US Economic Performance, Japanese Economic Performance, and Implications for Korea

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I here consider the prospects for global and East Asian economic growth, both in the near term and in the longer term.

I focus on the major global growth engines of the European Union, the United States, Japan, and now the new engine China, and on some major global imbalances and risks, particularly the recent increases in U.S. interest rates that are influencing interest rates, stock markets, and foreign exchange rates throughout the world. I will not consider in any detail the current Korean economic situation, though obviously it is affected by what happens in the world economy. Finally, I address four Korean major long-term economic trends and issues.

Engines of Growth

Over the past half century, demand in the global economy has been pulled by three engines of growth: the United States, the European Union, and, particularly in the 1970s and 80s, Japan. The world now has a new engine in China, which is growing rapidly though it still is a smaller source of both exports and imports than the three traditional engines. Nonetheless, assuming China is able to successfully manage its very significant long-run domestic economic and political difficulties, it almost inevitably will be the fourth major growth engine over the next 25 to 50 years. Engines generate growth in other economies by importing large amounts from them, being a major source of the demand for their exports. Typically, even growth engines have to pay for their imports by exporting themselves, though the United States has become a notable exception.

The engines today are pulling at different speeds and with different effects. The three traditional engines are coming out of recession or subpar growth. The continental European economies – the eurozone – are improving on average, though with Germany and Italy as laggards, but only growing 1.5 percent this year and maybe 2.5 percent at best next year. What I find shocking is that the continental European countries have created and maintained a social welfare system that tolerates as normal an unemployment rate in excess of 8 percent. However, that is their social choice as rich countries. They also seem to have put themselves into a macroeconomic straitjacket, with both fiscal and monetary policy too tight.

The United States economy is the most Darwinian, with the least adequate social safety net. At the same time, it is the most dynamic of the advanced industrial countries, based on its ongoing technological innovation, its world class university educational system, and its dynamic entrepreneurs funded in various ways, including venture capital.

The American economy is now in the process of strong cyclical recovery from its recession of two years ago. This recovery is unusual in several respects. First, growth has been based particularly on continued, surprisingly rapid, increases in labor productivity. This has meant that employment has lagged, though it now is picking up. A second unusual feature is the high degree of aggregate demand being generated by the combination of a large government budget deficit and extraordinarily low interest rates set by the Federal Reserve System, the central bank. Two further unusual features are the persistent huge current account deficit in the U.S. balance of payments, now about 5 percent of GDP; and the continuing flow of immigrants, both of high skills and low skills, which always provides a new impetus for the American economy.

My major concerns about the American economy are the very large government budget deficit; the potential property market bubble as prices have risen while rents have not; and the still excessively high unemployment rate. The U.S. government tax policy is wrong, both in reducing taxes while we are fighting wars on terrorism and in Iraq, and in disproportionately benefiting the rich and even well-to-do at the expense of the middle class and the poor. Moreover, the U.S. government is weakening the social safety nets for poor Americans; we do not even have universal health insurance coverage. What is good for me is not good for the country. I, and of course others in my tax bracket, should be paying more taxes.

The performance of the Japanese economy since 1991 has been far below both expectations and its potential, and accordingly has been disappointing. However, in absolute terms the GDP and GDP per capita have not declined; they simply have grown much more slowly than people expected and than the economy has been capable of achieving.

Many refer to the 1990s as Japan's Lost Decade. My colleague Gerry Curtis more accurately refers to this period as the Watershed Decade. The Japanese economy, society, and political system are very different from what they were in 1990. Japan is in the process of a long run, fundamental transformation that may be almost as significant as that of the loss of World War II and the Meiji Restoration in the 19th century. The transformation process will take two decades or more to complete. I visualize the new Japan will be a country with an even higher standard of living, with modest growth as a mature economy, and a much more competitive, market-based economic system; and perhaps eventually a two-party political system or multi-party political system; and gradually evolving values as the young generation, brought up in families in comfortable circumstances, are quite different than their parents who grew up in the early postwar period of poverty and economic difficulty.

