# *Changing U.S. and World Economies and Their Market Prospects*

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Good morning and thank you for being here so early at the beginning of a new work week. Seven o'clock in the morning is very early by U.S. standards, even though it may not be for Korean standards. We are very appreciative that you have all come here to listen to my remarks this morning.

The theme of my remark is 'change'—change in the U.S. economy, change in economic policies in Washington, change in financial markets, change in the world economies, and change in trade relationships. Bernard Levin, a columnist for the London Times, once said "the future is not what it was". John Welch Jr., the Chief Executive Officer at General Electric, has said "the pace of change in the 1990s will make the 1980s look like a picnic, a walk in the park." Competition will be relentless, the bar of excellence in everything we do will be raised everyday and it has been said that every organization has to build into its very structure the management of change, an organized abandonment of everything it does. "It has to learn to ask every few years of every process, every procedure, and every policy. If we did not do this already, would we go into it now knowing what we now know?" That was said by Peter Drucker, an eighty-five-year-old authority on management, who is a well-known figure throughout the world in the management

field. These quotes of John Welch Jr. and Peter Drucker personify a major change in the United States today compared with some years ago.

The U.S. economy along with its companies and workers are explicitly or implicitly following these instructions. The U.S. economy is on the move and it looks healthier than what I have seen in the last twenty or thirty years. Policies in Washington by this administration and at the Federal Reserve are quite different from what they have been. There is a whole new controversial approach on trade with respect to the rest of the world. World economies are in transition and change is in the air.

Let me first turn to the U.S. economy, its current position, its situation, and outlook. Our economy appears to be in a long business expansion. The data tells us this, and what I call the 'structural underpinnings' suggest it. The fact that many industrialized world economies are not yet in full-fledged expansion is yet another reason to expect the U.S. business expansion to last a long time. Thus, when Germany, Europe, Japan finally begin to expand again, the U.S. will benefit on the export side and its expansion will last longer. The data tells us that the U.S. economy has expanded at approximately a 3.5% rate for each of the last two years. In 1994, the rate of expansion will again be somewhere around 3.5%. The data on the fourth quarter of 1993 and first quarter of 1994 on the U.S. economy suggest very strong growth, perhaps too strong a growth that will slow down to a more sustainable rate, but nevertheless very solid.

It is not so much the data that indicate the underlying health of the U.S. economy as it goes forward. I believe it is the structural underpinnings that look so positive these days. It is also the approach to policy both on the fiscal side and the monetary side. So, rather than go through the numbers on the economy, let me highlight for you those positive structural underpinnings that I am referring to. Chairman Greenspan of the Federal Reserve used to call the adverse structural situation 'headwinds', sometimes a 'gale', which prevented the United States from recovering. The gale, the headwinds, the structural underpinnings have now cleared and appear to be as good as they were any time in the last twenty or thirty years. First, there was low inflation— a 2.5-3% running rate on inflation, far lower than the inflation of the early and late 1980s, inflation that has come about in large part because of increased productivity growth, low rises in wage compensation, and small increases in unit-labor cost. The 2.5-3% inflation will probably also be this year's rate of inflation. Next year, inflation will rise some but not beyond 3%. Low inflation helps the purchasing power of both the consumers and businesses. Real purchasing power in the American economy has been rising very steadily.

Second, interest rates are relatively low, although it has been rising lately. In an entrenched business upturn, it is very natural for interest rates to rise, and no one should expect anything different in any modern industrialized economy that is well into a business cycle upturn. The increase of interest rates comes from more demand for credit and expectations of increased inflation, and at some point, a tightening of monetary policy

by a central bank occurs. But, the increases of interest rates in the earlier stages of a business expansion should not be enough to derail that expansion. It is only later on when inflation gets out of hand, and the central bank has to raise interest rates very substantially that the seeds of future recession are sown. The relatively low interest rates in the United States, now 1/2 to 1 point higher than the lows of six or seven months ago still are creating major benefits throughout the economy in housing, business capital spending, and keeping debt service burdens down— the second healthy underpinning in the economy.

Low interest rates in any country if maintained for long enough are the secret, the magic potion for recovery and revival. High and skyrocketing interest rates which normally come in as an answer to unwanted inflation are a recipe for eventual recession. In the U.S., interest rates are rising now and we think it will continue to rise somewhat but not enough to derail the business upturn. Relatively speaking, interest rates in the United States are at the lowest levels from where they have been in twenty-five years.

