

Korea's Growing Stature in the Global Economy*

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Thank you very much Dr. SaKong. It's always a pleasure to be back in Seoul and to have the opportunity to join you once again in a program sponsored by the Institute for Global Economics. In thinking about the title of your institute, I am reminded that you named it before the term "globalization" was well known at all. Indeed, I think your far-sightedness in creating this institute pointed to the importance of Korea not just becoming a strong economy in its own right, but becoming a strong and leading player in the global economy. So when I see the name of your institute, I am reminded of that because it has been a leading forum in Korea for some 15 years.

It is a pleasure to be back, especially in the springtime. You mentioned this morning that we had discussions when I was at the Treasury Department, and you were the Finance Minister back in the late 1980s, about simple matters like exchange rates, financial markets etc. and I recall you always seemed to invite me in the wintertime, and I thought you wanted to discourage me from coming. I remember on one occasion, it was a particularly cold weekend in January, and we decided to take a break from our discussions, and you suggested that I go to Mt. Soreak, but the snow was so heavy, I was unable to go, so I went to a temple a little farther south, but my shoes still did not keep my feet warm enough, and they ended up not thawing out fully for a week. So I can tell you that Seoul is much more pleasant in the spring than in winter. But in spite of that, I have always enjoyed my visits to Seoul, and have made many friendships which have lasted for many years. I also feel very privileged that I have a special family connection through my daughter which reminds me many of the strengths and characteristics of the Korean people which have carried Korea so far in these past decades.

Let me step back and say that it's also very good to visit Seoul when the economy is coming back. Of course it's no surprise, but if you look back two or three years, it was painful to see the sluggishness of the Korean economy. Of course we should've anticipated its renewed vibrancy, especially when Korea performed so well in the World Cup some four years ago. I was also very impressed with Korea's performance at the World's Baseball Classic. And for those who say that Korea is not an open economy, I had a surprising experience yesterday. When I arrived, I had just a few minutes to check in and I put the TV on just to see what was happening in the world, and there was a baseball show on featuring all of the homeruns last year of Ichiro Suzuki. And I thought, what a new world we're in, here I am in Korea with a baseball show featuring the homeruns of one of Japan's best baseball players. So indeed, this is a much more confident country than the Korea I knew some years ago.

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Korea faces many challenges in the world economy, and I would like to discuss how Korea can face and overcome these challenges in the context of the global economic setting. I think it was Charles Dickens's *A Tale of Two Cities* that began with something like, "It was the best of times, it was the worst of times". If you look at the surface of the global economy, it looks quite positive. The US economy continues to grow, quite impressively in some respects, but not without some weak spots. The Japanese economy is coming back, and this is a good sign, not only for Asia, but also for the entire world economy, because it has missed for almost 15 years, having a robust strong Japanese economy. We see some signs of life in the European economy. Germany for example, continues to be an export powerhouse and has shown some movement in deregulating its economy. Other emerging markets, and we all know the increasingly well-known stories of the upcoming China and India. But emerging markets around the world last year grew just above 5% on average which is quite remarkable. This includes Latin America, Central Europe, parts of Africa, and of course the Middle East fueled by the energy situation. And of course throughout Asia, we have China and India growing in the 10-8% range respectively. And then we have the Asian economy which is growing again into the 5-5.5% range. In my view, China and India today are countries of fascinating opportunities, but sometimes I have the feeling that there is too much hype about both of these economies as they still face many difficulties which will provide an opportunity to solidify its position at the top ranks of the global economy.

Before talking more about that, I would like to talk about some of the difficulties looming below the surface of the global economy. Indeed, Dr. SaKong mentioned the discussions we had back in the mid 1980s. Those discussions followed a collective coordinated attempt by the G-5 at the time to realign exchange rates, balance global demand and to reduce global imbalances. Eventually, that effort worked. High levels of protectionism were avoided, and on the whole, a severe global recession was avoided, although in 1987, you may all recall the stock market crash which captured attention around the world and temporarily set back the US economy.

