The Outlook for East Asian Economic Integration: Coping with American Protectionism, Chinese Power and Japanese Recovery*

David Hale

My assignment is to talk about what's happening in this region in terms of its cost of economic integration and also its relationship with the larger world, especially that with the United States. I guess the first point I want to make in the opening is that we have a world right now characterized by extraordinary imbalances, which are also highly complimentary. The largest imbalance in the global economy is the US current account deficit, 700-800 billion dollars, and a number around 7 percent of the GDP. That is truly an awesome number. Very few economists, five or ten years ago would have imagined that it could be possible that the any country, including the US, could run such a truly large deficit. But the reality is that the US has not had any major problem funding this deficit and attracting large capital inflows to finance it because of its relationship with East Asia. This region at the same time is running large current account surpluses that are helping to fund the American deficit. The Japanese surplus is 150-160 billion dollars; the current account surplus of non-Japanese East Asia is about 350 billion dollars. So you have five hundred billon dollars right here in this region of current account surpluses, which have been an offset for the American deficit. We have also had in the last two years large surpluses in the oil-producing countries. Russia now has a 100 billion dollar surplus. The Persian Gulf countries, Saudi Arabia has 200 billion dollar surplus.

So this has also created, a new supply of excess global liquidity, excess global savings to help America accommodate the American deficit. But there is no doubt, looking back in the last five years that the most important player in maintaining this global economic equilibrium has been East Asia. And we can see this in the data for East Asia foreign exchange reserve. Foreign exchange reserves in this region are now 3.2 trillion dollars out of a global total of 5 trillion dollars. East Asia alone when you include Japan and China as central players now has two-thirds of the global foreign exchange reserves. China is number one with 1.2 trillion dollars, Japan is number two with about 900 billion

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dollars, then Taiwan with about 300 billion, Korea is 250 billion, Singapore and Hong Kong 120 billion and 130 billion each. These are truly very impressive numbers.

The fact is, in general, depending on the country, anywhere from 60% to 90% of these reserves are invested in US dollar securities, either government bonds or bank liabilities. China reports to our Treasury of about 400 billion dollars of holdings in US government securities. But the Head of China's Foreign Exchange Reserve Department told me, in a lunch last week, that the country keeps over half of its reserves in bank liabilities. So on top of these government security holdings, there's also holdings in banks and bank securities. These are truly impressive numbers and again they help put into perspective how America is able to fund this very, very large current account deficit.

A lot of the big issues in the world of financial markets right now center on what will happen in the next two or three years to these Asian foreign exchange reserves and how Asian countries will in the future decide to recycle their current account surpluses.
There have been some innovations in recent times because of these large surpluses. Korea created two years ago a new investment company to manage 20 billion dollars of its foreign exchange reserves in a more aggressive way, not to just buy government securities, but to invest in the stock market possibly to invest in real estate or commodities. I met the head of the Korea Investment Corporation yesterday and he told me that about 40% of this fund created by your government two years ago is now invested in equities and 60% is in debt. At some point he might do more with commodities and other investment securities but he has not gone that far yet.

China announced last month that they are going to create a 200 billion dollar investment company to diversify their reserves; this entity hasn't been created yet. And it will be in business by the end of this year. It will have a very important mandate to invest this volume of money.

And the role model for this of course is Singapore; Singapore created a government investor corporation almost 25 years ago to manage its foreign exchange reserves in a more aggressive way. The so-called GIC in Singapore is now a major player in global financial markets, it is active in equity markets, in venture capitals and in real estate, it uses a large amount of external managers as well as having internal managers to run this money.

Norway also created back in 1990 a petroleum investment fund. Norway's large petroleum reserves have given that country a large financial surplus, now it is worth over 250 billion dollars, and this entity invests this money in global equity markets and global debt markets. Until recently it was 40% equity and 60 % debt and now they are about to go 50-50 in terms of their asset mix. So these are examples of how Asia will in the next few years be trying to manage its foreign exchange reserves more aggressively.

Will this be a threat to the US dollar? Well, we don't know yet. My own conclusion is it probably won't be. Because if they do invest in equities they will still be major buyers of American dollar paper. As the US Stock Market is still the world's largest stock market. It's got a capitalization value of 18 to 19 trillion dollars, which makes it almost equal to half of the global stock market capitalization. So it will be hard to have a diversification into equities without also buying US dollar securities. So the dollar may lose a little bit on the margin but I don't think it will be a huge capital outflow that it will jeopardize this relationship we've had recently with East Asia.

The current equilibrium we've had will be sustained for at least a few more years. And the fact is that the US asset markets aren't yet saturated with foreign money. If we decompose where foreigners have their money in America. It's spread over various asset places; foreigners right now have about 2 and half trillion in FDIs, that's manufacturing investment, plants, equipment, and factories, that money is not very mobile. Foreigners also own about 17% of the US equity market, that is about 2 trillion dollars, they own about 25% of the corporate bond market, a few trillion more. The only place that foreigners dominate is in the Treasury market, foreigners own about 45% of the Treasury market because of these large central bank foreign exchange reserves; these foreign exchange reserves are heavily invested, by definition, in government securities. The fact is the US still has 30 trillion dollars of liquid securities in the stock markets, the bond markets and government debt markets which are still domestically owned. So there are still plenty of securities that can be sold to foreigners to help finance the US current account deficit. So my own conclusion is that we can sustain this current equilibrium with this large current account deficit for at least a few more years.

