive to varying economic conditions across countries, the general pattern seems indisputable. International investment is increasing over time. Right now many countries hold significant positions in U.S. Treasuries, Japan and China being the most important examples. Other countries have been purchasers of mortgage-backed securities from Fannie Mae and Freddie Mac. In the first quarter of 2008 about 20 percent of these government sponsored enterprise securities were held outside the United States.

It is no secret that the subprime woes of the United States showed up in Europe and sometimes affected European banks to a greater extent than American banks. One of the early manifestations of the problem occurred about a year ago when a large European bank declared that it could not value asset-backed commercial paper held by some of its money funds, and as a result suspended redemptions from those funds. We have seen national and multinational action last week to rescue five failing European financial institutions, and finance ministers are meeting in Luxemburg today. Perhaps one of the ironies of the financial crisis that began in the United States is that much of the money ended up back in the U.S. as investors fled to the safety and liquidity of U.S. Treasury bills. This sparked a plunge in bill rates, and a sharp widening of spreads. This is further evidence of linkages not only in trade in goods and services, but also, and of course necessarily, in capital.

I am a firm believer that flexibility in capital and labor markets, low taxes and openness to trade are key factors in promoting economic growth. The evidence that I have shown you supports the view, but in fairness, I must point out that the evidence is neither conclusive nor comprehensive. History provides us with counterexamples of almost everything, and there is no exception in the current context. Post World War Two Germany experienced exceptionally rapid growth and was the envy of developed economies. In the early 80s, when we were in recession, Japan's economy and its interventionist approach of picking winning industries like electronics and autos was held up as a model. Sweden has been praised for its ability to combine growth with social programs. Still, I would argue that the economies that have adopted the most flexible, low tax and open views have enjoyed robustness and growth and have been able to withstand the largest shocks with minimal damage.

And speaking of shocks, let me now turn to the topic that has been on all of our minds, namely the financial crisis and the remedy in the legislation that the President signed Friday. The immediate source of the slowdown traces back to credit market turmoil, which surfaced over a year ago, and has as its root cause loose credit. Credit was available because of the large supply of capital that flowed into the U.S. over the past decade or more. The most obvious manifestation was easy mortgage credit which led to over-building in the housing market. During the past two years, we have experienced the effects of excess supply. This has resulted in declining home prices, difficulties in refinancing and higher foreclosures, which now cascade through the entire financial system.

In recent weeks, the financial problems have reached crisis levels with short term markets freezing up, banks being unwilling to lend to one another even overnight as reflected in high libor rates, TED spreads, and volatile Fed fund rates. The shortening of the commercial paper lending to 1 to 5 days and volume reductions, particularly among financial firms is the most recent pronounced difficulty.

When short-term credit is tight, it usually implies that long term credit is even tighter. This means that it becomes difficult to finance new projects, grow businesses and expand the workforce, and that becomes the nation's problem. In fact, it becomes the problem of the whole world because we account for about ¼ of world GDP and credit flows worldwide.

What will this do to the economy? It is too early to know, but we must expect that the next few months could be tough ones. The economy has been amazingly robust. The fact that we enjoyed 2.8% growth during second quarter is evidence of our resilience. But the financing freeze is a major shock that is combined with other shocks. The increase in oil prices since last year and the housing and stock market price declines, which translate into lower wealth and reduced consumption for the typical household, will put our economy to the test. Because of these strains on the real economy that if left unchecked could translate into a decade of malaise, we are taking decisive action to prevent further damage to the real economy.

Until recently, many believed that the credit problem was one of confidence and contagion, where preventing one or a few failures would be sufficient to avoid systemic risk. While contagion and confidence exacerbate the difficulties, the fundamental problem is one of a common factor that plagues many financial institutions. In this case, the common factor consists of assets, primarily mortgages and related products with high default rates.

The $700 billion stabilization program is large and amounts to about 5% of our GDP. Of course, this is the outlay, not the cost, but there is no denying that the program places taxpayer dollars at risk. It is not out of line with other industrial country experiences, the average being 12% according to one recent study[16]. Ireland just guaranteed the liabilities of their top six financial institutions, an exposure that amounts to about double their GDP.

Is it large enough? We believe it is. The market value of the highest risk assets is about $1 trillion and a fraction are already held by Fannie and Freddie. As a result, we can buy up

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[16] Hoggarth, Reis, and Saporta, "Costs of Banking System Instability: Some Empirical Evidence", Bank of England working paper 144, 2001.

much of this market, if that appears necessary. There may also be a need to inject capital into the system. Implementation of the legislation is now being designed.

Conclusion

Let me conclude. I have spent my time trying to provide arguments and evidence for what many of us take as given, that developed economies benefit greatly from flexibility, openness, and low taxes. Much of the evidence has been anecdotal and some of it is selective in the sense that data can only be provided for certain sectors and certain economies. But the overall story seems compelling. Those countries that have adopted policies that favor flexible labor and capital markets, low and efficient taxes, and openness to trade have enjoyed better growth and less severe cyclical downturns. The next few months may be trying times for the U.S. economy and that of the rest of the interconnected world. But the conditions that have contributed to our high growth and stability will also work to get us through this difficult period quickly and with the minimum amount of pain.

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