We also see a third healthy structural underpinning — productivity growth — in the United States. Productivity growth has been rising around 3% a year in manufacturing for the last three or four years. The service sector of the economy is also starting to show some good signs. Between 1973 and 1989, the productivity record of the U.S. economy was very poor. In the last four years or so, the seeds have been sown for what will likely be an above trend productivity growth for a while. This

is due partly to the restructuring of the American business, partly to changes in the American work ethics, partly to high unemployment rates and tremendous competition for jobs, partly to a burst in capital spending on equipment that has added to productivity, and partly to the intense globally competitive world that the United States now operates in. These are a host of factors that contributed to raising U.S. productivity growth rates unlike anything seen since the early 1960s. High productivity growth eventually raises the potential output of an economy, lessens inflationary pressures, and is the major long-run source of higher real wages and higher standard of living.

The United States financial system is very different today than it was three or four years ago, and this is the fourth major structural plus. The U.S. banking system is showing record profit for the third year in a row. The bad loan situation is well behind the banks. Bad loan reserves are very high, in fact, they have been over-reserved. There are fewer banks in the U.S. after the fallout in the aftermath of the late 1980s but their performance characteristics are as solid as they have been in the early 1970s. There are no major exposures for American banks at this time in real estate, internationally or otherwise. Eventually, they will overextend their loans into areas that will prove risky in the American business cycle.

Household and business financial positions have been also improved greatly in the last few years. One measure we use to look at household financial positions is a weighted average of eight categories of financial strength measures that shows about a 75% recapturing of the deterioration of household financial

positions that occurred during the 1980s. And the U.S. corporations have gone through a rather rough period of restructuring and finance with reductions and debt equity ratios experiencing a big decline in short- to long-term debt ratios and much lower debt service payments as a percentage of cash flow of about half of what it was three or four years ago. No economy can sustain a long business expansion without first getting its financial sector in shape. The U.S. financial house is in a much better shape today than it was three years ago, and is providing resilience for sustained expansion.

There are a few other pluses on the structural side. Believe it or not, U.S. federal budget deficits are declining. There have been two doses of deficit reduction applied in the U.S. economy. One was in 1990 under former President Bush. Taxes were raised and spending growth was reduced, especially in defense. If only he had done that earlier in 1988, he may have remained in office. But nevertheless, that deficit reduction, though it did not help the Bush administration politically, did move the path of the federal budget deficit lower.

And then in 1993, a new administration and Congress, both Democratic, approved another dose of deficit reduction as its first priority policy — higher taxes on high income Americans and some older Americans, and further reductions in the growth of overall spending. These two doses of legislation, a better economy and a much lower inflation in the U.S. economy, will produce in fiscal year 1994 a deficit of approximately 220 billion dollars. Three or four years ago, the expectation of the deficit for fiscal year 1994 was roughly 325 billion. Next year, in fiscal

year 1995, we are forecasting a deficit of 168 billion dollars. The deficit remains, but is much lower as a proportion of gross domestic product. And the growth of debt as a proportion of gross domestic product is now stabilizing at a fixed ratio of about 52%. Government purchases in real terms at the federal level will be down in 1994 for the third year in a row. There is no period in American economic history since the 1930s where you will find that federal government expenditures in real terms declined during a business cycle upturn.

That brings me to the next positive structural element in the U.S. situation. The expansion in the U.S. has been essentially occurring in the private sector and has been domestic-driven —consumer spending particularly on big ticket items, consumer durables, residential construction, a boom in capital spending especially on information processing, communications equipment, and on structures and more typical kinds of equipment. A boom in capital spending, consumer spending and residential construction strength is what has driven the U.S. economy to the pace that I have mentioned—3.5% a year in each of the last two years and about the same in 1994.

However, federal government has not helped at all in this business cycle upturn. In fact, just the opposite has occurred. The federal government has raised taxes two times in three years. Government spending in real terms is coming down and the non-government purchases, the entitlements, are growing at a much lower rate than three or four years ago. The diminished role of the federal government will continue by legislation. The

1993 legislation sets a ceiling on total federal government purchases at 540 billion dollars. That ceiling will be violated this year because of the 6.5 billion dollars of funds going to California on the occurrence of the California earthquake. But other than that, the ceiling is the law and it cannot be violated. If the federal government wants to invest in education, infrastructure, technology or innovation, it must take money from somewhere else and switch it into other pet project areas. Five hundreds and forty billion dollars is a little more than one-third of the total federal budget. The rest of it is in the entitlements and outlays, and that portion of the budget is also growing more slowly, at about 2.5% last year.

Believe it or not, somehow the U.S. has gotten its hands around this massive budget deficit problem. It is not gone or totally solved, but it has moved sucessfully in the right direction. The U.S. economy is driving forward mainly from the private side. The government is not doing it and neither is trade. Last year, an increased trade deficit subtracted from gross domestic product of over 50 billion dollars occurred. Next year in 1995 and 1996, when other countries such as Germany, Europe, Japan and we hope Mexico resumes recovery, U.S. trade should rise and the U.S. economic expansion should get a second wind to carry it through 1995, 1996 and perhaps even longer. This looks like a long, sustainable and entrenched business expansion in the U.S of about 3% a year for three, four or maybe more years. That is a plus for all the world economies, especially the economies from which the U.S. buys a lot, including the Korean economy.

