The United States and the World Economy: Current Situation and Prospects*

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It is a pleasure to be here this morning to discuss the United States and the world economy. I am particularly pleased to have the opportunity to speak about these issues in Korea – a country that exemplifies how good economic policies and participation in the global economy can unleash human potential and generate prosperity for all. Other countries have much to learn from Korea's example, past and present.

For any discussion of the global economy I think it is useful to begin with a statement of goals. Goals help us assess where we are and where we want to go. The Bush Administration's international economic policy has been guided by two goals: first, increasing economic growth, as measured by improvements in productivity and higher per capita income; and second, improving economic stability, as measured by a reduction in the severity, length, and frequency of economic downturns and crises. These goals apply to all countries – the United States, other industrialized countries, emerging markets, and the developing world. The challenge for economic policymakers is to find and implement the policies needed to achieve these goals.

Economic Growth and Stability in the United States

My academic research and experience in the government has taught me that getting international economic policy right starts with getting economic policy right at home. So let me start with the United States.

The policy responses to last year's recession were quick and decisive. President Bush's tax cut came at exactly the right time. Along with the operation of automatic stabilizers, the tax cut helped mitigate the recession. On the monetary side, the Federal Reserve moved early and aggressively to lower the federal funds rate. Low interest rates continue to support the economic recovery. These fiscal and monetary responses helped keep the recent recession mild by historical standards: real GDP fell only 0.6 percent over the first three quarters of 2001, well below the 2.3 percent average of all other recessions since the mid-1950s.

While the quarterly pattern of GDP growth has shown some fluctuation, it confirms our view of a well-founded underlying recovery. The healthy rebound in the fourth quarter of last year was followed by particularly strong growth in the first quarter of this year, which in turn was followed by a modest rise in the second quarter. All indications are

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that the just completed third quarter experienced healthy growth and the economy will continue to grow at 3 to 3 ½ percent.

Growth is no longer concentrated in consumption. Investment in equipment grew in the second quarter for the first time in seven quarters, assisted by the expensing provisions of legislation enacted in March, while orders and shipments data are signaling further gains in the third quarter. Interest rates have been the lowest since the 1960s, sparking a record pace of new home sales and allowing automakers to boost sales by offering generous financing and discounts. The unemployment rate reached a 7-month low in September.

With the right policies the current U.S. economic expansion can be as long-lasting, or even longer, than the expansions of the 1990s and of the 1980s, which were the first and second longest peacetime expansions in American history. American economic fundamentals are sound. Productivity has surged over the last year and by the second quarter was 4.8 percent above its level a year ago. That was the strongest four-quarter performance since 1983. Productivity growth has averaged 2.6 percent annually since 1995, well ahead of the 1.4 percent averaged from 1973 to 1995. Low inflation, flexible labor, capital and goods markets and the remarkable growth in productivity form a strong platform for the expansion ahead.

Economic Growth and Stability in Other Countries

Economic growth in the other G-3 countries, however, has been disappointing. Japan has not yet recovered from its long period of slow growth, deflation, and instability. Private sector forecasters project Japanese growth to decline by around ¾ to 1 percent this year and to increase by around only 1 percent next year. The higher rate of growth of the monetary base by the Bank of Japan since last year, if accompanied by changes in the banking sector, will allow the growth rate of bank credit and M2 + CD to increase as well. Germany is also growing very slowly. Private sector forecasters project German growth to be around ½ percent this year and to fall short of 2 percent next year. For real GDP in Germany to grow more rapidly, it is very important that the supply-side factors holding down the growth rate of productivity and of potential GDP be addressed.

The recovery is fortunately picking up a better pace in America. Private market forecasters expect growth in Canada to be greater than 3 percent this year and around 3½ to 3¾ percent next year. Conditions in Latin America have, however, become more generally difficult this year, and economic growth for the region is likely to be around zero. Clearly, raising economic growth in this region must remain a high priority. In this context, it is important to note that the poor growth figure for the region as a whole masks considerable diversity among the countries within the region. Strong economic policies in Mexico and Chile have set them apart in the region. Growth in Mexico is expected to be just short of 2 percent this year, rising to 4 percent next. Chile is expected to grow by over 2 percent this year and by over 4 percent next year.

Economic growth in other emerging market areas has been higher than in South America.

Growth in the dynamic Asian economies is particularly strong. Here in Korea real GDP growth picked up to around 6 percent in the first part of the year after the slowdown to 3 percent growth last year. In Hong Kong, Taiwan, Singapore and Malaysia growth has picked up, and it remains strong in China.

