

The International Financial Market and the Dollar/Yen Exchange Rate: An Overview and Prospects for the Future

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Thank you very much, Dr. SaKong. Excellencies, ladies and gentlemen, I would like to tell you what an honor it is for me to be with you this morning in this great swirl of a world market where things seem to be changing faster every moment. It is so difficult to try to understand what is happening. So quickly is it changing that, in a sense, it is like trying to put together a puzzle for which the pieces change shape as soon as you touch them. I can remember, particularly in light of your warm welcome this morning, when in 1996 and 1997, I had some ideas about what was going to happen to the Asian economies, I was less welcome in some Korean companies than I am today. But you've been through such a difficult period that you probably know much more about this crisis and where it is going to go and what is driving it than anyone. So, I don't want to spend a lot of time on that.

I would like to start this morning by thinking with you about the four or five main characteristics of the world economy as we meet. Then, I would like to think through the implications of those characteristics, how they could drive the world economy, and what policies are being put in place to address those forces. Finally, I'd like to conclude with some idea about what the more immediate implications for foreign exchange markets are, for interest rates and the global economic environment with which we will have to deal.

The first major characteristic of the world economy is excess capacity in almost every sector of traded goods, with the few exceptions

of those sectors which have high technological or proprietary barriers to entry, e.g. some pharmaceutical sectors or some of the information technology sectors. But in virtually every other sector of traded goods, we have huge excess capacity: steel, cars, heavy chemicals, toothbrushes, shoes, textiles, etc. Let's take cars for an example. In the developed economies at the moment, we can produce 60 million cars a year. In the emerging markets, we can produce 18 million cars. Yet, we will sell 45 million cars in the world this year. So, with a capacity of 78 million, we will sell around 45-46 million cars. Of the top 44 producers of cars in the world, only six are profitable after tax. Only 12 of the 44 companies are cash flow positive.

I could go through sector after sector, and find the same characteristics. Not just in one country, not just in one region, but globally. This is what is driving the tremendous process of rationalization in the global car industry. Ford just bought Volvo. Renault, the French state-owned enterprise, just decided to bailout Nissan. Daimler merged with Chrysler, and so on.

Second, we have extremely high debt levels around the world. You know what the debt levels are in Korea; they are on the front pages of the newspapers again today. But this is not unique to Korea, nor is it to Asia. If you think of the emerging markets as a group, as of September, according to the numbers of the Bank For International Settlements, (BIS) the total foreign currency debt of all of the emerging markets combined equaled 62% of their GNP. Now, you may remember when Latin America imploded in 1982, the foreign currency debt of the Latin American economies was only 31% of their GNP.

But, in addition to foreign currency debt, there is also a lot of local currency debt. So, if we take a country like Thailand, their total combined debt, foreign currency and domestic, is about 230% of GNP. In Malaysia it's about 245% of GNP, in Indonesia it's about

310% of GNP, and of course, you know what the numbers are in Korea. But it is not limited to emerging markets. In 1991, Japan's government debt was 51% of GNP. By 2001, it will be 150% of GNP. Imagine. Japan has put on about five trillion dollars in new debt over that ten-year period. My sense is that it is likely to go even higher than that before it peaks. These debt levels in Japan do not include the unfunded liabilities that the government has for pensions, which, if you include those, would push debt levels to above 300% of GNP.

Even in America, with its great performance in the public sector, — which apparently is now running a surplus — as the public sector has improved, there has been a very sharp deterioration of the household sector in America. Indeed, as the public sector deficit level has come down, the household sector debt level has gone up. And it has gone up more than the public sector deficit has come down. So, the aggregate financial position of America has continued to weaken through the 1990s and is today weaker than it was in 1992.

In America, the markets are open every day. America borrows about one billion dollars net from the rest of the world daily. The 'Goldilocks' economy is financed with other people's money. Last year, America borrowed 278 billion dollars net from the rest of the world. It will probably be a little bit over 300 billion dollars this year, given that the current account deficit is obviously going to be much larger. So, debt levels are extremely high.

Third, we have structurally slow growth in the world economy. Again, we could start with Japan, which accounts for 16% of world GNP. Even if everything goes right, Japan will have 0% growth this year. And according to the latest numbers, everything isn't going right. Last month, consumer spending was down 3.8% on a year-on-year basis. Yesterday the leading indicators came out again, and they suggest that confidence is starting to weaken still further. The Tan-

kan was out yesterday and it doesn't show much optimism. It indicates that companies are going to cut investment by about 10% this year. Japan's export markets are weak. So, it's very difficult to see how Japan is going to do anything dramatic. Even if Japan were to get 1% growth next year, it still faces a decade of difficulties. The demographics are going in the wrong direction. The financial sector, even if it is recapitalized, will remain weak and fragile for some time. The corporate sector has huge restructuring to accomplish in order to overcome its fragile financial position. So, we can't expect much from Japan.

The European Union has, like a lady in her forties wanting to wear a dress she used to wear when she was twenty, tried to fit into the Maastricht Agreement, and now is on a stability pact which is like a diet. That stability pact means that Europe has to keep very strict control on its finances. It has to keep the deficit levels at a maximum of 3% of GNP. Already the European Central Bank (ECB) has said that, as France, Italy, and Germany, the three core countries of the euro, won't meet their targets this year, they will have to tighten their budgets further. So, unless Europe figures out some way to loosen this 'corset,' these constraints of the stability pact, Europe is going to continue with the slow growth it has experienced through much of the 1990s.

