"Strengthening Korea's Position in the Global Economy"

Dr. Charles Dallara

Thank you very much, Dr SaKong. It is always a pleasure to be back in Seoul and a particular pleasure to be here with your Institute. I particularly like what your Institute has done to build analysis and understanding of the key issues in the Korean economy but also to help foster the debate of understanding Korea's role in the global economy. And I think your own leadership in this organization, in this special role is so crucial to Korea understanding its role in the world has enormously contributed to Korea's economic policy over the years and to Korea's strong place in the global economy.

Indeed as you mentioned I have had the pleasure of working with you, Dr. SaKong and with many here in Korea over the years, some 25 years and I do have, as many of you know, a special connection with Korea because my daughter was born here. She is very American now I am afraid to admit and not so much Korean anymore. She only spent six months here but each time I visit I try to bring back a touch of Korea with me so she does not forget her Korean roots. This time my colleagues have helped me bring back something called a *Bodegi*, which all of these gentlemen didn't know, Christy. My assistant Christy has just had a little baby boy and she wanted to carry him around in the traditional Korean mother's manner in a *Bodegi*. So we are going to be taking her back one little small touch of Korean culture.

You know I also see another important part of Korea when I am here, and this time I had some mixed feelings on one part. Because when I was last here, it was just after the Korean National Baseball team had just beaten the American National Baseball team in the World Series Classic. That was slightly painful as I am a big baseball fan and I had to, as we say in America, "eat crow". So I thought that maybe somebody was helping me remember this painful moment. Because when I got to my hotel room at the Shilla Hotel, and my good friend Youngwon Park of Woori Group knows this story because I saw him the other day, looking outside my hotel window I saw the most beautifully manicured baseball field that you can imagine. Now in the past Korea has been sometimes criticized of unfair competitive advantages. Most of this has gone away in the trading fields of course but now I see that you have unfair advantages in beautiful baseball fields for your young baseball players. But I think it reminded me of just how important sport can be in a country. And each morning I have got up and looked out with envy. Yesterday between my appointments, I saw a game underway. Unfortunately I was co-chairing a special event with Chairman Yoon of the FSS. I was tempted to go down and watch the game but I went back to my duties with Chairman Yoon. But someday I will go back to this field and watch young Korean baseball players develop into global competitors as they have already done and much to my admiration and satisfaction.

I am pleased to be here because it is a very interesting time for the Korean economy and a very challenging time for Korea. Let me, if I may, before I talk about some of my ideas of how Korea can continue to prosper in the world economy. Let me say a few words about the context, which Korea finds itself in today the strengths, and perhaps a few of the risks in the global economy.

As you might all be aware, that on the whole the global economy continues to move forward quite robustly. Growth in the United States is moderating somewhat but still remains relatively strong in the two and a half and two and three quarters range. Growth in Europe and in Japan is slightly strengthening, I have just been in Japan with my colleagues a few days ago, I must say you have a sense there of some renewed confidence that you did not find there three or four years ago. Some of the European economies are doing better but that is within a framework of low growth, two, two and half percent growth. And of course, here in Asia all of the world's attention has turned focus to remarkable story of China and India. Two rising giants in the global economy whose performance in recent years has been stunning in many ways and whose performance in the future will be crucial to determining how the entire global economy operates. But this rather positive scene is in many ways laced with uncertainties and challenges.

In the US, we have a quite serious weakening in the housing market, which has not yet dramatically affected consumer confidence, nor has it made any noticeable dent in US employment. But it is a serious matter that the US Federal Reserve is closely monitoring. As long as corporate performance remains strong in terms of earnings and profitability, although corporate investment is not so strong today in the United States. But as long as corporate earnings profitability remain relatively strong and as long as interest rates remain relatively contained, then I believe the US economy will continue to move forward.

There is a risk that the weakness in the housing market could deteriorate further and could lead to some breaks and some loss of consumer confidence that would damage US economic growth and indeed world economic growth. If you look in this region you can see that there is a cloudy dimension to the Chinese and Indian Story. The note of concern in India is perhaps of inflation, in China we have not seen any noticeable inflationary pressures, but the sharp rise in China's surplus should be a source of concern for us all, I think China is struggling.

And I was also in China just before coming here to Seoul and one has the impression that they are really struggling with their growth model today. They have a very dynamic economy but they have a control mentality. They want to control the economy but they don't really have the instruments to control the economy, they want to embrace globalization but only partly. In the last three years alone their current account surplus has surged and will approach this year 11% of GDP. I remember when Dr SaKong was the Finance Minister here, and Korea's surplus surged, but if my memory is correct it only reached 8 or 9% of GDP, not 11 or 12%. And as important as Korea was in those days, it was not the looming giant that China is today.

