MUTUAL INTERDEPENDENCE: ASIA AND THE WORLD ECONOMY*

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Thank you Dr SaKong for that very kind introduction. I am very pleased to be in Korea again—it's been too long. And I am especially pleased to be here at the IGE and to see so many old friends.

My focus today is Asia, and its role in the world economy. This is a continent that has been transformed in the past half century, and nowhere has that transformation been greater, or more evident, than in Korea. Rapid economic growth in most parts of Asia has had a dramatic impact on living standards. The reduction in poverty has been remarkable.

Today, Asia is a large part of the world economy, and the most dynamic. It has been an engine of growth for the world economy for the past several decades; and, as it has grown in economic size, so its contribution to world economic growth has increased. Emerging market Asia was the most rapidly growing region in 2004. The world needs Asia, and the contribution that Asian economies make to world economic growth: of that, there can be no doubt.

But Asia needs the world, too. Asian economic success is the result of economic policies that have promoted stability, growth and openness. But the continent's success has also been based on successful integration with the international economy. All rapidly growing Asian economies have used their traded goods sectors as engines of growth and have benefited from the open international economy.

Future economic progress—*both* for the advanced economies such as Korea *and* for the developing economies in Asia—depends on a global economic system that continues to expand. More than ever before, we live in an age of mutual economic interdependence.

So this morning, I want to examine how the economic transformation of Asia came about, and then to consider the implications for Asia's future role in the world economy. I will argue that this role is one that permits Asian countries legitimately to make demands on the rest of the world, but it is also one that brings obligations for Asian countries too.

The Asian transformation

The modern Asian economic miracle is a phenomenon of the period since the end of the Second World War. The war itself had left its mark on the region. Figures put together by the economic historian Angus Maddison show that even in 1950 several Asian economies were still worse off than they had been in 1913. Per capita GDP on a purchasing power parity basis had fallen in many Asia countries including China, India, and Indonesia; and

* A transcription of the speech given at the Distinguished Lecture Forum on Thursday, June 30, 2005

those same countries accounted for a smaller share of world GDP in 1950 than they had in 1913.

Estimates by Maddison also indicate that Asia had been in relative economic decline since at least the beginning of the nineteenth century. In 1820, Japan is estimated to have had a per capita GDP marginally above the world average, China slightly below; Asia excluding Japan is estimated to have had a per capita GDP equal to about four fifths of the world average. The same series of figures suggest that by 1950, Japan's per capita income was slightly below the world average; while China's was little more than a fifth of the world average. Asia excluding Japan had a per capita income that was roughly a third of the world average.

All that was to change dramatically, as we know. Japan had joined the ranks of the industrial economies before the First World War. But in the postwar period, it became the first economy to experience the sort of very high growth rates that had no historical parallel. In less than a quarter of a century, Japan grew so rapidly that it had a GDP per capita in 1973 almost three times that of the world average—and had almost caught up with Western Europe.

Japan may have been the first, but it was soon followed by other Asian countries, not least, of course, Korea. Angus Maddison's figures show that in 1998, Korea's per capita GDP [in 1990 purchasing power parity dollars] was almost 16 times what it had been in 1950. Its share of world GDP had risen from 0.3 per cent in 1950 to 1.7 per cent—a more than five fold increase during a period when the country's share of world population had remained constant, at 0.8 per cent.

Data from the World Bank's World Development Indicators enable us to track the comparative progress of Asian countries from 1975. China's real per capita GDP rose almost eightfold between 1975 and 2003—and fourfold from 1985. Indian growth has also begun to accelerate—real per capita GDP rose 2.4 times between 1975 and 2003—with most of that growth coming after the reforms of 1991.

By historical standards, the postwar growth rates were unprecedented. In the period after 1960, the Korean economy recorded growth each decade that exceeded the growth of the British economy during the whole of the nineteenth century. Real per capita GDP in Korea, Thailand and Singapore has grown by more than 5% a year, on average, since 1960. Since 1990, Asian per capita incomes have grown nearly twice as fast as that of the United States.

The domestic policy framework

This remarkable economic performance was no accident. Success reflected a strong commitment from policymakers, sustained over long periods, to bring about the rapid rises in growth rates needed to raise living standards and reduce poverty. It reflected a determination to adopt policies that would foster growth and to stick with these policies with a single-mindedness that policymakers in other parts of the world have viewed with awe. I think it is true to say that nowhere were policies aimed at accelerating growth adopted and implemented with greater determination—tempered by a pragmatic readiness to adjust when circumstances dictated—than here in Korea: and the results are evident. In 1960 this was one of the world's poorest countries, and the third poorest in Asia. Today, as you know, it is one of Asia's richest economies.

Trade has been critical to Asian economic success. As growth accelerated in the postwar era, so did the importance of trade to Asian economies. In Korea, the export to GDP ratio rose from 3 per cent in 1960 to 26 per cent in 1975 and 38 per cent in 2003. In China, the acceleration has been more recent: the export to GDP ratio was 2 per cent in 1970 and rose to 34 per cent in 2003.

The experience of Korea, China and other Asian countries underlines the crucial importance trade plays in fostering rapid economic growth. As every economist knows, an open trading system is crucial for lasting economic success. Closed economies can have temporary spurts of rapid growth although such spurts are often followed by sharp reversals. But no country—either in Asia or anywhere else in the world—has achieved sustained rapid growth without opening its economy to the rest of the world.

Trade brings competition—and this is a powerful force for increased economic productivity and thus higher real wages and employment. Competition helps increase efficiency and ensures that resources are allocated in the best possible way. It helps eliminate domestic monopolies. And so it drives down prices both for domestic consumers—as well as producers in import-consuming industries—and in the international marketplace. Prices fall because trade barriers are removed. Import-competing industries are no longer protected and monopolists are, as a consequence, forced to lower prices and to improve their efficiency.

