The US Economy on the Brink? Japan on the Edge? Implications for Asian and the World Markets[*]

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After having attended the World Economic Forum in Davos last week, I can report that the atmosphere there was one of subdued optimism. Subdued because this time last year the US was growing at 8.5% annually, which was faster than China, and is now at the 0% growth which Alan Greenspan has reported. This feels like a hard-landing. However, there is optimism that by the end of the summer this will not be a hard-landing and we will be moving ahead. Also, because we are now into an electoral cycle in many of the G7 countries, most of the G7 leaders were not at Davos this year. The only leader who did attend, Prime Minister Mori of Japan, was only there briefly. Therefore, the Davos meeting this year focused much more on business issues and moved away from the political circus that Davos has sometimes been in the past. As a result, Davos was much more workmanlike this year.

Having said that, it is clear that the world economy is changing so quickly that it is extremely difficult to keep up with. For example, at the BIS meetings held in mid-December the Federal Reserve explained that they had been surprised by the speed with which US economy slowed in December. Even an economy as closely managed, followed, analyzed, predicted, forecasted and as big as the US economy can bring huge surprises.

In terms of the G7 countries, in June, July and August 2000 the leading indicators, which lead the real economy by 6-8 months, were already rolling over. Last August and September when we were working with companies on these numbers, I suggested that they should prepare for a slowdown, but few companies accepted that. In fact, as late as November 30 I told a large global US company that we expected a slowdown. They said there was nothing in their sales numbers, forecasts or order book that indicated this. I talked to them today, having just announced their results for the fourth quarter, and they told me that the month of December had simply disappeared. That is an example of how quick it is turning.

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The emergency interest rate cut that was made on December 4 was made against that background, but it was also made against the more important and critical realization of the difficulties that were starting to emerge in the credit markets. In particular, the spread between 10-year US treasuries and the high-yield (junk bond) index had climbed to over 9%. This meant that second-, third- or fourth-tier telecom companies, Internet companies or new economy companies starting up who had recently made a management buyout or a levered buyout, were paying 15-17% for money in December. Therefore, those markets were effectively closed. As a result of this and companies subsequently getting squeezed, problems immediately began to emerge in the banking sector. For example, in December the Bank of America increased its provisions for non-performing loans by 300%, effectively for this type of development.

That spread between the junk bond index and the 10-year US treasuries peaked in 1991 at 10.3% at the time of the US financial banking crisis – only 1 percent higher than it was a few weeks ago. Also during this period the spreads between 10-year treasuries and emerging market paper also started to soar. That is what blew up Argentina and Turkey in November. If that spread is not brought down quickly and substantially further, we will see other countries in Latin America and Eastern Europe getting into big problems. In a sense then, when these pressures get very intense, some of the underlying problems of the crisis of 1997 and 1998 come right back to the surface.

The current slowdown in the US economy is not an accident; it was engineered. The Federal Reserve had been taking up interest rates for about a year. This is because last year we were growing so fast in the world economy at almost 5%, the fastest growth in 17 years, that inflation began picking up. If inflation were to pick up, the G7 central banks would have to take up interest rates a lot more than they have in the last year. If this were to happen, given the huge debt loads being carried around the world, we could find ourselves in real difficulty again.

It is true that the US has reduced its debt in the public sector in the last 8-9 years, but it has increased its debt in the private and household sectors more than the public debt has gone down. So the US financial position is more precarious than it was a decade ago. A decade ago, the US was worried about borrowing $450 million per day from the rest of the world. Today it is borrowing about $1.1 billion dollars net from the rest of the world every day the markets are open. 10 years ago Japan's government debt was running at around 51% of GNP. By the end of 2002, it will be around 151% of GNP.

Virtually all of the emerging markets, with some exceptions, have also seen debt loads increase substantially. If one looks at what is happening in countries like Thailand today, it is clear that much of this debt is going to be taken on to the public books. In fact, in many countries, that will be the only way ahead. The only regions of the world that have brought down debt on aggregate are Europe and Canada. So with this huge build up of global debt, if interest rates are too high there will be very big problems. That is how it started to emerge and the shocks, pressures and warnings of that began to show in the banking system as we moved through December.