The negatives are that the defense spending is still being cut, Germany, Europe, and Japan are still in quasi-recession, and Mexico's growth is weak, thus hurting U.S. exports.

American corporations continue to downsize and restructure. And job creation is, not what it used to be. Where jobs are actually being created, they are soft. It means that they pay less than jobs used to pay in the United States, and they do not carry the kind of security or fringe benefits that they previously had.

But despite these negatives, and they are less than they were a few years ago, the aforementioned structural positives are really carrying the day and present a set of structural underpinnings that look the best from what I have seen in decades. Now, the report card on the economy and the change that I mentioned at the beginning is a change toward health, vibrancy, and a solid performance in the U.S. economy, in contrast to the period 1988-1991. As part of the entrenched expansion and solid performing economy that I have described, interest rates have begun to rise. This is the third year of the expansion and interest rates have begun to rise. Normally, interest rates begin rising somewhere in the first year of a business cycle upturn. One reason they did not rise sooner in the United States has to do with the low inflation that has emerged with the growing U.S. economy which was the lowest it has been since the early 1960s. For the long-run health of any economy, inflation must be kept low. And, low inflation means interest rates can stay low. The combination of low

inflation and low interest rates helps purchasing power and capital spending, and increases the long-run potential of an economy. This time around, the Federal Reserve, mindful of the inflationary pressures that historically arise by the third year of a business expansion, has altered its approach to monetary policy in order to prevent inflation from picking up later, which then would drive the central bank into a very punitive monetary policy stance, and ultimately would lead to recession. We, economists and econometricians, call the kind of change that the central bank is engaging in as 'structural change'.

The Federal Reserve is now attempting to make monetary policy in a manner unlike anytime in American modern economic history. As part of that process, financial markets in the United States and around the world have reacted, interest rates have risen, and stock markets have gone through sizeable corrections in most of the major economies.

So, let me say a little about this policy, what I think the Federal Reserve is trying to do, and what it means. In the context of a second large category of policymaking changes in Washington, this policy can be described as preventing a problem before you know there is a problem. That is, preventing inflation before it becomes an obvious problem. There really are two choices for the central bank: to fight inflation when inflation begins to pick up and is obvious in the major indices, or to fight inflation before inflation shows up as a problem in the major indices. I think the scientific community, realizing the lag between the timing of when the central bank makes a change and the impact on the economy and inflation, will certainly

applaud this new approach. Of the two approaches, fighting inflation after you see it versus fighting inflation before you see it, the latter seems efficient because the first has never worked.

So, as a risk taker, I would rather try something that has a chance of working than something that has never worked. In the old way, when inflation picks up and begins to accelerate, the Federal Reserve has raised interest rates. But the nature of the inflationary process is that by the time it appears, the process is well-entrenched and cannot be abruptly stopped. Central bank policy in our country has always been too little and too late on fighting inflation. Inflationary pressures have continued to build even after the central bank tightened monetary policy. Ultimately, the central bank has always had to raise interest rates so high creating a credit crunch and ultimately producing a recession and high unemployment. That is hardly a successful recipe.

This time around, by raising short-term interest rates a year or so ahead of when inflationary pressures might show up as a problem, the central bank hopes to prevent the problem of higher inflation next year and the year after. You might call this a preemptive approach on fighting inflation, a dose of castor oil or a dose of medicine ahead of observing a problem. It is preventive medicine in economics. The implementation of this preventive approach is in the form of three settings for policy by the Federal Reserve. One is called accommodation. This setting of low interest rates has been in effect for three or four years. The second is policy neutrality. This is the setting in

which the Federal Reserve is trying to move into now. It involves higher short-term interest rates which at the moment are undefined. There is a third setting — restriction. This is a setting of much higher punitive interest rates. The central bank has made it clear that it does not wish to move to restriction as a policy objective at this point. The objective now is to adjust short-term interest rates to levels consistent with policy neutrality in the medium setting. Policy neutrality on the part of the central bank is a new term. At this point, the best way to define it is that it corresponds to the levels of short-term interest rates that would be consistent with a balanced path of growth in aggregate demand against aggregate supply or the potential output of the U.S. economy.

Now, in implementing this approach on February 4 and announcing it on the same day, it was clear that the initial dose of higher short-term rates moving the federal funds rate from 3 to 3.25% was not the level that would ultimately correspond to policy neutrality, nor could a one-quarter point hike in short-term rates do anything much to soften the economy and deter inflation a year or so from now. Financial market participants knew when the Federal Reserve announced its new policy that higher short-term interest rates would have to be applied.