Trade also helps create employment, especially in emerging market countries. Open, developing, economies have an outlet for large pools of unskilled labor: instead of being a drain on resources, unskilled labor becomes an opportunity to benefit from export markets for goods whose production is labor intensive in the early stages of economic growth. And those jobs enable workers to learn the skills that later permit movement up the value-added chain once most unskilled labor has been absorbed.

Asian policymakers have recognized the importance of trade liberalization, and they have reaped the benefits. Of course, other factors have also been of great importance in determining Asia's success: macroeconomic stability must remain a cornerstone of any strategy aimed at promoting rapid and sustained growth; attention to education, appropriate infrastructure, and a wide variety of other measures is also crucial.

The external environment

The extent to which appropriate policies matter is clear when we look at other parts of the world where Asian-style growth rates have proved elusive. It is worth remembering that Asia's impressive growth performance was often achieved against an unpromising backdrop: countries with few natural resources, or small populations, and that are geographically distant from most of the main industrial country markets, have grown at a pace that apparently more favorably-situated countries elsewhere in the world have failed to achieve.

So the domestic policy framework has a crucial role to play, and it is arguably this that explains a large part of the gap between the rates of growth achieved in emerging Asia and in some other regions of the world. Sound macroeconomic policies; structural reforms that make economies flexible and responsive and that encourage competition and make it possible for markets to flourish; and openness to trade: these, along with improving education, better infrastructure and other measures, are all vital ingredients of lasting economic success and sustained rapid growth.

But the international environment is also important in determining the magnitude of the benefits of sound macroeconomic and structural policies. Without a favorable international environment, the rates of growth that would have been achieved even with an appropriate domestic policy framework would have been significantly lower; although of course countries with inward-oriented trade strategies have fared even worse.

The multilateral trade regime established at the end of the Second World War has played a crucial part in the rapid expansion of global trade in the past five or six decades. The founders of the Bretton Woods system set up in 1944 saw trade as crucial for growth. They were determined to prevent any repetition of the beggar-thy-neighbor policies of the 1930s, and to reduce and eventually eliminate protection in the context of a multilateral trading system.

The progressive elimination of tariff and non-tariff trade barriers has been a persistent feature of the international trading system under the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organization. It is no coincidence that the sharp fall in tariff rates and the removal of quantitative and other restrictions that took place in successive rounds of international trade negotiations was matched by an unprecedented expansion in global trade. They were inextricably linked: one would not have been possible without the other, and together they created a virtuous circle, with expanding trade stimulating growth and growth creating a favorable environment for further trade liberalization.

Look at the numbers. In 1947, average tariffs on manufactured imports among the industrial countries were over 40 percent. These tariffs were progressively reduced, so that by the late 1990s they had been lowered to less than 5 percent in the main industrial countries—the European Union, the United States, and Japan. As the newly-industrializing countries (NICs) embarked on successful development strategies, they too began reducing their levels of protection. Today, average protection in most of the developing world is far below what it was a decade or two ago.

At the start of this new century, world trade was worth around $8 trillion—25 per cent of global GDP. That compares with $1.5 trillion, in comparable dollar terms, in 1970, and 13 per cent of world GDP. According to the WTO, the volume of world trade in 2000 was 22 times its level in 1950. Merchandise exports have grown by 6 per cent a year on average for the past 50 years. World trade has consistently grown more rapidly than global GDP, and continues to do so. Last year, global growth was 5%; global trade grew by 8.5%.

Along with many other parts of the world, Asian countries have benefited greatly from this rapid expansion of trade. The more open an economy is, the more it will benefit from expanding global trade, and Asia has clearly demonstrated the truth of this. As a result the Asian continent accounts for the much larger share of world trade and world output that I mentioned earlier. And, as you know, without this rapid growth the enormous gains for Asian citizens in terms of improved living standards, as well as sharp improvements in all the main indicators measuring the quality of life—health, education and life expectancy—would not have been possible.

By harnessing the benefits of multilateral trade liberalization, Asian economies attained their high rates of growth. And Asia has contributed significantly to the rapid expansion of global trade. In doing so, Asian countries have acted as a model for others to follow.

It is clear that the lessons from Asia's experience can be applied in many other parts of the world; and this is especially true of those regions that have yet to attain the sustained rapid growth that Asia has achieved. Rapid sustained growth is essential for poverty reduction: and Asia has blazed a trail for others to follow.

The currently favorable global economic climate is a favorable background for emerging market and low income countries to pursue structural economic reforms that will significantly raise their potential growth rates and make their economies less vulnerable to shocks. It is also an opportunity for Asian economies to build on their success hitherto.

In this context, let me say a word about regional trading arrangements. As economies continue to grow and to benefit from the expansion of trade, it is natural that there should be attempts to foster economic and trade links among neighboring countries. Such groupings have, in the past, brought many benefits as trade barriers have been lowered and trade relationships have strengthened. One has only to look at the experience of the European Union to see what can be achieved.

But it is important that regional trade arrangements should be complements to and not substitutes for multilateral trade liberalization. The EU eliminated trade barriers between its members in the context of rapid multilateral liberalization of trade; tariffs fell by 40 percentage points globally and by 45 percentage points within the Union. European trade with the rest of the world was expanding rapidly even as Europe was integrating.

Neither poorer countries seeking to raise their growth rates significantly, nor Asian countries looking to continuing rapid growth, will be able to realize their ambitions if the multilateral trading system is undermined.