Now against the backdrop of this current account deficit there have been over the last five or six years some major changes in American trade policy as well as in the trade policy of this whole region, which will have important implications for the future. Ten years ago, East Asia had no bilateral trade agreements. All East Asia had was the GATT Framework (General Agreement on Trade and Tariffs) created in the late 1940s and evolved then in 1990s into the World Trade Organization. There were no bilateral trade agreements in this region.

But since that time several dozen have been created. The US has signed FTA Agreements with Australia, Singapore, and have just signed last month one with Korea. Singapore has ones with Australia, the United States and now with India. Australia has done FTAs with America, Thailand and is now negotiating one with China. China is now proposing the creation of an East Asian regional free-trade zone, they proposed this at the ASEAN Prime Ministers' conference four and five years ago and it has been under way for some time now and hope is to have it in place by 2010.

As a consequence of the East Asian financial crisis, we also began five and six years ago new experiments in regional financial cooperation, we had a meeting of key political leaders a few years ago at Chiang-Mai, Thailand and this set in stage for a whole new framework for policy cooperation. We now have regular meetings in the region with finance ministers, deputy central bank governors, there is now even study groups tied to this initiative on financial regulations issues and issues like that. And the countries have created about 48 billion dollars in currency swaps in the event that there is a new financial crisis.

At the time of the East Asian Financial Crisis ten years ago, the Japanese Vice-minister of Finance Mr. Eisuke Sakakibara proposed the creation of a regional IMF, an East Asian IMF. The Americans rejected the idea, the Chinese failed to support it, it very quickly died. But it would be fair to say that ten years later as a consequence of this Chiang-mai process, we now have in the region a lot of the key elements in what would be involved in having an Asian IMF. We haven't created the actual organization, we don't have a secretariat like the IMF would have, but we have with these currency swaps and the policy deliberation processes the potential for much more cooperation. Much more interaction than would have been the case ten years ago when the great financial crisis engulfed this region. So this is I think a very important development and it has quite important implications as we go forward.

The other very important development since the East Asian financial crisis ten years ago in terms of trade flows in this region has been the creation of vertical-specialization process centering on China. Over the last ten years, there has been a significant growth of inter-regional trade in the East Asian region. But if we decompose it, we will see the dominant driving force in this process of regional trade expansion has been the shipment of intermediate goods from Korea, Taiwan, Japan and ASEAN to China. Where China turns these components and parts into finished goods for export to North American, to Western Europe and to Japan. Now here are the numbers, this is the component share of exports for the major countries of the region, the world economy 20% of foreign trade is in components, for Japan it is 27%, for Korea it is 26%, for Taiwan it is 40%, for Malaysia it is 48%, for Singapore it is 48%, Philippines 65%, Thailand 27% and China is the lowest with just 16%. So we have here a whole new process of economic integration in the region in which this region supplies China with components, China produces the finished goods. The consequences of this is has been that China has a huge trade surplus with North America 250-260 billion dollars, big trade surplus with Europe but runs trade deficits with all the countries in this region. A massive deficit with Taiwan, 55-60 billion, 30-40 billion with Korea, twenty billion with ASEAN and so on. And if we decompose this trade again we will see is that what this means is, is that a lot of this inter-regional trade is in the end focused on markets that are outside of this region. In the official data you now have inter-regional trade that is almost as large as trade with Europe, North America and Japan, but if you decompose it in terms of end markets where the goods actually go, North America, Europe and Japan still take 61% of the region's exports where China just takes 6.5%.

So this huge growth in inter-regional trade has very much been a part of this Chinese economic take off, and the Chinese economic take off has been of course quite extraordinary. China's exports this year will exceed a trillion dollars and by 2008 China will probably be the largest exporter, larger than both the United States and Germany. Which have been for many years very nip and tuck in terms of which one will be the leading export nation. And this whole Chinese export boom has had very powerful spillover affects on all the countries in the region including Korea. The new risk though is that China may over time become more self-sufficient in producing these components and parts and if they do it would be of a loss of export opportunities for Korea, Taiwan, ASEAN and the other countries in the region. We don't yet know how far this process will go and we don't yet know how far China might change this process of vertical-specialization. There is no doubt it has been a major feature of trade flows in this region now for the last several years.

So as a consequence of this trade process, this integration process with China, there is no doubt that the US now looms as a major risk and a major challenge for this region in the next few years.

I see America creating two major risks for this region, the first centers on the US business cycle, the second on US politics and the danger of US protectionism. Let's examine both of those risks.

First the business cycle, there is no doubt we have had over the last year a major slow down of the American economy. The growth rate of the US economy has slowed down from 4% plus over a year ago to two to two and half percent recently. And the major factor for the depressing of the economy has been housing. After a housing boom of the first five to six years of this decade, there has been a major decline in home building activity and we are seeing for the first time in 50 or 60 years a decline in house prices and this will persist for a while. Because we have now had in recent months a major crisis in our so-called sub-prime mortgage market, the mortgage market for low-income and poor people. As a consequence of this credibility crisis, the banks will now greatly curtail current access to lower-income Americans. So we are going to have several more months of weak housing starts and weak house prices. And this has knocked off a point, a point and a half off the US growth rate.

The new risk to the American economy and has developed in recent months has been capital spending. We've had two quarters in a row of quite weak capital spending. And this has come as a big surprise to American economists, because last year the American profit-share GDP rose to a fifty year high. Corporate balance sheets are more liquid now than in forty years. When your corporate sector is highly profitable and has great liquidity, you expect them to spend aggressively on capital goods or on new investment but they haven't been doing that because of the housing downturn, because of concerns of rising gasoline prices. Corporate managements in the second half of last year have turned very cautious and they began to reduce their capital spending. Instead of buying capital goods, they have devoted their resources to buying back their stock. Last year American corporations spent 600 billion dollars on share repurchases. They did that because we now incentivize our management with stock option programs to want to promote a higher share price. And the result of these option programs has been to fundamentally change how corporate managements behave and think. We now have among our corporate management an extraordinary obsession with share prices and so they are using their capital not to invest in new capital goods but to repurchase their stock. This is a fundamental change in US corporate behavior and has over the last six months contributed towards the economy's weakness. So the US will be a weak economy here in 2007 with a growth rate of probably just a little above 2%.