Financial market participants, however, did not know how much higher, how many more doses, and what the ultimate level would be for short-term rates that the Federal Reserve was moving to. That uncertainty and the lack of knowledge injected tremendous uncertainty premia into financial markets so that

buyers of long-dated U.S. fixed income securities could not step up to buy those securities, not knowing how high and when the Federal Reserve would raise the federal funds rate. The end result was a very sharp rise in federal funds rate, about twice as much as the ultimate increase. Those high interest rates spread into markets overseas, and at the same time, the dollar corrected downward for various reasons. We think this is mainly because of a whole host of political problems and risks around the world that suggested the investors to buy gold rather than the dollar.

A combination of the uncertainty of the Federal Reserve process, the rises in short-term interest rates, and the rises in long-term rates led to a stock market correction in the United States and an equity market that had gone too far ahead of fundamentals. Thus, stock markets around the world contracted as well for similar reasons. This particular set of events—the corrections in the markets that have gone on—should not be taken as a sign or symptom of problems in the U.S. or other economies. It really is a part and parcel of standard procedure in the American business cycle. That is, when interest rates are raised by the Federal Reserve for the first time in an on-going expansion, the stock market almost always corrects. It is natural and normal. If it did not happen, I would be much more concerned than the fact that it did happen. Four thousand on the Dow Jones Industrials in January made very little sense on the economic fundamentals of the U.S. economy which are very positive. Four thousand on the Dow Jones Industrials makes a lot of sense in the summer rally in August or toward the end

of this year. The equity market got too far ahead of itself and the bond market was probably over-bought. The uncertainty and its unknown nature of the new Fed policy was the major driving force for the corrections.

Where is the Federal Reserve on this particular issue at the current time? On March 22, the federal funds rate has been raised another quarter point. Our estimate for that policy neutral federal funds rate is somewhere around 4.25%. It could be as high as 5% or it could be as low as 3.75%. The range is that wide; this is a new approach to policy. At 4.25%, the federal funds rate in real terms would be about 1.25 on a 3% inflation rate. A 1.25 real short-term federal funds rate is more in line with historical norms at times when the U.S. economy was moving in a fairly balanced way. Our guess is another two, probably three doses of higher short-term rates applied to the U.S. economy by the Federal Reserve before it stops, in order to arrive at a short-term interest rate level that is consistent with the phrase, 'policy neutrality'. With this kind of increase in short-term interest rates along with long-term interest rates about where they are now, which is a percentage point or so above the levels of February 4, there will be some damage to the interest rate sensitive areas of the U.S. economy later this year and some loss of growth in 1995, not enough to significantly raise risks of recession, but probably enough to limit or cap how high inflation goes.

The odds are good in the central bank's approach to limiting inflation later on in the longer-run by taking action now when

inflation is not an obvious problem. Therefore, there should be approximate success for this experiment. I say that the odds are good because the other factors underlying inflation are very positive at the moment. In the United States, break-even points are low, productivity growth is high, and unit labor costs are rising at a mere 0.5% rate. Oil prices and sometimes other sources of U.S. higher inflation are quiet. Inflation rates around the world are staying low and most of the major industrialized countries have relatively low interest rates. Wage compensation is rising very slowly in the United States and that tendency will not turn around quickly.

The major threat to inflation in the United States next year is too much aggregate demand against the pace of growth of potential supply. It is the growth rate of the U.S. economy that needs to be toned down so that demand grows at about the rate of potential supply which is now rising at somewhere between 2.5-3.0%. This approach by the Federal Reserve is a long-run approach in the U.S. economy. It is designed to keep inflation down over the longer-run, to preserve the gains in productivity that in the longer-run will produce higher potential output, and to maintain higher real wages and higher standard of living in the U.S. economy.

The central bank in no way desires to cause a recession in the U.S. economy at this time. There is no major problem today on inflation, and therefore, there is no reason for the Federal Reserve to do what it has so often done in the past to raise interest rates, thus creating a recession and squeezing inflation out of the U.S. economy. It is acting early enough so that it

should have time to help keep inflation relatively low and not have to employ extremely punitive methods of monetary restriction as it has always done in our past business cycles.

The second policy change in Washington also has a striking characteristic in its orientation towards the long-run. The current administration and congressional policies are primarily driven by politics and by the changed American view of short-run versus long-run. It is very striking to me.

Let me briefly bring to you the articulation of the administration's approach to policy, as reported in the *Economic Report of the President*. I report it to you because it is very different from the past. It is surprisingly long-run in its orientation. After all, we Americans are not known for having a very long-run perspective horizon. The whole world knows us as being short-run in orientation, quick and impatient in terms of bottom-line results, and with an attention span that is not much longer than a five-year-old's attention span.