Therefore, the Federal Reserve has cut rates and thus reassured markets. The spreads have lessened slightly; the junk bond spread is now only 750 basis points, instead of 930. More junk bonds than ever before were issued in the last three weeks. More money has been raised for those new economy, Internet and telecom companies in the last three weeks than was raised in the last quarter, so that has relieved some of the pressure. The stock-markets, while still slightly unsteady, seem to have stabilized. There is a confidence that the Federal Reserve is going to do the right thing and as we move ahead the US economy will stabilize so that, by summer, we will be moving again.

There is much optimism that the European economy is going to grow at 3% or more. However, I believe that Europe is also going to get blindsided like America. The numbers on Europe today look very much like the numbers for the US in September and October 2000. The leading indicators are rolling over very quickly and the first cracks in the real economy are starting to appear. At the weekend some downward revisions came out of Germany again. So, I expect Europe to also slow down quickly.

If this happens and the European Central Bank does not cut rates, then that will start to feed into the markets. The markets will then begin to think that the US alone cannot carry this. Therefore, we have to watch the Bank of England and the ECB very closely over the next month or two. If they do not see what is coming, they are going to find themselves behind the curve and the slowdown in Europe will then be sharper than would otherwise have been the case.

As the US has to slow to relieve some of the pressure on its own economy, Europe has to keep enough growth to offset that slowdown while Japan has to stay stable. This should leave enough growth in the world economy to continue the financial consolidation of the emerging markets after the 1997-98 crisis and to continue the rationalization of the old economy, which still has so much excess capacity.

One example of the difficulties caused by the slowing economy is the current state of the car industry. Daimler-Chrysler has just announced 26,000 lay-offs, as have Ford and Delphi, the parts supplier owned by GM, and GM themselves have just closed several factories. This sector is typical of the old economy, where about 76 million cars are made globally and only 52-53 million of them are sold. If growth is weak, the weakest players in that sector will immediately run into problems, therefore, there has to be growth to continue the rationalization.

Of course, there also needs to be some lift in the world economy to keep financing and keep the buoyancy there for the shift to the new economy. That is the strategic objective that the G7 finance ministers and central bank governors are working on. As a result, the US will have to cut rates more than most of us believe in order to get there. It would not surprise me if there is a zero first quarter, which is what Greenspan has already said he expects. Furthermore, I would not be surprised to see the US be close to zero in the second quarter also. As a result, I expect to see the Federal Reserve's fund rate around 4.5% by summer.

The difficulty that Greenspan has at the moment is that under the Clinton-Rubin-Summers regime there was a very clear fiscal policy, at least from 1994, so he knew exactly what was at his disposal. It was within this framework of a stable and clear fiscal policy that he could fine-tune the monetary policy. However, at the moment, we do not know what the fiscal policy of the new administration will be. Therefore, Greenspan has to make adjustments that will have an effect in 6-9 months, while not knowing really what fiscal policies will come in on top of these adjustments. So, the risk is, if the Federal Reserve discounts to some extent the fiscal policy of the new administration and anticipates a stronger or weaker fiscal policy, that could lead to turbulence in the economy and further adjustments later this year or next year.

In my view, the best solution would be a "rules-based" fiscal policy, similar to the European rule-based system with targets for your fiscal policy. Canada has also adopted a type of rules-based approach, where 50% of the surplus goes towards debt reduction and 50% goes to other policies and tax reduction. The Canadian finance minister probably thinks that if the surplus goes below 1% of GNP it should all be used for debt reduction. Consequently, if the US Congress and White House come to some a similar compromise, where fiscal policy becomes quite clear, a lot of the confusion would be taken out of the markets and therefore reassure investors. As a result, I think risk premiums would come down in both the bond and equity markets and this would be good for growth. Another positive move for the markets would be for this administration to make commitments to help the economy by lowering taxes and by reducing US private and government debt, which is higher today than it has ever been relative to GNP. In fact, one of the reasons for the fantastic last 8 years in the US is the commitment of the government to reduce debt.