That, however, is about the longer run for Japan. Right now the key question is whether the Japanese economy is only in a very good business cycle upswing, its third in a decade, or whether it is breaking out of its economic doldrums and is onto a path of sustained recovery to its long-run full employment growth path. Certainly much of the economic news is very good: two years of sustained and increasingly rapid GDP growth, and increasingly widespread business optimism and consumer confidence. Given the lack of aggregate demand and under-utilized labor and capacity, the Japanese economy has the potential to grow for several years at three to four percent a year until full employment is restored. Then it will move to its normal full employment potential growth rate of one to two percent a year.

Japan is almost at the point of returning to a sustained growth path. While I want to be a believer, I will not be convinced that Japan is on it until ongoing problems are more clearly being resolved. These include the mild but persistent deflation; the high rate of unemployment, especially of younger Japanese; and, relatedly, the excessive number of part-time workers, some 23 percent of the labor force; continuing declines in land prices; weakened corporate and financial institution balance sheets; the widening economic disparities between more urban and rural regions; and the extraordinarily weak financial system – banks, life insurance companies, and some government financial institutions. I worry too that the official GDP real growth rate is overestimated, perhaps one percentage point or so, due to technical problems in estimating the GDP deflator. Offsetting this, however, is the evidence at the individual company level that business is improving, in substantial part because companies have done significant restructuring and cut costs, even though more still needs to be done.

A year ago, Japanese were excessively pessimistic about their economy. This spring, they have been, in my view, excessively optimistic. The recent shock to the Japanese stock market may have cooled their enthusiasm somewhat, though it is hard to tell. I expect growth to be very good in 2004, but to slow down significantly in 2005, not a recession but probably not enough to overcome sufficiently the persistent problems I have just mentioned.

In East Asia, the most exciting and most dramatic story is that of the continued rapid growth and economic transformation of China, the new Asian giant. While China has a number of domestic economic difficulties, including the banking system, inefficient state-owned enterprises, huge environmental problems, lack of water supply in the North, to name a few, probably the reasonable assumption is that China will continue its rapid catch-up growth for the next several decades. Rapid, however, is not nine percent plus growth. It probably means something like seven percent growth, gradually lessening as the economy continues to develop, as has been the case of Japan from the 1970s, and Korea today.

China's immediate problem is that the economy has been overheating due to a domestic investment splurge by businesses and by local governments. The Chinese authorities are trying hard to slow down the growth rate, but do so in a way that results in a soft landing of growth at, say, seven percent, rather than a hard landing of a suddenly much poorer economic performance. While this is basically a cyclical issue, it is of great importance right now and in the year ahead.

The dangers of the China shock is that its engine impact will weaken as growth and its imports slow sharply, having a strong negative effect on its trading partners. However, some other effects will be more beneficial. Raw materials prices, including oil and many minerals, have boomed dramatically in the past year, driven in substantial part by increases in Chinese demand. Previous oversupply of many minerals and natural resources meant that significant new mine developments have not taken place globally for more than a decade. Oversupply has suddenly shifted to excess demand. As the Chinese economy slows down, so too will its demand for and global speculation in raw materials, which will reduce their prices for all the countries that have to import them. That is of course particularly important for Korea and Japan.

Two Global Economic Imbalances

We face two important global imbalances. The first is the huge current account deficit in the United States balance of payments. The U.S. has to obtain foreign capital inflows of some $550 billion a year from the rest of the world if the dollar is not to depreciate. The dollar has already weakened about 11 percent on a trade-weighted basis from its peak two years ago. Nonetheless, the U.S. current account deficit has continued to rise, in part because it takes 18 months to 2 years for exchange rate changes to have a major impact on imports and exports, and in part because the U.S. economic recovery and growth is generating further demand for imports. The key questions are: will foreigners be willing to lend the U.S. $550 billion every year; and how much further depreciation of the dollar is necessary if the U.S. wants to return to a more reasonable current account deficit of 2 to 3 percent of GDP?

Typically most foreign capital flows are private: business foreign direct investment (and the U.S. is a big recipient of FDI); foreign portfolio investment in U.S. stocks and bonds; and foreign bank loans to U.S. corporate and financial institutions. But to that has been added in the past two years the huge public capital inflows to the U.S. from foreign governments, most notably Japan and China but Korea and other Asian countries as well, as they purchase dollars to prevent their currencies from appreciating. This has limited the exchange rate appreciation to the euro currencies of the European Union, and the U.K., Australia, and New Zealand. Not surprisingly, those countries have vigorously criticized Asian government foreign exchange interventions as placing on them an undue share of the burden of adjustment to dollar weakening.