Today we also face a serious problem of global imbalances. The British author, Arthur Conan Doyle who wrote the Sherlock Holmes series of books, one of which was entitled, *The Seven-Percent Solution*. Today we have our own seven-percent *problem* which is a 7% current account deficit in the US, and a 7% current account surplus in China, and the two countries are at the center of a set of global imbalances which are not being effectively managed. Now of course in today's world, it's clearly beyond the capacity of any country to manage its external position directly and authoritatively because globalization and the power of markets is a reality today, and Korea must accept that reality and move with it. At the same time, it is important for many leading economies to come together to try to find a coordinated path to resolve these imbalances, because if this doesn't happen, there is a serious risk that we could face significant problems in the global economy.

It isn't easy, even for a country as economically attractive as the US, to every day pull in two billion dollars. When I gave this speech in Central Europe not long ago, we had some people in the audience still learning about the market economy, and I talked about the US

importing two billion dollars per day to finance our current account deficit, and someone asked, “does this include weekends?”, and I answered that yes it does because we have a huge current account deficit which requires the rest of the world to bring capital to the US. Now some of this comes voluntarily, working by the beauty of the marketplace. But some of it comes because of central banks in the region including I’m sure your own bank along with China, Hong Kong, and many other countries in the region whose central banks are keeping the American dollar afloat, but in some respects, keeping the world economy afloat.

In my view, this is not a terribly healthy picture, and it will be important for the G-7 plus leading countries outside the G-7 to work together to develop a coordinated approach to solve these imbalances. And yes, it will require greater exchange rate flexibility by other Asian economies, and here I must commend the Korean authorities for the courage and leadership they have shown on exchange rate policy. But if you look at Asia, and even Japan in these last few years, there has been rigidity in the exchange rate which has inhibited global adjustment. Of course this is not to say that the burden of global adjustment should rest in Asia. Indeed, the US and Europe have crucial responsibilities which they must address. We must find a way, globally, for the US national savings rate to strengthen while at the same time, not completely losing the momentum created by US consumers. But if you look at the global imbalance picture, it is compounded by the fact that we now have a somewhat vulnerable dollar, rising interest rates in many economies around the world, energy markets that are going to pose problems for many countries around the world. All of this creates an environment for Korea that is challenging.

Let me use this backdrop to focus on two areas where I would like to encourage my Korean friends to persevere in their efforts. Because if I look at the macroeconomic picture and policies in Korea today, then yes, the excess credit card expansion of some years ago cost the Korean economy dearly. But if you look at the overall macroeconomic stance in Korea today, it is quite impressive. And I know that Dr. SaKong encouraged me to come with constructive criticism, but it has not been easy to find things to criticize concerning the macroeconomic policy. If you look at your external position and inflation and the fiscal picture, it’s a strong performance. Indeed, I would come back to my earlier statement that Korea is to be commended, for recognizing sooner than many other countries in the region the importance of the influenced market shaped exchange rate.

If we look at what has been accomplished in the Korean economy in these past eight years or so, indeed in terms of reserve accumulation, personal growth, just in this period, from the difficult days of 1997, per capita income in Korea has risen to over 16,000 from just over 11,000. You now have a very strong and increasingly competitive financial sector which was not the case 20 years ago. This is evidenced by leading Korean financial institutions to compete head to head with global firms. All of the major players are here today, and I’m confident that Korea’s financial institutions can compete with them. But I think if we look at two broad objectives: Korea as a regional financial hub, and the FTA, we see that many steps have been taken, but much more needs to be done with confidence, dispatch and serious commitment.

Just one week ago I was in Singapore, and you are all aware of some of the advantages that Singapore and Hong Kong have today as regional financial centers, but you should also be aware of Korea's advantages. For instance, the growing pool of invest able funds created by the pension industry here which is an exceptionally attractive dimension, the improved corporate governance environment, the willingness in the last decade to allow foreign firms to bring in technology, expertise and products. All of these provide a base that can be used to transform this concept into a reality and indeed, some of the measures taken point in that direction, including the creation of a single supervisor in the Financial Supervisory Service. Yesterday I had the pleasure of paying a visit to the FSS, and I was told that just last week, they opened up a one-stop-shop for foreign financial institutions interested in expanding, opening or adjusting their operations in Korea. Steps like that send important signals to global financial players.