Of course, the counterpart of this surging current account surplus is the flood of capital, which comes into Korea and then has to be repositioned in the rest of the world through reserve management. They are now creating a new agency to manage part of these reserves and we have to wait to see how this sorts out. But I don't feel entirely comfortable that this new agency will report directly to the State Council and not be integrated into the existing professional teams, which manage China's reserves. Of course China remains very concerned, understandably embracing more actively market forces in their exchange rate policy. But nevertheless this will have to come, because right now China's exchange rate policy and surplus is creating perhaps an unfair problem for Korea and the rest of Asia, and indeed America and the rest of Europe.

You have the situation in Japan where we have an increasingly confident economy, a strong current account surplus but nevertheless a weak currency. This I have noticed is a big concern in Europe and in Korea, understandably so, of course at the heart of this is the monetary policy in Japan and so-called "Carry-trade" which encourages the borrowing from around the world and encourages the constant outflow of capital from Japan. This is not an easy problem to deal with but I believe that Korea, Japan and China should sit together and have serious talks about their problems, both among the three of them as well as within a global context.

Because global imbalances cannot be addressed through bilateral talks, I believe that Secretary Paulson's strategic dialogue in the US and China is definitely a good move in the medium term, well framed, well focused recognizing that change in China will take time. But at the same time I believe there is a role for multilateral discussions both in the region and globally and we would like to see the IMF play more of a role here.

The "Carry-trade" issue in Japan brings me to some of the global financial uncertainties in the world today. Because we are in a world awash of liquidity and this liquidity is moving in all corners of the globe today. We don't see in economies today a shortage of capital but we do question whether the credit being extended by banks, by hedge funds and credit which is fueling the sharp rise in private equity deals around the world is really being priced on a risk-adjusted basis.

Many of my friends in the banking community are bemoaning about the deterioration in credit standards and in the so-called "covenance" that surrounds loan documentation today. But as much as they complain about it, they still give the money, at low interest rates and with weak covenance.

If you look back to some of the crises of the last two to three decades whether or not it is global banks lending to Indonesia for projects that never materialized or US banks leaning into real estate fifteen years ago or global lending by Japanese, European and American banks to emerging sovereign markets twenty five years ago, weak documentation, weak credit standards were at the heart of many of these problems and I think we should be concerned about this.

We do not fully understand the systemic implications of the role the sharp expansion of hedge funds in the world today. Our board will be discussing these matters in a few weeks in Greece in determining whether we will launch a project in this field. But right now I think there is considerable uncertainty surrounding the systemic implications of how so much credit is being provided by hedge funds. When I was in Europe recently the Chairman of one of the largest banks in Europe showed me a chart, only seven years ago corporate borrowers particularly middle-grade borrowers depended primarily on banks for their credit. Over the course of just seven years their role has almost been completely replaced by hedge funds as a source of credit to middle-quality borrowers in Europe. This phenomenon is similar but slightly different in the United States, this is of course partly related to the substantial growth in derivative instruments in global financial markets. In many ways these instruments have become wonderful, positive additions to global stability and risk management.

But here again I don't think we fully know how these instruments will respond in moments of stress, we have just completed a study at the Institute, putting forward recommendations to banks around the world on how banks should best manage liquidity risk in their own organization and these are the experts in the world, the top liquidity risk managers in Goldman Sachs, in JP Morgan, Deutsche Bank, UBS, Morgan Stanley, Merrill Lynch but you read the report you do not come away feeling entirely comfortable. Do not read this before you go to bed, because unlike most of our reports it will not put you to sleep, it will keep you awake a little bit because it leaves very clearly the impression that in a moment of stress, moving collateral around the world may be necessary in order for a firm under liquidity pressure to attain liquidity from a central bank. Moving collateral is very difficult, because you look at global firms today and they have huge pools of liquidity backed up by collateral. If they need to go to the

Federal Reserve, or the Swiss National Bank or the European Central Bank in a moment of stress because they are losing liquidity. And you know this can happen, just like this, this is not a matter of solvency but a matter of confidence. If they need to do that the central banks will not extend credit to them, emergency lines of credit without collateral and the collateral cannot easily move across borders today.

We live in a very paradoxical world financially, which is fraught with complication because firms, financial firms increasingly including Korean firms are managed globally. When you manage risk at JP Morgan, and I did this some years ago personally, you do not look at what your risk is on the balance sheet in just the US or just in Europe you have to consolidate it on a global basis. Firms are being managed globally, markets are global, but regulation is still very much rooted in national policies and in national orientations.