The administration's first policy priority consist of deficit reduction that was very different from what President Clinton argued would be his first priority in his campaign. If you recall, President Clinton argued that "jobs, jobs and more jobs" was the number one priority. And then in February of last year in an address to the nation, he told Americans that taxes would be raised, government spending would be cut, and although there were quarrels over the numbers, the net deficit reduction from what would have occurred otherwise was about 450 billion dollars over five years.

Nevertheless, policy plank number one is deficit reduction. By all who study it — budget experts, Chairman of the Federal Reserve, Allen Greenspan, and us — it is certified as bonified deficit reduction. The quarrel always was in the nitty gritty of how it was done and in the details with most arguing that it would have been better to do more spending reduction and have fewer tax increases. However, in the overall lump sum and elements of the deficit reduction and legislation, it is virtually a universal agreement that this was a credible, bonified deficit reduction compared with what might have occurred under the previous law. The administration's description of this policy plank, one of the five key planks of policy in its economic program, is that deficit reduction is meant to lower interest rates and to help increase the private sector savings rate in the U.S. economy so that more capital formation and capital spending will occur, in turn, leading to higher productivity growth, higher real wages and higher standard of living for Americans. Higher productivity growth, higher real wages and higher standard of living cannot happen overnight off of deficit reduction. By definition, raising taxes and cutting spending is more likely to cut jobs in the short- to intermediate-term than to create jobs and bring some pain to the consuming and business public. The effects of deficit reduction, if indeed they are lower interest rates and increased savings, take a long time to unfold, and then the response of the economy in terms of more capital formation and savings flow into capital spending and increases in productivity growth takes even longer. Interestingly, deficit reduction remains as the number one plank.

The second plank in the economic program of the administration is health care reform. The argument, an exposition of this from various administration people and in the *Economic Report of the President*, is that health care expenditures in the United States are an overwhelming burden on every sector—on households, businesses, and the government sector. And, if those costs could be reduced through the reduction of inflation of health care services and through a more efficient provision of them, then more spendable income would be available. Workers would be more productive, then businesses in turn would be more productive, and naturally real wages, real spendable earnings and standard of living of Americans would rise. Now, there is a health care proposal on the table. It will end up being very different in terms of what is eventually passed among the original proposals of the President. I am now only speaking of the goal of health care reform of the administration and the context in which it is being put forward, similar to how deficit reduction is being put forward in terms of how it affects the long-run real standard of living of Americans.

The third plank is foreign trade. Here, the administration argues that it is seeking to increase U.S. exports to help the United States be more competitive internationally and looking to prod its trading partners to open markets and to increase their rate of economic growth so that U.S. exports will rise. Why? Here too, is the same theme. Export jobs pay more on average than other jobs in the U.S. economy. The greater our U.S. export is a share of gross domestic product, the greater will be the share of jobs in export industries, thus signifying

higher real wages and greater standard of living for Americans. Whatever the administration does in trade and however our trading partners react, I think it is clear that here, too, there is no quick fix, and there are no results that will happen right away. This approach to trade and this objective is yet another long-run objective.

There are two more planks in the economic program and they have to do with investment in people and infrastructure. This will come in the form of whatever funds the administration can find under the budget law to spend on training and re-training, which is included in a labor re-training proposal brought before Congress. It also comes from attempts to spend on public sector infrastructure which more and more is being shown to help productivity growth. Here, too, the story is the same: education, training and infrastructure expenditures are used to raise productivity growth, potential supply, real wages and the standard of living of Americans.

Finally, the last plank is investment in innovations and technology, for example the information super highway. Same story once again — productivity growth, real wages and the standard of living of Americans.

I mentioned these for two reasons. One is to give you a flavor of the direction in which policy is going and has been going in the United States. And secondly, to sensitize you to this longer-run perspective, a very unusual perspective in Washington, almost totally without any historical parallel. This is not

the Washington I have known, this is not the Washington that you have come to know and from what you might not expect, this is a set of policies distinctly long-run in nature. Along with the Federal Reserve that is acting as the head of the game in trying to keep inflation down, I only want to report this to you, and you can draw your own conclusions on what that means.

For part of what it might mean to you, the administration's long-run goals are to reduce the share of consumption in gross domestic product, to reduce the share of the deficit of the government and federal sector in gross domestic product, and to increase business capital formation and capital spending as a share of gross domestic product, thus increasing machinery, equipment and computers. It involves iron and steel which is very positive if it happens for a country like Korea, and it increases the exports of the United States as a share of gross domestic product. These goals are almost the reverse of the 1980s, and so it is politically unexpected. What is most revealing to me is that to achieve them, a long time is necessary. In economics, results do not appear one or two years after policies are started to achieve these objectives. It could take as long as four or five years, even though eight years is too unusual.