You also have submitted new legislation of the consolidated capital market act, which we welcome because it should move Korea past some of the segmentation which for too many years has characterized your financial markets here. The launching of the Korean Investment Corporation just last year, and the movement toward full foreign exchange liberalization, which I would suggest should be accelerated if possible. These are important steps, though they aren't enough. In my view, it's crucial for Korea to tackle some of the longstanding difficulties which still characterize the Korean financial markets and in some respects, the Korean economy. I would put at the top of this list, labor market issue. If Korea wants to move to the next level of economic prosperity, and I'm confident it can, then it must blend many of the natural strengths you have with much more flexibility in the factors of production, especially labor.

It is a paradox to talk about moving Korea into the most advanced sectors of high technology if you cannot have a flexible labor force to blend with high technology. This is a challenge which has been lingering in Korea for many years, and I think it will take strong governmental and corporate leadership. In this arena as in some others such as the issue of foreign presence in your economy, I sometimes have the impression that Korea is struggling between its past tendencies and its future possibilities. All of us who are friends of Korea understand why Korea tends at times to be defensive and inclined at times to be somewhat nationalistic. Any country which has similar history as Korea, probably has the right to be somewhat defensive to foreigners, and somewhat nationalistic, but having the right to do so doesn't mean it is the right way to the future. Just as every Korean family wants the future generation to be stronger and prosperous than the last, the Korean government and society should leave behind some of these tendencies of the past. Tendencies to react negatively to foreign presence in the economy which still arises from time to time should increasingly become something of Korea's past. The mindset to view the rest of the world as a difficult competitor should be relegated to the past because Korea can compete with any economy in the world in my view. But if these sentiments towards labor market rigidity, and foreign presence in the economy aren't overcome, Korea will continue to be seen as a rather challenging environment for foreign financial institutions and foreign firms in general to operate in.

If you look at Korea today and ask, why is foreign investment so low? Two of the factors I've mentioned are crucial in this. Korea's economy doesn't need huge amounts of foreign investment, but it could benefit significantly from a more dynamic integration with the global marketplace through foreign investment in some sectors. This can strengthen the foundation of Korea's efforts to move to the next level for being a more service-oriented economy. Blending your strengths in manufacturing and high technology with new strength in service areas will require more integration with global financial markets and the global economy on the whole.

The government must also learn to refrain from becoming too involved in the Korean economy. This isn't easy because it wasn't until the 1980s under Dr. SaKong and others that efforts were made to deregulate and disengage the government from some aspects of the economy. This process has continued for 20 years, but is still unfinished. Korea will succeed if it moves with the trends in the world. And the two most powerful trends in the world today are globalization, and the power of markets. And when you have policies which try to resist either of those trends, those policies will only inhibit Korea in my view, from what it can achieve. Any country that has achieved what Korea has in the past 45 years should move confidently to eliminate barriers to foreign investment, to inject greater flexibility in the labor markets, and to welcome any and all who want to operate and invest in the Korean market, because this can only serve to increase the resiliency and underlying strengths in the fundamentals of this economy.

Of course, if you look at the financial hub there are other things that need to be done. Tax issues need to be addressed more fully because the history of the financial market development around the world suggests that tax policies are crucial variables. Look hard at what your tax policies are with regard to the operations and investments of foreign and domestic financial institutions, and create an attractive tax regime. I would also say to look at your immigration policies and make sure that they are fully compatible with Korea as a financial hub because if they aren't this will be a detriment. Firms are moving some of their operations to Singapore in this region, and one of the reasons has to do with immigration policies. It will also be important to strengthen corporate governance. I travel a lot around the world, and I see the global trend towards higher standards of corporate governance. I see this also here in Korea where the framework has improved considerably.

