

The Economic and Foreign Policies of the New US Administration and Congress*

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I have to start with both an apology and a confession. Dr. SaKong and I thought it would be smart to have this event on the Friday after the American election on Tuesday, by then things would be clear; we would know who the new administration was and I could give you a precise picture of American economic and foreign policy over the next four years. Unfortunately, I cannot do that. The confession, however, is that now my speech has become much easier. The reason is that for the last several months, I have been giving speeches around the world about the possible outcome under either of two outcomes to the election. Instead of having to do a new speech about just one of those, I can just give you the same speech about what could happen under either candidate, because we do not know who is going to be President. It will take several weeks before we know who it is going to be and, although it is remote, it is not impossible that we may have to consider a Hastert administration.

It is conceivable that we will not have elected a President by January 20, because there are going to be court challenges to the votes in Florida and perhaps other states. It looks like there will be recounts in several states and we literally do not know how fast that can be resolved. If the election is unresolved as of January 20th, then it is up to the House of Representatives to select a Speaker of the House and he becomes President. The current Speaker of the House is Dennis Hastert from Illinois who has been speaker for the last congressional session. The Republicans won a very thin majority in the House but presumably enough to reelect speaker Hastert, who, on January 20th, could be sworn in as President if the election itself has not been decided. He would only remain President until the election was decided, which at some point it will be, but we do not know long that process might take to unfold.

Regardless of who becomes President, the significance of this election is that it was, for all practical purposes, a tie. If George Bush becomes President by virtue of finally winning Florida and no other states change, he will have been elected by two electoral votes, which is virtually a tie. The popular vote now has a difference of less than

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200,000 out of 100 million – less than 0.2% of the vote, i.e., a tie. Just one hour ago, the recount in Florida was down to a Bush lead of 340 votes out of over 5 million – a tie in the decisive state. The Senate may wind up as an absolute tie of 50-50, but at most it will be 51 Republicans and 49 Democrats; a virtual tie. In the last Congress of the House of Representatives the Republicans had a majority of six, but it looks like this time they will have a majority of three or four – a virtual tie.

The outcome of this election is about as close as you could come in the real world to a split vote of the national population. You could interpret that in various ways: on the one hand, you can say that the American public prefers to have an immobile government (which is in fact a revealed preference). If one looks throughout the postwar period, in the great majority of the time we have had a President of one party and a Congress of the other party. Most of the time there have been Republican Presidents and Democratic Congresses, but in the last few years there have been Democratic Presidents and Republican Congresses. It is almost as if the invisible hand of politics is working to provide checks and balances on government, rather than action, but if you come to an absolute tie of the vote it is that to a considerable degree. The other implication, which is less positive, is that we will have an immobile government that will be able to do very little. In this case, the vote would be so evenly split that not only is there no mandate to a President or Congress, there is not even a working majority to deal with the big issues that were discussed in the campaign, such as reform of social security, medi-care, education. So, despite all the talk you will hear about bipartisanship, I think the outcome is likely to be a very immobile and inactive government.

However this Presidential race comes out, there will be tremendous bitterness from the losers to the winners, and probably vice-versa, which will lead to a very strong resolve to get back next time. In fact, even before all this bitterness, it was quite likely that in our next Congressional election, which is only two years away, the Democrats will win and recover the majority. The reason in the Senate is that next time twice as many Republicans as Democrats have to stand for reelection and with such a thin margin going in, it is a high statistical probability that the Democrats would win the majority in 2002. In the house more Republicans than Democrats appear vulnerable. Therefore, the Democrats would have no incentive to cooperate in the next two years to put through programs under a Republican majority, because if they just wait two years, they can be in charge. So, sobering as that sounds, I think one has to honestly contemplate

that gridlock will be the nature of the US political scene for at least the next couple of years and it is highly unlikely that any major domestic policy initiatives will be taken.

On the whole, however, that may not be so bad. The big issues that were discussed in the campaign - social security reform, medi-care, etc. – are fortunately long-term problems and actually it was surprising to many of us that they were discussed so actively in the campaign. The social security trust fund is in good shape for at least another 20 years, maybe more than that depending on your economic assumptions. The medical support system is OK for at least another 10 or 15 years. So, there is not an immediacy required to deal with those problems. Moreover, if the parties disagree on how to spend the budget surplus, then it is more likely that the budget will remain in surplus and we will pay down the debt, keep interest rates down and maintain the economic policy which has been so successful over the last 5-10 years. Personally, I think that is the best outcome because I do not like Bush's tax cuts, I do not like many of Gore's spending programs and I would rather run the surpluses, pay down the debt and keep interest rates down. I think that is the formula that has worked and produced this enormously successful American economy. I think it is quite desirable for that to continue. So, the outlook that is characterized as gridlock sounds bad, but may not be so bad in practice.