The Doha round of international trade negotiations has reached a critical stage. It is vital that the momentum be maintained if there is to be a successful outcome to the WTO ministerial meeting in December, which in turn will give fresh impetus to further trade expansion.

I believe we have a convergence of interests here, and a chance for Asia to play a leading role in resolving disagreements and breathing new life into the global trading system that has served Asian countries so well in the past. A Doha round agreement will bring huge benefits for developing countries. And by strengthening the multilateral trading system, and opening up global markets still further, an agreement would also strengthen the prospects for continuing rapid growth in Asia.

Asian countries are already prominent in the negotiations, of course. But I think Doha offers a real chance for Asian leadership in the world economy and it is perhaps appropriate that the crucial WTO Ministerial meeting is taking place in Hong Kong. There is scope for Asia to do more to push the Doha negotiators towards the agreement that we all need. The key message to get across in the Doha negotiations is that everyone needs to show a willingness to move. It is—of course—essential that the advanced economies fulfill the promises they have already made to reduce agricultural and other protectionist behavior. But this by itself will not provide the momentum for further multilateral trade liberalization that we all want to see. Developing countries, too, must commit themselves to reducing protectionism and they will gain greatly from so doing.

I argued earlier that opening Asian economies up to trade had been a vital ingredient in raising growth rates. It was—and the same thing was true, earlier, for the industrial countries. Halting the process of liberalization before it is complete would deprive the poorest countries the chance to benefit in the same way, and to begin the process of catching up. It would deprive millions of people of the chance to escape from poverty. The more open economies become, the more they and their citizens can benefit. This is true of unilateral liberalization, of course. But the benefits for all countries of further multilateral liberalization are far greater.

Leadership means more than bold words, though these are certainly needed in the Doha negotiations. Effective leadership also means arguing by example. For the Asian countries to push ahead with commitments to further liberalization now will greatly strengthen their bargaining power and influence in the Doha round—and in the world economy more generally.

And that means being ready to take difficult decisions for many countries in Asia, including Korea, perhaps above all on agriculture. Those countries around the world that restrict access to their agricultural markets and that subsidize farm exports need to show that they are ready to reduce and eliminate such protectionism. This would bring significant benefits to consumers, and raise growth rates, in those countries—whether they be in the European Union, in the United States, or Asia. It would also help developing countries. And the best outcome in terms of increasing global welfare would be if action to liberalize was taken multilaterally, which would also reduce the adjustments that individual liberalizing countries would need to make.

It is right to call on the industrial countries to get serious about agricultural trade reform.

But the liberalization of trade between the developing countries themselves is vital if the full potential benefits of a Doha round agreement are to be realized. We need to see recognition among developing countries that it is not in their own interest to apply protectionist measures against each other. Protectionism simply undermines their growth prospects.

The international financial system

Multilateral trade liberalization has been crucial in enabling Asian economies to experience from rapid sustained growth. But the founders of the postwar economic order recognized that the expansion of global trade required a stable international financial system. Maintaining international financial stability is, of course, the principal task of the IMF. But it is clear from our Articles of Agreement that this is because financial stability is an essential condition for the expansion of trade and economic growth. The founders of Bretton Woods had learned from the bitter experience of the 1930s, when the international financial system had proved so fragile and stability so elusive.

The Bretton Woods system has, I believe, proved to be remarkably durable, adaptable and successful. In the period up to 1971 the system of fixed but adjustable exchange rates established as part of the postwar settlement provided a stable framework that fostered growth. And it did so at a time of considerable change in the international economy as the industrial—and the developing—countries recovered from World War II and experienced the most rapid growth of global GDP in any quarter century in human history. The Fund's ability to provide its member countries with temporary financial support during balance of payments crises proved critical, on more than one occasion, to the maintenance of stability in the system as a whole.

The transition to floating exchange rates in the period 1971-73 was, with hindsight, much smoother than anyone had anticipated. Rapid growth and greater economic integration required economies to be increasingly flexible, and the fixed rate regime that had served the world so well was no longer sustainable. The abandonment of fixed exchange rates was timely, since the greater flexibility that came with floating rates helped the industrial countries cope much better with the oil price shocks of 1973-4 and 1979-80 than would otherwise have been possible.

The switch to floating rates demonstrated the adaptability of the postwar financial system, and the experience of subsequent decades provided further evidence of this. In the early

1980s, the system had to cope with the so-called third world debt crisis when many countries were unable to repay, or service, the large debts they had incurred, mainly from Western banks, in the 1970s. At the time, many observers assumed that developing countries would be forced in the future to rely almost entirely on official capital rather than commercial bank or other private lending to finance development. Once again, the system proved sufficiently adaptable to confound the pessimists, and, with the assistance of the so-called Brady bonds and other market-based approaches developing countries were able, gradually, to recover from the setbacks of the early 1980s and to regain access to private capital, in the form of bond financing directly from the markets as well as from the commercial banks.

The Bretton Woods founders had assumed that the postwar world would be reliant on official capital flows—that private flows would never resume the importance for economic development they had before 1914. The first signs that this might have been a misguided assumption came in the 1960s: Korea, as everyone here knows, was the first emerging market country to borrow on the international capital markets for the purposes of financing long-term investment, back in the 1960s. In the 1970s, the banks acted as a major source of finance. In the 1980s, it was thought that the debt crisis might mark the end of private capital flows, but by the 1990s, private international capital flows were soaring, as investors sought the best return on their capital. Such flows were a force for good, enabling developing countries to benefit from increased access to capital.