This has to change, yesterday we had a remarkable gathering and I would like to give credit to FSS Chairman Yoon for co-chairing and hosting and organizing the program bringing together top regulators from around the region and top bankers from around the region to talk about how we can build more efficient regulatory regimes in Asia. This is going to be crucial to global financial stability moving ahead, because there is much too much segmentation, much to much inconsistency among regulators around the world, each having their own formula of how to approach regulation, but banks operating globally. This paradox will need to change otherwise it will change because there is a crisis in a major financial institution, which is poorly managed by global regulators and central bankers. I am encouraged after yesterday's meeting that the leaders of Asia are moving to address these issues.

Against this backdrop of many positive elements but many uncertainties and risk in the global economy and I haven't even begun to mention oil prices and Iran and other elements of risk which add uncertainty to the picture.

Let me turn to the Korean economic outlook because I find that during my visit here for the past two days there is some degree of anxiety about Korea's position in the world economy. And I ask my colleagues here, and we have here with us today two of our seniors colleagues, Ron Stanley who is here in Korea for the first time, our deputy managing director who manages our regulatory and membership relations among many other things and Greg Fager, who is probably here for the ninety-ninth time, who manages our Asia-Pacific Department and who understands the Korean economy exceptionally well, as well as all of Asia. Now he is venturing off into unusual areas like Cambodia and he is venturing off into the new economies of Asia in addition to the more mature economies of Asia like Korea. And I ask my colleagues if they could give me the growth rates for the top twelve economies in the world. And if you look over the last 3 years and if you were to ask which of the top twelve economies has grown the most rapid in the last 3 years and what is the second strongest performer in the world in the last 3 years among the top twelve economies?

The first one is a bit too easy to know which of top twelve economies has grown the most rapid because it is your big neighbor, China. But what is the second strongest growing economy among the top twelve economies in the world? Who wants to guess? Korea. Surprise, surprise. I come here you have all this anxiety, I hear about a weak government, I hear about competitive problems, I hear about a service sector struggling, I hear about labor markets. These are all real issues but I am sometimes a little perplexed that Koreans do not see their own economic future with more confidence. Even for such a mature economy, 4.7, 4.2, 5.0, no other economy in the world that is as large and as mature as yours is growing so rapidly. But aside China, because China's economic development and level of maturity is perhaps what, 25 years behind Korea's. It is hard to know for sure, it is rapidly catching up certainly, but the relevant comparison are perhaps the more mature economies and here, despite your problems the performance has been quite impressive.

We see an economy with manufacturing still performing quite impressively, exports are running at double digits, I think the latest estimates for export range in value terms are somewhere in the 15%, export growth to China even higher, probably in the 18 to 20% range. Yes I know, that profitability and margins are being squeezed. And this is a legitimate matter of concern. And I know you have unemployment concerns, particularly in the younger people of Korea both the educated and not so educated people and this is a legitimate source of concern. I think that with attention and energy being focused on a few key areas, and let me mention what those are; I think the Korean economy will continue to prosper even in this world with this huge country next to you, which I sometimes compare to a dragon on steroids. That may not be the most complimentary way to refer to China but the exchange rate policy is perhaps someway steroids have affected our baseball world and I hope not yours. And in spite of this I still think Korea has huge potential to prosper.

First in the service sector, it seems to me that meaningful progress is essential towards your goal of becoming a financial hub. Sometimes I am not sure if this talk of a financial hub is rhetoric or reality, sometimes it seems like a bit of both.

You are making changes; you have a new capital markets law on the books, which I understand maybe passed in two to three months. You have pension reform moving forward. You have a regulator, which is actively looking for ways to streamline regulation, to make it more user friendly. At the same time the government's attitude towards financial markets is still not one of partnership in my view and needs to become more business friendly and more supportive of innovation in the financial markets. Regardless of whether financial firm participants are Korean headquartered or foreign headquartered, it is important to be as blind as possible to the nationality of financial institutions if you really want to build a deep and robust attractive capital market here. I believe that the Korean banks here are much more stronger than they were some few years ago. And we now see strengthening in Korea's security and insurance sectors. But nevertheless there is considerable scope for strengthening the efficiency of Korean financial markets.