Foreign policy is of course another matter. Whoever is President, despite the thinnest of majorities, does have the constitutional authority to manage foreign policy. Despite the bitterness that will be there, I suspect the basic tradition of bi-partisanship or non-partisanship in foreign policy will continue. The candidates, in spite of all their rhetoric, did not really display very much significant difference in the way they view the world or their foreign policy projections, so I think other countries like Korea, where there is such a heavy dependence on the US and close relations with the US, need not worry that there is going to be any radical change in American foreign policy, nor an immobility of American capability to act on the international scene when problems arise.

One complex area where our domestic issues and our international issues intersect is international economic policy. I will spend most of my time talking about this, suggesting what might or might not happen under either of the possible outcomes and give you some framework for thinking about what might be the meaning of the outcome as it unfolds, probably over the next few weeks, not just the next few days. There are

three sets of issues I want to focus on, all of which could be affected differently by the outcome of the election, both the Presidential election and the Congressional election. These three are: (1) the macroeconomic outlook and policy, (2) the international financial scene, particularly the exchange rate of the dollar and associated currency and international monetary issues, (3) trade policy, which is of course, a major element of concern in Korea and also throughout the world.

In terms of the US economy, the fundamental question I face throughout the world is whether the dazzling US economic performance of the last few years is solid or whether it is a bubble economy and could therefore collapse the way Japan's economy did in the early 1990s. My answer to that is unambiguous and positive. I believe the US economy is extremely solid, extremely strong and may get even stronger over the next few years. It is certainly not a bubble economy and can be expected to continue to provide a very strong foundation for the world economic outlook.

The US economy has been growing for the last 10 years, but keep in mind that, except for one two-quarter dip 10 years ago, it has actually been growing steadily for 18 years. This is really an 18-year expansion during which 45 million jobs have been created and unemployment has dropped to the lowest level in 30 years without any noticeable inflation. It is a stunning performance, and the question is whether it is sustainable. I believe it is because it is clearly based on a dramatic improvement in underlying productivity growth, which is what really counts for economic performance. Total factor productivity, which is the best overall measure of resource usage, has tripled in the last three to five years. Labor productivity, which measures the overall productivity growth in the economy, has more than doubled to greater than 3% per year. Alan Greenspan, who is probably our best economist to assess all of this, continues to say that there is no sign that acceleration in US productivity growth has come to an end, i.e., not only has productivity growth more than doubled, it is continuing to accelerate.

There were a number of skeptics among academic experts on the topic, but they have now all agreed that the only real issue is the debate over whether the sustainable long-run growth potential for the US is now 3.5% per year, 4% per year, or even more. There will be cyclical fluctuations around that; we had a slowdown in the third quarter to a little under 3% growth, but the long-run steady state potential now is around 4% per year, which is about double what we thought it was as recently as 5 years ago. Virtually no American economist thought we could ever reduce unemployment to these

levels without triggering inflation, but it has been done and it has now been sustained long enough to believe that it is real.

I think there are two basic reasons for this. One is the information technology revolution, which is now extending throughout the economy. In fact, Greenspan says he cannot find any sector of the economy that has not been touched by the IT revolution, but many of them are just beginning to absorb its benefits in terms of higher productivity and that is why productivity growth is continuing to accelerate and is likely to grow even further.

The second big factor in my view, which is often under-appreciated in the US itself, is globalization. The US has experienced the most rapid pace of globalization of any mature industrial economy in history. Only 30 years ago, exports plus imports of goods and services accounted for less than 10% of the US economy. Today that number is more than 30%. The openness of the US economy has tripled in one generation, which is unprecedented in historical terms. In fact, taken as a group toward the rest of the world, the US is now a more globalized economy than the European Union and the US is much more globalized than Japan. That globalization in turn means enormous day-to-day competitive pressure on American industry, and if you ask me a single reason why US industry despite this enormously successful growth record continues every day to improve productivity, downsize, restructure, merge, improve its performance, it is because American industry knows they are competing in a global economy and they must continue to improve mercilessly in order to survive and prosper.

The last time we had a boom like this in the US was in the 1960s. Toward the end of that 10-year expansion American industry became very complacent, very lazy, productivity growth dropped, wage increases were excessive and it sowed the seed of 10-20 years of relative decline of the American economy in the 1970s and into the 1980s. This time there is no sign of that whatsoever and I attribute a great deal of that to the effects of globalization placing this enormous continuing competitive pressure on the US economy. Those same competitive pressures of course cause dislocations of workers and firms, anxieties, and backlash against the globalization process, but it is clear that globalization has a hugely beneficial effect on our overall economy. At my institute we believe as much as half of the improvement in productivity may be attributable to globalization. Of course, it is hard to distinguish between globalization

and the IT revolution, because they are intimately interrelated and they reinforce each other, but the two together have had a huge effect on the US economy.

Of course, what about the stock-market? Could it crash any day and bring all this down? I do not think so. First of all, one must remember that the average high-technology stock has already declined from its high by an average of 70%. The averages have not dropped that much, only 40% for the hi-tech stocks, but the average individual technology stock has declined 70% from its high. That is a huge correction, i.e., we have already had a lot of correction. I believe we have had a very substantial correction and the economy has continued to grow right through it.