By the 1990s, however, the pace of change in the world economy had accelerated further, and the financial system faced new tests. The world was becoming increasingly interdependent; and this brought huge benefits in terms of the expansion of trade and the acceleration of growth for many countries. But as capital moved around the world in search of the most productive home, it became clear that economic rigidities and policy mistakes would be exposed much more rapidly than in earlier times. The series of financial crises, beginning with Mexico in 1994, taught all of us some painful lessons. As all of you here know only too well, the Asian financial crisis of 1997-98 came as a severe, and painful, shock. Decades of rapid growth came to a juddering halt as economies contracted, living standards fell and unemployment rose. The Asian miracle seemed, for a short time, to have ended ignominiously.

That diagnosis was wrong, of course. As we might have anticipated, Asian countries displayed remarkable resilience in the aftermath of the crisis. Confounding all the gloomy predictions, most countries bounced back with remarkable speed. Korean GDP was back to pre-crisis levels within two years, for instance. Indonesia, the last of the crisis countries to complete its Fund-supported program, was able to exit at the end of 2003.

Nevertheless, the Asian crisis, and others in Russia, Argentina, Brazil and Turkey, taught us some valuable lessons. With hindsight, of course, it should have been more evident to many of those involved—including the IMF—that trouble was brewing for some of those countries.

The proximate cause of the crisis in Asia was the sudden sharp reversal of capital flows to the region. Net inflows to the Asian crisis countries were roughly 6.3% of their GDP in 1995, and 5.8% in 1996. In 1997, net outflows were 2% of GDP, a figure which rose to 5.2% the following year. The economic dislocation caused by the sudden reversal was huge, and would have been so for any country.

But, as we now know, the change in investor sentiment was not wholly capricious. There had been a huge expansion of credit over a relatively short period of time. Rapid credit growth is almost always indiscriminate and, in many Asian countries, the result had been a sharp rise in the number of non-performing loans (NPLs). These NPLs had reduced the rate of return on capital, and, in time, they reduced the rate of growth. Once the international capital markets recognized that credit had been misallocated, it was inevitable that they would reassess the risks involved in lending to countries whose fundamentals were less sound than they had previously appeared.

As investor sentiment shifted, several factors conspired to make the situation worse. Fixed exchange rates compounded the problem. Poor regulation of the banking and financial sector in many countries had enabled banks to build up liabilities in one currency and assets in another. Government assurances that exchange rate pegs would be sustained left currency mismatches unrecognized. Devaluation then left financial institutions facing massive losses, or insolvency. Once the cushion of foreign capital was removed, the weaknesses of domestic banking systems were revealed—as was the impact on economic performance.

The contraction in GDP that most crisis countries experienced made things even worse, of course, because the number, and size, of non-performing loans grew rapidly. The further weakening of the financial sector inevitably had adverse consequences for the economy as a whole. In short, the crisis economies found themselves in a vicious downward spiral.

Asia's experience in the late 1990s reminded us of things we already knew, but whose importance we perhaps underestimated. There is no getting away from the need for a sound macroeconomic framework, but the crucial importance of a sound, well-regulated financial sector is now more widely recognized as well. The Asian crisis countries now have better macroeconomic frameworks in place. Monetary policy has become more focused. Fiscal policy reforms are under way in several countries. And flexible exchange rate regimes are now the order of the day in most countries in the region.

The Asian crisis also underlined that the benefits of short-term exchange rate stability are greatly outweighed by the risks that pegged or tightly-managed exchange rate regimes bring—not least from the danger of currency mismatches in the corporate and the banking sectors. Fixed exchange rates can result in very large—and sudden—changes in the rate, thus creating great volatility and lost output over the longer term. The move to flexible exchange rates in most countries has reduced vulnerabilities.

Before the crises of the 1990s, we had perhaps not fully understood quite how important a healthy financial sector is. As economies become more sophisticated, so the role played by a strong, deep, financial sector in allocating resources efficiently becomes ever more critical. We also now appreciate the importance of a healthy corporate sector—and how much this matters for the soundness of the financial sector. A weak financial sector cannot be nursed back to health if corresponding weaknesses in the corporate sector are ignored—any remedy will turn out to be no more than a short-term fix as more corporate loans go bad.

To achieve a strong, well-regulated financial sector means addressing issues such as non-performing loans; capital adequacy; and effective supervision. Financial institutions need the appropriate incentives to develop the skills required to assess and manage credit risk and returns. Effective bankruptcy laws—that strike the right balance between creditors' and debtors' rights—need to be in place. Much has been done in Asian economies to address the weaknesses exposed by the crisis of the late 1990s. And it is no coincidence that those countries that have been more aggressive in the area of financial sector reform have enjoyed better growth performance. And the IMF has been using its bilateral Article IV consultations and other means to take these lessons to all its members.

But there is always more to be done, in part because some countries have yet to complete financial sector and other reforms; and in part because the world economy is always evolving, and economies need to be ready constantly to adapt to new challenges.

A readiness to adapt, a willingness to learn from experience—these are all essential for lasting success, and they are also important characteristics of economic management in many Asian countries. Indeed, one of the most remarkable features of the postwar order has been its adaptability; and this, in turn, has helped the system be a durable one. As the world economy continued to evolve, the international financial system adapted as well. At every stage, national policymakers and the Bretton Woods institutions have sought to learn from experience. The 1990s taught us, for instance, that capital account crises were fundamentally different in nature from current account crises that had initially plagued many countries in the early postwar period.

Asia and the world

The international financial stability that has been characteristic of the postwar period has been an essential underpinning for the rapid growth of the world economy over that period. Asian countries have been major beneficiaries of this stability; and they have been major contributors to it.

This is a continent that has experienced remarkable success—and is continuing to do so. And economic success has brought with it greater influence in the world. Real influence depends on changes in the real world—the larger and more powerful economies become, the more influential they are.