Labor markets as it applies to Korean firms and foreign firms operating here is an important area of further reform. I understand the desire to train Korean citizens to be at helm of financial institutions here. But I also see the benefit of approaches like we see in Singapore today where they are blind about who comes in to manage their financial institutions. They want talent and they are open to talent wherever it comes from. This has been key to the success of London as a financial center and will be the key to Singapore's success and I hope will be a factor here in Korea. You know in recent years we have seen substantial foreign participation in the financial sector in

Korea and yet it is somewhat worrisome to me to see that when we see foreign investors generate profits on investments in Korea, that this sometimes generates a popular sentiment that there is something wrong about this.

Now Greg told me last night, he said, "you better be careful when talking about this deal here in Korea that is so controversial". And let me be clear here, I'm not questioning the right of a country, indeed the obligation of a country and its legal system, to investigate illegal behavior by either its own citizens or foreign investors if this has been the source of profitability or is somehow involved in transactions. Courts should be allowed to run their course in Korea, in the US. You have an impressive judicial system here in Korea, quite frankly, and I think we can all have confidence in the judicial system. But this is rather different from Korean leadership acquiescing to another phase of Korean anxiety about foreign profitability and foreign investors in your market. Korea cannot afford to be ambivalent about globalization today. Simply, they cannot afford it, Korea in my opinion, must embrace globalization vigorously. And this will be the key or one of the keys to success going forward and you are doing this in other areas.

I must congratulate both the government and business community here for the support of the Korean-US FTA. When I was here last year, talking to my good friend Dr SaKong, I was not so confident this would happen. But it is happening. I think that the commitment of your President and indeed the commitment of our President in the United States has been steadfast and I think will in the end lead to a final ratification of Korean-US FTA which I think will be of benefit for Korea as well as a benefit to the United States.

You know multilateral trade negotiations are stalled, we know that, and we know therefore that bilateral trade negotiations have taken on an unusual importance. In the long run they should not replace multilateral trade liberalization but in the short run they provide an opportunity for an economy like Korea to gain their competitive advantage and access to global markets and provide an opportunity to strengthen the efficiency of your own economy through more liberal engagement with the rest of the world. And I am pleased to see it, and I am not taking it as a full gone conclusion that your National Assembly will approve this nor indeed the US Congress, but I think it will happen, I hope it will happen. And I see now that there is the opening of Korean trade talks with Europe.

In my hotel, the Shilla Hotel, I was very curious on my floor there is a sign right off the elevator, right on my own floor, "EU-Korea Trade Negotiations: Administrative Office." And it is a hotel room and for the first couple of days I was here the door was always closed, so I was concerned that these negotiations are not going anywhere, they don't seem to be around. But yesterday as I was leaving the hotel I saw the door was open, so I went in and said, "I am glad to see that you are now moving forward." And the European gentleman said, "Oh, but we just began, it's going to be a long process." And I said, "Don't make it so long as the US did, because I think there is big advantage for you and Korea here and it may not be as difficult."

And then I encourage Korea to pursue what is known in racing circles; now Koreans aren't as obsessed with horse racing as Chinese, but if you have ever been down to Happy Valley in Hong Kong, you know something called the trifecta. I don't know if this means a lot to you. But it is where you bet on three horses in one race and you win all three, you pick all three to place. Well, I think the Korean trade trifecta could be a US Free-Trade Agreement, European Free-Trade Agreement and a Chinese Free-Trade Agreement and I think you will be even better placed to move forward in the global economy.

Let me say one or two other things. I mentioned the importance of labor market reform when it comes to financial markets, and this is a more general point to, I do think that there has been very little progress when liberalizing and flexibilizing your labor markets. And I think that if Korea wants to remain at the forefront, if Korea wants to still be, five years from now, the second strongest performer in the top twelve economies then I believe it is essential that you make further advances on labor market rigidities in this country. You have a wonderful education system, it seems to me Korea knows how to educate and train its people but that you don't know how to flexibly put together the factors of production. You have capital, you have trained labor but technology at its very roots is how you mix the factors of production. That is the definition of technology. And Korea has such a technological advantage but if you cannot flexibly move the factors of production around to meet the changing needs of the global economy then Korea will suffer.

Let me conclude by a note of confidence, we see Korea at the Institute, and we see Korea in global markets as a very strong economy, as a very vibrant economy, but not always a confident economy. You always worry about your political leadership, we always worry about our political leadership but economies can survive weak leaders as well strong leaders, this is at the very nature of the global economy in the 21st Century. If you allow business to do its job, if the government views itself as the partner and the ally of industry and finance and not the controller or the boss of industry and finance, if further steps can be take in liberalization in the areas I have mentioned then I think Korea's role in the world economy can be approached with the same success and confidence that it plays in Asian culture.