It is of course possible that some exogenous shock, possibly this political uncertainty, could lead to renewed declines in the stock-market. We have then run that prospect through our econometric models and even the results there are fairly reassuring. Suppose the big stock-market averages, such as the Dow Jones and the Standard and Poor's, dropped by 30 or 40% and stayed there for a year or two. It would certainly slow our economy, probably by 1 or 1.5% percentage points per year for the next couple of years, but it would not push the economy into a recession. So, even in the case where we had a big further stock-market correction it does not look like it would bring the economy into negative terrain.

The final point of my optimism is the US policy position. If it turns out I am wrong, or if the stock-market did crash, or some other shock occurred that forced the economy in a negative direction, we have available both monetary and fiscal policy to respond very rapidly and very forcefully to correct any possible significant downturn. The budget is, of course, in large surplus; about 2.5% of GDP last year and getting higher in the current year, so if we needed a fiscal stimulus, a tax cut, we could do it in a matter of weeks and stimulate the economy.

Perhaps even more important is monetary policy. Real interest rates are very high by historical standards and recently the Federal Reserve has been tightening to make sure that inflation did not pick up. In fact, the problem has been viewed as the opposite; not as a slowdown but possibly as overheating, so the Federal Reserve has been tightening. However, the result is that there is enormous scope to ease monetary policy if necessary to deal with the problem. We saw it 2 years ago when there was the fear of a global credit crunch. When Russia defaulted, Brazil was about to devalue and LTCM (Long-

Term Capital Management) defaulted, there was sincere and realistic concern about a global credit crunch. The Federal Reserve quickly reduced interest rates three times in a row and the crisis passed, but it showed again the potential for flexible and rapid policy response to deal with any problems that might emerge. So, my confidence about the US outlook is underlined by this policy potential to deal with problems if they were to arise.

I do not want this to sound like “American triumphalism,” because the US still has huge economic problems. For example, problems of income disparity are getting worse; real incomes were flat for 20 years and have just begun to grow again in the last 3 or 4 years; our primary and secondary education system is poor and is not producing the kind of people we need to maintain this performance in a globally competitive economy over the next generation or two; and our external imbalance is a problem that I will come to later. So, the US has problems and I do not wish to suggest that everything has been overcome, but I do think the economic outlook is very strong. I am sure there will be dips around that long-term norm, but I think the outlook is quite good and therefore, under whatever administration we have, the US economy will continue to do well.

My main concern about the outcome of the election was that a Bush administration with a Republican Congress might actually go ahead and put through a very large tax cut program. I think that would be the largest risk to the American economic outlook, because at a time when we are at full employment, when there is some modest risk of an inflationary pickup, the last thing we need is a big stimulus to demand coming from a tax cut or anything else. The Bush proposal, as his advisers have crafted it, is fairly responsible; it is long-term and gradual, but if it got into the Congress, it could be speeded up, increased and could occur more rapidly.

One must remember what happened last time we had a shift from a Democratic to a Republican administration; the Reagan administration came in with huge tax cuts, huge defense build-up, “Reaganomics,” and the onset of massive budget deficits that then plagued our economy for over a decade. The Reagan tax cuts however, had two things going for them that Bush, Jr. tax cuts would not. The first is that when Reagan did it, the economy was in recession, so there were lots of resources available to be stimulated by the tax cut without promoting inflation. At least the timing was good in that sense, whereas a George W. Bush tax cut would have very poor timing.

The second thing is that Reagan's big tax cut, and resulting budget deficit, were financed by the rest of the world. There was a big budget deficit, sky-high interest rates, the dollar soared, huge amounts of capital came in and, essentially, the rest of the world financed the Reagan budget deficit. That was possible because, when I left my position at the Treasury in charge of the international account and turned it over to the Reagan people in 1980, we left the US in current account balance and as the world's largest creditor country. So, Reagan had a big creditor position that he could run down to finance his tax cuts and carry forward his program without crowding out private investment in the domestic sense. Now, of course, the US is the world's largest debtor country and already has huge external deficits, so that cushion is not there. Therefore, a Bush Jr. tax cut might have some quite nasty consequences and that to me is the biggest risk coming out of this election.

Let me now turn to the external deficit. I think the external deficit is probably the biggest area of risk for the US economy today. The external deficit is the one big imbalance in the US economy. The trade and current account deficits are both running at annual rates of about \$450 billion, which is about 4.5% of GDP. Those deficits have been increasing at a rate of about 50% per year for the last 2 years and they are on top of a US net foreign debt position which already exceeds \$2 trillion, about 20% of GDP, and are rising at about 20% per year. In short, the US is on an unsustainable path, in terms of its external imbalance.

We published a major study on that at my institute about a year ago and concluded that, when industrial countries like the US begin to run current account deficits in excess of about 4% of GDP, they are clearly in the danger zone. It does not mean an immediate crisis. Indeed we predicted that the situation could be sustained for another 2 or 3 years; now 1 year has gone by and so far it has been sustained, so that prediction was right. But we do believe that it is now getting close to the point where the deficit will no longer be sustainable at current exchange rates, interest rates and the like.