Will the slowdown turn into a recession? I don't think it will, because the Federal Reserve Board has not been as restrictive in this business cycle as it has been in previous business cycles. Our inflation rate has gone up over last two years from 1 and half percent to 2 and half percent. But it has not gone to the levels to require the Federal Reserve Board to push interest rates to the lofty levels we would have seen ten or fifteen years ago. The peak of interest rates seven years ago was 6 and half percent, the peak of interest rates fifteen years ago was about 9 percent, the peak of interest rates twenty-five years ago was 20 percent, and we are still at 5 and a quarter percent. 5 and quarter percent has dampened the economy, slowed housing but it has not created the kind of severe credit shock, the kind of severe restraint that would set the stage for a full-scale recession. It looks like we will still have a soft landing. But this will be a source of growing deceleration for the global economy.

One of the big questions is can other countries be affected by America. We don't know yet. Because the American downturn so far has been so concentrated on housing, it has not yet had major affects on American demands for consumer goods produced in East Asia. The weakness in capital goods has not yet showed up on the trade accounts, so we don't yet know about whether we will see a decline of the import of capital goods to America over the next few quarters. But the odds are there will be some reduction in the demand of capital goods because of the slowdown we can now see in domestic spending. But so far the impact of the slowdown has not been that severe in East Asia because it has been so concentrated on home building, so concentrated on residential construction. But as we move through the rest of this year we will see at least some modest negative effects.

China will be vulnerable because China still depends first and foremost on America as an export market. America takes about 25% of China's exports, exports to America are equal to 10% of China's GDP. So if the American economy remains weak through the rest of this year, China's export growth is going to slow. China's export growth in the first quarter, if it is still growing at rates close to 30%, will be where it was much of last year. America's slowdown is not yet visible in China's trade account. But if this downturn persists for two or three more quarters this will begin to show up in China's trade account sometime this summer or this autumn. So this will be a major challenge for Asia here in 2007.

The second great concern I have for the US and this region centers on the issue of trade policy. We had in America, five months ago, mid-term elections for the American Congress and the Democratic Party regained control in both the House and the Senate for the first time since 1994. And this political change does pose a risk for the US trade policy because the Democrats have become over the years very protectionist, very opposed to new free-trade agreements, very opposed to the Doha global trade round, very opposed to the process that we broadly refer to as globalization. We elected twenty-eight new members of the house from the Democratic Party, out of those twenty-eight, twenty-six are very protectionist. We elected six new democratic senators, several of those men are also very protectionist. The most protectionist is Sherrod Brown from Ohio, he wrote a book two years ago opposing globalization, he would advocate going back to the kind of tariffs we had in the 1930s. He is a highly radical advocate of restrictive trade policy. So there is a risk now that the American Congress will fail to support new free-trade agreements or the completion of the Doha global trade round.

Let's examine how the negotiations are going right now on Capitol Hill.

Rather than simply saying that they will reject new free-trade agreements, the Democrats are saying that what they want to do instead is have these free-trade agreements to be amended to provide more protection for workers in foreign countries. They want to insist that any developing country that gets into an FTA, agree to sign the nine treaties of the International Labor Organization that govern labor relations in various ways. The problem with this demand with the Democrats is that the US itself has signed only two of the treaties and many American states have labor laws that contradict these treaties. In the American South, for example, we have something called the "right to work" law that allows workers to remain outside trade unions. American corporations are allowed to break strikes by hiring non-union workers. In twenty states there is a law that requires that if a person is leaving jail, he is to get a job as a condition for parole. We require that the exit from jail involve somebody seeking employment. These laws, these policies do contradict these global treaties. So it creates the question, how can the US insist that other countries sign these treaties if we don't sign them ourselves? And the White House is concerned that if we now impose these demands and assert all these labor legislations and treaties, that other countries will be able to sue the US on the grounds that we ourselves are not in conformance, in convergence with these treaties. That you could sue the state of Georgia, the state of Alabama, because they have this "right to work" law which allows workers to avoid trade unions.

So there is a lot of tension over this issue, when I left America a couple of days ago, the issue had not yet been fully resolved. The negotiations were still going on behind the scenes between the Congress and the White House and the Republican Party in the Congress, as the Republican Party in Congress is very, very concerned about protecting state labor laws.

In June, President Bush's fast-track trade negotiating authority will expire, and unless he regains his trade negotiating authority there is no way we can complete the Doha global trade-agreement because you cannot pass trade legislation in the US Congress and get anything done unless the President has fast-track trade negotiating authority. Some Democrats like Senator Bob Baucus have said we should extend the President's authority to try and give the Doha trade round a chance of succeeding. But because the negotiations themselves aren't going very well, because there has been now for many months an impasse between America and Europe, India and Brazil on issues involving agriculture trade, it's going to be hard to rally the Democrats in Congress over the next few months to give this President new fast-track trade negotiating authority. So now the Doha round is now also very much at risk. This is going to be a difficult environment in general a very difficult time for trade policy in general.

What does this mean for Korea? Well, Korea's FTA agreement has three major problems in the US Congress, the three major issues are first and foremost beef, secondly automobiles and thirdly rice.