Nevertheless, the pace of change in Asia has been so rapid that it has been argued that Asia's voice in the global economic institutions has not kept pace. Certainly, many of the institutional structures do not yet fully reflect the changes that have been taking place in the world economy. We at the IMF are clear about the strength of Asia's case and Fund management supports the proposals for a rebalancing of voice and representation at the Fund, so that Asia's economic weight is more properly reflected.

That is an issue that will have to be addressed sooner or later. But the Fund operates by consensus and ultimately, as you know, any change will require the agreement of all the Fund's shareholders. Precisely because the Fund is a consensus-based institution, though, Asia's voice carries more weight in our Board discussions—reflecting increased Asian influence in the real world—than the current voting shares might imply.

There are already many ways in which Asia can make its influence felt. This continent has already set an example for others to follow in terms of achieving rapid sustained growth. Asian countries, as I argued earlier, can also take a leading role in furthering the vital cause of trade liberalization.

Conclusion

Let me briefly sum up.

Asia's economic progress in the past half century has been truly remarkable. In no era have more people in the world escaped poverty. Many of those have been in Asia in the past fifty years and, indeed, in the past decade as growth accelerated in India and China. The example of what can be achieved by sound policies, dogged pursuit of economic reforms, and trade liberalization is inspiring.

This is an important moment. We have an opportunity to build on the progress of the past fifty years, and to help those countries still struggling with poverty and slow growth to catch up. A vibrant, healthy world economy is in all our interests. None of us benefits by some being poor—this is not a zero-sum game.

Asia now has a chance to ensure that other countries can follow the Asian path to economic success. Yes, that means policymakers adopting appropriate policies and sticking to them. Here they can learn by the example set by Asian countries.

But rapid growth also depends on a stable international financial system and a multilateral trade system that fosters the progressive liberalization of trade. And here Asian countries can help by doing what they can to preserve the international economic system that served them so well in the past and by working to ensure that regional arrangements complement rather than substitute for the multilateral approach that has brought so much prosperity to so many.

As we approach a critical point in the Doha round of trade negotiations, there is a real chance for Asia to make a difference. Asian leadership at this juncture could help strengthen the multilateral trading system and so ensure that all countries, industrial and developing, can benefit from an expanding, prosperous global economy.

Thank you.

QUESTIONS AND ANSWERS:

Q To my best knowledge, the question is how to harmonize globalism, regionalism and nationalism, since the IMF is one of the most influential global financial organizations. In this respect, I'd like to ask two short questions.

Do you have any comments on the idea of a Northeast Asia Development Bank, a sort of sub-regional bank? I understand there are already a number of sub-regional banks in other parts of the world. Could we have one in Northeast Asia?

Second, North Korea made some economic law amendments, which included a foreign exchange control act and a customs act. With such controls in place, when and under what conditionalities would the IMF or the Asia Development Bank (ADB) accept the DPRK as a member?

Q Very conspicuously absent in your talk this morning are any comments about the very controversial current policy issues across the Pacific and across the whole world, namely the dangers of a continued accumulation of a current account deficit by the US on one hand and the accumulation of a surplus by the rest of the world. You said nothing about what the Chinese policy ought to be toward any exchange rate, nor what the US policy ought to be to resolve its fiscal imbalance. I would like to hear your insight and knowledge on these this issue.

A I have not recently seen very much of what the current Northeast Asia Development Bank proposal is. We already have an Asian Development Bank, which is comparable to the African Development Bank. In this sense, it would be sub-regional and therefore more like the Caribbean bank, or something like that.

Usually, what happens is those sub-regional banks are the retail arms for, for example, the smaller Caribbean islands or the South Pacific islands. There are some coordination questions with regard to the ADB, in this case, or the World Bank also. This is much more a World Bank or ADB issue than it is an IMF issue. I have really not kept on top of that, though I know the proposal is there.

As to what conditionalities the IMF would impose, if you look at our articles one of the things members are required to do as part of membership is to provide certain data to the IMF about certain macroeconomic issues. If and when the proposal for North Korean membership in the fund were to come up, the first thing that would happen would be that there would be a mission that would go and, among other things, look at the state of data availability. They would make sure data enough is available upon which to base an assessment of the macroeconomic stability of the country. On that basis, there would be a discussion.

Then, after, there're no conditionalities at all if they don't want financial support. If they wanted financial supposed, there would have to be a discussion of what policies were appropriate so they could come to macroeconomic sustainability without the fund as soon as possible. It is not something we could say ahead of time. There have been some discussions. There have been people at conferences at many places. As you know, the issue would depend very much on the situation of the time and what the macroeconomics of it was. That's not something that will be on the table soon. We don't know enough, and we don't know what the situation would be when that arose.

Concerning global imbalances, I was focusing on Asia's emerging growth and its growing role in the world economy. Of course, part of the global imbalance story is a story of the emerging Asia and its increasing importance. People are looking at that.

The IMF has had a great deal to say about those imbalances. We've deliberately called them "imbalances". They are imbalances on both sides. One country cannot run a deficit unless the other country has a surplus. The ideal adjustment is going to be four-fold, though with actually more than four.

Quite clearly, there is going to have to be structural reform in continental Europe. The Europeans agree with this. They need faster growth. Their growth rate has been very low. To some extent, eastern European countries that have been doing better have buoyed them, but we really need another percentage or a percentage-and-a-half point of growth. Right now that does not look possible without structural reform.

In Japan, the same kind of thing can be true. We can hope we're slightly closer to being there in some regards. But, again, our Japanese growth has been sluggish.

It's really interesting to go back and ask yourself what would have happened in the 2000-2001 recession if the US had not grown so rapidly. The rest of the world would have had a real problem then. On the other hand, when it grew rapidly and most of the rest of the world did not, it meant the US was going to run current account deficits. It was a natural counterpart of its more rapid economic growth.