Policies to Promote Economic Growth and Economic Stability

Keeping economic growth strong when it is strong and increasing growth when it is weak, rests on adopting the right economic policies. A fundamental principle of the Bush Administration's approach is that every country must have ownership over its own economic policies. Every country has responsibility for addressing its own economic challenges and forging its own economic destiny.

History and experience provide ample evidence of the kinds of policies that deliver higher productivity growth and higher living standards. Sound fiscal policies and low-inflation monetary policies are, of course, essential. But they are not enough. Pro-growth legal and regulatory policies encourage business investment, innovation, and entrepreneurship. Investments in health and education provide for physical well-being and build the skills of the labor force and population as a whole. Sound tax policies – particularly lower marginal tax rates – improve incentives for work and investment, while strong rule of law and intolerance of corruption gives people confidence that they will be able to enjoy the fruits of their work and investments. Strong financial systems allow capital to be put to its most efficient use. Free trade provides new avenues for growth and fosters the diffusion of technologies and ideas that increase productivity.

The Bush Administration is committed to pursuing pro-growth policies such as making the tax cuts permanent, controlling the growth of government spending and reducing the deficit. The corporate responsibility act, which provides for new standards for corporate accountability, will enhance the strength of our capital markets by ensuring that people saving for their future can get accurate information for sound investment decisions. With the passage this summer of trade promotion authority for the President, the Bush Administration is committed to pushing ahead to lower trade barriers throughout the world, including through the new round of multilateral negotiations begun at Doha.

History also tells us a great deal about the kinds of policies needed to improve economic stability. My own research has examined the role that more effective monetary policy has played in reducing volatility in output. Monetary policy geared toward low inflation, combined with sound fiscal policies that allow automatic stabilizers to operate over the business cycle, are key to promoting sustained and stable economic growth.

While economic stability is important for all economies, it is particularly important to emerging markets. The frequency of financial crises in the 1990s has served to discourage investment and damage expected profitability in many emerging markets. As a result, after averaging nearly $150 billion per year from 1992-1997, private capital flows to emerging market countries fell off to less than $50 billion per year in 1998-2000.

Restoration of strong private investment flows at lower interest rates is crucial to enable these countries to invest in the productive base of their economies and raise the living standards of their people.

Policies that reduce a country's vulnerability to financial crisis are therefore important both for improved economic stability and higher economic growth. These include prudent debt management policies, strong prudential standards, avoidance of currency and duration mismatches, and greater transparency. Exchange rate arrangements are also important, in particular avoiding soft pegs and choosing either a flexible exchange rate or full dollarization.

The Korean Example

Korea stands out as a country that has adopted strong policies to promote economic growth and to reduce external vulnerability in the wake of its financial crisis. Korea's policies are instructive for others, and I would like to highlight some aspects that I feel are particularly important.

First, Korea has pursued sound macroeconomic policies. The Bank of Korea has credibly adopted an inflation-targeting monetary framework, and allowed the value of the won to be determined largely by market forces. Core inflation in 2002 looks likely to be within the Bank of Korea's target range of 2 to 4 percent. The Korean government has maintained public debt levels well within prudent limits. And since the crisis, Korea has built its international reserves to the point where today they are about double short-term external debt and roughly 90 percent of total external debt.

Second, and equally important, the Korean government has brought about significant structural changes in the economy. Korea has sought to improve its regulatory and supervisory framework for the financial sector. Korean banks have been encouraged to improve credit analysis, lend on the basis of commercial considerations, and recognize, rather than paper over, non-performing loans. As a result, the health of the Korean banking system has improved dramatically. NPLs have been reduced to average OECD levels. Bank capital positions now exceed the Basle capital requirement. Last year, the banking sector collectively recorded a profit for the first time since 1996.

The financial markets have recognized these strong policies. Credit rating agencies have restored Korea's sovereign credit rating to the A range of investment grade and Korea's sovereign spread has declined.

Korea is an example of what other countries can achieve with the right policies. It also exemplifies what it means to exercise strong ownership over those policies. The Korean government's initiative in adopting good policies is as strong as ever. As Central Bank Governor Park Seung noted recently in a speech in Washington, DC, Korea has adopted a new economic paradigm: an open economy - driven by knowledge and technology-driven companies, and supported by a sound financial system. This is seen in the government's reduced role in the financial sector, increasing unwillingness to intervene on behalf of inefficient corporations, efforts to improve the insolvency regime, and increasing openness to foreign investment.

Concluding Remarks

As the recent slowdown has demonstrated, we share a common interest in increasing economic growth and improving economic stability in the global economy. Each country has a role to play in adopting the right economic policies to advance these goals. Experience has demonstrated what policies lead to rising standards of living and growing prosperity. In the final analysis, the prospects for the global economy rest upon our continued dedication to applying those lessons.