Event Transcript

High-Level Panels on Japan-US Common Economic Challenges

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Adam Posen: Well good morning ladies and gentlemen. In the interest of courtesy to our global network of podcast and live-stream watchers we will start roughly on time. I'd like to welcome you to the special joint event between the Sasakawa Peace Foundation – Sasakawa Peace Foundation USA, and the Peterson Institute for International Economics.

My name is Adam Posen; I'm the President of the Peterson Institute. And it's been our pleasure here to host for the last day-and-a-half, a distinguished group of economists and former policy makers and mostly economists who were former policy makers from both sides of the Pacific and our high-level group focusing on common challenges to the US and Japan. We've had a very fruitful couple days of discussion and while we're not here to inundate you with grand and banal proclamations, we hope to share with you and our audience abroad the spirit of some of our discussions and some of the specific points we raised, both on the real and reform side of the economy and on some of the mandatory macro fiscal issues.

But first I'd like to call upon retired Admiral Dennis Blair, who is now, I believe, Chairman of the Sasakawa Peace Foundation USA, to say a few remarks about our intent and what we've done. Dennis, thank you.

Dennis Blair: Well thanks very much Adam for hosting this fine event and thanks to all of you for joining us to launch the public part of this high-level working group on Japan-US economic challenges. And we're delighted to co-sponsor this project with the Sasakawa Peace Foundation in Japan and with the Peterson Institute and to work again with Adam Posen; he's done just a terrific job as the President of PIIE, such an important organization. And of course he's-has a distinguished reputation as one of America's leading experts on Japan's economy. So wonderful leadership and thank you Adam.

And we're also delighted that our co-chair from the Japan side, Professor Motoshige Itoh, not only a preeminent economist, a long-time adviser to many prime ministers and notably Prime Minister Abe who is now trying to take so many dramatic measures in the economic life of Japan.

At Sasakawa, we decided to launch this new initiative because it's been really more than 15 years since the last important trek to bilateral economic dialogue and it's really time to discuss the common economic challenges and common economic aspirations of the United States and Japan.

And I'd like to set these economic discussions in the slightly larger security context, because we are at an important—I'd really go further and say a critical juncture in the development of East Asia, which is the economic and power and growing power center of the world. For 60 years, it's been a combination of American military power. It's huge and ever growing consumer market. Japan's economic development, its overseas development assistance, these have really been the pillars under which East Asia has developed so dramatically, both economically and politically. And now these pillars are in question. China has been challenging American political influence, American military domination in the region. The US market notably turned down a few years ago and it's only barely recovering. Japan has been in a period of economic stagnation for 20 years.

So the big pieces of the tectonic plates are moving in the security architecture of East Asia and the United States and Japan, the largest and third largest economies in the world; very powerful military forces. Similar democratic values need to work together in order to move into the next phase because security and economics are and always have been intertwined. And while the United States and Japan neither can nor desire to go back to that old formula that worked for the past 50 years, they have to restore sustainable economic growth in both countries and cooperatively in order to maintain and rebuild a strong political and military policy that will support our shared vision for that part of the world, which includes a peaceful, prosperous democratic free-trading Asia benefiting all of the citizens of the region.

So it's an important time and it's important that Japan and the United States talk together at the informal as well as the formal levels and figure out the way forward. If Japan and the United States are working together I firmly believe we can make Asia's future even better than its past. If we don't we risk all of that.

And the issue at the center of concern now, working together, is the Transpacific Partnership. We'll hear some more about it in one of our panels, but the group spent quite a bit of time discussing the economic and the political factors that are involved. But of course, there's more than just narrow economic and political factors at play in the TPP. The larger significance of it is to establish together with the other countries that are working in the TPP negotiations, a set of economic relations that really will support that prosperity, freer trade, higher standards on the economic issues of the future, the important issues: intellectual property rights protection, labor standards, the role of state-owned enterprises. It's really getting this framework right that will be the key to a brighter future. And if the US-Japanese negotiations broke down on an issue like say, pork, when these huge wider issues are at stake, which will really determine the future of the region and potentially of the world, I don't think that history would forgive us.

There's a matter of timing; each country has its own politics, each country has its own domestic interests which it must work through, but I think we have to keep our eyes on the prize here and ensure that we are moving forward and reach that goal. It's so important to both our countries and to the regions.

So with that, let me turn the podium over to Motoshige Itoh, who have a few words to say and then I think we have our panel starting.

Motoshige Itoh: Thank you very much for giving me a few minutes to talk about this new project. About 25 years ago I was invited to the meeting here in the Institute to have a kind of a forum between the American economists and Japanese economists, to talk various issues between the two countries. At that time the most heated discussion was trade conflicts on the automobiles and integrated circuit. So time changed, but still I think there are many, many things we have to discuss between the two countries and many new issues are coming. So I'm very glad just we can restart this kind of dialogue and I hope we can just provide a better output from our discussion. And so thank you very much for coming to the public seminar today. Thank you very much.

Dan Bob: I'm Dan Bob with Sasakawa Peace Foundation USA and we want to kick off this morning's event with a first panel, which is going to be focused on trade and competitiveness. And as the other speakers have mentioned, we had a really good set of discussions yesterday and today about a range of issues. A lot of time was spent on trade and competitiveness, particularly on TPP.

And we're going to begin today's panel asking Professor Itoh Motoshige to come back and give a few thoughts. For those of you who are not familiar Professor Itoh, he is a Professor at the Graduate School of Economics at the University of Tokyo, where he formally served as Dean. And importantly, he's on the Council on Economic and Fiscal Policy, which gives direct advice to the Prime Minister and the cabinet on major economic issues, including on the third arrow in the reforms that will be taking place in Japan.

Our second speaker will be Bob Lawrence from Harvard. He's the Professor of Trade and Investment at the Kennedy School of Government, and previously served on the Council on Economic Advisers, and is a non-resident fellow here at Peterson Institute.

And then we have with us also Hideichi Okada, who is currently the Senior Adviser to NTT Data Institute of Management and Consulting, but previously served as Vice-Minister at METI for International Affairs from 2010 to 2012. And before that was Director-General of Trade Policy at METI. And batting cleanup for us will be Jeff Schott, who's the trade guru here at PIIE; been here since 1973, but among many other things, has taught at Princeton and Georgetown and wrote a book in 2012 on understanding TPP.

So my understanding is each of the panelists will come here to speak, because we've got a presentation up there. But when all the panelists are finished we'll take Q&A from up there. So if I could turn it back to Professor Itoh.

Motoshige Itoh: Thank you very much. We just discussed so many issues and I'll just try to highlight some of the aspects I am just familiar with. Because we have an expert on TPP and competitiveness in this session, so I'd rather just focus on the "Abenomics," which may be a very good starting point.

And as you know, after Prime Minister Abe took office and he just introduced various drastic measures and that surely has surprised the market. And now, everybody is talking about what is the next stage of "Abenomics?" And obviously the so-called third [inaudible 00:12:00] is very important.

Now, before just talking about just the second stage of "Abenomics," I have to say the performance of the Japanese economy after Mr. Abe took office was more than I expected in the beginning. Let me just name a few, point out few economic indicators, like inflation rate. As you probably know, we are suffering from deflation a few years ago. It's now constantly increasing and trying to reach a level of the 2.0%, I hope. And the unemployment rate was about 5.5%. After [inaudible 00:12:40] it's now 3.6%, which is almost close to what we call the full employment. And the growth rate for the fiscal year of 2013 was more than expected [inaudible 00:12:56] something like 2.5%, which is very high. And profitability, you probably know is very good, so everybody now in Japan is expecting an increase in wage and bonus, which will be also very important as well as the economy, and many other areas. So, so far so good.

But the question is: What is coming in the next? And I think it is very important just to think very carefully; what's the sequence of the process of the policy influence on the economy? The sequence is very important. And there are two missing, I think, words usually when people are talking about economics. One missing word is time-lag and the other missing word is demand-supply distinctions.

Now let me first talk about time-lag. Because Mr. Kuroda, the Governor of Bank of Japan was so successful to just surprise the market. So everybody is now talking about what is coming next from Bank of Japan? And of course that is very important, but you have to just go back to the University to remember what you are taught in the University, there is a time-lag between the timing of the introduction of the policy and the timing of the effect on the economy. Especially in the case of Japan, just stopping deflation is a very important element to just discuss the process of the [inaudible 00:14:27] real economy.

We often talk about the concept of the real interest rate. During the period of deflation, just remember what happened is inflation rate is minus 1.0%. A nominal growth rate is something like minus 1.5%. And the interest rate was very low, but the real interest is very high and so no investment, no expenditures. Under deflation, the best thing is just to invest on cash.