The reason I suggest that this is such a risk to the economy is that the likely method through which the current account unsustainability would be corrected is through a sharp fall in the exchange rate of the dollar. In fact, there is no other way for the external deficit to be corrected except for a massive US recession or worse, and as I said, that is not likely. The only real possible outcome is a substantial decline in the

exchange rate of the dollar. I do not think the US has to eliminate its current account deficit and our judgment is that it needs to be cut roughly in half from about 4% of GDP to 2%, which would cut it to maybe \$200 billion and still require a lot of foreign financing, but be at a level that our calculations suggest would be sustainable. That in turn would require a decline of the dollar of something like 20-25%. Now, the dollar already declined a lot against the Japanese Yen 2 years ago when the Yen hit a weak point in the middle of 1998, it then strengthened 30% and stayed in the 100-110 range. In a way, that was the first step in the inevitable decline of the dollar. The next big step will of course take place against the Euro, which is hugely undervalued, probably 30-40% on our calculations. Whenever market psychology changes the Euro could rise very rapidly and that will probably be the main counterpart to the decline of the dollar that I foresee. Other currencies are somewhere in between; for example, the Canadian dollar and the Korean Won I expect to move 10-15% up against the dollar when the dollar goes through this inevitable period of substantial decline.

The real issue in terms of impact of this movement, which I regard as inevitable, is whether it takes place in a hard-landing or soft-landing modality. One could imagine a hard-landing where the correction took place in 6 months or a year and was quite disruptive. If the dollar dropped 20-25% within 6 months or a year, it would tend to push up inflation in the US by about 2 percentage points and that would push up interest rates by 200-300 basis points, which would in turn push down the stock-market and we would have a triple hit to the economy. I think it is that sequence of events: higher inflation, higher interest rates, a sharp decline of the stock-market coming off a rapid decline of the exchange rate of the dollar, which is actually the greatest threat to the American expansion and therefore to the world economy.

Here too I am relatively optimistic and that a soft-landing is more likely. The reason is that the continued underlying good performance of the US economy, even if the external imbalance is unsustainable, will continue to attract foreign investment. There will be lots of direct investment inflows and takeovers by European and other foreign firms and, even if the level of investment from abroad into the US is reduced, as it will be, it will continue to flow. I do not see any reason why there should be a precipitant withdrawal of funds from the US which would be required to cause a hard-landing. Moreover, at least on current readings, it does not seem likely that Europe or, even less so, Japan would be looking so dynamic as to attract huge amounts of capital inflow that would come out of the dollar and force the dollar down very sharply.

Finally, there is the policy response. The G-7 could, and would, intervene to slow down any rapid decline or possible freefall of the dollar. Remember this is one of those rare cases where the G-7 would be in agreement: the US would not want to see the dollar collapse, neither would Europe or Japan want to see their currencies skyrocket as it would hurt their competitiveness and undermine their economic growth, which is not that impressive in the first place. So, there would be a clear confluence of interests among the G-7 countries, which I think would clearly inspire them to intervene cooperatively and effectively to limit the reduction in value of the dollar and its adverse effect on the US and world economies. Again, one can always be skeptical and say that the G-7 might still fail to act, as their record has not been very good in recent years, so I do not suggest there is no risk of a freefall or hard-landing of the dollar, I will only say that it is less likely than the soft-landing alternative.

Having said that, I will make one remark about the election outcome that is partly in jest but partly serious. In the postwar period there have been three very large declines of the dollar and every one of them occurred when we had a secretary of the treasury from Texas: John Connally in the early 1970s, Jim Baker in the middle 1980s and Lloyd Bentsen in the early 1990s. People forget that the dollar fell to its all-time record low only 5 years ago in 1995, when it was down to 80 Yen. It got to that point after Rubin came in, but most of the decline occurred while Bentsen was still secretary of the treasury. So, I like to joke with my friends in the Bush camp that the previous record of Texans being in charge of the exchange rate was not so good and I warn friends around the world that, if correlations of that type hold, they better worry and watch out for what might happen in the future.

More serious is the fact that some of the Bush advisers are ideologically opposed to any kind of intervention in the exchange markets and, in fact, are also opposed to the whole system based on the IMF and international financial cooperation. Again, I will go back to the last time a Republican administration replaced a Democratic administration. There was absolute total rejection of the idea of intervention in the exchange markets, and that was one reason why the dollar soared to overvalued levels in the mid-1980s, the US trade deficit hit record levels and the US became the world's leading debtor country. The first Reagan administration was ideologically opposed to intervention and there are some in the current Bush camp who take that view. So, if that prevailed, there could be a period where the dollar strengthened even more, which would simply

set things up for a bigger fall, like the 50% fall that happened in the second Reagan period, but there could be more disruption of that type. Moreover, some of Bush's key advisers, with whom I have testified before congressional committees as recently as two years ago, actually proposed elimination of the IMF. I do not suggest that would be Bush policy and I do not suggest it is the majority view in his camp, but there are some on that side of the political spectrum that do take some fairly radical views on the international financial system and that has to be watched also. Lest you think I am partisan because so far I have been criticizing a possible Bush administration, I am shortly, on my last point, going to criticize a possible Gore administration, but on these points there are some worrisome signs and possibilities if Bush wins the election.