Clearly, that has to be addressed. That means, among other things, reducing the size of US fiscal deficits. The US administration has already committed to do that, to get that deficit down below 2% by 2009, although I'm not sure of the exact year or amount. As it happens, the fiscal deficit in the US did come down a significant amount already last year, largely because of unanticipatedly good growth.

In terms of China, that may be a small part, though not the whole part, of the imbalance. Most observers would say that China needs somehow to increase consumption domestically relative to production. That could be through measures to increase domestic consumption, or exchange rate, or a combination of things. The IMF has told the Chinese that we believe that in their own self-interest additional exchange rate flexibility is desirable for precisely the reasons I did outline in my talk, namely that you get one more source of “shock absorber”, if you like, which is a healthy thing. Otherwise, you can be called upon to make a very abrupt adjustment.

We see it as a need to fix a global imbalance, with everyone participating in the adjustment process.

Q I would like you to share your views on two topical issues nowadays. I know the general IMF view, but I’d like to have your personal views. The first is the global housing sector bubble. The other is the oil market and oil price. Both have very significant short and long-term implications for the global economy. How do you assess this housing sector bubble issue? Is it significant enough to cause concern? And the oil sector, the basic problem there is the rapid increase of demand and shortage of supply. How do you assess these issues and foresee future developments?

A Well, the housing bubble is the more difficult of the two. In part because it is not obvious that there even is one, and if there is, what would be done about it. Also it is difficult to tell when something is a bubble and when something is a natural part of market forces. Most of the numbers I see, and these are not IMF numbers--I’m going by things I read the same as you do--most of the numbers suggest that there may be a few places where housing prices are rising quite rapidly, residential construction and otherwise. But this is not a national or global phenomenon.

There are four parts of the United States where there is a fairly major run up in housing prices. And you can argue what it is but it definitely is not a nationwide thing. And supposing that the United States wanted to cut that down, it’s not obvious how they could do so with the normal tools of monetary policy, without having the negative consequences that go far beyond the housing market.

Allen Greenspan gave a very good talk at Jackson Hole 2 or 3 years ago, and it’s published in the corresponding Federal Reserve volume. In it he asked what could the Fed have done in the 1990s if it wanted to do something about what was later recognized as the stock market bubble. And he concluded that even if there were more evidence than there was at that time, that if the Fed had used it’s instruments to try to stop the bubble, it would have brought on the recession sooner and not necessarily done much else that would’ve been useful because it is one sector of the economy and it’s not clear what can be done that makes much sense in that regard.

In most cases, real housing prices do not look all that high. There are questions in many countries; I don't know anything about Korea, but in many countries about the extent to which the price indices is correctly adjusting for quality improvements. Houses in the United States at least are hugely larger than they were, closets are larger now than bedrooms used to be. Three-car garages are now too few and the places look like monsters in many cases but this is apparently what people want. So when you see that the median house prices have risen, it is not entirely clear how much of that is because the price of a standard house has gone up as much as people have wanted more and more frills in houses, and I think this is an important consideration.

There have been efforts to adjust, and in the United States it does suggest that the actual index overstates housing price increases depending on who does it between 15 and 30 percent. Whether those numbers are right, low, or high I don't have a feel for, and I haven't spent enough time on. I guess the real question is whether overall economic policies are ok. Are there things in the text code or otherwise that distort peoples' decisions is an important thing in every country to look at. In the United States there is the interest deductibility and the mortgage which presumably is somewhat of a distortion in housing prices. That is politically untouchable in the United States, so you might as well forget that one.

And on it goes, there may be other things that distort the housing market that can be looked at, sometimes relaxation of zoning laws can do quite a bit. And there are other things like that, but I think it's probably ill advised to make that a part of macro policy because there's no way a macro instrument can or should target the one sector. But as I said I just don't know enough about the circumstances here in that regard. I just came from Japan where of course they do not have that problem, and they would love to have it. We are all paid to worry and we would like things differently.

Oil is and can be a macro economic phenomenon, although of course it is less so than it was. In the United States, if I remember the numbers correctly, in 1973 oil or energy (I'm not sure which), expenditure was 8 percent of GDP, and they were down to one and a half at the beginning of this oil price run up. So remember oil prices were four fold in 1973 and so far it is much smaller, and given that we all have become somewhat more energy efficient, our macro impact is almost surely smaller than it was. The irony of oil prices is that while there is a relatively high price elasticity of demand you can't just go and decide, "my car will now get twice as many miles per gallon", you have to go and buy a new car. And people don't do that right away, so there is a lag.

And the same thing on the production side, the oil companies aren't going to go out and look for new oil sources or look for places where it will be more costly to extract when they have to invest for a year or to unless they are sure or reasonably confident that oil prices will stay high. And what we've seen so far is a situation where as you said is demand driven, where there was almost no excess capacity in the system, and meanwhile the oil producers are convinced that the oil prices will not stay high, so they are not investing, and consumers are convinced that the price will fall, so they are not economizing. And as long as that happens the price will stay high so ironically the price will fall just as soon as everyone has changed their minds and thinks that the price will stay high.

It's interesting, I think it was when Exxon-Mobil had their annual meeting a month or so ago, and it was reported in the paper. One of the shareholders asked the chief executive officer why, "Exxon-Mobil has billions of dollars in cash reserves, the oil price is high, why aren't you investing more?" To which the chairman's answer was quite simple; "Commodity prices never stay high". He just dismissed it. As long as most of the oil companies are thinking that way, we will see marginal adjustments in supply when you can put in a small amount and get a little extra.