Overall, I share the broad view that the US will do better in the second half of this year; maybe 2% in the third quarter, 3% in the fourth quarter with growth between 1.5% and 2%. However, that will not be enough to reduce the tensions in the Korean economy and elsewhere in Asia. In order for that to happen, the ECB will have to cut interest rates by at least one percent and Germany and France will have to keep their promises of tax cuts. I hope to see other countries in Europe follow the example of Germany. I think they will, because once a country the size of Germany makes substantial tax cuts, there is likely to be a period of tax cut competition across Europe as the positive effects of these tax cuts are felt in the biggest economy. If that happens, two-thirds of the G3 will be moving in the right direction.

The third element of the G3, Japan, is much more problematic. It was interesting to listen to Prime Minister Mori at Davos. Responding to remarks that had been less than optimistic about Japan, he said in his speech that the Japanese economy in the 1990s grew by 13%. In the next paragraph he said that the potential long-term growth rate of Japan is 3%. If one compounds 3% over a decade and then subtracts 13%, in effect he said that Japan lost 20-23% of the growth it should have had in the 1990s. Therefore, an economy of $5 trillion today would be 22-24% larger if Japan had not missed the 1990s. That is almost the size of the GNP of Germany and is bigger than the GNP of the rest of Asia combined. So Japan is almost one Germany smaller today as a result of the crisis they faced in the 1990s. That is a measure of what Japan lost in the 1990s as it dug itself deeper into this hole.

The Japanese economy today is crushed beneath a mountain of debt. As I said, the government debt that appears on the balance sheets will be around 150% of GNP by the end of next year. We believe that the claims on the Japanese state that are off the balance sheets are at least as large. For example, the Long-Term Credit Bank was taken over by the Japanese government and sold to new owners. When it was sold, the new owners were skeptical of the valuations that the authorities were putting on the balance sheet. Those negotiations got to a point where the authorities did not want to reduce those valuations any further, so the new owners agreed to accept the valuations. However, they asked for a put-option so they could put the balance sheet back onto the authorities at any time over the next 5 years if any of the loan values fell by more than 20%. Therefore, that is a $146 billion balance sheet guaranteed by the government which is not on the official government balance sheet.

As you saw last summer with the loan of Sogo, $18 billion dollars was pushed back to the government, who politically could not accept it. The government thus encouraged the city banks, which they had just capitalized, to take over that bankrupt loan, in effect putting the loan back onto the government books. The same dynamics exist in terms of the Nippon Credit Bank: $361 billion in guarantees over the last 30 months to small- and medium-sized companies, virtually none of which will be paid back, at least not on the balance sheet.

So government debt is around 300% of GNP. The government always says they have lots of assets. But of course, if you were to sell any of those assets, it is not certain that you would get the price that is on the government books for them. For example, the $26 billion dollar bridge between Honshu and Shikoku, which carries approximately 200 cars per hour, probably generates enough revenue every year for a paint job. It is unlikely anyone would pay $26 billion for it.

In the private sector, total bank loans are 141% of GNP as of the end of December. Companies then have commercial paper, convertible bonds, warrant bonds and corporate bonds on top of that, which all together very quickly amounts to five times GNP. There has never been a major economy in peacetime carrying a debt load of this magnitude. Even after World War II, when UK and US debt were at record levels, they were never close to five times GNP.

People say that Japanese interest rates are at zero, so the debt costs nothing. But of course, it is not the nominal interest rate that counts, but the real interest rate, because asset values are driven by where real interest rates are.

So what are real Japanese interest rates? The government officially says the economy is deflating by 1.5%. The Bank of Japan and the Federal Reserve both accept that they underestimate price declines due to technological innovation by about 1%; for example, the $2000 computer two years ago that now cost $800 and is three times faster. The indexes cannot pick up these changes. Therefore, it is deflating at 2.5%. Japan is also an economy where there is a lot of discounting and price-cutting occurring because it is under so much pressure and the discounting occurring at point-of-sale is not included in the indexes. In the third quarter we found discounting in the car sector to be at 13.2%, none of which is in the indexes. So, overall, it is deflating at over 2.5%.