The final point is trade policy, which is extremely important. I mentioned at the start that I believe the expansion of globalization of the US economy is one of the key reasons for our economic success and the whole renaissance of the American economy. But, as I mentioned, we also know there has been a tremendous backlash against globalization within the US. It may be hard for people here and around the world to understand that, but in poll after poll more than half the population of the US opposes globalization by saying, "we do understand it has benefits, but we also believe it is very disruptive, it causes us great anxiety and insecurity and we would rather not have any more of it." They do not say we should go protectionist or roll back the existing openness of the US economy, but they do resist any further reduction of barriers or intensification of the globalization process. This is why, even with the strong economy we have had in the last 8 years, our domestic political situation is in total stalemate over trade policy.

Since 1994 our President has had no authority to negotiate any new trade deals, which is one reason why the Seattle ministerial of the WTO failed; the US was in no position to participate, let alone lead a new negotiation. The US put forward unbalanced proposals asking other countries to reduce their barriers but offering nothing themselves. That was destined to fail but our administration could do nothing else, because they had no authority to offer any further liberalization of US trade barriers. The voluntary sectoral liberalization process in APEC stalled 2 years ago, most immediately because Japan refused to liberalize some key sectors, but also because the US was unable to support a balanced package of reduction of barriers because it was unable to put any of its own barriers on the table due to a lack of domestic authority to reduce barriers to further US imports. So, even going into this election, which comes out closer yet, US

domestic political have been stalemated over the globalization issue and the US has been unable to do much on trade.

We have been studying that issue in great depth at my institute and some of the conclusions are fascinating. This majority that I mentioned that opposes globalization does not break down along industry lines; it is not people in the textile and steel industries who oppose it and people in the other industries that support it. Actually it breaks down according to the level of education and, therefore, the level of skills in the American workforce. Those American workers who are not college graduates, even if they have good jobs today, simply do not feel capable of competing effectively in high-wage jobs in a globalized, competitive, hi-tech economy and therefore are anxious and insecure about the globalization pressures for further job dislocation, having to take on new occupations, etc. The US has more college graduates as a share of the population than any other country in the world, about 25%, but that means that 75% of our population is not college trained and the statistics show that many of them feel they are not capable of competing effectively in a globalized economy and so they resist globalization.

We have done major studies of the impact of trade-related job dislocation for American workers and again, the results are fascinating. About one-third of those dislocated get new jobs that pay just as well as the job they lost, another third get much better jobs, but about one-third take lifetime earnings losses of 40-50%, which are big losses. It is mainly married women who are unable to shift geographically to take advantage of new employment possibilities and so there is a strong and widespread backlash not from a big percentage of the population, but several million people who are against the process. Obviously, it is up to us to deal with that problem domestically through improving our education system, training programs, etc. However, it is a fact underlying the backlash against globalization and this stalemate that has kept the US out of the world trading system in any active way for the last few years.

Of course, the world trading system has not stopped as a result of US inactivity. Indeed, what I expect will continue to happen, unless the US does something about it, is that other countries will accelerate the pace of making deals without, and around, the United States. If I were asked to characterize the world trading system today, I would characterize it as a rapid proliferation of regional and sub-regional trading arrangements outside the US. The European Union is expanding to the Mediterranean and also just

did a deal with Mexico. In Northeast Asia, Japan and Korea are talking, Japan has just signed a “new age economic agreement” with Singapore and is talking with Mexico and several others, while Korea has been talking with Chile and others as well. There are studies on a Northeast Asian free trade agreement between Japan, Korea and China, which our studies have shown would be of great benefit to Korea. There is a virtual explosion of regional and sub-regional agreements as the US has become inactive in trying to put together new trade agreements, either at the regional or at the global level through the WTO and I believe that process is likely to continue unless and until the US gets back in the act.

Now, what would be the outcome of that? We know that regional arrangements can go either way. On one hand, they can be divisive by creating blocs, they create trade discrimination and they can, over time if left to their own, divide up and split large parts of the global trading system. Indeed, if the proliferation of trade and financial regional arrangements in this area continue to develop, we could see over time the development of an East Asian trading bloc and a tripartite world, along with Western Europe and North America that would divide the world into three pieces, which would be very dangerous and very unstable.

On the other hand, the proliferation of regional arrangements earlier in the postwar period has had a very positive catalytic effect promoting global liberalization steps in order to reduce the discrimination that the regional arrangements put in place. Indeed, throughout the postwar period there has been very positive interaction between regional and global liberalization where the two acted to ratchet up the process of liberalization over time. Some of the strategists involved in pursuing the new wave of regionalism have exactly that strategy in mind; to try to restart the momentum of liberalization through the smaller regional and sub-regional agreements on the hope and view that those will inevitably force the other countries, including eventually the US, to defend their own interests against discrimination by getting back into the act and liberalizing at the broader level. I think that would eventually happen in the US, though how long it might take is a risky process in terms of the possible development of divisive and discriminatory bloc arrangements that could be counterproductive and negative along the way.