But the real problem is going to be what happens later. Now our projections at the IMF--which are secondary, we are not the primary source--suggests that probably between now and 2010, the growth in supply will approximately equal the growth in demand. But starting about 2010, based on what we now know, there is little prospect that the non-OPEC suppliers are going to be able to increase their supply as much as they have in the past. Therefore there's some basis in believing that in another 4 or 5 years the oil price may start going up because of this longer term secular trend. Before that, this doesn't seem to be the case, but what has happened, is that there's almost no gap between capacity and demand.

So anybody who sees anything in the world that might mean that there is a temporary shortfall in supply: Nigeria, Venezuela, offshore India, a refinery explosion in Texas, all of these, every one of them sends the oil market up because people are nervous given that there is such a small gap, and in the short run the price elasticity of demand for oil is so low. So the oil market is volatile, we've seen these swings. So far the forecasts are that we are above what price will settle at for the next 3-4 years, but we have been wrong for a year now, so, one hesitates to say what will happen as we go forward.

Q I have a difficult question about IMF conditionalities during the Asian financial crisis. The question is about the conditionalities and whether the way IMF handled the Asian financial crisis was appropriate. A connection I just wanted to tell you about is that I wrote a column in a newspaper a long time ago, and people used to call the Korean currency crises, "IMF crisis", as if IMF caused a crisis. But I thought that it was not appropriate because when the Korean war was going on the UN came to help us but we didn't call it the UN war so I think that "IMF crisis" is not the appropriate word even though many people thought that IMF caused the problem. Now, we all know that this Indonesian case is quite different from the global case, but even in Korea's case people like to know the IMF conditionalities and if the way the crisis was handled was appropriate.

A One of the things I think is so hard to recognize and that makes public discussion so difficult is that everything is probabilistic--there is very little certainty. Especially when you are getting big capital outflows. The first problem is to stop the bleeding, and if you don't do quite enough, you'll lose a lot, if you do too much, you can back off fairly fast.

Now you don't want to do more than you have to, but how much do you have to? Well, what kind of confidence do you want to be sure that your measures will really take hold?

We have had countries where they have seen the capital outflows intensifying and they have taken small actions, and it just makes the capital outflow bigger. The real question is what would have happened had the conditionality or the measures been less strong? And the difficulty there is we don't know. Remember in Korea it was in early December when the IMF program came in and the capital outflows didn't stop until the second round in January. Already there is one basis for saying IMF conditionality was not enough the first time around based on what happened.

The second thing is that it is much easier once you stop the flow to relax things so that you don't have to stay with a very hard stance. But failing to have a sufficiently tough stance at first can make the total amount of effort you have to do much greater. And I think that makes it very difficult to evaluate whether it was the right amount or not.

Remember the IMF team had 72 hours to come up with a program. Remember that everybody in Korea said, "We won't come to the IMF no matter what, we don't want you, stay out". And then in 72 hours the IMF was supposed to come in and give a program. Now my own judgment--and I wrote this before I knew I'd come to the IMF--was that indeed, the IMF team did very well to come up with a program like that as quickly as it did. And I think they were, in my judgment, correct to be careful to try to do enough so that the capital outflow would stop. Once it stopped, then other measures could be gradually adjusted, as one was confident that there was no longer a risk of triggering another kind of major crisis situation. So I would say on the whole, now, IMF clearly overestimated the extent to which the fiscal adjustment would be required, but I'm not even sure there that that was a mistake.

A country in a crisis that doesn't make a strong fiscal adjustment is a country where the foreign creditors are going to think they're not serious about getting over the crisis. And part of it's simply the signaling, It's important to know this, and after all if you cut back on fiscal expenditures, no country has had a problem increasing them again, that's not an issue.

It's painful, but on the other hand, especially under these circumstances to get a very strong signal. Now, remember that Korea recovered very quickly relative to all the forecasts in the papers and forecasts in the policy discussion. At the time of the Korean crisis, the recovery began sooner and was far more dramatic and quicker and more expansionary than any anticipated. So I don't think based on hindsight that you can criticize either the Korean policy makers or the funding people for that.

Now what is true, and what everybody is guilty of, is that none of us were sufficiently acute in spotting that the crisis would come. Because quite obviously had we seen it 6 months before and appropriate measures undertaken, it might have been avoided, and now I think we've learned not so we can be perfect but so we can be a little better at it.

And I think that there was learning in the 1990s, people had not seen crisis like that before, everybody thought Mexico was one off at that time, and so it was very soon after that. And as I said the world economy changes, and as it changes, the kinds of things that bring about things do it. So I would say yes, all of us are guilty, we didn't see the crisis coming, and that is the fault of all of us. But once that it was there, I find it difficult, even with hindsight, to say that I'm confident that the adjustment could've been made smaller, and still had been effective. Maybe it could have, but if I was doing it all over again, I'd want to take a stronger adjustment and then as things came good, I'd ease up, but that's just one opinion.

Q You did mention one of the lessons we could learn from the Asian financial crisis. What other major lessons do you think the global community as a whole and IMF could draw from this Asian financial crisis? What I'm getting at, for example, is before the Asian financial crisis; the provincial supervisory and regulatory function was not considered that important.

When I was in the government for example, and we were pressured to open our capital market, I never heard the word sequencing or the intermediate regime exchange rate system. But after the crisis we now know that proper sequencing is very important, and the provincial regulatory financial supervisory function is very important, and so forth. So what do you think are the most important lessons we could draw from this crisis?

A I think the whole world appreciates the importance of flexible exchange rates, and I think most people would now say that either you have to be willing to be arbitrarily close to a currency board and committed forever, at all costs, and make your monetary and fiscal policies subject to that every day. You have no latitude, you fix the currency board, and then you let it go. Or you go to the other extreme on the flexible exchange rates.