Now what happened now is the consumer price index is just moving towards 2.0%, nominal growth rate is moving towards 3.0%, and nominal interest rate is still very low. So obviously, it has a very strong influence on the investment behavior and the household consumption behaviors. And the interesting thing is just to market [inaudible 00:15:21] just responded this kind of change of atmosphere very quickly after Mr. Kuroda started the [inaudible 00:15:27] process. So you probably know, for example, expected in financial rate just revealed in the market indicator such as the price index form, just moved very quickly. But when it comes to just the behavior of ordinary business people, manufacturers, exporters or ordinary people, it takes some time for them to just realize now Japan is very different process of inflation. Wage is increasing, which just pushed the price and so forth.

So we probably will have a very visible influence on the real economic activity from now on. And you probably recognize, for example, just the investment by [inaudible 00:16:13] sector just jumped up very rapidly in these days.

Now the second very important thing is just the distinction between demand and supply side. Everybody is talking about supply side because the growth rate didn't surprise me. But the important thing is it takes some time for supply side policy to have an influence on real economy. We need a labor market reform, of course. A labor market reform is very important, but you can just imagine labor market reform will have an effect on the practice of the employment or effect on the performance of the economy, maybe in 2 years or in 3 years. We need a reform on our [inaudible 00:16:52] sector, it is very important. And the forming [inaudible 00:16:54] sector is very effective to just enhance our competitiveness. But again, that kind of policy we have is some time to just be realized in actual competitiveness.

So there's some kind of missing link between the very immediate effect of the monetary policy and the very long-term effect of supply side policy. So what happens is demand side.

If you just ready very carefully the newspaper, the third [inaudible 00:17:24] of "Abenomics" is not growth strategies. The third [inaudible 00:17:29] of "Abenomics" is the growth strategies that promote private investment, and they're different. When you say just growth strategies, it just implies supply side policy, reform [inaudible 00:17:40] market. But when you say the growth strategy that promotes private investment, just have that ultimate implication of the demand side.

Now you probably know Japan just suffered a lot from 20 years of economic stagnation and very weak demand. That was not very good for us, but there is at least one good thing. That is, we actually corrected the [inaudible 00:18:05] problems. So household sectors, corporate sectors, banking sector just corrected the [inaudible 00:18:11] problem over-debt or just over-borrowing and now they have a huge amount of cash. The problem is they are not just using this cash.

I had once a very interesting discussion with a very famous business person in Japan, Mr. Son. He's the President of SoftBank. Japanese people know him very well because he decided to buy Sprint-Nextel of the United States, and is one of the biggest purchases by a Japanese company from an American company. And surprising for us is he borrowed about 75% of the money for investment from banking sectors. So it's very kind of risky investment. And I was just appearing in the TV program and he came to my program and I asked him, "Are you okay for this kind of very risky project?" And his answer was very interesting; he said, "I am a boy." I don't know whether this is English [inaudible 00:19:14] or not, that means the problem for Japan is not lack of money, lack of financial resources; the problem for Japan is the lack of the business people who take risks to make investment.

So in that respect we have a lot of opportunity if we can just agitate the business community to just move forward. And that is maybe the very important part of just stopping the deflationary mind.

So I think the growth strategies for the government has very interesting combination of the very important supply side reform which will provide sustainable growth in the future, but at the same time to change the mindset of the business community to just make them to just invest more. So this is very important timing.

And the government I think now increasingly recognizes the importance of this combination/demand side-supply side. Now you probably know just what kind of a supply side policy or growth strategy policies now discussed in Japan. And to name a few, I have several very important examples: corporate tax reform, reduction of corporate tax rate, or just TPP, which will be discussed by other presenters after me, is also very important timing now. Not only just the trade negotiation is important, but also it will be very important timing for us to change our mindset for agriculture policies and other policies.

And also, the government is now working very hard to just attract more foreign direct investment to Japan which will also provide a lot of opportunities for our economy and also increasing the participation of female workers, which has a very strong support by the Japanese people because we have to do a lot of things to just have more participation workers and so on and so forth. But the important thing is there is no magic to the supply side. So what is important is you have to do as much as you can do so that you can have a collection of just the result of the [inaudible 00:21:25] supply side policy and more important thing is change the mindset of the Japanese business community, Japanese people, and also oversee investment in Japan.

So I want you to just have more focus on what the demand side of the Japanese economy it's changing from now on. So I'll stop here and I'll ask the other people to talk about more of the contents of the present policy. Thank you very much.

Dan Bob: Thanks Itoh [inaudible 00:22:01] that was terrific. And now we're going to turn to Bob Lawrence, who's going to give a more direct talk about TPP in three scenarios.

Bob Lawrence: Well thank you very much. Yes, TPP is still a work in progress; it's under negotiation. And as I listen to the debates about it I hear three contrasting views. And I believe there's an element of truth in each of these views. Ultimately, the negotiations and their implementation will tell us what mix of these three views actually turns out to be correct.

The first is the view which was given to us, actually most prominently by the policy makers themselves who are implementing the program. They're offering this Transpacific Partnership as a solution, both to the needs of Japan internally, when it comes to structural change. Indeed it has been pointed to as a key component of the third arrow of structural change within Japan, as well as a response to the needs of both Japan and the United States, for a global economy that is better suited to the needs of the emerging supply chains and multinational firms that operate in that economy.

The multilateral trading system essentially has been at an impasse. It has failed to produce the kinds of agreements which relate to deeper international integration that the multinational corporations have called for and has been unable to do so basically because there's a split among its members and unanimity is required for an agreement.

One group of members, you can call them The Willing, are really eager to see agreements on foreign investment, to integrate with respect to common standards, or reconciling differences in national standards. And I think it's because what they seek is a governance structure which allows firms to be truly global. On the other hand there are a group of countries, some major emerging economies, who believe that it's in their interest to have more interventionist domestic policies and indeed to protect their domestic economies. And so it's been impossible to get an agreement at Doha. Nonetheless, those who are more interested in deeper integration have moved regionally. And the TPP and indeed the [inaudible 00:25:26] are manifestations of this drive to negotiate agreements that can deal, not only with tariffs, but with the behind-the-border barriers, which are essential to the operation of these arrangements.

I would also point to a second major trend which relates to the desire of those concerned about environment, to those concerned about labor standards, to have these issues included in a trade agreement. And the TPP also is likely to respond to their demands. So from one vantage point, this is an agreement which has deep consequences for the global trading system, which is likely to also have geopolitical consequences. It raises the issue of if these countries can join, if Korea and others join too, what kind of pressures will be placed on China? So from all of these vantage points this is an agreement with great potential, provided it can be negotiated in sufficient depth it could really transform the global trading system.

So that's the positive spin, that's the positive scenario. But there's a second view, again with some elements of truth, which says that actually there are considerable political problems facing the negotiation of this agreement and people who raise questions about whether the agreement is going to go far enough. Particularly when it comes to Japan, major issues relate to the question of agriculture. The structural needs of the Japanese economy, I think everyone agrees, require a major opening and restructuring of the agricultural sector. But the normal political responses have been to resist that opening and the talks that have been embroiled in discussions over the details of tariff structures and so on, which are quite understandable but nonetheless, not really compatible with the view that what is needed is deeper structural change.

On the American side there are a fair number of people who oppose these agreements in principle. And there's a serious issue about whether even if an agreement is negotiated, it's actually going to get passed by the US Congress. Trade Promotion Authority, which the President proposed in his State of the Union Address, was immediately rejected as an issue for this year's legislative agenda. And so it's quite natural that there's a skeptical view about these agreements.

And then there's a third question and I would characterize this as the stumbling blocks view of these agreements, as opposed to the positive spin which is being given about building blocks. This is an agreement that after all will reflect the political driving forces in the group of countries who are in the room. And the question is whether they negotiate an agreement that can in fact be used as a model or as a building block for others to join. If we do include issues like labor standards and environment in the agreement, if we do have particular deals which we cut within the context of that negotiation, will it then be possible for the large emerging economies like India, or like China in particular, simply to sign up and join on the same terms? Or in fact, will we see the evolution of a world economy in which there are the standards makers and the standards takers; those who are able to agree with each other and others who've been excluded with major negative consequences, not only for their own interaction, but also for the multilateral trading system?

So I just wanted to present those three pictures. As I say, I think we need to be mindful of all three. What we need to have is an agreement that's negotiated, that can genuinely deliver on the potential for structural transformation, on the marketing opening potential, and on the provision of governance that are required for global integration. At the same time, I think we need also to be mindful of the need to construct an agreement that can genuinely serve as an integrative and building block arrangement, rather than one that actually fragments the global economy.

So with those three reflections I look forward to my colleagues' interactions to hear which of those they feel is most likely. Thank you.

Dan Bob: Thanks Bob, that was great. And now we're turning to Hideichi Okada, who will talk a bit about regional integration and supply chains.