On the other side of that, Toyota can borrow money at 2.4% for 10 years, but Corporate Japan broadly, outside of those bullet-proof, quasi-government companies like Tokyo Electric Power, is borrowing money at between 3% and 5%. As a result, real interest rates are above 5%. Therefore, the money in my pocket is increasing in value by 5% per year. So why would I buy or invest in anything? That is why investment in assets is weak and why asset prices continue to be under pressure. The only thing holding asset prices up in the last couple of years has been this tidal wave of government spending. But when the government debt is this high, there will come a point when the government is forced to start retrenching on investment and spending. They will not do it before the next elections, but the issue is moving towards the top of the agenda.

If the government cuts back on fiscal policy and continues to have very high real interest rates, with this much debt it is obvious that asset prices will be pushed down again, which will generate a new period of bad debt. For instance, if the debt and the assets are both five times GNP, and the asset prices fall 3%, 3% of five times GNP is 15% of GNP, which is twice the capital of the banking system. So it is obvious that when the figures are this large, only a small change can cause a very big problem. As a result, our view is that the Japanese situation is far from being resolved.

There are still huge difficulties to be worked out in Japan’s economy. The biggest of which is leadership. There have been many countries in Asia that have faced crises in the 1990s. Some have tackled crises head on by providing leadership when it was not easy to address issues. That leadership fulfilled the role that politicians should fulfill, which is one of representing the future and explaining to people that in order to achieve the country’s goal there must be changes and therefore difficulties, but the government will make policies that will help people deal with the risks that come from these changes. This was how Korea dealt with crisis and it is one of the reasons why Korea is going to be so well positioned in the future.

Japan is the opposite. The political leadership in Japan has turned its back on the future. Some politicians are increasingly looking nostalgically to the past to find solutions. By refusing the future, Japan has only worsened its situation. In my view, it will take a shock to force the leadership, or to bring in a new leadership, to address the future. Indeed after the elections this summer, there could be even weaker leadership in Japan. In the G3 context Japan remains the big question mark, not over the next three-six months, but over the next 2 to 4 years.

Despite these problems in Japan, the world economy will grow in the second half of this year and accelerate into next year. This is good for markets because they tend to look ahead 6-9 months. For instance, the broad stock-market bottomed in October and the technology stock-market bottomed in December, but there was a fantastic run-up of the technology markets in January and last night the Dow Jones closed at almost 11,000 again. As signs begin to come out of Europe, the first one probably being from the Bank of England cutting interest rates when the Monetary Policy Committee reports this week, and as we move towards the March FOMC meeting, we will prepare for another cut by the Federal Reserve. I believe Australia will also cut interest rates this week and Canada will follow between now and the end of February. Once all of this begins feeding into the markets, a clearer picture on fiscal policy will emerge. After this correction, the next phase of the stock-market is going to be surprisingly strong.

In terms of Asia, it is clear that the Asian crisis has separated the wheat from the chaff. Today the world economic environment is heavily penalizing those countries in Asia whose reforms stalled and did not move ahead. With the brilliant exception of Singapore, that is the case for much of Southeast Asia. Singapore has embraced the future, embraced globalization and moved ahead on the trade front. It is now repositioning, restructuring and creating global platforms in the airline and telecommunications industry. Singapore is possibly the lighthouse that countries in the region will follow three or four years from now.

In Northeast Asia, there are two countries that have done broadly the right things. Firstly, China has continued to progress on reform. Recently there have been many comments about the corruption and scandal there, but the government is now bearing down on it. I think these are very positive developments. 10 days ago the decision was made to privatize the Bank of China, which has vast implications for the financial sector to be the next major area of reform. This has to be the case in order to break the current situation where the high Chinese savings rates are channeled to the old state companies, which essentially destroy their value. Moreover, less than 1% of total bank loans goes to the private sector of the economy, which represents 20% of GNP, is developed, creating jobs, paying taxes, increasingly driving exports and is growing four times faster than the state companies without government help. But these companies today require systematic, stable and steady financing and the decision now to move ahead on the Bank of China is the key first step as we move in that process.

I think this will be followed by very positive developments in terms of the supervision and opening of Chinese capital markets. For instance, the permission for private companies to systematically list in Chinese markets. I think this will be followed by reforms that will put in place a pension system that mobilizes funds for the long-term and creates stable long-term pools of capital for investment through the stock-market. I think this is China's most important phase of reform since the early 1980s and it is fully committed to these policies.