I had the privilege of having dinner with the Prime Minister Han Deok-soo and this was a special opportunity with the Deputy Prime Minister that Chairman Yoon had organized. But the most interesting person at the dinner may not have been the Prime Minister, it was Miss Kyoung-mi Yang. She is I gather a well-known actress in Korea and throughout Asia. One of the remarkable things about Asia in the last few years has been this remarkable spread of Korean culture throughout Asia. She is not just a popular actress in Korea, I was told last night that Malaysians love her, Thais love her, Singaporeans love her, Chinese lover her. So if you can approach Asian culture with so much confidence, I am sure you can take this same kind of confidence and apply it to the global economy and Korea may yet have the same influence on the global economy that you have in Korean entertainment and culture today. Thank you very much.

Question and Answer

Q: I have a couple of questions associated with the trans-Pacific payments imbalance or the Chinese imbalance.

First, a small question, there are some signs that the US-Asia global imbalance has begun to be a bit abated, relative to the GDP, do you agree that the imbalances problem has peaked as it were and that they are now being contained.

That is one question, now another one, you emphasized the elasticity aspect of the payments adjustment and you were optimistic that with the revaluation of the Chinese Yuan that the imbalances would lessen. But then you are well aware the absorbtionists' viewpoint perspective on that according to the fundamental determinant of the payment imbalances or balances are the absorption involving the US and China on both sides. Unless you do something about your propensity to consume and overspend in the United States that this so-called Trans-Pacific Imbalance will continue to remain there regardless of what you do to the exchange rates.

And one more thing, you have been emphasizing the Chinese surpluses as the major cause, but then you are not attributing much role to the Japanese continued accumulation of surpluses, in quantitative terms they are more or less equal to each other, and we may not be able to solve the problem without solving the Japanese problem. What do you think about these questions?

A: I think they are three difficult questions. I am going to answer them and then I would like to invite Greg to add a word or two.

I think with regard to the issue of absorption and the issue of elasticity versus the absorptive issue in the region and then I will come back to the balances that are mitigating. Of course, external deficits are a reflection of savings balance but I do believe over time that the price connection point, that the exchange rate will be the difference here in affecting industry choices in both countries. If you look at China today there is reasonable hope that consumption will increase over time, I think this could be facilitated by making the world's goods more affordable for Chinese industry and Chinese consumers and this is what would happen. It would boost Chinese demand, in my view, as a result of further flexibility in the exchange rate. And of course, China will have to take other measures to promote domestic demand as well. But I don't think this is something that can be very easily artificially stimulated, I think it is happening already, but I think China will have a more balanced growth model with a more flexible exchange rate regime and have less risk of inflationary or liquidity problems in the future.

China has already gone through many phases of non-performing loans. And right now there is so much liquidity moving into China that one has to wonder again whether this is a risk. Now I don't think we see this as a major risk, but there is a disconnection between China's import of capital into its banking system and the quality of risk management in this banking system today. So I think China is running certain risks for itself in the global economy with its current development strategy.

With regard to the US, yes, over time certainly we would all like to see a more reasonable balance between savings and investments in the US and I think we may get there. I think the virtual absence of household savings in the US is a relatively unique phenomenon and even though personal savings in the US has been weak. But I think as we move away from this real estate boom and clearly we are out of the real estate boom, that we will see some return of household savings in the US.

And of course there needs to be a more focused medium-term effort for government savings. We have a looming fiscal problem associated with social security entitlements and the government is not focused on this today and I think this is a big mistake.

When Secretary Paulson first came to the Treasury, the first speech he gave was for Congress to work more with the Executive Branch to tackle the fiscal dissavings in the US over the mid-term. But virtually nothing is happening here, politics are prevailing over good economics and this is a serious risk for our fiscal future because at some point the medium-term fiscal burden in the US structure will become a near-term fiscal burden.

So I don't deny the importance of having the US tackle its savings problem but nevertheless I think it is still helpful to have the surpluses and deficits more distributed around the world today.

I don't feel I see much abatement in the surplus problem in Asia, in fact I think the economies of ASEAN are struggling, you see countries like Malaysia not just to mention Korea which have allowed market forces to become more important in the determination of their exchange rates, Thailand. But this is creating problems, look at what the Thais did just three or four months ago. Now it is Greg's view and I agree, that the Thais made a mistake trying to clamp down on capital inflows. But if you look at what is happening two forces are contributing to difficulties for Asian economies, global liquidity is pushing up exchange rates and the Chinese suppression of market forces in its exchange rate.