Hideichi Okada: Can you please put my slide on the screen? Okay. Oh thank you for your kind introduction Bob Dan and good morning everyone. I'm Hideichi Okada, and it's a great pleasure to be here as part of this at the First Annual US-Japan Economic Dialogue, jointly hosted by Sasakawa Peace Foundation and the Peterson Institute of International Economy.

First of all, I would like to express my deep appreciation to the Sasakawa Peace Foundation for its effort to try to revitalizing various policy dialogues between Japan and the United States in a wide variety of areas. I'm also thankful to its dedication to keep encouraging a policy dialogue between the two countries made by Peterson Institute of International Economy.

Let me start with this slide. This shows the trade flows among Japan, China, ASEAN countries, United States, Canada, Mexico and European countries. The size of arrows represents the volume of trade and the color of arrows indicates the weight of intermediate goods, such as parts and components in those trade flows. Dark blue represents 70% or more, the purple 60%, blue 50%, green 40%, orange 30% and yellow less than 30%. This chart tells you that Japan exports are mainly parts and components to China and ASEAN countries. And then these countries export finished goods to the United States and Europe.

So as you see in Asia, horizontal division of labor beyond the border has been highly developed. And it seems to me that the US is becoming an important part of this supply chain. And these are internationally intertwined supply chain in Asia-Pacific has been and will be supported by the efforts to be develop regional economic integrations as shown in this slide.

Let me start with the lower left-hand side corner of this slide. ASEAN 10 countries have been playing a very active role to establish ASEAN plus FTAs with China, Japan, Korea, India and Australia and New Zealand. And it is quite natural to think about setting up 10 plus 6 FTA instead of 5 ASEAN plus 1. So China proposed 10 plus 3 arrangement in 2003, and Japan proposed 10 plus 6 arrangement in 2006. And then it finally ended up with the idea of regional comprehensive economic partnership or RCEP, and in 2012 16 heads of states announced their decision to start negotiation.

The launch of the negotiation of China, Japan and Korea on the upper left-hand side corner FTA was announced in 2012 November 2. Xi Jinping has been refusing to meet with Prime Minister Abe since Abe took his office. And recently there are no bilateral meetings between government officials from Japan and China, but the negotiation on CJK trilateral FTA is an exception. Officials from the three countries had four rounds of negotiations as of now.

The upper right-hand side of this slide indicates TPP, when Japan finally joined the negotiation in July of last year. Japan and the United States are major trading countries and share the goal to further enhance economic growth, expand regional trade and investment through strengthening the [inaudible 00:35:56] based trading system. It is important for Japan to have a high standard regional FTA arrangement with Asia-Pacific countries, including the United States, when business has been developing highly integrated supply chains over the [inaudible 00:36:13] as the previous slide.

Some of my friends in China told me that it looked to them that TPP was a part of the US strategy to exclude China out of the Free Trade structure in Asia-Pacific, but I do not agree with that idea. As you know, in 2011 at the APEC Summit in Yokohama, all the leaders of APEC Economies, including Chinese leaders, agreed that their future final goal is to build a free trade area in Asia-Pacific or FTAP, which was originally proposed here in this building and that both RCEP and TPP were two possible pathways for their ultimate goal of FTAP. I'm very pleased to learn that recently China shows its strong interest in TPP.

Now let us take a look at the comparison of the tariff rates of certain products among major countries. It is well known that the tariff rate on rice in Japan is extremely high, but however, when you look at the other tariff rates on the vegetables and fruits, such as spinach, carrots and lemons, Japanese tariff on those agricultural goods is not so high compared to the other countries. And as you know, Japanese tariff on industrial goods is almost zero. There is the famous [inaudible 00:37:58] demand 25% tariff on pickup truck.

Then what happens between US and Japan on negotiation on TPP. It is photo when President Obama and Abe enjoyed the Sushi restaurant in Tokyo when President Obama visited Japan in April. During the course of the Sushi they also talked about TPP and both leaders committed to taking bold steps necessary to complete a high standard ambitious comprehensive TPP agreement. They announced that "they had identified a path forward on important bilateral TPP issues," and also they said "that it marked a key milestone in the TPP negotiations, and would inject fresh momentum into the broad [inaudible 00:39:09]."

The size of the GDP of Japan and the United States account for 80% of total GDP of the TPP 12 countries. Every country in the negotiation is watching very carefully what's going on between Japan and the United States. I strongly believe that speed of the negotiation and the content of the agreement between Japan and the United States are very important because they create a momentum of the whole negotiation and also they set the standard of the ambitiousness of the whole agreement. Between Japan and the United States the two countries share most of the points on [inaudible 00:39:53] issues. The major areas for negotiation right now are market access on auto and certain agricultural products. I think it's hard negotiation, but I'm very respectful to negotiators from both countries for their hard work to try to forge out a win-win solution to this very important 21st century agreement.

And 2 weeks ago, when trade ministers from 12 countries gathered in Singapore, it seems to me that the development of the recent bilateral negotiation between US and Japan in late April created a new momentum among other negotiating member countries for promoting and advancing the negotiations.

I will not touch upon much about the "Abenomics" and its third arrow, but as Professor Motoshige Itoh pointed out that now Prime Minister Abe is focusing on promoting the third arrow, the growth strategy, to encourage private investment. Key elements of these initiatives are deregulation in the area of energy, welfare, medicine, labor, agriculture, creation of national strategy special zone, a reduction of corporate tax, increase of women in the workforce. Though critics said it's the speed and level of accomplishment it's not adequate, but I believe that the things are heading for the right direction.

Finally, I would like to share this photo with you. This is a photo I took from my office in Tokyo. A gray storm building on the right-hand side bottom of the picture is the Supreme Court and the green area is the Palace. The photo at the right-hand side bottom is the one which was taken 10 years ago. All these new buildings and tower were built in these 10 years. During these 10 years Japanese economy was not in good shape, and there was no government initiative to encourage constructions. It was a deregulation, which expedited the private investment in this area. Every time a young [inaudible 00:42:26] came to my office to seek advice for growth strategy I always took them to the window side and showed the view and tell them that the key of the growth strategy is deregulation.

Thank you very much.

Dan Bob: Okay, and batting cleanup we have Jeff Schott. Jeff.

Jeff Schott: Thank you very much. One of the things that we pride ourselves here at the Institute is trying to encourage an informed public debate on important international economic issues. And so I'm very pleased to have been able to participate with the Sasakawa Peace Foundation in this project to have a better understanding of the Transpacific Partnership in particular. We've done a lot of work on this here at the Institute. And to try to encourage a similar intensive public debate in Japan we published and translated our major study on the Transpacific Partnership in Japanese. So hopefully our viewers in Japan will be able to get a hold of this copy and have greater access to a basic understanding of what the TPP is.

Now Japan became the 12th participant in the TPP negotiations a little less than a year ago and has made incredible strides in coming up to speed and participating very actively in the negotiations. It has very important economic and foreign policy objectives. And I think in order to clarify some of the three scenarios that Bob Lawrence presented earlier; it would be useful just to take off very quickly some key objectives for Japan and the United States in their joint participation.

For Japan the TPP should help advance its domestic economic priorities by spurring policy reforms that create a more attractive environment for investment; that's what Professor Itoh mentioned before. Peter Petri here and his work at the Institute, has estimated that the TPP could boost Japanese GDP by more than 2.0% above baseline growth when the deal is fully implemented and generate double-digit gains in Japanese exports. That's big gains for an economy and would be a function of the reforms that would be required by the agreement.

Second, the TPP should also support Japan's policy of deepening trade ties with countries in the Asia-Pacific region. Japan already has a number of trade agreements, but they're not of the same quality as the TPP and so the TPP would help upgrade a lot of Japan's economic relations with partner countries in the region, just as TPP will help the United States upgrade NAFTA.

So that's very important, but Japan and the United States don't have an existing pact. And so one of the important benefits of the TPP would be to provide a surrogate for the long-vetted but never launched bilateral FTA negotiations with the United States.

Third, the TPP is also an important component compliment to trilateral talks that Japan has with China and South Korea, as well as broader negotiations of the regional comprehensive economic partnership. The 10 plus 6, or ASEAN plus 6 negotiations that really were an inspiration of Japanese policy of 5 or 6 or 7 years ago. The RCEP and the TPP are not alternatives. They can and should be pursued simultaneously and indeed, many countries are already doing that. Seven of the 16 participants in the RCEP are also in the TPP, and 4 other countries in the RCEP are considering very carefully future participation in the TPP. South Korea, Indonesia, Philippines and Thailand. And even China is seriously studying for the first time TPP participation before the end of this decade.

And so what we see is a convergence towards the TPP among the countries in the Asia-Pacific region, and I think that's very important. It tends to indicate that TPP is a building block to regional integration and will not be the stumbling block that Bob Lawrence posed in his three scenarios.