The other East Asian country that has done the right things is Korea. At the moment there is a lot of tension in Korea and for obvious reasons; in the last year energy prices have soared and DRAM prices have plummeted. So in a sense, the terms of trade have moved dramatically against Korea. As this happens, earnings and investment fall, growth slows, wages come under pressure, consumption falls, stock-markets get hit and currencies slide. As a result, this has brought many of the unresolved problems of 1997 and 1998 back to the surface. This provides a good opportunity to use this new period of tension to move ahead on the reform agenda because every step that Korea takes on the reform agenda gives it an advantage over the competition that is coming.

I do think Korea is committed to progressing with reform. However, after a period of 10% growth, it is difficult to explain to people that the economy will slow very quickly in the first and second quarter this year. So, the more progress there is on reform, not just in the government but in each company, the better off Korea will be.

I am very optimistic that, due to the turnaround in the US economy and the support there will be from the European central banks, stock-markets are going to do very well and growth will return. I also think that the slowdown in the first half of this year is going to bring commodity prices down substantially. Last night the natural gas prices finally cracked and oil prices peaked 6 weeks ago, so I expect that the price of oil will be $18 per barrel and gas prices will be down by the summer. As a result, there will be a lot of pressure taken off one side and on the other side, as we have this adjustment in the hi-tech markets, I would not be surprised if DRAM prices are bottoming at the moment.

So, I will attempt to make some predictions. In terms of the currency markets, I believe that this will be a year of volatility. Indeed, there has already been a lot of volatility in the last few weeks as the Euro has moved from 82 against the Dollar to 97 and is now back to 92-93. I think we will continue to see that volatility in the Euro-Dollar rate. In fact, I expect to see the Euro slide back into the high 80s before it bottoms again, then over the next 6-9 months I think it could be trading up to 105-110 against the Dollar.

In terms of the Yen, it is difficult to be anything but pessimistic in the mid-term. Certainly the policy set in place at the moment, i.e. easy fiscal policy and tight monetary policy, is exactly right to allow for a strong currency. That is how Germany achieved the record high Deutschmark after unification. It also the policy mix Ronald Reagan and Paul Volcker used from 1980-85 when there was a record strong Dollar. However, I expect the Japanese will be forced to ease monetary policy by effectively having the central bank buy long-term assets. Once that starts, effectively printing Yen to accommodate the build up of debt, the Yen is likely to weaken substantially. So I could see the Yen over the next couple of years dropping to surprising levels.

So what are the implications of this for Northeast Asia? One of the big consequences of the Asian crisis was the breaking of the link with the Dollar, with the exception of China and Hong Kong (paradoxically, China linked with the Dollar during the crisis). For example, in the last 6 months, there has been an extremely close correlation between the movement of the Korean Won and the movement of the Yen.

Therefore, my opinion is that if the Yen were to weaken substantially, first of all it would create huge difficulties for China. For instance, in 1998 when the Yen reached 147, China raised a lot of noise about it. I think China would raise a lot of noise about it sooner this time. If the Chinese are expecting the Yen to weaken, I think over the next year they will begin putting more flexibility into their exchange rate. A month ago Governor Dai announced that they would widen the band about which the currency fluctuates, only by 0.5%, but that shows the beginnings of an exchange rate that will give China more margin to maneuver.

Secondly, Korea and Taiwan will have to watch these developments very carefully. If one shadowed the Yen and the Yen went to 150 when the Korean Won was trading at around 11 Won to the Yen, it is obvious where the Won might be.

What might this mean for trade issues? The US already has a big current account deficit now, but it is interesting to think what it would be if the Yen was 150, the Won was 1450 and the US was growing. Furthermore, it is interesting to think what would happen in Europe if the Euro were 110 to the Dollar. Rather than waiting for these things to happen, I think it would be wise to consider them now and engage the US administration in a discussion about these issues. It must be remembered that Japan is not a small country and if it gets into trouble, there will be difficulties for the rest of the world.

However, I am confident that, thanks to the reforms that have been put in place in the last 3 years, Korea will navigate those difficulties if they occur. There have been enormous changes since 1997-1998, but I think those changes and more changes in the future, will position the Korean economy to sail through the difficulties that may be ahead. With this in mind, I would always bet on Korea.