I did not intend to overlook the Japanese role in global surpluses, I believe it is a serious concern but I am not sure I see an easy solution to this until I see Japanese interest rates rise. It seems to me this is the key and we will see this and maybe it should happen sooner rather than later because as long as the "Carry-trade" is happening around the world, it's going to be a difficult. And I think Korea needs to be careful on its own here about the "Carry-trade", not to bring in too much cheap money into Korea dependent upon low Yen interest rates. You know, this exchange rate environment with Japan will change at some point and if Korean financial institutions and Korean households borrow too much in Yen and get caught on the wrong side of an exchange rate move, a so-called "unwinding" of the "Carry-trade" it could be a matter of concern.

Q: I have basically two questions, one is related to the regional financial deal field and the other is to domestic one.

First, as a result of the cross-Pacific trade imbalance and East Asian economies were able to accumulate huge foreign exchange reserve. I believe last week the ASEAN-plus 3 finance ministers got together in Kyoto to expand the existing Chiang-mai Initiative and to utilize the foreign exchange reserves to create an Asian version of the IMF, in this initiative they are also talking about the exchange rate coordination between RMB, Yen and Korean Won. So I would like to hear your views on East Asia's move to use excessive foreign exchange reserves to create the Asian version of the IMF

The second question is during your presentation you touched upon the expansion of the international hedge funds and the cross-border movement, plus you implicitly that anti-foreign capital sentiment emerging in Korea after seeing foreign corporation making profits, although you did not say anti-foreign capital per se. Now here is my question, at this point POSCO and even Samsung Electronics are at the risk of being taken over by foreign capitals if international hedge funds continue to flow in to operate Korea's security market. Now in Korea there is a move by National Assembly lawmakers to enact a regulation to curb the flow of these hostile activities. Would you say something on this, how would you view this kind of move especially as Korea is heading to become a financial hub in East Asia?

A: Well, you know I was along with Greg and my other colleagues in Kyoto last week and participated in this ASEAN plus-3 idea and this Chaing-mai Initiative, which as you indicated, is talking about an Asian version of the IMF. You know, we have an expression in the US which I am sure you have a counterpart for here in Korea, which is don't try to fight the last war. Which is I am afraid what they are trying to do here.

I questioned a very senior Korean official about this yesterday, I should not say whom, and I said, "Why are you focusing on this problem now? This was yesterday's problem." He said, "Well, it makes people feel better, they still remember the pressures of the 1990s." I do understand the benefits of regional cooperation and I do understand the benefits of regional integration. But I would say put the energy into deepening regional bond markets, put the energy into improving regional corporate governance, the equity markets of this region.

This is not the problem, how many reserves did Korea have ten years ago? I could count them, the billions of reserves on one hand, in December 1997, we still don't know for sure but your reserves were certainly pushing down to zero. Today they are now, what, 240 billion dollars. And so Korea needs to participate in regional reserve fund, to protect it from the misguidance of the IMF? I don't think so. If you don't like the IMF, then use your stronger voting power in the IMF to change its policies, the IMF is an organization that has huge talent but has lost touch with the world. But the way to solve it is not to tell it to go away and go bother Latin America or the US and China, the IMF does have a role to play there. Korea should play a role in reforming the IMF and bringing it into the 21st Century, not creating some Asian alternative, which is after all is built around the premise that you don't like in Asia, IMF conditionality. Well, it was not perfect conditionality but it was not as bad as some people think, after all, I think, the IMF should be given some credit for helping Korea and some countries steer through some very, very difficult times. I don't think they handled everything perfectly, far from it, but if you have a major problem.

1997 and 1998 was not a currency crisis, and this is what I listened to in Kyoto, all the Foreign Ministers are talking about, "We need a regional fund to deal with the currency crisis." It was an economic crisis, there were problems at the heart of the Korean economy, at the heart of the Indonesian economy, the Thai economy, they weren't currency. Currency was the symptom of it. If you have a major infection, do you call it a fever crisis because you have a 102 temperature? You have to go to what the source of the infection is. So I think a lot of this to be honest is misplaced priorities, I don't see any of this as relevant and I think we should really focus on other things in the region.

I think just briefly, I had to spend some years managing this committee in the US called CFIUS, it sounds like disease, Committee on Foreign Investments in the United States where we had to review investments in strategic industries and there is a role for an organization like this but they generally become vehicles for protectionist pressure. Korea doesn't need another vehicle for protectionist pressure.