That brings me to the final point, which is that the outcome of the election could also be very important in terms of US trade policy. Here I will say some positive words about

a possible Bush administration. The Bush campaign is sincerely and aggressively aiming to restore traditional US leadership toward trade liberalization at both the regional and global levels. In the regional case there is an action-forcing event, the Summit of the Americas that is coming up in Canada in April. The objective of that third Summit of the Americas is to start the negotiation for a free trade area of the Americas. I think a Bush administration would want to pursue that negotiation actively. That in turn means that they would work with the slim Republican majority in the Congress to try to get at least a green light in terms of the authority to negotiate. That would have to be ratified in subsequent legislation, which I do not think could happen by April, but if they could get a blessing in principle, they might restart the process of active US trade liberalizing negotiations as early as April in a western hemisphere context. Then I think they would carry it on into the next WTO ministerial, which is scheduled for late next year, and try to start a new multilateral round. It is hard to say whether the Bush administration, assuming it did try to do that, would be able to win Congressional support since the Republican Party majority is so thin in both Houses, but I think there is a good chance they could. There are also at least 40 or 50 Democrats, so-called "new Democrats", who I think would support a revived US effort to reduce trade barriers. I think, along with a Republican majority that was loyal to a new President Bush, they probably could get the majority and would restart US active participation in global trade policy.

On the other hand, I think a Gore administration might not be able to do so. That is partly because there would be the same divided government we have now, with Republicans controlling the Congress and also because President Gore would be largely beholden to the labor unions, who would have played a decisive role in getting him elected and he would be thinking about getting reelected, particularly in the climate in which this election would come out, so I think he would be very unlikely to take a major trade liberalizing initiative strongly opposed by his own strongest support group at the outset. At a minimum, if he were able to work out some kind of compromise in the Congress, it would be based on his insistence, which was clear in the campaign, that any new trade liberalization should include international agreements on labor standards, environmental standards and maybe, he has said, human rights. We know that would run into major opposition from most other trading countries around the world, so if our domestic gridlock could be overcome, it would be replaced by international gridlock and it would be very unlikely to achieve new negotiated progress involving the US. Therefore, the trend of regional and sub-regional agreements without the US would be

likely to continue.

In other words, I think the outcome of this torturous election process probably will make a difference, not on social security and medi-care and the domestic issues that I focused on at the start, but on these international economic topics, which mesh the domestic issues with foreign policy where the President has greater authority but must have congressional support for most of what he does. The outcomes could be quite different in terms of the macro-economy, certainly in terms of the exchange rate, and most clearly in terms of trade policy. And so, as we all watch very closely how this outcome evolves, there will be very large stakes out there. Obviously, large stakes for us in the US, but also very large stakes for people in Korea, in Asia and around the world.

Q&A

Q: I would like to comment on the last point you made that said whichever administration takes over it will make a big difference on the external front. In general I agree with that. The President has more power in dealing with financial matters alone, but when it comes to trade, he has to deal with Congress and with the very thin Republican majority, so it seems even a Bush administration could not take much of an initiative on the trade front. Could you comment on that?

A: The question is whether a Bush administration could be very active on trade with its thin majorities in the Congress. It is a fair question, but I think that if Bush were to move very early to try to get fast-track negotiating authority, he would have a good chance to do it. The reason is the following. In the aftermath of this very bitter election there is going to be a lot of party loyalty, at least in the first six months or year of the new Congress. So, if Bush is President, I think he will be able to command the loyalty of a very large number of the Republicans in the Congress, even if they do not agree with him on an issue. We traditionally see that in the US; any President who is newly elected comes in with some honeymoon period, if not from the public or the opposition, at least from his own party and, particularly the way this one is evolving, I think most of the Republicans would feel committed to support a new President Bush on most of his major initiatives in his first year. That in turn raises the question, would Bush make the trade issue one of his top initiatives? I think he would, partly because it would be almost impossible for him to succeed with his big domestic initiatives,

because the party loyalty would not be as effective there and the issues are more complicated and more long-term, so they might be put aside. He might also come in with the big tax cut, which could then tie up the Congress. I am hoping that he would not do that right away, for the reasons I indicated – it is not really needed at this point and would be costly. So, I am hoping, but I cannot be sure, that there is some reasonable chance that Bush would make trade one of his top three or four initiatives, do it early and therefore gain the benefit of the loyalty of his party.