Beef is a big issue because Senator Baucus of Montana is the Chairman of Senate Finance Committee, any trade bill has to go through his committee and he has said publicly he will not support legislation for the FTA unless his beef farmers of Montana have access to the Korean market. And the hope is, there will be a verdict by a group with a French name OIE which controls the global beef trade, in the next weeks which will give Korea cover to basically allow improved and better access to American beef. If that comes to pass, Senator Baucus will support the FTA.

The auto issue centers on the fact that Ford and Chrysler are very frightened of Korea. General Motors invested in Daewoo in this country several years ago when Daewoo went bankrupt; therefore General Motors is very silent on this treaty and not very critical. But Ford and Chrysler allege that Korea has many non-tariff barriers to trade in automobiles, this market cannot be penetrated and therefore it is unfair to improve Hyundai's access to the American market. Right now Hyundai produces in America half the cars they sell there, the other half are imported from this country. Because Hyundai has done well in recent years, they are talking about building a new American plant, if they do they might be totally self-sufficient and they will not have to import cars at all. Right now, half their car sales are imported. And both Ford and Chrysler are claiming that there is no way that the FTA can produce a true level-playing field. So they will not be supporting the FTA with Korea. And the problem is, this will have an influence on the members of Congress from Michigan and there are some powerful members of Congress from Michigan with the Democratic majority.

The third issue is rice and the ranking Republican on the Trade Subcommittee comes from a district down south that produces rice and therefore he will be lobbying for better access to the Korean market to US rice exports. Because we don't have a very large rice industry, I don't think this will be all that big a problem.

But there is no doubt that the beef issue and the auto issue will be important and they can get in the way. And as I just mentioned, the Democrats will also demand that any FTA with Korea include these new labor guidance to guarantee protection of Korean workers. Now because this country has very strong trade unions, you have a lot of history of restrictive work practices, labor practices, so I doubt there will be a lot of problems with these IOL conventions. But you would have to study them very carefully to see if there are any conflicts with Korean law, because the Democrats will probably insist in some capacity that the FTA also have these amendments on labor market regulation.

So this is going to be for Korea a difficult three or four months. I think the chances for enacting the treaty is still good, but nothing is guaranteed because we do have these tensions, we do have these disagreements on various microeconomic issues. And unfortunately on trade policy, microeconomic policies are very important because members of Congress are very much affected by what's happening in their district, what's happening in their constituencies.

Now the major focus of the Democrat protectionists is not Korea, it's China. And there are now circulating in the US Congress a couple of dozen bills designed to basically reduce trade with China. To impose more barriers to Chinese imports, countervailing duties, anti-dumping duties, just in general to make it have higher tariffs. There was a bill introduced a year and a half ago by Senator Schumer of New York to impose a twenty percent tariff on Chinese imports unless that country had a significant reevaluation of its currency. Hank Paulson persuaded him back in October to withdraw that bill. But because of America's growing deficit with China, the Democrats are talking about bringing that bill back sometime this summer. So this China issue is going to be in the year ahead a major, major test of Congressional policy on trade.

And let's look at what China will probably have to do in response.

As I mentioned a minute ago, China now has a major trade surplus, it will be within eighteen months the world's largest exporting nation and it has 1.2 trillion dollars of foreign exchange reserves. Those reserves increased by 140 billion dollars during the first quarter, they increased by a million dollars every minute during the first quarter. And they will probably expand in the year out by a further hundred billion or more. And they could be by 2007 1.5, 1.6 trillion US Dollars. These are truly awesome numbers. They create a challenge for Chinese monetary policy, because China has to sterilize all of these reserves or they will contribute to faster growth, money supply, credit and could ultimately prove to be inflationary. And indeed China has already issued over the last few years 650 billion dollars of sterilization bonds to try and neutralize the impact of this huge growth in reserves. So China now has domestic pressure on its government to do something about the large trade surplus and about the rapid growth in foreign exchange reserves. This issue of the trade surplus is not just a global issue, not just an American issue; it also has domestic consequences for China's economy. And there are basically three ways that China can try to respond to this challenge.

One, the most obvious response is to allow the exchange rate to appreciate much more than it has, China began to flow its exchange rate in July of 2005 and since that time it has gone up six and half percent up against the US Dollar. I was at the Central Bank in China last October and they told me their plan for the next five years was to reevaluate the currency by three to four percent every year until 2012, to reevaluate it by 25 percent over five years. A slow motion, gradual response to this huge trade surplus. But my own guess is now there will be pressure on China to allow the exchange rate to appreciate more rapidly, not by 5 per cent this year, but maybe 7 or 8 percent because of both the impact of the huge trade surplus on their reserves and also because of these trade tensions with the United States.

The second possible response is to try and recycle the money by encouraging large capital outflows. And capital outflows from China are increasing now, Chinese firms are engaged in more foreign investment, they are also for the first time in their history buying foreign companies. Last year for example Lenova, the computer company bought the personal computer division of IBM. The Chinese Offshore and Oil Company CNOOC made a takeover bid last year for an American company Unocal, a deal that would have been worth 18 billion Dollars. It was vetoed by the US Congress, but it was a sign that China is now embarking on a search for global oil reserves so it can't do deals in America for political reasons but it can do them elsewhere. It announced plans in the last year, to invest five billion dollars in Nigeria, to invest a billion dollars in a new nickel mine in Papua New Guinea, to invest billions of dollars in infrastructure projects in Brazil and Argentina to facilitate trade with China. So China is going to be over the next few years a bigger exporter of capital via FDI.