Q&A

Q:
You mentioned an increase in the volume of junk bonds in the near future. Do you think that this will increase the volatility of the short-term credit market and, as in 1997, become an element of instability? As you know, the Korean government seems to be worried about this phenomenon and is devising a means to monitor it. Could you comment on this possibility?

A:
The high-yield securities, or junk bonds, started to come into their heyday in the 1980s in America when many companies had become entrenched and assets were not being

managed very aggressively. So some smart investors said, "if we could take over those companies, get rid of the management, manage those assets more aggressively and restructure, we could get much higher returns on those assets." And because there were huge pools of savings available, people began putting these things together. In fact, that is how companies like Microsoft got started; because people realized that the technologies were going to grow so fast that they could carry very high interest rates during the initial period. Hybrids of these were then also conceived for some of the emerging markets (particularly Latin America which got into so much trouble earlier in the 1980s), which then, linked to debt-equity swaps or US government bonds, encouraged people to put their money at risk with good returns.

So far, much of the new economy has been financed in this way. Much of the telecom sector will also be financed in this way, mainly due to investors seeing these as new technologies and therefore being uncertain how things will work out, thus increasing risk premiums. Secondly, there seem to be sectors that are growing very fast and therefore it will be possible, once you get to a certain growth rate, to pay those bonds down quickly. However, those equations can only work if there is high and stable growth, either in your sector for your company or, more broadly, for the economy. But, of course, in the last year the central banks and the G7 have worked to slow growth down, effectively causing the huge expansion of this type of financing, particularly for the new economy, to diminish rapidly. So just at the moment when much of the new economy needed a new round of funding, it was not available and consequently this led to the massive NASDAQ crash.

Therefore, the added volatility related to this type of financing is the reason why there are such high interest rates and, therefore, an investor would not buy just one junk bond, but rather a portfolio of junk bonds. This is because *X*% of the bonds will probably be from companies that will eventually go bankrupt. But if the portfolio is diversified, the higher yield covers that risk.

If one is carrying very high interest rates and is highly levered, one must monitor and manage things very carefully. When things come down hard like in 1997/1998, it is the companies in the countries that have the highest leverage who get killed. So close monitoring is very important. This should not be a large part of financing, but there are areas that can be and have been very successfully financed in this way and I expect that to continue in the future. However, if a whole country or large parts of an economy begin to be levered in this way, there is likely to be a lot of trouble ahead.

Q:

Firstly, to what extent do you think the current sharp decline of the US economy is due to the interest rate increase by the Federal Reserve? Secondly, what is your opinion of the fundamentals of the US economy in terms of the corporate and financial sector?

A:

The US economy slowed for essentially two reasons. Firstly, the big increase in interest rates and secondly, the big increase in energy prices. The difference in energy prices from January 1, 2000 to December 1, 2000, i.e. the difference in cost for the world, was about $500 billion. Of that $500 billion, $200 billion came directly from the pocket of the US consumer. Another $200 billion from Europe and about $100 billion from Asia made up the rest. Those two forces together drove the slowdown in the US economy. But I now see both of those forces reversing; interest rates are decreasing and I predict oil prices will also decrease substantially to below $20.

Regarding the fundamentals of the US economy, in 2000 about 49.6% of US capital investment was in IT-related goods. In 1990, the proportion of US capital investment in IT-related goods was 17.2%. So it has increased almost 3 times as a proportion of total investment and total investment has risen. It is this commitment to IT that has led to the increase in US productivity in the 1990s. From 1975 to 1995 the average growth rate of the US was 3%. From 1995 to 2000 the average growth rate has been just over 4% and the macroeconomic models show that virtually all of that increase has come from the increase in productivity driven by the investment in IT. There will be ups and downs in that investment and our view is that it is not completed yet. In a sense, in terms of the long-term growth trend of the world economy, we have entered into a period of rapid technological change where the growth rate has accelerated as we go through this adjustment. At some point in the future it will flatten out again, possibly reflecting the long-term underlying trend. But at the moment we are in a trajectory that is taking us higher due to this technological innovation.

In my view, the problem with the US economy is the broad debt level, which is higher on aggregate today than it was 10 years ago. The US seems to be gambling that it will move so far ahead in the new economy that the royalties from future sales to the rest of the world in this sector will, over time, be able to bring down the current account deficit and restore the balance.