I mentioned the Summit of the Americas that is coming up in Canada in April. You remember that the whole idea of NAFTA was a Reagan-Bush initiative; Clinton carried it through but it actually goes back to Reagan's 1980 campaign. The Republicans view a free trade area of the Americas as very much their thing and they would sincerely like to get that going in a serious way. So, with that as an action-forcing event plus what I mentioned already, I think there is a serious chance that Bush would make it an early initiative, would command a large majority of the Republicans and would get 40 or 50 Democrats who believe in free trade and are not beholden to the labor unions, and that could be enough to get a majority. I do not think that would solve the problem of the backlash against globalization in the US; there would still be the anxiety that I talked about, a lot of people would be unhappy, the issue would return later, but in the short-run I think there might be at least a reasonable chance that we would get enough Congressional support to get the US back in the game. I also said at the outset that the Democrats are likely to win back the House in 2 years, so there may be a narrow window. It may have to be done in the next year or two or it may not get done for the indefinite future. That is my fear; if I am wrong and a Bush-Republican team were unable to get the US back on track on the trade issue in the next year, it could be 5 years or more, during which period this regional proliferation and division of the world into trading blocs could easily occur. That is the fear and the narrow window that I think might exist.

Q: Does that mean that a Bush administration could get fast-track authority sooner than a Gore administration?

A: I think Bush has a better chance. Gore would clearly insist that any fast-track legislation included a requirement that new trade agreements include labor standards, environmental standards and maybe human rights. He might not be able to get that through the Congress. Clinton tried hard in 1997, but was unable to do this, the

business community opposed it, the Republican Congress opposed it and that is why we have this gridlock domestically now. It is possible that a Republican Congress facing a President Gore might say, “well, we have to live with him for 4 years, maybe 8, so we should make a bargain and give him authority with some compromised version of those requirements (labor and environment).” But then, I suspect, the US would be required to take positions in the international negotiations that would be rejected by a large number of its major trading partners. So, even if you overcame the domestic stalemate, you might simply replace it with a continued international stalemate of the type we saw at Seattle, where there was almost total rejection by the developing countries (and some others) of the Clinton administration’s insistence on including labor and environmental standards in the negotiations. So, whether you look at the domestic level or the international level, I think the prospects would be much better under a Bush administration, although even there I will admit that it is no sure thing.

Q: I would like to ask a question on economic cooperation between the two Koreas.

The integration of the Northeast Asian economies into a meaningful trading bloc and the removal of the Cold War legacy from the Korean peninsula are very important. In this context I think in order to ensure the two Koreas ongoing economic cooperation scheme, we need to come up with an international consortium-financing scheme. I would like to ask you whether you think the US could work on the international consortium financial arrangement to support the ongoing economic cooperation scheme provided that North Korea complies with the missile or development program as the US suggest.

A: As you may know, Marcus Noland has done extensive studies on the question of economic integration of the Korean peninsula, explicitly including the factor you mentioned of how to finance North Korean integration into a meaningful economic institution.

With possible Japanese reparation payments and some lending from the World Bank, the Asian Development Bank and others to help out in the political context you mentioned, I think the US would certainly cooperate.

I think the idea of a Northeast Asian Development Bank is a good idea to add resources to the process, to dramatize the emergence of a Northeast Asian economic region, and certainly, if there were continued evolution of cooperation in the trade area and the

monetary area, then a Northeast Asian Development Bank would be quite a logical part of that overall framework. I would simply make the same point on that that I made with respect to trade policy: any new regional or sub-regional agreements need to be organized in a way that is consistent with, and supportive of, the broader multilateral processes. Certainly, the ADB has always had that relationship with the World Bank, the global development financing system, and I am sure a Northeast Asian Development Bank would as well, but that is the only caveat I would put on it. I think in that context it would be a good idea.

An analogy of this is the creation of the European Bank for Reconstruction and Development after the collapse of communism in Europe. The whole idea of the EBRD was to help finance and manage the transition from communist economics to the market economy and the EBRD has been pursuing that goal for 10 years. The driving force here would be the end of the Cold War in Northeast Asia, so an analogous creation of a development finance institution would be perfectly appropriate and could even be likened to the creation of the EBRD.

Q: Regarding the question of US foreign policy on the Korean peninsula, especially the engagement policy of the Clinton administration and Kim Dae-jung's sunshine policy, will there be a clear change if there is a Bush administration?

A: I do not think there would be much change with a Bush administration on foreign policy as a whole, and particularly towards the Korean peninsula and the sunshine policy. There might be a little difference in rhetoric as there has been in the campaign. The Bush campaign has taken a more distant approach toward China than the Clinton administration and has talked in terms of greater emphasis on the traditional US alliances in Asia, meaning Japan and Korea, and a little less emphasis on a new relationship with China combined with a slightly greater tendency to view China as a possible threat in the future rather than as a partner in a strategic sense.

I think that is more rhetoric than operational policy. Bush strongly supported WTO membership for China and I have not seen any major operational differences. A Bush administration might be more inclined toward theater missile defense, but the Clinton administration was headed down that road as well and the domestic politics support that. The Bush administration, like most Republican administrations, might tilt a little more strongly toward Taiwan than the Clinton administration or other Democratic

administrations might, so I think that main substantive difference, if any, would probably occur round the margins of policy, rhetoric and posturing toward China.