China introduced a policy last year of allowing eighteen billion dollars of portfolio investment that buys domestic insurance companies and domestic prime management firms, but so far they have not taken advantage of it, the banks for example have a fourteen and a half billion dollar quota, but in the last year they have only exported five hundred million dollars they have been reluctant to go oversees because of the concern of their appreciated currency, reducing returns on foreign assets. But the fact is, that last year, other foreign currencies did outperform the RMB, the Korean Won in the last year and half has gone up fifteen percent, compared to six percent of the RMB, the European currencies have been strong, the British Pound has been strong, the Australian dollar has been strong. The Chinese institutions could have found asset classes last year outside China that would have outperformed their own domestic currency. So in time, we probably see also more diversification into foreign markets by

Chinese financial intermediaries.

And the final policy response to this challenge of managing the foreign exchange reserves is to tighten up domestic monetary policy. And they have been doing that steadily over the last year by increasing the reserve requirements, over the last year they have been taking the reserve requirements of the banking system from six percent up to twelve percent and they have raised the reserve requirements several times. And the goal again is to reduce the impact of this surplus liquidity, this excess liquidity on domestic financial markets, domestic money and credit. So these are the possible responses that China can have to this challenge of managing this huge growth of foreign exchange reserves and the large trade surplus. And my own conclusion is they will in the year ahead do all of these things, the exchange rate will appreciate more, not by five percent, but six or eight percent, they will keep trying to tighten monetary policy through reserve requirement changes and they will do more to encourage capital outflows, both through direct investments as well as through various kinds of portfolios and capital allocations. This won't fully solve the problem but it will be an important series of steps designed to try and contain the impact of these large trade surpluses, rapidly growing foreign exchange reserves and China's economy.

What about other players in the region? The other most important county in region, of course, is Japan. And Japan now has the currency, the Yen, trading at a twenty-year low on a trade-daily basis. The Yen has been a very weak currency in recent years because Japan still has a very low interest rate monetary policy. Japanese money market deals are only fifty basis points, a year ago they were zero. And Japan has had this zero-rate policy for six years to combat deflation. The Bank of Japan decided that deflation was coming to an end so it decided to move in a more restrictive direction. This time last year it reduced the surplus liquidity of the banking system and in July it raised interest rates to twenty-five basis points for the first time in six years. I saw Mr. Fukui, Japanese Central Bank Governor in Tokyo six months ago, he told me his goal before he leaves office was to raise Japanese interest rates to 1.5 percent, to get there by March of 2008. But now because we have had data recently showing weakness in consumer spending and persistent deflation he is off schedule, he's not been able to raise interest rates as quickly as he wanted to and my guess is that by the time his term ends next year, we will be lucky if we get to even to 1 percent. There maybe room for only one or two Japanese monetary interest hikes in the year ahead, there will probably not be four more.

There will also be this summer; a midterm election for the Japanese Diet and this is an election where Mr. Abe right now is suffering in the opinion polls. Because he is not doing well in the polls, his government has been lobbying Mr. Fukui to go slow on monetary tightening and now his Cabinet Secretary is making requests to Mr Fukui about succession next year in Bank of Japan. Up until a few months ago, it was widely assumed the new Governor of the Bank of Japan in the March of next year would be Mr. Muto, the current Deputy Governor who joined the bank in 1983 after spending many years at a high level in the Ministry of Finance. But now Mr. Shiozaki has promoted two other candidates Mr. Takenaka who was the Economics Minister a year and a half ago and Mr. Eto, a professor at Tokyo University who was a member of the Prime Minister's Economic Advisory Council. Both Mr. Eto and Mr. Takenaka have both been opposed to Japanese monetary tightening on the grounds that the country is still suffering from inflation. They want a very go-slow policy, in terms of monetary tightening. So what this means is the Japanese interest rates are going to remain slow for quite some time and these very low interest rates have had a very major impact on Japan's capital account.

First, over the last two years they have encouraged huge capital outflow by Japanese investors looking for higher yields in other countries. Japanese retail investors over the last couple of years have exported over 160 billion dollars in capital into bond markets in New Zealand, the United States, Australia and Europe, looking for higher yields. And for a country like New Zealand, this has become a very dominant factor in the financing of their current account deficit. They sell something called Uridashi Bonds to Japanese retail investors and they very much dominate New Zealand's capital account and they have in recent months pushed the New Zealand dollar to a twenty-five year high, 74 Cents in the US, just last week. So this has had a very major impact on other countries' markets.

We've also developed something called the Yen-carriage rate. The Yen-carriage rate is a process of global hedge funds and other investment institutions borrowing Yen to invest in other countries' asset markets. There is no way we can clarify precisely how big the Yen-carriage rate is, I have seen estimates as low as fifty billion dollars, I have seen estimates as high as a trillion dollars. The BOJ have told me in private conversations that they think it is a hundred billion dollars. But the reality is we don't collect data from hedge funds to keep track of this phenomena, all we can do is engage in guesswork. But we know it is a factor, whenever you see market correction that causes people to become risk-averse, it causes the hedge funds to reduce their liabilities, when they do that there is an immediate rally in the Yen. We saw this back in late February, there was a Chinese stock market crash, the Shanghai market fell ten percent in one day, this produced a wave of corrections all over the world for the next two or three days. New York fell, Tokyo fell, Europe fell, Australia fell, and as the hedge funds reduced their leverage, the Yen rallied three and four percent. Then a few days later the market stabilized, began to improve, hedge funds once again began to borrow and began to speculate and the Yen weakened again. So we have this phenomenon of the Yen-carriage rate, which has played a major role in depressing the value of the Japanese Yen.