On the trade side, the desire to raise exports as a portion of the gross domestic product has implications for the U.S. trading partners, of which much of this has already been seen mainly in U.S. trade with Japan. The drive to raise exports as a portion of GDP to make the U.S. more competitive worldwide, and to

push trading partners to increase growth and to open markets is coming in the context of NAFTA with Mexico which is distinctly free trade in direction. It is also occurring in the finally signed GATT agreement: 111 countries signed and the World Trade Organization was established. You have the support of free trade worldwide from this administration in the form of these two agreements, and at the same time, you have what appears to be a paradox of contentious trade negotiations with a country like Japan in order to raise exports. They may seem inconsistent but they are not. They are a part of a results-oriented approach to trade by the United States. The bottom-line is that this administration is pushing very hard and wants U.S. exports to be a much larger share of the gross domestic product.

Those who are carrying out this objective are eclectic, non-theoretical and non-doctrinal types of individuals. I am jokingly talking about lawyers and attorneys. Economists, of course, are very theoretical, and are all free traders. Free trade is all that matters to us, and so we think in those terms. But the economists are not running the show on trade. The lawyers are and have been giving the instruction to get exports up as a proportion of the gross domestic product. How I interpret this is that whatever it takes to make that happen, it will be done. And that means getting involved in contentious, friction-ridden, risky negotiations with Japan and other countries where the playing field is not perceived as level from the U.S. side.

The U.S. approach on trade with Japan will continue to be

very bottom-line oriented ranging from attempts to cajole, induce and push Japan into stimulating its economy to raise growth since Japan is the second largest buyer of U.S. exports. These range from measures for open markets to measures that Japan will be asked to change its distribution system and the intra-firm trade that goes on by applying a whole range of attempts to open markets and increase growth in Japan that given the Japanese approach and culture, will not be very agreeable in Japan. So, that means difficulties in trade as far as the eye can see and the use of measures like Super 301 and others in order to achieve the goals. That, I believe, is the way it is on trade with the United States. There is no theory guiding what is going on, and it is strictly bottom-line results.

What will eventually soften the contentiousness between the two countries will be the natural improvement in the trade deficit the U.S. carries with Japan for economic and other reasons. There are many seeds of improvement in the bilateral trade deficit with Japan. That is to say, the seeds have been sown for that huge current account surplus of Japan to wind down on. We are expecting that to begin in the second half of this year. After a year or so of reductions in the current account surplus between Japan and the rest of the world and in the bilateral trade surplus with the United States, the trade friction will probably soften. Until then, a very heated situation will occur.

Finally, the world economy is going through a change and is in transition. The U.S., Canada, and Australia are well along

in business expansions and are showing a very solid upturn. Germany, France, Spain, Scandinavia, the Netherlands, and Belgium are in a transition this year to a slow and modest recovery in their economies next year. As part of that, interest rates in Europe and Scandinavia must and will come down significantly through much of this year, and short-term interest rates and long-term interest rates are also to come down to some degree in order to set the stage for reasonable recoveries for those countries in 1995. Out in the Asia-Pacific region, Japan's economy is also undergoing a transition. Working its way out from a massive excess of difficulties, the Japanese economy will probably show a reasonable recovery next year. Outside of Japan, the other Asia-Pacific countries continue to be very prosperous in their own orbit. There is solid, dynamic growth patterns in countries ranging from Taiwan to Thailand, Malaysia, Indonesia and now India. Hong Kong and Korea probably have too strong a burst for growth because inflation is on the high side here. But, growth in the non-Japanese Asian countries remains in the 6-7% range and there is no end to that in the near future. On top of that is the boom coming and emanating from China overlaying the already strong economies here by helping to buttress them.

Back in our own hemisphere in Latin America, if Mexico gets through this period of political instability, it will likely show stronger growth. Countries like Argentina and Chile are doing much better. The prospect in Latin America, with the exception of the political instability, looks very positive.

In Eastern Europe, surprisingly, Russia, Poland, Czechoslovak-

ia and Hungary are showing solid growth. I don't want to forget the U.K. which we follow very closely. It looks like it is on a stable recovery path with surprisingly low inflation. It is a toss-up whether lower interest rates are needed since the U.K. economy is now in very solid shape. By 1995, 1996, and 1997, when all of these countries are growing and expanding, the world economy in total should be going through some golden years. Almost all the countries of the world will be firing in business expansion. The world economy is in transition to generalized prosperity over those years, a world more at peace in a large scale sense than it has been in many decades, and a world that should produce some very positive economic results for Korea.