Let me move on to say a few words about the Korean-US FTA. I am impressed with the willingness of Korea to engage in these negotiations because it suggests to me that your leadership recognizes that Korea must seek every advantage it can in today's global marketplace. The chances that Korea will benefit from the next global round of trade negotiations are reasonably good, but this will take time. And in my view, it is wise for Korea to be opportunistic and seize opportunities, to strengthen trade ties with important trading partners such as the US and Europe, especially at such a time when the world is so fascinated with China and India. This is a much stronger economy and financial platform. When I look at the financial systems of China, India, and Korea today, and I read all the hype about these two countries, I wonder what is really going on, because

your financial system is so far ahead of theirs. But they are attractive magnets for trade and investment, and Korea must find ways to overcome these distractions in the global environment. One way is through the upcoming FTA, and I believe for a country that has benefited so much, and shown so great a capacity to compete in global markets, that this can only be a strong positive for Korea. If you look just in this decade alone, Korea's market share in the automobile trade in the US has almost doubled from 21/2% to over 4%. This can only be enhanced by a balanced FTA.

Korea has already demonstrated its prowess in penetrating the Chinese market, and frankly, I think that as you look out over the next decade, Korea has every reason to believe that it can move into the single digit when it comes to being among the world's top economies. I've been reading for some time that Korea is the 10 largest economies in the world. I'd like to come back next time to a Korea that is no longer in double digits. I would like to see it closer to five than ten, and that is not just a dream, it can be a reality, but only if Korea moves confidently to tackle these problems and position itself to be one of the top economies in the world.

I sometimes wonder if my Korean friends have as much confidence in their capacity as the rest of the world does. You shouldn't underestimate the admiration which many hold for the Korean economic transformation over the last four decades. I was in Latin America with Vice Minister Kwon. We were at the Inter-American Development Bank meetings in Brazil. Now if you look back 45 years, Korea was on a par with many of the Latin economies. Today, with the possible exception of Chile, no Latin American economy is even within reach of the Korean economy. And the room became completely quiet when they were listening to Vice Minister Kwon because they all felt there was so much they could learn from Korea and how you have transformed your society and economy today. Even when I'm in the US, I gain the same sense among business professionals that Korea's achievements speak loudly of the potential for Korea to move forward. But I think sitting here in Seoul; it is easier to see the challenges you face.

I think Koreans tend not to dwell on past successes as much as on current problems. I think that is good in one sense because it helps you focus on what needs to be achieved, but I also think that that awareness of the problems should be blended with a great deal of national self-confidence about your capacity to overcome those problems, because if that confidence is blended with determination of government, market, and business leadership, because this is no longer a world in which governments have all the answers, we know that. It can provide leadership and direction, but the other leaders in society, the business, financial, academic, and intellectual leaders must be part of the team that takes Korea to the next level. If this sense of self confidence and awareness of the problems can be blended with determination, I for one am confident that it won't be too long before Korea takes its place not just as the 10th largest economy in the world, but as one of those further up in the top ten.

Questions and Answers

Q I am a research fellow at the Korea Institute of Finance, and I have a question on the current account issue concerning the US and China. How seriously do you think the US government is about placing serious pressure on China? Also, if China responds to being determined as a currency manipulator country, and they strike back saying that part of the current US deficit problem is because of the domestic government deficit of the US, what do you think the US would have to say in that situation?

A The real pressure is on the Chinese currency come more from the reality of their economic situation than from the US. I think the decision of the Treasury Department of whether it considers China a currency manipulator is more a symptom than a major issue in the relationship, because it demonstrates the difficulty of finding bilateral solutions in today's complex global economy. The US didn't coin the term, "currency manipulator"; this was embodied in the reformed IMF articles of agreement in the late 1970s. It's the IMF's responsibility, and not the US's responsibility to make judgments on which countries may be manipulating currencies, and this is a role that the IMF in my view should step up to. But not in isolation. I think the economic situation in China today with the pressures that suggest that the economy is potentially on the edge of overheating again, are part of an economic dynamic which in my view suggest that the economic future of China would be much healthier if they were to move towards a more flexible exchange rate system. And eventually, I believe this is where they want to go, but both economically and politically the most viable approach to solving this problem is not for the US and China to push one another around about what they think about each other's financial or fiscal policy, but to work within the IMF to find a multilaterally coordinated solution. Both countries need to move, but also other countries in the global community need to take actions to contribute to a resolution to the global imbalance. Surely the Chinese are right when they point to US fiscal problems, but at the same time, pointing at each other bilaterally is not going to get us to a solution, so I think we are in a world today where multilateral solutions are needed.