Now this low value of the Yen is also becoming a major trade issue in America. Members of Congress from Michigan are very alarmed about the growth of Toyota and the decline of General Motors. As they are introducing trade bills saying we should punish Japan for having a weak Yen to try and protect GM and Chrysler. I don't think this legislation will be an act, I think Hank Paulson will be successful in persuading Congress that we cannot control Japan's currency policy, that Japan's currency is weak for market-related reasons and not intervention and its weak because Japan has to have this very combative monetary policy to fight deflation. But the fact that we have this legislation in the Congress, that this bill is designed to punish Japan is again a sign of how the environment has changed. How the Congressional Democrats are more aggressive, more protectionist and will if given an opportunity, to try and find ways to string back Asian countries that they perceive are engaged in unfair trade practices and in particular by having undervalued exchange rates. And there is no doubt that with both Japan and China there are complaints, and there have been complaints for some time, that they have undervalued currencies. That these undervalued currencies are a tool for conquering global markets.

The members of Congress have no sense of China's Monetary history, they don't realize that back in 1997-1998 China helped stabilize East Asia by not devaluing its currency, they have no understanding that China adopted the dollar exchange rate target in 1994 as a way to have a stable pillar for its monetary policy, there is just a remarkable ignorance of how this whole process is working over the last ten or twelve years. The focus is not on Chinese history or Chinese monetary policy but the focus is very much on one thing, the very, very large trade deficit and the fact that it might represent the loss of jobs in American manufacturing industry.

So the bottom line is that we are right now in a somewhat dangerous time, we got a weak US business cycle, which will dampen growth in the world economy in the year ahead, not dramatically but on the margin. We have a US Congress tilted very much in a protectionist direction and the White House, the President and his team had better find some way to work with the Democrats to try and save these free-trade agreements.

And not just Korea is involved, we also signed FTAs with Colombia, Peru and Panama and we are now trying to get these bills through Congress. Democrats are demanding all these bills have these new labor amendments and we don't know yet if there will be a compromise on the whole labor issue to save these bills. So we have right now before the Congress four FTAs, and if we go out a year we could of had negotiations that would have led to four more FTAs. We've had over the last two years negotiations about FTAs with Malaysia, with Thailand, with South Africa. Right now there are no bills, we have not reached agreements and if we don't make any progress on the current FTAs, Korea, Latin American FTAs, it will mean the other ones will simply die. And I think if the Democrats do strangle US trade policy, if they do kill the FTAs, this will be a major blow to America's ability to play a leadership role in East Asia.

As I mentioned a few minutes ago, we now have had a tremendous amount of innovation going on right now in trade policy in this region, lots of new bilateral FTAs among Asian countries, as well as Asian countries with Europe, with Latin American countries like Chile, financially with the US and Canada. If the US cannot offer Asian countries the possibility of FTA agreements, as the way it has economic relations with those countries, it will be passing on its leadership on to China. It will strengthen very much China's ability to play a dominant role over the next ten to fifteen years in shaping this region's trade policy. So it is not just Korea that is at risk right now, or even Peru or Colombia or Panama, it is the whole ability of the United States to play in a constructive leadership role in driving the larger issues that set and determine global trade policy.

So we do face some major challenges and some major risks, I am hopeful that reasonable people in the Democratic leadership, people like Charles Rangel and Senator Baucus of Montana will be able to find a compromise and carry the backbenchers with them in enacting these new FTA agreements. But as of today there are no guarantees. There is a great deal which is now in play, there is a great deal which is now at risk, all we can do is watch very carefully over the next three or four months how Congress resolves these issues. Because as I want to stress again, what is at stake is not just Korea, it is of the whole ability for the US to play, a major and important leadership setting global trade policy over the next five or ten years.

Questions & Answers

Q How do you foresee in China the monetary policy as they have raised it seven or eight times in one year, for the reserved requirement rate, and three times the interest rate. Every economist anticipates there will be more frequent interest rates raises. And how do you foresee the frequency and range of interest rate raises and what would be the impact, or what would be the by-product for raising interest rates?

A Well, the interest rates raising policy process in China is very different from that in the US or Korea. The Central Bank carries out monetary policy but it does not make the decision on monetary policy, the State Council under the influence of the Prime Minister or even the President makes these decisions. So it is a very different policy making process than you have in this country, in the United States, Britain or in any other industrialized nation. The Central Bank is not independent.

And there is broad perception going out that the Chinese economy is growing too rapidly, the recent growth rate in the first quarter here was almost 11%, the government target. The various forecasts made by government officials are talking about a growth rate of 8%. There have been several attempts over the last year to bring administrative controls on capital spending. Because China has had here one of the greatest capital spending booms in human history. The investment share of the GDP was 40%, at the peak of the Korean boom in the 1990s, it was 41%, and so 48% is truly an awesome number. What is even more awesome is the fact that they have this kind of capital spending and are running a kind of current account surplus. They are able to do this because the domestic savings rate is also around 50%. When you had the capital-spending boom in 1990s, you were running at least a moderate current account deficit.

So, the conclusion of most economists in Beijing and Hong Kong who follow China is they will raise interest rates at least one or two more times, but because nominal GDP growth is 14% and interest rates are only around 6%, it is doubtful that we will have a truly restrictive monetary policy, it will dampen things on the margin but it will not be highly restrictive. It may on the margin dampen some of the recent real estate booms in the big cities; it might on the margin dampen the Shanghai stock market, which over the last twelve months has gone up by a 150%. In the six weeks since that correction we had in late February, the Shanghai markets have performed a further 30%. So it is truly robust market, indeed a million people a week now in China are opening a new brokerage account to trade in the market.