You know our Chairman here, Dr. SaKong, said this morning that even France, with its election of Sarkozy, seems to be learning that you have to embrace globalization. That's true, but unfortunately when Mr. Sarkozy was Finance Minister he thought Danone Yogurt was a nationally strategic industry. And I agree with Dr. SaKong that Sarkozy will be a more global President, but do you really want Korea to get into the business of protecting industries for strategic reasons and getting this into the hands of politicians, I don't think so.

We are not proud, I am not proud as a United States citizen that we could not allow

Dubai Ports Authority to take over the ports operation in New York. They already operate a number of port operations in the US. We have to be open to global capital and global forces if we really want to form a strong dynamic economy. Greg, do you have anything to add to these earlier issues I mentioned about Asia.

Mr. Gregory Fager: Charles, I think you covered it quite well. Let me say one thing, because I think the question was have the imbalances peaked in Asia?

I must say, we certainly don't see that, in fact the surpluses are still on an upward trend, of course that is dominated by China. But a couple of factors that aren't given much attention is the weak investment outside of China and you see this throughout the region, where investment is very sluggish in your neighbors. So import-growth is very weak and that is what is pushing some of these imbalances further.

For China, a very important phenomena we noticed a few years ago and its very natural as you can expect that when foreign investment came in and when they were expanding their production capacity from a low-base, Chinese producers relied a lot on the rest of Asia for sourcing their imports and they still do. But we are seeing the supply channels fill-in in China, so when you look at their export and import growth, export growth is much faster than import growth, and even with a slowdown in exports over the next two to three years, imports are still lagging quite a bit behind.

So the trade surplus is on an upward trend even with slower export growth and so this issue I think is going to be with us for sometime. This does suggest for the rest of Asia, when you take out China, much as what Charles was talking about, that the focus on reserves is misplaced, the focus should be on generating investment and growth. And we don't see that around Asia, so they have a false sense of security, stronger reserves isn't security when you are not growing the way you should be growing.

Dr. Dallara: Let me add one small point here. When I was in China I spoke to the Deputy Governor of the People's Bank and I said, "you know economic prosperity is not just about jobs, of course, we all know that jobs are crucial to social stability and economic prosperity but it is also known that it is about wealth creation. China is transferring 10% of its wealth creation every year abroad, this is what they are doing, they are making a trade-off of jobs focus and transferring wealth by running a current account surplus like this. This is not a long-term recipe for China to do this, no country, in my view, that is at this stage of development can afford socially for 10% of its wealth creation to go oversees every year and that is what is happening today.

Dr. SaKong: I was just going to make two comments. One is regarding this global imbalance issue. I just want to remind you of the fact that the global imbalance can be seen from two perspectives. One is the *Rashomon* version and the other is the Blind Men and the Elephant.

The *Rashomon* version was that four people came out of the woods where there was a murder and each has a different story even though there was just one true story. But of course there is one person who committed murder yet they all tell different versions. That is the *Rashomon* version. And Blind Men and the Elephant one is that people touch different parts of the elephant and give different versions of what they felt.

Some people look at this exchange rate issue, some people just look at the fundamental issue, some people look at the investment issue and the US side. I think an effort should be made to mend all these things, so the real story of this global imbalance is to deal with both versions taken into consideration

And with regarding to the Chiang-mai Initiative, I for one would like to see this initiative evolve into a full-blown regional monetary fund, which is not a substitute to the IMF. The mode of operations should be consistent with the mode of operations of the IMF. And it should be complimentary and supplementary to the IMF and not a substitute of the IMF. The conditionalities should also be consistent. So it is not just a matter of managing this current reserve, but it is a way of managing a future crisis. We may not have the kind of financial crisis that we had in 1996/7, but we could have another one.

I always take the analogy of the fire fighting squad in a village. So there is a village-wide firefighting squad and in addition to that the neighbors get together and make their own provisions for firefighting. And as long as they don't throw gasoline on the fire while the firefighters are pouring water on it then it is ok. As long as the mode of operations is consistent, I don't see why other regions see this move as not desirable.

Actually, when the IMF idea came out, Larry Summers, the Treasury Secretary, came out very strongly against the idea. And Charles, as you know, the intellectual community is changing their attitude a little bit differently but I would like to see this Chiang-Mai Initiative regional monetary fund consistent with the IMF and I would like to see the US involvement there just like you have with the World Bank and the IDB, we have an IDB and an EBRD. So a regional-level monetary fund would be good for not only the region but also the rest of the world and in that regard I would like to see it. But it is a long way to go though. As with the IMF, the Kyoto Agreement is very vague and they only agree to multilateralize rather but they did not agree if it should be contract or government-to-government treaty, they haven't agreed on it.