Fourth, the TPP helps offset discrimination that Japanese firms now face in some foreign markets due to trade pacts in which Japan is not a signatory, most importantly the Korea-US Free Trade Agreement, which has affected some competition between the three countries.

And fifth and perhaps most importantly, and with a bow to Admiral Blair, from a strategic perspective, the TPP deepens US engagement in the Asia-Pacific region at a time when both countries face continuing political and strategic challenges in North East Asia. Working together in the TPP for mutual economic benefit will also improve the already strong US-Japan relationship.

So there's good reason for both countries to work together and they're doing so. Japan's entry into the TPP talks made the negotiations more difficult, more complicated, but it also made a big deal more likely because there's a lot more on the table. Benefit for the United States, benefit for the other TPP countries who are now negotiating with Japan.

Certainly there has been a bottleneck on the agricultural negotiations. That bottleneck seems to be breaking down as a result of the progress that was made in April in talks in Tokyo between US and Japanese officials. While the details of that progress that it's being called are not well-defined, I think the indications that we get are that it seems to be evolving along the following lines: First, that Japan will commit to substantial reductions in tariffs on key products, but may not fully eliminate all the products, all the tariffs on all the products. What's important as Mike Froman said in Singapore a couple of weeks ago, is that the deal open up substantial new market opportunities and that makes a big difference in accessing the Japanese market and selling more goods to Japan. And that I think is an interest in both countries.

And I think that type of progress opens the door to broader work among the 12 countries to develop the final compromises needed in the areas of the negotiations that are still open, with regard to intellectual property rights, with regard to some investment issues, particularly investor state dispute settlement, with regard to the labor and environmental chapters, and with regard to disciplines on state-owned enterprises. In many of these areas US and Japanese positions are quite complementary. And indeed, US and Japanese officials have been working very closely together to try to build a broad consensus needed to finish the TPP negotiations. I think for both the United States and for Japan the benefits in those areas grossly outweigh the economic benefits from the hard but limited frictions that we have on agriculture. Those problems need to be resolved to ensure that there is political support for the overall deal. But I think when we do the balance of the TPP for both the United States and Japan we'll find that it's strongly in our economic interest; it's strongly in our political interest to finish the deal before the end of this year.

Thank you very much.

Dan Bob: Thanks Jeff, that was great. If I can ask the panelists to come up on stage, we have just a little bit of time left over for Q&A.

Again, thanks all for terrific presentations. If I could take the prerogative of the chair just to ask one question; there's been a lot of discussion about the upside for TPP agreement, and I tend to think that failure on TPP is unthinkable. But if the unthinkable were to happen, what would be the consequences, not only economically, but politically, strategically?

Hideichi Okada: It's very difficult just to think about failure at this moment. It may take some more time in the negotiation. If it's not going very well immediately, but I think there's some kind of momentum for having the agreement. And also, the one thing which hasn't been discussed yet, that is kind of the interaction among various type of the FTAs. TPP is not only the negotiation we are doing in Japan. RCEP, and also we are now negotiating FTA or EPA with Canada, we finished an agreement with Australia, and we have a negotiation with EU. And the United States also have a negotiation, not only in TPP but also EU. So this has a very interesting dynamism of negotiation.

We started the negotiation with Australia some years ago, but it was stalled for a while. But the activation of the TPP negotiation actually gave a very interesting stimulation to just speed up the process of negotiation. So I hope this [inaudible 00:53:47] of the interaction will just continue for a while so not only we can just finish the TPP negotiation, but also other negotiations. Thank you.

Bob Lawrence: Well I think failure would be a really serious setback, especially for American Trade Policy. This is the centerpiece of our initiative in Asia and the consequences of failure would mean that we could try to go back to the drawing board and I mean, much depends on the reason for the failure, but I think it would be a severe setback. And meanwhile, other countries, the Europeans and others, would continue to pursue their initiatives. So I think relatively speaking, it would be severely damaging to the United States.

I think the great upside of the TPP and of the TTIP is that it presents a challenge to the multilateral system to come up with its responses, which help other countries participate in these deeper integration agreements. The failure of the TPP negotiations would therefore undermine that impulse as well. So I think in fact, we could also see that the WTO, ironically, would be weakened as well. So I think there are risks underlying this initiative that face both countries.

Then the final point has to do with the role of TPP and Japan's structural reforms. There is the issue of agriculture, but I think far more important, as Professor Itoh has spoken about, is trying to stimulate investment. And I see liberalization and opening of markets, particularly in non-traded areas for foreign investors, as giving a major impulse for mergers, acquisitions and investments. And so I think that opportunity would be lost as well and it would be a severe setback for the structural arrow in the "Abenomics".

Hideichi Okada: Let me see an impasse in Geneva as Bob Lawrence pointed out. High standard regional economic integration arrangement suggests TPP would play an important role for a freer trade system right now.

I participated in lots of trade negotiations, and as you may think that I won't say I always try to solve the easier one. And toward the end of the day we will have a most difficult agenda on the table. So I believe that both US and Japan are at the very critical moment, so I think that both sides have to work even harder to seek an arrangement agreeable by both sides. And I can't imagine TPP without Japan because TPP without Japan will be less meaningful. And also, if Japan is also only pursue RCEP I don't think that we can make us move toward higher standard with just the RCEP arrangement. So we have to push every regional economic integration arrangement, especially TPP will be one of the key elements right now, I believe. Thanks.

Dan Bob: Jeff, did you have any comments?

Jeff Schott: I think Robert Lawrence put it very well and I just reinforced his comment on the risks of the multilateral system if it's shown that we can't put together a deal among like-minded countries. Thank you.

Dan Bob: Okay, we have time for—I'm afraid for only one question, and there's a mic I see back there. So if you could identify yourself.

Claude Barfield: Claude Barfield, the American Enterprise Institute. Jeff gave a very optimistic view about the agricultural negotiations, but as he and maybe Robert know, there's been a growing course here in the United States put in by the business community to say, "Well, if the Japanese can't compromise we should just leave them behind." How seriously do you take that, in other words kick them out? How seriously do you take that and what are your own views about this possibility if we can't reach agreement in agriculture?

Dan Bob: Well, you have domestic negotiations and international negotiations. And I think the business community is rightfully trying to steal the resolve of negotiators to get the best deal possible. I don't think the business community views failure as an option, but I don't regard the lack of total elimination of every tariff as a failure. And indeed, in many products you can have a very substantial liberalization that is very meaningful and causes a substantial change in the policy of the Japanese government and opens up new export opportunities. So I think the negotiators are moving in that direction, of course making the final commitments to sensitive policy reforms needs to be done in the context of the broader package where you know you're going to get benefits across the board, affecting benefiting agriculture, manufacturing and services. And so that has to be put together, so I think I'm still optimistic and I think the negotiators are doing a good job.

Bob Lawrence: I guess I'm somewhat more negative. I think a key element in American Free Trade Agreements has been to seek virtually universal coverage. I think it was unfortunate that sugar was accepted from the US-Australia agreement and I think if we were to agree to exclude large numbers of tariff lines and even if we were to allow for small tariffs to remain in place, that would set bad precedence for future potential agreements with others. The WTO requirement is for liberalization in substantially all trade. The word substantially has a variety of interpretations, but I think there's merit in that rule and I think it would require a serious examination were we to be confronted with the prospect of having an agreement that had significant exclusions.

Dan Bob: If I could just clarify, I agree with Robert, but the problem is solved if we don't have different exclusions or exceptions than we had in the [inaudible 01:01:25] FTA, where you had a number of tariff lines where there was partial liberalization as well.

Motoshige Itoh: Just a very brief comment about just negotiations. Although just information not just given for outsiders like us, but we are watching very carefully from outside and there is some kind of up and down about expectation. Three months before President Obama is coming to Japan, I am not just expecting just the agreement will be made very immediate; I expected more time required.

And then there's very intensive negotiation, maybe 2 weeks or 1 week before President Obama's visit to Japan and there's a kind of increasing expectation there's going to be some kind of agreement. And even in that process of adjustment I think the number of the issue is just becoming more focused to some limited area, pork and maybe automobile and some other areas. So as Mr. Okada said, negotiations are starting from the easier one and try to just finish the more difficult one in the event. But the important thing is we do have some kind of progress, so we have to do more effort to just finish the final point of this difficult part of negotiations.

Dan Bob: Well, thank you all very much. I only wish we had a little more time for questions, but lunch awaits and as does the second panel. So please join me in thanking our panelists.

[Lunch break]

Adam Posen: Good afternoon everyone. Notice the change from good morning to good afternoon. We've had one great panel and you've been fed and I hope our web-streaming fans are out there as well. Welcome back. I'm Adam Posen, President of the Peterson Institute for International Economics and it's my pleasure to be calling to order the second half of this event we're doing the Sasakawa Peace Foundation, the Sasakawa Peace Foundation USA on US-Japan common economic issues and challenges.