So we have elements now developing of a bubble and I am sure the authorities would like to rein it in. Indeed in many recent weeks, officials have said publicly that they are concerned that the stock market is a bubble, really going too far, too quickly and that something should be done to slow it down, so there will be a biased towards restraint.
But Chinese interest rates will not get high as to fundamentally dampen the business cycle, whatever they do will be on the margin. Because of the concern about the excess liquidity coming out of the foreign exchange reserves they will I think continue to raise reserve requirements until they feel they have got this problem under control. But because reserves increased by a hundred and forty billion dollars in the first quarter alone it is not clear how far they will have to go. They will just keep tightening until it gets to the level where they feel it is under control. And right now, because the reserves are growing, they don't feel like they got everything under control. So they got a challenge. And there will be further monetary tightening and there maybe more administrative actions to try and reign in capital spending. A year ago they made the Governor of Inner Mongolia sign a confession that he had too many capital spending programs, that was quite unusual. The tradition in China was that local officials compete to have a high rate of economic growth, to get promotions to other jobs. This was the first time a local official was severely criticized for being too aggressive towards economic growth.

We have a Party Congress coming up in October, many people are trying to have capital spending, and high rates of economic growth to get ready for the Party Congress and want a promotion as China gears up for a leadership change in 2012. Perhaps once the Party Congress is over, there will be some slowdown in this capital spending.

We will also have the Olympics next year, once the Olympics are over there will be a big decline in construction activity in Beijing. Right now Beijing is going through 40 billion dollars of new capital spending programs to get ready for the Olympics. But a year from now that will be all over and that will surely at least slow the economy down in Beijing.

So China will at some point over the next twelve or eighteen months slow down. It will be a combination of monetary tightening, administrative action on capital spending and of course the US economic slowdown. The old rule of thumb a year ago was every 1% of decline in US GDP growth will weaken China's export growth by 8%, hasn't happened. Year-on-year growth rate in the first quarter was still almost 30% but sometime by this summer or autumn, this US downturn might begin to finally bring down the growth rate of Chinese exports from 30% to maybe around 20%. And if they do that will help slowdown the economy because exports now in China are 36% of their GDP, a very big number.

Q Thank you for your comprehensive and detailed analysis on the Asian and World Economy. I would like to raise one question to you; it concerns the diplomacy of China. It seems to me that one of the most important factors that will decide the future of the Asian as well as the Global Economy will be how to get energy, oil, and natural resources. China's policy has been criticized for being too aggressive, the United States and China seem to be facing off everywhere in the world. What do you expect the future strategy of China to be?

A That's a very good question. I have actually written some quite significant articles on China's role in the global commodity markets. Because I do think this looms as a major geopolitical challenge, not just an economic challenge.

The first point I would like to make is that we did in 2003 and 2004 pass what I think is a great landmark in economic history since the British Industrial Revolution. In 2003 and 2004, China for the first time ever in the 20th Century, overtook the United States to be the world's dominant consumer of most industrial raw materials. China's share of global copper consumption is now about 22%, the US is 16%, for nickel China is 12%, the US is 10%, for steel and iron ore China is off the charts, China's steel production is now 450 million tons that is more than twice as large as the US and Japan combined so China now controls global steel and iron ore trade. In 2004 China also displaced

Japan to become the world's second largest oil consumer, its oil consumption now is at about 7 and half million barrels a day. Because its domestic output is only 3 million barrels, it has now emerged as a major oil importer and therefore it has now embarked upon a great global search for natural resources for oil and for metals both.

If we look at the oil sector there have been many big deals done. They made a loan for two billion dollars two years ago to the Angolan government to get oil leases, they announced a year and a half ago a two and half billion-dollar investment in Nigerian offshore oil fields. President Hu Jintao went to Lagos last April to announce two and half billion dollars of Chinese infrastructure investment. China is also investing in the oil sector in Indonesia. Two years ago they bought on the Kazakh stock exchange a company called PeteroKazakhstan for four and half billion dollars and six months ago they bought a second Kazakhstan oil company on the Kazakh stock exchange for two billion dollars. They announced in recent months a plan to invest in Venezuela; most foreign oil companies are leaving Venezuela because President Chavez nationalized everything. But Chavez wants to be an ally with China, so he has let them come in and invest as the American, British and European oil companies pull out.

So there is no doubt that China is going to be going forward a major player in all the natural resource sectors. It's going to be a major investor in major markets and this will continue indefinitely, because China is going to have in the next twenty or thirty years a huge increase in its automobile population which will generate tremendous demand for gasoline.

Let me please give you a few numbers on this, Goldman Sachs, the big New York investment bank produced a report last year on the world automobile population in the 21st Century. The numbers are truly awesome. In 2005, the American people had 140 million cars, the Chinese people had 15 million cars, and the Indian people had 5 million cars. In 2050, Goldman Sachs estimates that the Americans will have 208 million cars, the Chinese will have 500 million cars, and the Indians will have 600 million. If you believe those numbers, the price of oil is going to increase five or six times. Which means that China will force us by 2020 to abandon gasoline, to abandon petrol and to go to fuel cells or some new technology. Because we won't simply produce enough oil on this planet to accommodate this kind of car population. The best experts I know on oil think that we have the potential over the next ten or twelve years to increase global output from 83 million barrels to maybe 93 million barrels with new fields in Kazakhstan, West Africa, Russia, Saudi Arabia. But to accommodate this kind of car population in China and India we would have to go to 140 million barrels, we are not going to be able to do that with the current levels of technology and no oil reserves. So this is going to be a major issue in the next twenty years and the only solution we have is technology, we will have to replace the traditional internal combustion engine with something built on hydrogen and fuel cells because we just can't accommodate this kind of car population.