Let me summarize then. I talked about four kinds of changes: first, the change in the U.S. economy to a healthy economy with the best structural underpinnings in twenty or thirty years which will lead U.S. economy to grow and stay in a sustained expansion for the next few years; second, changes in Washington policy with a new Federal Reserve approach which is the major cause for financial market corrections around the world, but corrections are normal in business cycle expansions and, in a sense, are healthy because they purge systems of excesses before the excesses get too bad; third, the change in the approach to economic policy in the Clinton administration from many previous U.S. administrations. It is distinctly long-run oriented in economic policies and a very unusual approach in Washington, one that I have not seen in the past, including continuous attempts to keep the deficits declining as a

percentage of GDP; and lastly, the change in the world economies, from stagnation and recession in Europe and Japan to better growth in 1995. There are changes in the Asia-Pacific with the exception of Japan, because economies are strong and situation in Latin America is improving, all adding up to good economies with relatively low inflation in most of the world over the next few years.

## Discussions

**C** **Dr. Il SaKong** (Chairman & CEO, Institute for Global Economics)

Thank you very much for the very detailed and illuminating analysis of the U.S. and the world economy. Now, it is time for some interactions with the floor.

**A** **Dr. Sinai**

I'd be happy to answer any detailed questions I didn't get a chance to answer during the talk.

**Q** **Dr. Gon Sub Shim** (Executive Managing Director, Daewoo Securities)

I want to hear about the movement of the Japanese yen exchange rate.

**A** **Dr. Sinai**

The dollar should, on average, rise somewhat against all major currencies. The dollar-yen rise will likely be less than the dollar-deutsche Mark and the European currencies because the cloud of trade hangs over the dollar-yen. And that cloud of trade and trade contention for market participants involve concerns that the United States could, at any time, talk down the dollar or try to depreciate the dollar. I do not believe it is the U.S. policy

to manipulate the dollar-yen, but so long as the trade cloud hangs over, market participants will fear that. With that, and with the fundamentals of stronger U.S. growth, higher U.S. interest rates working for the dollar and the positive underpinnings that I described, we do expect 105-110 yen per dollar in the early summer and 110-115 by the end of the year. The dollar should fundamentally move up against the yen this year.

**Q** **Mr. Sang-Seol Lee** (President, Woljeong International)

Can I ask a general international trade question? What would be the relationship between WTO and the United Nations in the process of world economic development? That is my first question.

The second question is: could you tell us your views on MTO, WTO, ITO, and GTO?

**A** **Dr. Sinai**

First, I don't think the relationship between the World Trade Organization and the United Nations is well defined yet. It will be defined in terms of what the WTO does and how it approaches various trade problems. The UN is concerned much less with trade than it is with international political events. The WTO as the new mechanism to implement the recent GATT treaty will be supported strongly by the United States. I believe the basic international trend is toward free trade, and more open trade for which I take the signing of GATT after all these years and NAFTA as important signals for that. The contention that

the United States now has with Japan and China on matters of trade is a side effect and is not really the basic trend. My view is that this is a world that is more at peace than it has ever been in my lifetime and the tendency is much more towards competing and fighting over economic matters rather than other matters. It's basically positive in the long-run.

Is your second question on the MTO?

**Q Mr. Sang-Seol Lee**

The Multilateral Trade Organization(MTO) is being established to be WTO, just as the International Trade Organization was under the United Nations banner in 1946 but was never actually born. Also talking about the global world economic development, GTO (Global Trade Organization) is also yet to be born in the twenty-first century. Can you briefly comment on this?

**A Allen Sinai**

I think the trade issue will be separated more and more from the kinds of political consideration and confrontations that are being tackled by the UN. And I expect that these world trade organizations would be strongly supported by the United States in the context of what it is trying to achieve on trade. The studies and the economic analyses that come before the President and the people around him are very strongly in favor of increased trade flows and tighter trade interactions between countries, because the gains from the freer trade relationships are very great to all in the long-run.

**Q** **Dr. Il SaKong**

I have two rather academic questions to pose here. The first one is regarding the preventive approach to fighting inflation that you mentioned. It sounds more like monetary fine-tuning in a way. Of course, you said that there are other underpinnings which would help this approach to work out better. Nonetheless, with all the past controversy of whether fine-tuning would work or not, if that approach is working now, is it due to better information, better theories or a better financial system, in addition to the favorable conditions you mentioned?

The second one regards your view on optimistic U.S. economy. The U.S. economy is doing best among the OECD nations today. Based on that, can anyone make a long-term judgement regarding the reversal of the relative decline in the U.S. economic strength in the long-run? Since Paul Kennedy wrote his book, many people does believe the U.S. economy is on the downhill.

On the other hand, because of this recent economic revival in recent years, many think that the trend may be reversed. I would like to hear your views.