We've already spoken about the trade aspects and TPP in particular, we're now going to be talking about some of the common macro-challenges, fiscal and monetary and in particular, balancing the short-run needs with the long-run sustainability issues, which is of course critical for both Japan and the US.

I'd like to call upon my colleague Dr. Marcus Noland, the Institute's Executive Vice President, Director of Studies to chair the Panel.

Marcus Noland: Thank you. We're going to go slightly out of order of the agenda as it's been presented to you because a slightly different order was presented to us originally this morning and it's the order in which the names have actually been presented to me to read the bios.

So our first speaker will be Takatoshi Ito. He is Professor at the National Graduate Institute for Policy Studies and Project Professor at the Graduate School of Public Policy, University of Tokyo. He has recently concluded his tenure as the Dean of the Graduate School of Public Policy at the University of Tokyo. In the public sector his previous positions include Senior Adviser in the International Monetary Fund's Research Department, Deputy Vice Minister for International Affairs at the Ministry of Finance and serving as a member of the Prime Minister's Council of Economic and Fiscal Policy. He is the author of many books and articles, most importantly the 2001 volume No More Bashing: Building A New Japan-US Economic Relationship, published here at the Peterson Institute, co-authored with me and a fellow named Bergsten.

Our second speaker will be our president Adam Posen, who in addition to being president of the Peterson Institute; he was a member of the Monetary Policy Committee at the Bank of England. He is a member of the Council of Foreign Relations, the Trilateral Commission, the Bellagio Group, but as far as I know, not the Illuminati.

Our third speaker will be Masahiro Kawai of the University of Tokyo Graduate School of Public Policy. Until recently, Hiro was the Dean of the Asian Development Bank Institute. He was previously Special Adviser to the ADB President in charge of Regional Economic Cooperation and Integration. He also has served as Chief Economist to the World Bank's East Asia and Pacific region, where he was my wife's boss, and as Deputy Vice Minister for International Affairs in the Ministry of Finance.

Our final speaker, batting cleanup to continue the baseball metaphors that work equally well for Americans and Japanese, is Peter Fisher, who is currently Senior Lecturer, Senior Fellow, Center for Global Business and Government at Dartmouth University. Before that he was a Senior Director at The Blackrock Investment Institute, Chairman of Blackrock Asia, Undersecretary for Domestic Finance of the Treasury, Executive Vice President of the Federal Reserve Bank of New York.

To save time in terms of getting up and sitting down, I would ask the four speakers to just play tag team. When the previous speaker finishes just come on up here. And then after Peter speaks we will all converge on the stage. So Taka Ito, please.

Takatoshi Ito: Thank you very much for the kind introduction and I'm very happy to come back to this building and give you some thoughts on Japanese macro situation. And I'll talk about mainly on monetary policy and fiscal policy.

So you've already seen in the first panel the Abenomics. So Abenomics has three arrows: The first one is aggressive monetary policy in inflation targeting, the second arrow is flexible fiscal policy, and the third arrow is growth strategy, mainly structural reform.

As you might have read in the newspaper in the last 15 months, the first arrow has been a big success, to create, to get out of the deflation was the objective and we have achieved halfway towards the 2.0% inflation targeting. Japan was under 20 years of stagnation and 15 years of deflation and we are getting out of this long stagnation and deflation. This is a remarkable achievement and this was the cooperation between our Central Bank and Prime Minister Abe's initiative of a big change in Central Bank policy. So it completely changed from a defeatist, weak Central Bank to an aggressive Central Bank to expand the balance sheet, which is known as QQE in Japan, Quantitative and Qualitative Easing. So it's almost consensus that the first arrow has been a big success.

And the second arrow, Flexible Fiscal Policy, needs a little bit of explanation. The first part of this Flexible Fiscal Policy is a timely, short-run counter-cyclical fiscal stimulus. So when needed, like cooperating with the monetary policy to push really boosting demands, fiscal policy was stimulus, in the stimulus mode. So right after Abe took Prime Minister-ship, he orders the big supplementary budget to work on the weak demand part and this really helped to change the mood from deflation to something new and the growth rate immediately went to 4.0% range in the first half of last year.

But that was misunderstood by some people, that this government is just putting fiscal stimulus all the time. It was not, because the Japanese fiscal situation is actually really bad. The debt to GDP ratio is more than 200%. Now Greece got into trouble when their debt to GDP ratio was 130%, and Italy and Spain, they are in the range of 100% to 80%, still got into fiscal crisis. So Japan was 200% debt to GDP ratio; some people thought Japan is on the verge of fiscal crisis. Others thought, "If 200% and no crisis, then we could go to 250%." Both are wrong. So a fiscal crisis didn't happen, has not happened, there are good reasons that those 200% debt are held by Japanese residents who are extremely home-biased and [inaudible 01:11:29].

Through the Japanese Banking System, domestic residents hold 95% of the Japanese debt. So that's fortunate for the fiscal authority, but there is a limit. So when these private savings are exhausted or saturated by the government debt, fiscal crisis will come. So now the simulations and so on. I skipped all the details, but my simulation shows that fiscal crisis will happen in 10 years if nothing happens and that will be a very, very bad situation.

Now, how to avoid the crisis? So deficit can be closed; deficit is expenditure more than a tax revenue situation. Deficit is large still in Japan. How to close the gap? Well, expenditure cuts or tax increase; one of the two. Expenditure, actually Japanese expenditure has been really restrained in the last 20 years, except Social Security spending. Social Security spending has been steadily rising and rising and rising and all other expenditures including self-defense and University Professor salary and bureaucrat salary all declining and our public works has been declining. So if you think that Japanese fiscal deficit has been caused by runaway public works, infrastructure, bridges going nowhere, tunnels going nowhere, that's wrong; it has been controlled in the last 20 years, declining to the minimum.

So in OECD ranking that the size of the government of Japan is the last or second last among the OECD countries. So there is very little you can cut in the expenditure, except you control the pension and other social security expenditures, which is politically very difficult, but still that would help. So the best bet is tax increase. Now which tax, income tax, corporate income tax, or value-added tax? Those are the three major tax items and those are the candidates.

Income tax, well, we are on the verge of the dramatic demographic change. All the Baby-Boomers are now aged between 60 and 65. In 5 years they'll all retire and that tips the balance to the retirees. And if you increase income tax, that is just putting more burden on the younger generation population is shrinking. And the pension system is already biased in favor of the older generations and the younger generation know that they cannot get as good social security pension plan as their parents'. So increasing income tax is aggravating this inter-generational inequality.

Corporate tax, tax rate is 40% and we're talking about decreasing corporate tax rate to keep the Japanese companies in Japan. Japanese companies off-shoring are holding out, whatever you call that, they're building all their operations abroad, partly because of the high corporate income tax. So the best bet is consumption tax.

So that is why Prime Minister Abe initiated this consumption tax increase, which happened this April 1. So consumption tax has been on the low end, 5.0% until March this year was raised to 8.0%. And next year, October, it's going to increase to 10%. Ten percent VAT is still low among the OECD countries. While US is an exception, but [inaudible 01:16:33] VAT. But most European countries have the VAT rate of 20%, or plus minus 5. So when Greece got into trouble, the VAT was already 19%. IMF came in, you have to do a tax increase, and they raised to 23%, but didn't have much.

While Japan has from 10% to 25%, there is additional 15% point tax space, tax increase space. And this has to be exploited, unfortunately, to balance the budget and produce some surplus, to bring down this huge debt to the sustainable, more long-run sustainable level. But the good news is that there is a way to do it, which is consumption tax increase. And the bad news is, if you don't do it there will be a fiscal crisis in 10 years. And Mr. Abe knows this and the Abe cabinet is working on the growth policy to make the economic growth rate higher, which makes the ground for the tax increase. And if everything goes well, by 2020 the Tokyo Olympic games, we will have 20% consumption tax rates and strong growth despite the tax rate hike. Thank you very much.

Adam Posen: Thank you. It's been my privilege to participate in the discussions as a member and as a co-chair with Motoshige Itoh. And so now, let me try to offer a few thoughts on some of what we learned about Japan's implications for the US and our attempts to bring together, sort of the two sides of the Pacific on these challenges. And I think the place we have to start is the nuance view of fiscal sustainability that was sort of apparent in Takatoshi Ito's presentation, and I think has successfully become the norm since the correction of some of the Reinhart-Rogoff claims.