Again, I do not see major policy issues that would come out differently, but if they pursued theater missile defense or national missile defense, which they probably would, it could of course cause confrontation with China. That in turn would have implications throughout the region, including the Korean peninsula, and possibly for the evolution toward Korean unification. That difference would be the main area where a Bush government might cause some different outcome in this part of the world. I do not think there would be any noticeable or significant difference toward the Korean issues themselves, but there could be some differences deriving from relations with China and that could be the big source of uncertainty and possible confrontation in the future.

Q: How long do you think it will be before the setting up of the proposed Northeast Asia trade association? The idea is very good, but there are many conflicts of interests among the nations as well as a balance of power problem.

A: My understanding is that the issue is being studied in think-tanks in the three countries. It is not under active negotiation and there is no political momentum toward it at this time. So it is at a very early stage. As I mentioned, we have done a study of about twenty possible sub-regional trade agreements in this area starting with Korea-Japan, then adding China, then adding ASEAN, then adding Australia-New Zealand, then going to all APEC, then going to all WTO. It is very interesting that a Japan-Korea-China free trade agreement actually is quite beneficial for all three countries. There are also some adjustment costs, but there would be substantial economic benefits for all three countries and notably for Korea, so the economics tend to be supportive.

It does raise a very interesting possibility for Korea, which is to be the intermediary between the two giants and a possibility for bringing them together at some point. My guess is that the outcome will depend on what happens in other areas. By this I mean that, unlike Europe, Asian economic cooperation seems to be moving first in the financial area more than the trade area, and that is an outgrowth of the financial crisis; the whole ASEAN plus 3 movement, the network of bilateral swap arrangements that are now being negotiated and look like being quite significant, which include both Japan and China, look like they could begin to develop some cooperative relationships

among the same countries in the financial area in a way that is less politically difficult. It is a technical thing because currency, mutual support agreements, can be put together without a lot of domestic political debate, and it may be that the coincidence of moving ahead first in the financial area in this part of the world will provide a starting point for broader cooperation that could happen later on.

The other element goes back to what I was saying about the US and the world trading system. If the world trading system gets back on track, the WTO is successful and there is a new multilateral round, then I suspect that a possible Northeast Asia free trade agreement and even some of the other possibilities in the area would tend to recede in importance in favor of focusing on the WTO and the broader negotiations. But, if those broader things fail to happen, perhaps because the US continues in gridlock domestically and is unable to participate, then I think there will be an impetus to continuation and even acceleration of alternatives. I think countries who are heavily dependent on trade, want to see markets open, and want to use trade liberalization to promote their own domestic reform process, as China does, will look for alternatives. That is where something of a broader nature like a Northeast Asian agreement could come along. It would still be several years before that would happen, but I could imagine that if the alternatives did not work out, something of that type could happen.

I think it is important to remember that the Chinese political leadership is pursuing trade liberalization largely to reinforce domestic economic reform within China. A year ago, I happened to be in a very small group that met for an extended period with President Jiang Zemin just one week after he had personally been involved in the negotiations with the US to smooth the way for WTO entry and he was very clear. He said very explicitly, "I view WTO entry as intimately related to China's deep sleep during its feudal period while the West was moving ahead smartly after the renaissance." In other words, China withdrew from the world in 1800 only to have two miserable centuries and he is not going to let that happen again. Now, the WTO is how he wants to proceed. If the WTO moves forward and is successful, that is what he will focus on. If the WTO were to falter, he might well look for alternatives. That is a lot of 'ifs' and contingencies along the way and I do not think it is a highly probable set of developments, but it is certainly not impossible and I could see it unfolding under those circumstances over a few years.

Q: You said that the US trade deficit is unsustainable and should be corrected and

your implication was that the Korean Won would perhaps need to be appreciated substantially. We have a heavy dependence on our exports for our growth at the moment and we depend a lot on the US economy. So, if the Korean Won has to be appreciated substantially in the coming years, is it safe to assume that the external environment will continue to be very difficult in addition to all these domestic problems?

A: The question has to do with my prediction that the dollar declines and the Won appreciates and does that significantly hurt the Korean economy. All I suggested was that the Won would appreciate modestly, 10-15%, against the dollar. I also suggested the Euro would appreciate 30-40% against the dollar, so that is a major depreciation of the Won against the Euro. I also suggested the Yen would go up probably 10-15% maybe a little more, so the Won would not appreciate against the Yen, possibly even depreciating slightly. So, the trade-weighted exchange rate of the Won would not appreciate, and might even depreciate. Therefore, if you look at it in the aggregate sense of Korea's overall trade position, I think you do not need to worry, at least on those rough estimates, that there would be any deterioration of Korea's competitive position. There would be some shift and maybe some decline of competitiveness in the US market and against US firms, but a substantial improvement against Europe and maybe some improvement against Japan. I think on balance the trade-weighted net effect on Korea would probably not be very much. I also postulated continued strong economic growth for the US, which would provide a strong foundation for the world economy and for economic growth in Korea and this part of the world.