Q Indeed that was very comprehensive and I am very much enlightened. I have basically one comment and one question. Twenty years ago you had experienced a terrible trade imbalance against Japan and you have gone through an agreement with Japan with an appreciating Yen almost 50% within 3 years. But that major exchange rate realignment has not resolved the current account trade deficit. I suspect that similar things might happen despite your recommendation to appreciate Chinese RMB so rapidly and I would like to hear your view on this, unless there is a regaining of the competitiveness of US manufacturing I don't think the exchange rate realignment will resolve the global imbalance quite like you predicted.

That's my question and the other comment is, on the US-Korea FTA, this is the largest cross-Pacific FTA, far bigger than the deal with Colombia or so. It is a very significant question for the US to engage in East Asian regionalism. So in this context, I think the Korean government is ready to re-import beef but with respect to automobiles, I think US cars are not really popular despite whatever actions we take. I want to know how we can convince these senators from Michigan, I would like for the Korean government to convince the US lawmakers.

A Well, for the first question there is no doubt that exchange rate movements do not fundamentally affect current account imbalances unless they also have an impact on the domestic savings and investments because the current account imbalance represents a gap, a deficit on savings and investments. And the real reason why the US has a current account deficit is that it has a negative household savings rate as well as a government budget deficit, there is a positive savings rate in the corporate sector with some high levels of profits but the household sector for the first time in our history is itself in deficit, so the combination of these two phenomenon, the government deficit and the household deficit has given us this very large current account deficit and the exchange rate by itself cannot solve the problem. But there is a perception that an exchange rate change can over time on the margin have some impact on competitiveness and therefore allow the US to enjoy more export-led growth as well to encourage some import substitution and indeed because the dollar has been weak over the last three years against the European currency, plus other currencies like Australia and Canada, the US has enjoyed in recent months almost double-digit growth in exports. There is a perception this devaluation has had a benign affect on US trade with some regions.

On your second question, this issue of the automobiles, there is no simple answer. My guess is the ultimate answer will be for Hyundai to build a new factory and for Hyundai to produce even more cars in the US, maybe importing components but having final assembly in America. If that happens, there will be a Congressman with this plant in their district that will support Hyundai; you can already see in Congress some members who have plants from Toyota, Honda being more pro-Japanese.

The fact is the foreign plants now employ tens of thousands of Americans. But they are not in Michigan, they are in Tennessee, South Carolina, Alabama, they are in Mississippi, Texas, they are not in Michigan. Because of its high-level of trade union domination it has not been able to attract foreign companies. Ontario is a player in this too, last year Ontario produced more cars than in Michigan because Canada has a National Health Care program so it's labor is less expensive than in Michigan where we have private health insurance and the automobile companies have huge private sector health liabilities. And Ontario is also very concerned about competing with Korea, Ontario companies have told me they are very concerned and they will also find it difficult to access the Korean market for either automobiles or for auto parts.

So you got general fear in North American that this market here is not open, that there is non-tariff trade barriers and they will just keep on making this allegation and there is no easy way to resolve these complaints. They are just simply going to be a fact of life. But Hyundai, I think, by its investment program in America might be able to go part way in addressing the concerns.

The other thing you might do is simply create a quota, to buy 25,000 cars from Ford, just have a quota and find some way to use those cars here in Korea. I think the sales right now here in Korea are less than 10,000; they are very, very tiny. Maybe if you gave some guarantee that you can use the cars for something that might also go some way to appeasing these concerns. The problem is Ford made a bid for Daewoo back in 2001 when it was bankrupt, Ford made a bid higher than GM, but after they looked at the books Ford dropped out, then GM came in and bought Daewoo for a very low price. So GM is potentially out and they have to use General Motors to explain to the US Congress that Korea is not closed. And these corporate lobbies are very important, let me say that China has the benefit in Washington of corporate lobbies, China has something Japan never had.

In our trade tensions with Japan ten or fifteen years ago, there was no corporate lobby in Washington for Japan because there was no American FDI in Japan after World War II. The Japanese basically banned FDI. They did not want it. China, by contrast, has been totally open to FDI, China now has over 750 billion dollars of FDI and many US companies are very successful in China. GM has around 12 percent of the car market in China, Kodak has half the camera market, Procter and Gamble has a large share of the soap market, we've got some very powerful lobbies in Washington saying "please don't pick on the Chinese, we like them." And that is a big, big asset for China in these debates over trade policy.

You must do the same thing; you must seek out here in the American corporate community the firms that are doing well like General Motors and others and have them help to lobby members of Congress. Because these lobbyists do know how to talk to Congressmen and they can talk about how there is trade from their district with Korea, how they are creating jobs in their district because there are opportunities in Korean market place, and this is just the way politics is done, you have got to have a little constituency to help you. And China now has a very powerful corporate lobby taking its side.

The National Association of Manufacturers is deeply divided, they've got fifteen thousand members, the top three hundred members do not want protectionist policies against China because they are active in China and doing very well, the five thousand smallest members in Michigan, Ohio, Minnesota or Illinois are protectionist as they don't have the resources to invest in China, they are totally domestic, they are afraid of Chinese competition, so they are defensive, not aggressive, they are protective not proactive. This is a great dividing line in US business but the reality is, the big, big lobbying groups, the big companies have taken China on its side because US business in China has been highly successful in the last five years in carving out large market shares and enjoying very high rates of return. And General Motors I can tell you now, makes more money in China than it does in the US. It makes a difference.