The recent rise in interest rates – to which I turn shortly – has recently temporarily strengthened the dollar as short-term capital flows have reversed course, but I think it almost inevitable that the dollar will continue to depreciate over the next several years. I might note that some very good American economists, including colleagues at Columbia University, think the U.S. trade deficit is not a serious problem at all, that the U.S. economy is so attractive that as interest rates rise capital will pour into the U.S. I am more cautious, however.

The second global imbalance is cyclical, not structural: namely, the extraordinary low levels of nominal and real interest rates throughout the world, levels that can not and should not be maintained, and indeed are now beginning their upward adjustment to more normal levels, first in the U.S. and as their economies recover, in Europe and Japan – though Japan will be the real laggard.

Interest Rate Expectations and Financial Markets

Interest rate expectations and financial markets are increasingly significant. I find it curious that this year global economic growth is the best in 16 years, yet many people seem worried. It used to be that when GDP growth and corporate profits rose, especially following an economic slow-down, people tended to become optimistic and stock prices rose. Of course expectations about the future have always been important. Now it seems that expectations are focused somewhat less on the real economy – the production of goods and services, business investment, employment, R & D – and more on the financial economy – stock, bond and property prices, exchange rates and movements in interest is in rates which so strongly affect the prices of these assets.

Since interest rates and asset prices change virtually instantaneously, unlike the prices for goods and services, preoccupation with interest rate movements and financial markets has imposed a more short-run view of the future. Most managers of financial assets want to know what the prices of financial assets will be tomorrow or next week, not five or ten years from now. There are of course exceptions. The buy and hold strategy, epitomized by the immense success of Warren Buffet in the U.S., probably characterizes the behavior of many American households holding assets who feel they cannot compete with the professionals in short-term financial markets. However, very few portfolio managers of stocks and bonds feel they can adopt a buy and hold strategy, especially since they are typically rewarded on the basis of their quarterly or, at longest, annual performance.

Two benchmark interest rates are particularly important: the U.S. Treasury bill rate, and the equivalent short-term government interest rate in one's own country, such as the Bank of Korea-based benchmark rate, since asset holders always have some degree of bias in favor of their home country assets. The benchmark rate is a short-term credit risk-free rate - that is why it is a benchmark – which is determined essentially by the monetary policy of a country's central bank. The benchmark anchors an economy's interest rate structure, which increases by length of maturity and by the degree of credit risk of the financial asset; these rates are typically set through supply and demand in financial markets.

The US, Korean, and other country Treasury bill benchmark rates, and indeed the structure of interest rates, are linked globally by the foreign exchange rate and its movements. Financial markets are the most globalized of all economic activities, and they respond virtually instantaneously to significant changes anywhere in the world. Stock market prices in the Korea, Japan, and other Asian markets are driven in significant part by changes in foreign demand for those shares – both positive and negative. Foreign firms and institutions hold Korean securities to achieve the benefits of global portfolio diversification; hedge funds and others actively participate in cyclical swings in domestic financial markets, and try to benefit from what they consider to be their superior analytical capabilities. Our net balance the foreign increase in holding Korean assets benefits Korea, as well as foreign holders.

It is not simply the actual changes in the benchmark interest rates. Changes in the expectations by market participants of future changes in the benchmark rate now drive interest rates domestically and globally. That is what we have seen over the last six weeks or so: a sudden shift in expectations that the US Fed (the central bank) will first raise its short-term rate sooner rather than later – namely later in June rather than in November after the US Presidential election, or in August. This is significant because US interest rates, both nominal and real, have been extraordinarily low for such a long period; the Fed's monetary policy has actively supported the US economic recovery from the 2001 recession. In anticipation markets now have driven up interest rates throughout the world. This has a desirable smoothing effect, insofar as the expectations are correct. In fact they seem to have gone too far, and markets are now readjusting back somewhat.