**A** **Dr. Sinai**

Let me answer the question about the prevenptive approach of the Federal Reserve. Simply fighting the problem before it shows up a year in advance is a new approach. The various indicators of future inflation that we watch do not suggest that inflation would pick up significantly this year. But, there is

evidence in the output gap—the gap between potential output and actual output—utilization rate and the unemployment rate that we are moving into a range that could possibly bring about higher inflation. Assuming about a 3% growth, it will be sometime next year. So, what is new scientifically is to raise short-term interest rates a year ahead of time. In the old way of running monetary policy with an excessively high unemployment rate and a relatively low inflation rate, the central bank would not have raised short-term rates until perhaps a year from now.

The second scientific item which is perhaps new is the kind of inflation watch that is now on at the Federal Reserve and elsewhere. Because this new approach is ignoring what the Consumer Price Index (CPI) and Producer Price Index (PPI) say in favor of looking at such things as commodity prices and gold prices, the output gap, however it is measured, the utilization rates, and the unemployment rates, are at about 6.5%. The bond market is probably half a point higher than it would be if it were not looking at the kinds of indicators I now talk about. What the bond market is doing now is discounting a 20% risk of higher inflation next year by raising interest rates. What that will do to the earlier higher Federal Reserve short-term interest rates and the market reaction on long-term interest rates will be to take growth out of the economy, to dampen inflation expectations, and a year from now, forestall whatever inflation we might otherwise have had. That is the science of it.

Now, are there more methods or better models to analyze

this? I think the same models of economies including ours exist to analyze it and we have run our model on this kind of thing. It is a 600-equation open economy model of the U.S. economy on very detailed financial markets. It tells us we will lose on what's happening so far with about half a percent of growth this year, eight-tenths of a percent of growth next year, and will cut inflation by two-tenths or three-tenths of a percentage point. We cannot be sure what it will do to the inflation expectations, which is part of what makes a business go, but it probably will dampen it as well. What we don't know is how much the rate hikes have to be in order to achieve a certain amount of slowness in growth and dampen inflation. It certainly isn't the half point hike; it is at least another half, maybe three-quarters of a point hike.

Your second question was, for about a year now, maybe longer, "the U.S. is on the move". The trend toward the decline of the United States as a world economic power is reversed. Trends are analyzed depending on how long you define the trend, and I can't say how things will be in the year 2020 or 2030. However, for the rest of this decade, the U.S. is really on the move. There is a lot that goes into that, but fundamentally in the U.S. political system, what is occurring in Washington, what the Federal Reserve is doing, and what is reflected in the current administration are really nothing more than the messages America has sent to the politicians. Americans are getting what they want. To me, it is another example in the history of the United States of an amazing ability of questioning itself in terms of what it does and how it does

it to go through rebirth, revival, renewal. That has happened previously throughout the history of America, and I have seen this happen again over the last three or four years. And as an amateur historian and an economist, I am absolutely convinced that the U.S. is on the move.

Your question suggests, with all due respect, that it is something that neither you nor the audience here appreciates. Nevertheless, it is true. I hardly mentioned all the dimensions in which this is happening. I mentioned only the structural underpinnings of the economy. Again as a historian, it is interesting that Japan is going through a very difficult period. Japan is not on the move and neither is Germany, going through a very difficult period in the aftermath of reunification. And the U.K. is more on the move than Germany or Japan. And believe it or not, some of the non-Japanese Asia-Pacific countries, located in the most dynamic part of the world, are still on the move. But, watch out for the United States. This is a different United States in its economics, politics and its corporate life from what we have been telling you about for some years.

**Q** **Amb. Thomas Harris** (British Ambassador to Korea)

I am very grateful to Dr. Sinai, for making it very clear that not all of Europe is in a recession. The question I want to put to you is to follow up on the earlier question on trade policy and to ask you two things.

First, will President Clinton really apply himself to the

ratification of the results of the Uruguay Round in Congress in the way he did on the NAFTA deal? And, will we get that clearance through Congress this year?

Secondly, how is Congress going to replace the thirteen billion dollars worth of tariff receipts that will be lost as a result of the outcome of the Round?

### A Dr. Sinai

The answer to your first question —"will President Clinton be as supportive of the final passage of GATT as he was on NAFTA?"— is absolutely yes. And characteristically, he may do it at the eleventh hour. But, there is no doubt that if it needs be, all the stops will be pulled out on that just as they were on NAFTA. This is a very strong commitment of the United States to GATT.

The thirteen billion dollars of lost tariff receipts on the tax side from GATT takes place over a period of time. So, it is not a big sum of money in the context of the budget law. It would be one of those items that would be like the earthquake in California: excused from the budget law so that it will not force the U.S. to cut spending or raise taxes to offset that.

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## Dr Sinai

The answer to your first question is that President Clinton will be as supportive of the final passage of GATT as he was on NAFTA — absolutely yes. And if history's any guide, he may do it at the eleventh hour. But there is no doubt that [illegible] be all the steps will be pulled out as they were on NAFTA. This is a very strong commitment of the United States to GATT.

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