Q In relation to this global imbalance issue, Dr. C. Fred Bergsten has been advocating for G-3 countries to do something together. What is your assessment of this likelihood of some agreement?

A Well I think I would agree with Fred that a multilateral approach, wherein each country commits to take action as part of a coordinated approach is desirable. But what are the real prospects of this happening? I would say not that high until market pressures are stronger. This is the concern that I have. If you look at the last few months, you'll see the US interest rates have increased noticeably. Now they did the same last spring, but they backed down. Today we're in a different environment; the US housing market and dollar look vulnerable. It seems to me that it will take more volatility in the marketplace before policy makers really step up to the plate.

Q On the foreign exchange rate problem, it's not the analytical approach, but kind of a feeling or hunch that you said the US-China exchange problem is not a bilateral, but multilateral solution by IMF, but recently, Korean won is appreciated more than the Japanese yen. Usually at the 10-1 rate, but it's going down to 900, and maybe coming back next year in the market, they say it will reach 800 before Korea goes to IMF. Do you have any kind of reference zone rate between US-Korea exchange rate, or some kind of target zone rate inside information, or do you think this is also a multilateral solution kind of problem?

A I have no magical answer, and I think it's impossible to have one in today's world. I do think that your question underscores how important it is to have a multilateral approach to this because Korea has every right to be concerned. You have allowed the forces of the marketplace to increasingly influence your exchange rate while Japan has not. And in my view, at a point where it is important for all Asian economies to contribute to the solution of global imbalances. This may well require Japan to accumulate less reserves as it moves forward with its economic recovery, because sitting here in Seoul, the Won/Yen rate is a crucial issue. But I don't think any of us can sit here and forecast it or have a particular zone in mind, but I do think that we're approaching a time when many of the Asian economies will need to look at their interests and ask themselves if they are really served by suppressing market forces and the exchange rate.

Q Can you give some sort of a new model for a very efficient political development decision-making system? I think economists should address broader questions as well--we should stretch our minds beyond the exchange rate.

A Your question does stretch the mind because it addresses so many different aspects in which Korea's and America's political systems have evolved, and global tensions and priorities as well. I think unfortunately that the reality is that the US has been seriously distracted by the Middle East and terrorism in general, and Iraq specifically these past few years, so many of our other foreign policy objectives in the US have perhaps not had the attention that they deserve. Even a crucial relationship like the one between the US and Korea. But I think there are opportunities, and I think it's important for Korea to recognize how important the US-Korean bilateral relationship continues to be for the Korean economy and security.

It seems that it has become incumbent on Korean leadership to not necessarily condone US foreign policy in different parts of the world, but to realize how important the bilateral strategic relationship is and to continue to reach out and speak out and demonstrate leadership here against anti-American sentiment. In the Korean financial crisis of 1997-8, the long-term partnership did matter, and if Korea has an economic problem in the future, will the partnership be strong enough so that the US would be there? I'm not sure what the answer is.

But on a positive note, if I look around at how many governments of the world shifted from a military system in the 1970-80s to a democratic system, there must be many, at least 30, Korea's democratic processes, though you may see more of the weaknesses of the system living here in Seoul, comparatively speaking, I can say that I find few democracies that are in this two-decade maturity phase that are functioning as well as Korea is. Now does this suggest that Korea is in great shape? Perhaps not, with problems of nationalism and anti-American and anti-foreign sentiment to deal with, but you don't have what many of the embryonic democracies of the world have which is you don't have the tendencies toward populism, and I think this is important. But I do think it is important that the government provide the leadership to set the tone for the relationship. Surely the US will come back to a time where we give more attention to the US-Korea relationship, and frankly I think the US FTA provides a good positive focal point for that today.

Q My question lies in the ACU, the Asian Currency Unit. What are the implications for the future of a financial hub in Korea? And why is the US, at least those at the ADB meeting, against it?