As our colleague Joseph Gagnon has documented and many others have observed, it is difficult to find any point in history where a country that had its own currency is issuing debt in that currency and has an independent Central Bank has had a crisis of fiscal policy. That doesn't mean it can't happen and we can think of circumstances where it might. But it does mean that we're not all sitting here teetering on the edge at every moment. Instead, as Japan has demonstrated and the US has been increasingly demonstrating, as numerous members of our group would agree, when you have too high a fiscal deficit recurrently you run into another number of other problems; you tend to displace public investment, you tend to bias things towards the present and against future generations, you tend to have less room in case of true emergencies, Japan surviving the Fukushima tsunami and the accident certainly knows where the true emergency is, but the US surviving 9/11 is also a true emergency.

There are issues of credibility and how people view the world. It is not costless to run ongoing large deficits, even if it is not crisis to run ongoing large deficits. And so part of what I think we've usefully been talking about, is this question of how does one make progress on resolving these issues without phony claim of a crisis? And I think this is a place where the current Japanese government, the technocrats of the Ministry of Finance and the Bank of Japan and the Japanese people frankly, deserve a certain measure of credit, that they have reached an intellectual consensus that I think most of us find justified, that Japan, like the US has a share of GDP going to taxes that is much lower than what we know can be sustained. It doesn't mean that you have to become the Netherlands circa 1984 and put everything into the public system, but it does mean that there is a good 10 to 20% of GDP in Japan and the US and notably really only in Japan and the US, where the tax rate has stayed much lower and you could raise taxes without causing hugely undue distortions.

Now that is not the only way you can resolve these issues. As we discussed, there are better and worse ways to spend money and there are certainly pieces of money being spent by both governments that can be cut back. But I think the common point and the big lesson from Japan for the US is the idea that a steady, long-term tax increase plan on a national basis can be managed.

Now our colleagues who work on Europe in this Institute will also talk about the sort of enforced crisis plans of austerity in Western Europe and that's a different matter. And I think we should be very conscious of the fact that in Japan, even if we are seeing a path towards a 20 or 22% value-added tax rate over say 10 years, that's a fiscal drag of less than 2.0%, probably 1.0% a year. And that is not trivial, but nor is it tragic. And it is very much a challenge to the US to think about having a radical restructuring of tax code, let alone an upward, well-established, credibly committed path.

Now let me not get carried away here. The Abe government and Prime Minister Abe himself have said it's not guaranteed that they're going to raise the taxes again this fall or commit this fall to raising them next year, let alone the additional percentages to come. Speaking solely for myself, not for the group, I would just issue a warning to people in the Abe government who would like to postpone this, that they do so at their peril; that there are a large share of Japanese equities and of trade in Japanese Yen that are totally subject to market forces, even if the Bank of Japan is buying up JGBs and you could see a very stiff correction, in fact I would strongly expect a very stiff correction if we get to late October, early November and the Abe government does not affirm the next step of the tax increases.

Again, is this a crisis in the sense that those people who've been betting on the collapse of the JGB market will make money? Probably not. Is this really bad in the sense that it would be a huge asset loss in Japan and a setback to momentum and probably build-in a permanently higher interest rate? Yes.

So now, turning to the US. We had a number of experienced ex-treasury officials, some of whom you'll hear from shortly, and ex-white house officials in our group and we all are, I must admit and I shouldn't say we; I'm not one of them, members of the group who do that I think are suitably chastened, even more than our battle-hardened friends on the trade front, about what is feasible and possible, remembering that we all just came out of the tantrums over the government shutdown and the debt ceiling and all the rest of it.

I think we did however, thrash out two important things that are worth remembering. The first is, there seems to be real improvement on the rate of price increase in Health Care. And remember that what makes the US debt scary is the rate of inflation in Medicare. It's not our demographics because we are fortunate to have much nicer demographics than Japan; it is not the level of current spending, it's the rate of inflation outpacing everything else. Our Bill Cline has done some interesting work on this and has a paper on the website looking at some of these issues.

But the bottom line is there is a strong case to be made that we've seen the rate of inflation of Health Care decline over the last several years; that it may continue to decline. In fact, we may even see some Health Care cost reduction. Now I'm going to leave aside whether that is thanks to despite Obama care ACA. I think there's reason to think that is contributing, but we don't need to get into that. The fact remains we are seeing this in the data. And while we cannot yet count on it as a sustained thing, it helps to emphasize how tractable this problem in reality really is, instead of people throwing up their hands and saying, "Oh my God, we're doomed because we've committed too much to Medicare or Medicaid or Health Care or the VA system," it is instead, "Oh, you mean we have been walking around the world, telling the Japanese, let alone the Greeks, let alone the Argentineans, 'Time for you to do structure reform.' Maybe we can do some structure reform at home." And in the US there is structure reform to be done.

A final point about monetary policy. I and I think the other people on our panel, our group, who have been active in monetary policy, are pretty unstinting in our praise for what the Bank of Japan has been doing for the last year, plus Professor Itoh already mentioned that, I will not recap it. I will simply say that as we extend that to the Fed, I think we are looking at a world where the Federal Reserve is facing a limit to how high they can reasonably go on interest rates in the near to medium term. I think even people with very differing views of the short-term forecast or the amount of slack in the labor market, would agree that given financial regulations and given slow down in productivity, that probably the Federal Reserve cannot shoot for a neutral rate as high as we used to. This has a number of implications, but the most important one is to say that the room for play we have with the interest rate may be much less than people are accustomed to, even when we get off the zero lower bound. And so for that, as well as financial stability reasons, we may need to think about a broader set of tools for the Fed, which of course the Bank of Japan has already begun to implement. Thank you very much.

Masahiro Kawai: Thank you very much. I am Masahiro Kawai. I am going to talk about the subject of integrating long-term and short-run macroeconomic policies. I have a slide, I don't know what I should be doing. If somebody can tell me it will be useful. Oh, okay, great.

Now from a short-term prospective, when there is some shock hitting an economy we have macroeconomic policy, monetary policy, fiscal policy. But in the long run we want to make sure that sustained, non-inflationary and non-deflationary economic growth is going to take place with financial stability and with fiscal sustainability. So that's really the issue I want to talk about Professor Itoh and Adam, from their perspectives talked about this issue.

Now monetary policy, of course Japan, the Bank of Japan has been using QQE, Quantitative and Qualitative Easing since April, 2013, to achieve sustained 2.0% inflation rate. And Mr. [inaudible 01:30:53], Taka Ito talked about fiscal policy to support aggregate demand. Now aggregate demand is now being supported in order to make sure that economic growth would continue, so that the next year the consumption tax rate could be further increased. In the second quarter of this year we expect a downturn of GDP because of the consumption tax hike, but in the third quarter we expect positive economic growth to come back. So the government wants to make sure that aggregate demand would be sustained in order to convince the general public that another consumption tax increase could be implemented.

From a long-term perspective, if you take a look at this graph, it's a really amazing situation for Japan for 20 some years. After the bursting of the bubble, nominal GDP, blue line stayed stagnant for 20 years. Red graph is real GDP. Yes, we observed real GDP growth in Japan when nominal GDP was virtually constant. That was achieved by a declining GDP deflator. This has been a significant problem and over time in the 1990s and the 2000s, Japan persistently ran a fiscal deficit and then debt was accumulated.

In 1990 net government debt was only just about 10% and in 2013 it was 140% of GDP; 10% of GDP to 140% of GDP, in terms of net government debt as a ratio of GDP. Government revenue was 30% or so in 1990 and 2013 it was also around 30%. But the government expenditure rose from 30% in 1990 to 40% in 2013. So revenue was stagnant and then expenditure persistently rose and then we have this government debt problem. From a medium-term and long-term perspective, this fiscal sustainability issue is at least one of the most important challenges for Japan.

Financial stability in the case of Japan, I am not that much worried; it's manageable. One of the biggest concerns is that if 2.0% inflation is achieved then the bond rate can increase, meaning that the bond price would go down and that would have a significant impact on bond holders, including the commercial banks.

According to the BOJ analysis and the usual circumstance of reasonable increase of the bond interest rate, the banking sector is basically sound. The overall banking sector is sound. However, there could be several small regional banks which may be affected, but systemic problem can be contained. So from a medium-term and long-term perspective, financial stability issue would be managed.

Fiscal sustainability is quite important. I agree that there's more consumption tax increase would be needed, but also containing spending would be quite important, pension spending, health spending have been rising persistently and somehow we need to contain this increase. And also we need to achieve healthy nominal GDP growth, 2.0% inflation, plus real GDP growth of 1.5% or 2.0% and then making sure that the interest rate would not jump up. I think if we can do this combination of containment of spending and consumption tax increase and nominal GDP growth, supported by BOJ monetary policy and growth strategy. I think in the medium-term and long-term fiscal problem could be contained.

Just one or two words on the bond rate. The bond rate remains very low, the market behaves that there is more fiscal room and also foreign holding is limited; more foreigners could be induced to hold JGBs. Japan has huge external assets, which must be giving some comfort to bond holders and the BOJ continues to purchase the JGBs. And Mr. Kuroda has been saying that if 2.0% inflation is threatened he will do everything possible to make sure that path, 2.0% inflation is to be achieved. I think this would keep the interest rate low and growth rate exceeding the interest rate, fiscal consolidation is quite possible. Thank you very much.