Q:

My question is regarding what I see as a discrepancy in the perceptions of Koreans and non-Koreans of the prospect of the Korean economy. On the whole, as you seem to have expressed, the foreign perception of the Korean economy is one of cautious optimism. However, most Koreans seem to be deeply pessimistic and concerned about the future of the Korean economy. One possible reason for this is the fact that Koreans are overly concerned about the state of the political system; the government's weak coalition and the political fighting that goes on. Apart from that, do you think there are any other problems we should be concerned about that the international capital markets are monitoring?

Secondly, how serious is the international capital market's interest in following up on this current process of rapprochement between the two Koreas?

A:

If the recapitalization of the financial sector was carried through completely, I think that story would be stronger. Also, if the international investors could understand and see policies executed that would strengthen the medium-sized companies and bring them up technologically, it would be even stronger. There is a sense that there is a two-tier economy.

However, I think the way Korea has handled the crisis has actually won it more credibility internationally than the Korean people understand. This is also the case with the broader, more complex, historic issue that you raised, of relations on the peninsula. Investors believe that the levels of tension today are less than they were three years ago. If some of that momentum can be made to continue so as to put in place a blueprint for the next 10 years, and also some agreement on economic milestones for the next 10 years, then that would give investors even more confidence in the situation.

Q:

How do you see the outlook for foreign investment in Northeast Asia, both direct investment and portfolio investment, over the next few years? What factors are currently governing this?

A:

China has seen an increase in direct foreign investment in the last year of about 20% as people have anticipated the entry into the WTO. Remarkably, people are now moving factories out of Mexico into China because of the cost differences with China in the WTO. So I do not see a big slowdown in that area. In the old economy there is continuing pressure to cut costs, so production will move, to the extent that it can, to countries that are the most attractive, some of which may be in Northeast Asia.

If I am right that the world economy is starting to stabilize, the US and Europe are going to be moving in the right direction over the next 9 months. Therefore, although the US and European markets will go to new historic highs over this year, I believe the East Asian markets on the whole, with the exception of Japan, will outperform the US and Europe because the Northeast Asian equity markets are basically highly levered to growth in the US and Europe and to the US credit cycle. So I see a very good period for equities ahead of us.

Q:

In emerging countries, including Korea, there are problems not only with politics, but also with bureaucracy, media, accounting systems and the rule of law, i.e., things that are not easy to correct or improve in a short period of time. I think the difficulties of reform are related to these basic problems emerging countries face. In the 20th century, there are very few countries that have been able to overcome these problems, which took many centuries for the European countries to overcome. In most of the emerging countries there has been little progress in building institutions similar to those of the industrialized countries. In the coming decade too, because of many of these basic problems, reforms may not be that easy when the world economy is integrating so quickly. As a result, I think there will be a lot of confusion and instability in many emerging countries, perhaps mostly in Asia. What are your comments on this?

A:

I agree that the process of globalization is not going to slow down. If anything, it is going to accelerate. For example, the capital market and the market for technology and ideas are already global and the market for talent is almost there. So I think your first point is right and it would be wrong to think that the process of globalization is something we can hold off. Therefore, we should prepare for it, embrace it and live with it in a way that is positive, which we can capitalize on. That means moving ahead in all the areas you have just mentioned, as difficult as they are.

In my experience, people are realistic. They know there are extraordinary changes going on and sometimes they are afraid of them, because they do not know what they might mean for them. But I believe that in these periods of enormous change, if one talks straight to people and shows them what we have to do in order to get the rewards that are out there, one can build a lot of political support for moves in this direction. In fact, I would argue that that is the success of Clinton. Clinton understood the pace and scope of this change and that it created vast anxiety. But for those people who felt that anxiety not to become opponents of change, he had to put in social policies that would allow them to feel comfortable as they embraced the risks resulting from those changes. So, the more those reforms are explained and understood politically, the stronger the base will be and the better the performance.

In terms of Korea, there have been some tough challenges over the last 40-50 years. But there is no reason why Korea cannot do that again in a more complicated environment. I think that is the root of my fundamental optimism.