A A number of us were at the ADB meeting, and I didn't interpret the US as being opposed to this as much as they were questioning whether the ADB itself should be spending a lot of time and energy on this matter. I think these are two different issues. One, is an Asian currency a good idea? And two, is the ADB the right forum for this? And on the latter I tend to share the US skepticism because if there is to be an ACU, it won't be born out of the ADB, but out of the relationships among the central banks and finance ministries in the region. I think this is important, but in the long run, perhaps the ACU has some merit. But in the short-medium run to me, it doesn't show that much promise because of the diversity, dispersion and different economic and financial situations we see today. I think if we look at the lesson of Europe, it might tell us something here, that the currency union there has had much success. Monetary and financial stability at a very credible central bank, but that's not translated into economic success because the economic integration of Europe dramatically lacks the monetary integration of Europe in my view. I think this is a risk that Asia must think about. Would there really be meaningful economic benefits if a currency union is too premature relative to economic convergence in the region. And to me, this convergence is so far away, that I would suggest concentrating on the financial hub, and strengthening Korea's competitiveness. Keep an open mind on the ACU, as it isn't good to be dogmatic on these issues.

Q It is not a secret that Korean Parliament doesn't know how to organize itself. But my question is how can we solve this? You said we need confidence for our economy. Recently in Tokyo, there was a trilateral commission meeting, and the former editor of the economist magazine stated that the Japanese economy is now healthy in the sense that Japan's economy is on the same level as other developed economies. You said that Japan's economy is now restored and

Korea's economy is strong, but among the Korean businessmen and economists, we can easily find a certain degree of pessimism on the long-term health of the Korean economy. One reason for this pessimism is the Chinese economy which is coming up in five years; every major industry of Korea will be captured by China. Another source of pessimism is that we don't have confidence in the US management capability of US economy, especially with the 7% problem you mentioned. The US economy used to rule, but these days say that it can be a time bomb of the global economy. My question is that some people continue to warn that the vulnerability of the American currency can plummet in the near future, could you help us restore confidence in the US economy?

A that's perhaps the toughest challenge of all. Unfortunately I think you are right to be concerned, it may be a time bomb, but I don't think it's one that will necessarily go off. I think we still do have the world's most flexible and dynamic economy in the US, and it still has a huge capacity to adjust. But this could be painful for the rest of the world as it may require us to go through a period of somewhat lesser consumption, and higher savings, and some new realization that the increase of wealth in the housing market is not necessarily a secure form of long-term accumulated savings. Americans have gone through a period where their sense of personal wealth was affected both by the .com bubble of the late 1990s, and now the housing market of the last five years. We may well be entering the phase where American consumers need to look at underlying savings of the household. But here I think we should be encouraged by the fact that American consumer an individual confidence itself is a source of strength as there is a certain adaptability in the US economy which enables consumers to maintain confidence in their futures even in times of uncertainty. I think it will be crucial for the US to move forward to tackle our fiscal imbalance. We can't directly tackle the external imbalance without coordinated policies and further depreciation of the US dollar, but I don't think it need be disruptive. There is a risk that this will happen, but if we get some far-sighted management and new vigorous leadership out of the IMF, I see also a growing awareness by the US and Chinese authorities that if they don't find some strategic multilateral approaches here, that this could go bad for both countries. I think your concern is legitimate, but to a certain extent, the underlining resiliency of the US economy should perhaps be more our source of confidence than the economic management capacity.

You mentioned another concern that is a lack of confidence in the Korean business community due to China. Here I would say globalization is such a powerful trend, and Korea is known for its shipbuilding skills. These issues of labor market flexibility, of corporate governance, of welcoming in foreign investment to me are just like building the hull and superstructure of the new Korean economic ship that will sail into the global economy. And if you don't build it in such a way as to withstand the winds of a global economy, then you will be swept out to sea, but if you take that capacity of shipbuilding and tackle these weaknesses, you can compete with China. You will penetrate China with so much foreign investment, that the northern part of China will be confused and ask, is this Korea or China? You can do that in my view, as well as competing with China in other markets. Look at the corporate governance, banking, and capital markets in China today, they are exceptionally weak. So I would say again, go head to head with China,

but make sure that the superstructure of your economic ship globally is strong enough to compete in all markets.