Peter Fisher: Good afternoon. I'm Peter Fisher of the Tuck School of Business at Dartmouth. I'm happy to bat cleanup here. Also a board member of the Institute here. Let me just echo really, maybe in a different context, some of the things my colleagues have been saying about fiscal sustainability. I have a unique perspective among the group as I was once the Debt Manager of the United States government and would wring my hands at the thought of managing a debt of $4 trillion outstanding, when now we've almost quadrupled that. So the speeches I gave on the subject were perhaps premature.

What I'd like to emphasize really about the group that we had together talking that had been brought together by our sponsors, is the opportunity we have to think about things that we haven't figured out yet, the things we don't know, the things we're trying to learn. And I particularly feel that way, notwithstanding having spent my life in bond markets and debt management, by how much we don't know and how much we still have to figure out about debt sustainability, both in the long run and the short run.

In the long run, I have always taken to heart that a small island nation with a debt to GDP ratio of 200% did manage to work its way out of that crisis after the Napoleonic Wars, when the United Kingdom managed to bring down its debt to GDP ratio over the next 100 years. An awful lot had to go right for that to happen and it did go right. And so I completely share the view expressed by Adam and others on our group in this panel, that things can go right for Japan, but I think there's a lesson that we in the US have to take from the position Japan has gotten itself to.

I would emphasize back to maybe the importance of TPP and other things; the importance of productivity growth for both of us. That's really how we work our way out of a debt problem, a debt sustainability problem. How are we going to get our economy to grow a little faster? We found that in the 1990s in the United States when we even managed to run surpluses for a brief period. And Japan and we now face that problem, how do we get productivity going at a higher rate? And there are many things we have to learn from one another.

I think the United States needs to think hard about the lessons Japan has faced over the last decade in demographics. Our demographics are different, but the Federal Reserve certainly is paying attention to our labor participation right here in the United States and we should think hard and long about the path Japan has been down and what we can learn from that.

In the micro, in the near-term, as the former debt manager let me tell you I know when the crisis comes. It comes when you can't roll over your debt; when you're nervous that at tomorrow's auction sufficient buyers will not show up. And while we all can imagine that that's a problem of excess supply, you've got to borrow too much, I've always thought of that as the mere counter-factual. The real problem that will happen to you at tomorrow morning's auction is a failure of demand. That is a failure of bidders who were there a week ago or a month ago, not to show up. Something happened to their expectations that changed, that's leading them to not want to play and not come to the auction. And I think, as Adam emphasized, if you have your own currency, you have your independent monetary policy, interest rates and exchange rates have been adjusting, you're much less likely to come to that rather that donnybrook moment, if you will, than if you have other constraints.

So I think there are things now that we can learn from each other in thinking hard about the positions we've gotten in to and what it will take to dig our way out of holes that come back to reform, whether on the trade front or the domestic economy front that we all have to take very, very seriously or then the idea that we don't have to worry about a fiscal crisis in our future, I'm afraid will be in the null set.

I'll just briefly mention one other issue that I found fascinating, even though we're in very different positions, Japan and the US, on the rate of public investment and public infrastructure, I think there are things we still need to learn from one another about the dilemma of a constrained budget and what happens to that small amount that is left over for investment in public infrastructure and the perverse consequences of less and less productive investments being made. And I think that's a conversation we have that I'm very intrigued with. We see here less and less fiscal multiplier coming from out expenditures. Japan had that experience, even as they've managed to bring down the rate of bridges to nowhere. I think we both have to worry about that and that's a matter of political economy at the micro level; that's another area where I think we could learn from one another. So let me stop there and bring the panel together up here on the podium.

Marcus Noland: Okay, well I think we've had four very interesting presentations, and we actually do have some time for questions. There is a roving microphone at the front, and there is a standing microphone in the back, so I would invite you, if you're in the front, to raise your hands and if not to line up at the back. And since nobody has immediately raised their hand, I will ask the first question.

So one of the things that kind of struck me in these four presentations and the discussion of these macroeconomic adjustments, was the lack of the discussion of the exchange rate, which is an obsession of some people in this building and more generally, an issue of political concern in Washington and an issue on which historically the United States and Japan have had conflicts. So I would wonder if anyone on the panel would like to address the role of exchange rate adjustments in achieving these macroeconomic adjustments in the two countries.

Masahiro Kawai: So exchange rates, not too undervalued or not too overvalued, roughly an equilibrium exchange rate is a good thing to have for the macroeconomic event, macroeconomic stability. When the economy is weak the weaker currency will help to boost the exports if it's overheated, probably it's the overvaluation will help to contain the inflation. That's the general theory.

Now Japanese Yen appreciated from about 110 to the US dollar, to 80 Yen in the matter of half a year in the wake of the Lehman Brothers collapse. And that was, I would say, mostly because of the failure of the Bank of Japan to expand balance sheets when the Federal Reserve, Bank of England and the ECB expanded their balance sheet, tripled, doubled and 50% increase. So it was partly due to a portfolio shift and partly due to Bank of Japan's fault, but that overvaluation period, 80 Yen, from 2009 to 2012 was corrected by aggressive monetary easing, thanks to Mr. Abe's strong decisions to correct the Bank of Japan's mistake. And now, I think 100 yen, around 100 to 105 [inaudible 01:47:04], which Yen has been in the last 12 months. And I think this is a good range that Japanese corporations are now gaining strength and the fundamentals are getting better. So we are now back into the comfortable range and we hope that this will continue.

Peter Fisher: Could I offer a for a different perspective maybe? Which is exchange rates are an adjustment mechanism. One of my duties at the Fed was managing currency interventions for the US Monetary Authority and Alan Greenspan would like to remind me that no one has a good model of exchange rate determination, notwithstanding my monthly reports on what was driving exchange rates one way or the other. And I think that we in the United States especially will do well to recognize the importance of floating exchange rates and learn to live with their consequences. And to see that they play an important role as an adjustment mechanism. And clearly the Japanese Yen, given the difficulties the Japanese economy's been in, was much too tight for the last several years, much too strong an exchange rate, given the weakness in their economy and the risk of deflation that the second and then third largest economy in the world was facing.

So I think that the most important thing about exchange rates is for us in the United States to have the confidence of our conviction that we believe in them as an adjustment mechanism. Sometimes they'll go up and sometimes they'll go down and to not paint ourselves or our trading partners into any corners.

Masahiro Kawai: Japanese Yen depreciation is clearly a result of easy monetary policy or expectation of easy monetary policy before the actual implementation of easy monetary policy. It's a natural result and monetary policy has been targeting the domestic objective, domestic of divorcing deflation and supporting a growth environment.

Now the Yen depreciated on the real effective exchange rate basis by about 30% and initially there was a concern expressed by several Asian countries, China, Korea and a few others, saying that Yen depreciation could be a bigger thy neighbor policy. But actually what's been happening is that Japanese, real export hasn't quite grown. Although nominal value of export has gone up in terms of Yen and that's what's been helping the corporate sector, the exporters. They have obtained windfall gains and that's been making the Japanese economy brighter. So the exchange rate usually should have an adjustment mechanism, but so far Japan's trade account has not improved. But now Japan runs a trade deficit because of the increased fuel import and export has not been stimulated yet. Although over time, this effect may come in, but not at this point.

Adam Posen: I guess one last comment. As you're all, I hope, well aware, Fred Bergsten and Joe Gagnon from this Institute have done a lot of work, not all of which I agree with, but that's fine, on the idea that currency manipulation can be a very substantial problem and there are clearly people in the US Congress who believe that very strongly. And what I think underlies everything, Peter, Taka, Hiro and I are saying and in particular Hiro's last remark, is that there is a G7 norm that was established a year and a half ago that you don't directly unilaterally talk down or intervene in another member's currency without permission and that even though some over-eager members of the perspective Abe administration had to be called and warned on this in December of 2012, they then responded. And this is very different than say, the behavior of say from the People's Bank of China recurrently through the years.

And so even as we go forward with TPP, I think we should recognize that Japan and the US and frankly the EU, are allies in terms of saying countries should pursue their domestic monetary policy goals and not manipulate exchange rates, rather than as some people would cast that there's some division between Japan and US on this point. And remember that with the exception of some intervention in 2011, part of which was justified, Japan has not directly intervened in the exchange market since 2004. Now were they to change behavior on that, that would be a different matter, but they did not.

Marcus Noland: John Macon.