Thus, management of interest rate expectations has become very important for central banks everywhere. This is typically done through policy statements designed to reduce the likelihood of incorrect market expectations. What US Federal Reserve Board Chairman Alan Greenspan says or doesn't say affects financial markets everywhere. He wants to manage expectations so that as the Fed raises its short-term rate gradually over the next year or two, presumably in small steps of 25 basis points, long term rates will increase much less and the now wide term structure will compress.

I regard the rise in interest rates in the U.S. and globally as a desirable process of returning to a more normal pattern of interest rates in a full employment, non-inflationary economy, the long-run goal of monetary policy. In some countries, such as Korea, where domestic interest rates have not changed recently, the mechanisms of adjustment are exchange rate and stock market price declines.

I am by no means an expert on interest rates, so please take these projections with even more grains of salt that whatever else I have to say. Everything else being equal, I expect that over the next year or two, US inflation will rise to a little less than a 2 percent rate (measured by core CPI), that the Federal Funds and Treasury bill rate will be about 3 percent, and long-term US government bond rates will rise to about 6 percent.

However, not everything else will be equal. Unanticipated shocks inevitably occur, some good but most bad. There are important uncertainties and hence risks on the global economic horizon: the possibility of further oil price rises; the ending of disinflation and an upsurge in inflation; the likely slowdown of global economic growth due to slowdowns in 2005 in the US, Japan, and China; a Chinese hard rather than soft landing; unanticipated changes in the Iraq and Afghanistan wars or elsewhere in the Middle East; and almost inevitable terrorist attacks in one or another OECD country.

The Current Korean Economy

I want to make only a few general comments about the current Korean economy.

First, Korea is to be praised, relative to other Asian countries, for how rapidly and extensively it has carried out financial and other restructuring and reform programs and policies. However, that is only faint praise because no other Asian country has done a good job. Japan is an example of the high costs of delay, forbearance and wishful thinking. Relative to what needs to be accomplished, Korea's reforms are only halfway there; much more needs to be done.

Fortunately, the economy is recovering well so far this year, virtually doubling last year's growth rate of 3.1 percent to about 5.5 percent, and good growth is projected for next year – 5 percent or so. Good growth reduces the costs of restructuring and reform; the danger is that it makes decision-makers complacent in dealing with the real problems that certainly exist in the Korean economy. Nonetheless, whether business investment and consumption demand strengthen are ongoing concerns.

Probably the most important economic issue is how President Roh Moo-hyun and the Uri Party manage economic policy, especially labor-management relations. It will take major changes in the mindsets of both labor and management to turn the current confrontational mode into a win-win situation. It took Japanese labor and management some 15 years following the end of World War II to achieve that.

Four Major Korean Long-Term Economic Trends and Issues

Finally, I briefly address four major long-term trends and issues for Korea over the next 10, 20 even 50 years.

The most important issue is the reunification of the Korean peninsula, which I assume will occur eventually, though not soon, and will be essentially on South Korea terms. This will impose huge economic and social costs of adjustment on South Koreans, and eventually benefits as well. This topic is so important, so difficult and so complex that it is beyond the scope of this presentation.

The second major trend is the continuing rapid spread of the industrial revolution throughout Asia, in which Korea has been one of its early and ongoing leaders. Japan was the first Asian country to participate fully in the industrial revolution. Korea has been the second, together with Taiwan, Hong Kong and Singapore.

Korea's future industrialization process is straightforward, and long-term. Korea must continue to educate its labor force to ever higher levels of skill. Workers must continue to shift out of low productivity agriculture to high-tech manufacturing, and to increasingly sophisticated services. Technology is the long-run driver of successful economy growth. Companies must always be prepared and able to import foreign technology, to learn how to use it well, adapt it, and improve on it and develop their own technology. Korea already has many success stories, both large, well known firms and smaller ones.

I am confident that Korea will continue to climb this developmental ladder of increasing skills, investment, and technology. So too will the other Asian countries, of which China is the most spectacular case. Rising incomes and standards of living, and all that they require and generate, produce tremendous transformations of societies – urbanization, a huge middle class that wants political and social transformations and freedoms, not just a comfortable life. Korea has effectively and impressively made these adjustments, economically and especially politically – with two watershed events, the shift from a military-based, authoritarian government to a democratic government and political system, and the recent Uri Party victory, creating real political alternatives been conservative and liberal policy positions. There are today many political difficulties, tensions, and uncertainties, but I am optimistic about Korea's long run political future as a democracy.