Another thing is that this region is not ready to have a peer-pressure or peer warning, because we don't have this mutual trust or respect particularly in this Northeast Asia Region. But I would like to see it, but not to replace the IMF; it should be consistent with the mode of operations of the IMF. The macroeconomic coordination and policies and everything within this Chiang-Mai Process needs to done but nothing has been done and so there is a long way to go. I would like to see this Institute evolve into that direction but it will take a long time.

And I would like to emphasize, that as far as I am concerned, I would like to see the Chiang-Mai Initiative evolve into a regional monetary fund as long as it is consistent with the IMF.

You know, I was in Chile once, and I talked about this regional monetary facility and the Chilean Former Central Bank Governor Celia was saying, "Oh, all the East Asians have all the reserves, that's good for you but what about us." And I said, "It will help you." Why? Because the IMF has limited funds and the IMF has to take care of so many areas, if Asian problems are taken care of by Asians, good for you, because more resources can be used for you.

That's one thing, and another is that in this age of globalization, contagion is a fact of life; so Asian problem can be a Latin American problem, so we will take care of our own problems so it will help you. So I would like American friends, particularly in

Washington policy-making circles see this initiative as not as an alternative but as a complimentary thing.

Q: Thank you for your insightful remarks. When you mentioned the dynamic economy with a control manner I thought you were talking about Korea not China. Thanks for reminding us that Korea is the second fastest growing economy among the twelve largest economies in the last three to four years. Now over the same time span, if you look at the number of foreign direct investment, since I head up Invest Korea, the National Investment Promotion Agency, I believe Korea is the second worst performer in terms of inducing FDI after Japan. So at least on either extreme we are second and not the first. Do you have a view as to how important FDI will be or is it already to the advancement of the Korea economy, especially over the next decade or so. And any advice on how Korea can make itself more hospitable for FDI. I believe your members in the IIF consist of financial institutions that engage in both lending portfolio investment as well as in some cases FDI. So this is of concern to us.

And the second question is that when you mentioned trifecta, the third one was China and not Japan. Is there any reason why Korea should do any FTA with China ahead of Japan? Those are the two questions.

A: Well, let me deal with the second part of your question. I think in the long run an FTA with Japan will make sense but I am not so sure that whatever trade arrangements you have with Japan is really going to benefit you as much as it should. The Japanese have had a remarkable way of, maybe it is changing, but they have had a historical way of deflecting Korean products. And I am not confident that they would be as open to the range of impressive Korean products as China would be. China it would seem to me is a more natural partner whereas Japan is a more natural competitor. Maybe I am wrong, and certainly there is a huge market there and I don't mean to suggest that Korean firms should not look towards it. But I think for more historical, cultural and developmental reasons, China is to me perhaps a more naturally advantageous partner in the near-term at least more than Japan

With regard to investment, I do think Korea has a problem, and part of it is an image problem. And that is why I made the comment that I did. I think if Korea really wants to boost investment it has to have both policy and rhetoric, which embrace global investors. And today there are simply too many mixed signals about foreign investors in the Korean economy, so I think it is crucial to have both a foreign policy framework which does not raise new barriers to foreign investors but which clearly opens the door to foreign investors both in the financial circles and in corporate Korea.

And I think we should recognize that there has already been a good bit of foreign investment in the financial services industry here and I think the recent debate maybe obscures that you do have some integration here. If you look at some integration of foreign firms here in the financial services and it is healthy for the Korean economy. If you look at the broader picture, the amount of foreign investment is still relatively modest.

I still think that the most difficult thing for economies and countries to do is to know when the previous growth model needs to change. Japan woke up too late; they thought that their growth model of 60s, 70s and 80s would carry them through to the 90s. But they needed a much more flexible, a much more open economy in the 1990s and they didn't realize it until it was too late. They still had their version of the *Chaebol*, which after all was the forerunner to the *Chaebol* in many ways: the *Keiretsu* structure. And it hindered the capacity of Japanese economy throughout the 90s to adjust to the reality. Because their firms were holding shares in their other firms and were very reluctant to sell their shares, disengage and do their business in a competitive way, stifling entrepreneurs in Japan as a result.

I think that Korea has to realize that the model going forward will be a mix of large and medium-sized enterprises, an environment that bills on your technological skills to encourage innovation and that has to involve greater foreign participation in the economy. I realize that you have a government here that only has 8 or 9 months left before a new government takes over. But governments can send signals and they can establish directions, I hope that the Korean government, the business community, and leaders such as you with your organization can find ways to send signals to frame policies that will encourage foreign investors in the Korean economy.