John Macon: Thanks. John Macon, American Enterprise Institute. It seems to me you're treading a little lightly on the exchange rate issue. I had thought that in 2012 and in early 2013, the notion that was advanced, partly by the Abe government, but also I think understood by the US government, was that it was probably better to have a Japan that's growing in nominal terms at 3.0% than a Japan that is not growing in nominal terms and still has deflation and yet has a stronger currency. A weaker currency is partly an endogenous variable, it should be part and parcel of an effort by a country that has experienced deflation to reflate. And I think if the outcome is a faster growing total pie, everybody else can perhaps just stand back and let it happen. I'm always amazed at the American government's view, whereby we overlook over a trillion dollars of dollar purchases by the Chinese and never cite them for currency manipulation and get very sensitive about very small moves by other Central Banks.

Adam Posen: I think you phrased it as though there was a difference between where you were and most of us in the panel, but I don't think there is. And to go back and Minister [inaudible 01:54:29] from the Japanese Embassy read this quote here helpfully about a year ago. Then Chairman Ben Bernanke at the Federal Reserve had a very clear quote and testimony to, I think it was Senate Banking Committee, that you get reflation when you pursue monetary policies that support reflation, and that the Bank of Japan was doing something not meaningfully different on this score over the last year than what the Fed was doing. And the People's Bank in China is doing something quite different and at times the Bank of Korea has done something quite different. And so in line with what Taka was saying a few minutes ago, a big part of the reason why the exchange rate was bad and overvalued for Japan was because, unlike other reasonable Central Banks, the previous regime at the Bank of Japan chose to be deflationary during the crisis, which was insane, but it was credible. So the markets reflected that.

Marcus Noland: So we have time for one more question. Anyone wants to ask a question? Yes, Lee.

Lee Price: Lee Price from the FDIC. I have a question about 17 years ago, when consumption taxes were raised, some people think that contributed to the slowdown of the economy or weakening of the economy that seemed to be emerging; why should this time be different, that a sizable increase in the consumption tax won't? I think it's too early to tell what's going to happen in the third quarter and the fourth quarter; why should we be so confident now in the third and fourth quarter this year? Obviously this quarter is going to be negative, but after that, why should it be better than in 1997?

Takatoshi Ito: The experience of 1997 is completely misunderstood by many, and the misunderstood notion is that consumption tax hike in April 1997 produced huge negative growth in 1998. But this is mistaken because the negative growth in 1998 was mostly, if not totally, due to the banking crisis, which happened in November 1997 and the Asian crisis which started to happen in July. So without those 2 crises it would have been okay. So this time there is no Japanese banking crisis as Mr. Kawai mentioned, the financial system is robust and barring the external crisis, I think the economy will bounce back.

Peter Fisher: If I could just echo that description of history. I think when we look back in hindsight at 1999/2000, we thought, "Well, gee we wish we hadn't had a consumption tax increase in Japan." But the sequence that year in 1997 was it was actually the rather surprising rate of growth the Japanese economy had that got interest rates to be shocked, that led to the collapse of the Thai Baht. And so that was actually a movement of expectation the Japanese economy doing surprisingly well that create—there were many other contributing factors, a shock to the East Asian economies. And so I think when we look back in hindsight, we had a consumption tax increase, we had an Asian financial crisis, we had a banking crisis in Japan and when we got to 99 we look back and said, "Gee, it would have been nice if we hadn't had a consumption tax increase in Japan." But that's quite something else from saying it was the proximate cause of the rapid slowdown that Japan had at the end of 97 and into 98.

Adam Posen: I respectfully disagree with my colleagues on that; I do think it was the proximate cause. Nonetheless, I come out where they do on things will be different this time Lee, for much the same reasons. The financial system is much sounder and much better capitalized and much less leveraged as are household and corporate balance sheets in Japan now versus 97. So whatever shock you give will not be multiplied to the same extent.

And I think my colleagues alluded over this, the monetary policy in 1997 was wrong. They were busy tightening, basically, at the first sign of growth, which compounded the impact of the consumption tax hike. But the other point I would make is, even I, who usually am held up as the Kansian dove, wanting to always to stimulus, it matters now, as I've been saying for a while, that the debt-to-GDP ratio is 200 plus percent, whereas 17 years ago in 1997, it was a fraction of that. And so you had a choice in 1997 about spreading it out or offsetting it, which I frankly don't think you have quite the same amount of choice about it now. So to me those are the differences.

Masahiro Kawai: Just now, the economic fundamentals are much better than then. If you take a look at our labor market in Japan, the labor market is very tight; the rate of unemployment has come down persistently since the peak or immediately after the global financial crisis. Now our unemployment rate is 3.6%, just below the best performance just pre-crisis. And wage pressure, upward pressure is there and the BOJ, Mr. Kuroda says he would do anything possible if there is a threat to the goal of achieving 2.0% inflation rate. That's providing a lot of confidence on the part of the business sector.

Marcus Noland: Okay, well please join me in thanking our four panelists and we'll move on to the concluding session of our event. Thank you.

Adam Posen: I promise you this wasn't setup so I would keep coming back to the podium in some keystone cops way. I would like to call upon my colleague and co-chair of our group, Motoshige Itoh of the University of Tokyo.

Motoshige Itoh: Thank you very much. I'm just going to be very brief. As everybody is very busy in many different types of issues, in Japan I'm very busy talking about many, many issues about Japanese economic policies. So it is very important to get together to discuss the common issue, especially the important issue just across the pacific. So I think the discussion yesterday and today was very, very useful for us to just identify one of the most important area where we have to discuss more carefully. Now I think I just want to say about TPP, because that is very important issue for the integration of this vision and it is also very important timing at this point.

I think the—I just wrote some memo here. TPP is a very important project for both Japan and the United States to move forward to a new regime of the economic integration in these regions. And also, it will set kind of a momentum for the new rules for the global economic system. And just like other trade negotiations, just negotiations are not very easy. We both have very complicated politics in each other's, but the observation just show us we are now just focusing to start very limited area of the very difficult issues.

So whether we can just go through the difficult issues, such as pork, automobiles, it's very important where we can have a very good result of the new regime or just to go back to the old regime. So I think to highlight the importance of the issue and the timing is one of the very important tasks for us to discuss. So I hope we can just share some of the very important issue and them continue the discussion from now on on this issue. Okay, thank you very much.

Adam Posen: To close this, let me play my usual role of being a little more blunt than some of my distinguished colleagues, Japanese or not.

I think we've all agreed and cheerleaded for TPP for good reason. Motoshige Itoh has led that effort within Japan, my colleague Jeff Schott and co-authors have done some great studies here about its importance. Robert Lawrence has articulated, including today, how this sets a precedent going forward and I think Dennis Blair opening put us in context of how important this is to the overall relationship. And we should not lose sight that TPP is only one part of the US-Japan economic relationship, which includes cross-border investment, joint ventures, training of people in each other's schools, migration and co-production, extensive world of ties in intellectual property and development and on, and we can hope for extensive ties in natural gas and other energy trade.

We should also not lose sight of the fact that economics alone, even TPP within economics, is not the majority of the US-Japan relationship, which is multifaceted and strong. But this is an important moment as various of us have said repeatedly. And it's a difficult moment because, as Motoshige just reminded us, there's politics on both sides. And so realistically, whether we like it or not, we are unlikely to get a vote on TPP, a strong proposal on TPP in the US Congress, until year end or early 2015, after the election, the midterm election. And realistically unfortunately, that creates a vacuum wherein Japan and some other countries participating in TPP can try to, in a sense, backslide from the aspirations that we could have for the kind of high-quality agreement.

It is the responsibility of the US government and the government of Japan to make sure this vacuum does not become self-fulfilling; to make sure that we do make progress towards an actual high-quality agreement, which will be something that will open up jointly for us the markets that we need in East Asia as well as in Latin America by renewing NAFTA, that will jointly put pressure on China and Korea to play by rules that we can all recognize, including but not limited to exchange rates. These will be open deals, but deals depending on how good Japan and the US shoulder-to-shoulder can create a high-standard agreement that the rest of the countries in the negotiations can agree to.

And it is a finite window, not because of threats, possibly because of political patience, impatience, but realistically because Japan is facing a race where many other countries, including the US, are involved in many other regional negotiations. And if Japan and the US miss this window it will be to the detriment of both of us and the world trading system, but it has to be said as often as the case in economics, even though both would be worse off without the deal, one would be truly worse off.

And so I think it is important that we convey to our friends in Japan as well as in the US that, as Prime Minister Abe initially said when he bravely took Japan into TPP, reform and growth in Japan is needed so that Japan can play its role in Asia and have some control over its own destiny. And that does mean sacrificing backwards ideas on agriculture that are harmful to the Japanese people themselves. And it will be right if the US and Japanese negotiators get past those ridiculous things in order to achieve the greater goal.

Thank you all very much for your participation today. Thanks to the Sasakawa Peace Foundation for working with us. Thanks to my colleagues.