To grow well, Korea will have to continue to be flexible and effective in its ongoing reallocation of both capital and labor, and in the development and implementation of good economic policy. There will of course be many problems, difficulties and mistakes, but I am optimistic about Korea's future economic performance.

Inevitably as an economy grows and approaches the world's best technology practices --- the global production frontier to use the economist's jargon --- Korea's growth rate will slow down once its catch-up phase is completed. Eventually the Korean economy will probably grow at a maximum of about 2 percent per person, since no rich developed country has ever grown faster than that over moving ten year average periods.

The third major trend is Korea's demographic transformation. The demographic transition is just as dramatic as the industrial transformation – and the two are linked. One of the most dramatic value changes in Korea and indeed throughout Asia has been the shift from the quantity of children each family wants, to the quality of their children, as embodied in the family's investment in their children's ever higher education, health, and preparation for a different occupation than that of their parents. The Korea emphasis on education is extraordinarily strong.

Korea is well along the demographic transition --- from the pre-industrial pattern of high birth and high death rates, relatively short life spans, and rapid population growth to low birth and death rates, much longer life expectancy, and population growth slowing down or even declining. South Korea's population is expected to peak in about 2023 at 50.6 million, according to the Korean National Statistical Office.

To maintain a given national population level, women must have on average a fertility rate of slightly more than two children during their lifetime. In 1960-65 Korea's fertility rate was 5.63 and Korea's population was 25 million. Now the fertility rate is 1.41, and the population is 47 million. It is assumed that Korea's fertility rate will be about 1.4 over the foreseeable future – but probably not forever, since the Korean population would then disappear in a thousand years or so. After peaking, the Korean population is predicted to decline by about 12 percent to 44 million plus in 2050. When fertility will rise is anyone's guess, but eventually Koreans will be rich enough to want to have more children, I presume.

Nonetheless, for the foreseeable future this means not only that Korea's population is now ageing but that the number of persons of work force age will be declining absolutely within 15 years or so. Labor shortage will then be a chronic long-term problem. Society will have to pay more to support its retired population – but less to support its dwindling number of children. Some numbers: in 1960, 2.9% of the Korean population was 65 or older, in 2000 7.2%, in 2025 it is projected to be 19.1%, and in 2050 34.4%.

In contrast, children below 15 comprised 42.3% of the population in 1960, 21.1% in 2000, and will level off to 10.5% -- if current fertility rates persist – in 2050. Those aged 15-64, the potential work force, was 54.8% in 1960, 71.7% in 2000, and will be 55.1% in 2050, about the same as 1960.

This is not necessarily bad economically and socially. Despite the absolute decline in its future labor force, Korea's economy will continue to grow, if slowly, and so will the already high standard of living.

In these projections, I assume there will be no major immigration of foreigners into South Korea. More importantly, and in contradiction to my assumption of eventual reunification, I do not include the integration of the North Korean population into South Korea. That will certainly slow down but not fundamentally alter these long term demographic projections. Korea is by no means alone in these demographic projections, Japan is already further along in this process, and so too are wealthy European countries. The United States, with its substantial immigration, is the only major exception among the high income nations.

My final theme is the importance for Koreans of their Korea ethnic identity and the Korean language, in a world which will continue to become ever more interconnected economically, politically and socially.

There are virtually no minorities who live permanently in Korea. The major Korean differences are regional identities, commitments, and dialects…and they obviously are very important. However, they have been diminishing over time and will continue to diminish as a result of the common educational curriculum, labor mobility, and the role of TV. TV dramas and soap operas convey a great deal about common Korean ways of life, problems, and values. Over time, Koreans will become at a national level more homogenously Korean.

Korea – both South and North – is the only major place where the Korean language is predominant and overwhelmingly so, both spoken and written, even given the notable Korean diaspora. The Korean language adds to the sense of Korean uniqueness. In one respect it is a comfortable barrier to keep out foreigners. In another respect it is a barrier making it much more difficult for Koreans to internationalize. A key Korean challenge is how to be both Korean and international.

In conclusion, while I see many problems for Korea in the near term, I am optimistic about Korea's long-term future as an economy and as a democracy.