The question is, is there anything in the middle; well the answer is there obviously is, because some countries did it for some time. But it's surprising how few countries have managed to maintain a fixed exchange rate, without the currency board extreme for more than a few years. There are some, of course, but there are very few. And very often those are countries, for example, in Central America that had done it at a fairly large cost in terms of economic growth.

So I suppose most observers would say that in most circumstances, unless you are willing to be really disciplined on monetary and fiscal flexible exchange rates, and that quite clearly would've cut the magnitude of the crisis, because in the flexible exchange rate regimes, the banks themselves have much more and the companies have much more incentive to make sure that their foreign exchange exposures are hedged. And that right away can make quite a difference, even if there is a crisis, to how severe it is.

So I would say that that would be the first lesson, the second lesson, as you already said, we all know a financial system is important, but on the other hand, how much more important it becomes as the economy develops. And how crucial the allocation of credit to most productive activities is, is something that was there, but was in the back of my mind and now in the forefront of my thinking. And I think that's true of everybody else.

I think we're moving in that direction even in looking at various regulations regarding capital flows and so on, and for the same reasons, so I think the financial system is getting much more attention in terms of appropriate supervisory framework, good bankruptcy laws, the whole mess of institutions that surround the linkages between the financial and the real sector I think are getting a good and close reexamination and we are still learning from that part of it.

The other thing that came out of it that was interesting and not quite as obvious, but maybe more important, is the appreciation of the role of transparency. In some sense, we are urging our members, and our members are urging us (and we are acting on it), to be much more transparent; to publish much more and have daily indicators of what your foreign exchange reserves are. All of these things we do now have standards and codes that countries adhere to in terms of the quality of data that they will report, and how they will report it on standard formats so they're easily interpreted.

Many people still argue that had the Mexicans been forthcoming in 1994, it might've been quite a different story there. Interestingly enough, there is already some evidence that the countries that have greater transparency get lower spreads on their bonds when they're growing abroad. They're beginning to show up even in the demand side in financial markets. And the move toward greater transparency is something else that has come up that is quite important. But I would say that those are probably the major lessons.

Q China is accumulating large amounts of reserves and they have a huge trade surplus but they are still keeping to their exchange rate. How do you think that the UN thinks the Chinese currency should be appreciated?

A As you said they are accumulating very large reserves and that is going to put inflationary pressure on the economy. And in our judgment we think it is in the Chinese interest to move toward greater exchange rate flexibility. In part for the reasons I mentioned but also in part because otherwise they're going to experience very strong and growing inflationary pressures, so obviously they have a choice as how to cope with those pressures. There are other ways of doing it, but our advice has been to move toward greater flexibility and they've said they're going to do so. So I think that on that one there is agreement. The real question is when they'll do It and that's their decision.

Q **Y**ou noted the need to adjust the Asian representation in the global governments in the economy, and in that regard I'd like to share an idea. Much of the global exchange rate flexibility and so on is often discussed in the context of G7 or G8. However, as you know, China isn't a member of G7. When G7 or G8 members think China is a problem, they single China out and ask them to come to a meeting. And when China goes to G7 or 8 meetings they feel uncomfortable about being singled out and this puts a lot of pressure on them, which is unhealthy. And whenever you talk about this sort of thing in the G7 context, the arguments are likely to come only from Europe and the US, while Japan usually remains silent. So to remedy this situation, what do you think of the idea of expanding G7 to include two other important Asian economies--namely China and Korea--and call this new group G10?

A I think we are all grappling with the problem that 184 nations are not the effective decision making group and there needs to be some kind of representation. On the other hand, economic power is economic power, so of course you'd like more representation for Korea than for some small island. And how do to this--how to get there from where we are now is a very difficult question. The IMF is after all made of 184 members so it *should* be the format through which everyone can talk about these things, and we would like it to be so.

On the other hand there is a G7 role, and there is another G20 group--of which Korea is a member--which has some of the larger emerging markets. However, it leaves out some of the smaller countries, so they think that it's not an appropriate group, and on it goes.

I think we are all worrying about it, but I think there is now agreement that Asia is underrepresented in the IMF and I think that is an important step forward. Everybody really has only stated that publicly within the last year or two, so it is not recognized. However, I think there will be action, I don't think it will happen tomorrow, my guess is that it will take some kind of combined needs. Perhaps even for general capital increase for the IMF that then could be accompanied by selective capital increase for countries like Korea and others that are underrepresented combined with some kind of way to change representation between the imbalances of Europe and Asia.

But that's getting ahead somewhat, and this is something that has to be decided among the authorities of the country. Nonetheless, it is a difficult issue and I agree that it would be good if we could get a more global and workable group. The reason I think G7 keeps going is because you can easily get 7 or 8 together, but getting 20 or 40 people together in one place at one time to focus and to still have a meaningful dialogue is difficult.

SaKong Response: I am very glad to hear that IMF recently completed the pole and recognized that there needs to be readjustment in Asia. Actually, it has been a very slow process; it took more than 15 years--when I was in the government--we tried to increase the quota when the issue came up in the 1980s and now it's finally being recognized so it may take another decade or so.

Krueger Response: The real dilemma is that somebody has to give; there is no way you can own more than 100 percent of the shares. If you could tell more than 110 percent then I could get you there. In that sense, the Europeans or somebody has to be willing to cut their share. Actually, the U S has been very good in that respect because they started with a huge percentage share and they cut it down to 17 or 18. Yet there is still a need for more adjustments and unfortunately that is up to the governments, and as such, it is not something that the IMF can do.

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