Of course, all of Asia is putting itself back on its feet through an export-driven strategy. Domestic demand will remain weak. In Latin America, the numbers today look like they did in Asia in 1997. So, it's not going to be very strong. If you've got a company with huge amounts of excess capacity, huge amounts of debt levels and weak sales, what's likely to happen? Well, we all know what's going to happen. It's what happened to Korea. That, in a sense, underlies the world economy.

Finally, we have pretty weak leadership around the world. Russia doesn't have much leadership. The new German government still

has to prove itself. It was in power for hardly a month and the Finance Minister left. There is constant bickering between the Greens and the Reds. Japan doesn't have particularly strong leadership. It continues to be weak and fragile. We are now into the election campaign in the United States, and Clinton, although he has high levels of public opinion support, has gotten very little from Congress in the past, and can now get virtually nothing.

If you put all of that together, it's a very problematic picture. But it's more problematic if you think of how the world banking system is positioned. If we take the world's top 500 banks, again as of the end of September, they have total loans to the emerging markets of 2.4 trillion dollars. Now, the emerging markets' GNP is around 3.4 trillion dollars. The total equity of those 500 banks is around 1.6 trillion, including about 350 billion dollars in theoretical or 'virtual' equity of the Japanese banks.

So, the top 500 banks in the world and the developed OECD economies have loans of 2.4 trillion dollars and a real equity base of between 1.2 and 1.3 trillion dollars. Of course, they have loans to other countries as well. Now, imagine you're a banker, and you've made these loans. You have to ask yourself how much money will you get paid back. Does anyone have any idea how much money will be paid back by Russia? Well, you've seen the newspapers in the last two weeks. Deutsche Bank has been leading the international banking consortium on the Russian debt. The rumors are in the newspaper, and I guess we can't deny that Deutsche Bank has decided to accept about 2.5 cents on the dollar, plus a right to convert debt into equity at some time in the future, perhaps to save face. The auctions in Thailand ten days ago were at 18 cents on the dollar. Auctions have been held in Korea at 35-37 cents on the dollar. How much is going to be paid back by Indonesia? What about Brazil?

We'll do the numbers very quickly. If you get paid back 65 cents on the dollar - Some people say that's very optimistic - the write-offs

amount to one-third of your loans. If you have 1.2 - 1.3 trillion dollars in equity, it means two-thirds of your equity will be wiped out. Now, if that happens, the immediate result would be a massive contraction in lending around the world of between 4-5 trillion dollars. That will push us into a 1930s situation globally. That is the underlying dynamic that is at work in the global economy. It is not something you can fool around with. This is really serious stuff. That's why, in the last six months, after we went through the crisis of '96, '97 and '98, particularly last fall, when markets in American and Europe really started to shake, the leadership, — not so much the political leadership at the level of the Clinton, the Schröders and the Obuchis, but I would say, the financial leadership of the world in the form of the Greenspans, the Rubins, the Miyazawas and some people in this room — realized the risks that are at stake here and have engaged an extremely aggressive policy in the last six months to reflate the world economy. Because implicit in the dynamic is a massive debt-deflationary cycle.

With the interest rate cuts by the Central Bank of Canada last week, since October 8, 1998, we have now had 101 central bank interest rate cuts around the world from the member countries of the Organization for Economic Cooperation and Development (OECD). More will come soon because I believe the ECB will cut interest rates this week. I believe that we will see further interest rate cuts in OECD economies as we move through this year. It is unprecedented to see this enormous monetary effort to recreate demand in the world economy. When you have a massive imbalance of demand and supply and high levels of debt, if you try to rationalize by closing down supply, you guarantee that you won't be able to pay back the banks and therefore you go into a global financial crisis. So, we have to get demand to fill up that capacity in order to help companies go cash-flow positive, start paying back their banks, and reduce this problematic debt level around the world.

Second, in addition to the monetary effort, we've seen the Japanese commit 750 billion dollars to refinance their banks and try to stimulate their economy. I believe that as we get through the summer, the Japanese will be led to put another 250 billion dollars of fiscal stimulus on the table. So, this amounts to about a trillion dollars that Japan will have committed to rebuilding its banks and trying to prime its economy to obtain some new demand in the twelve months from September 1998 to September 1999. That's "New Deal" kind of spending. I believe also, as we move forward, that the Bank of Japan will adopt even more aggressive monetary policy. I'll come back and think through what some of the implications of that will be for the currency market.

As we move through the rest of this year and into the presidential elections next year, I also think that there will be increasing debate in America about tax cuts. I believe that tax cuts will be the center of the campaign platform of the Republican Party. I think Gore will also be forced to go in that direction.

As for Europe, I think the Social Democratic governments across Europe increasingly realize the predicament they are in. And I think that they will find a way to ease the constraints of the Maastricht Stability Pact. They will do so in a way that only politicians can. They will redefine spending. The Stability Pact of Maastricht says that spending has to be capped at a certain level, but they will define a part of spending as no longer spending but investment to make economies stronger in the future. If they can operate that, they will then tell us that the government will increase investment but not spending.

And so, I would see Europe also easing fiscal policy as we move through next year. As a result, in the G3 economies, we have a tremendous effort now engaged to lift the world economy. It doesn't matter what Thailand does. It matters if you're Thai or if you have investments in Thailand. But Thailand's GNP is equal to about 40%

of the capitalization of General Electric. So, even if Thailand or Malaysia does everything right, what really will drive things over the next two years is what the G3 economies are doing. If this effort to reflate the world economy works, then of course, you've got a very interesting situation for a country like yours. Not to be too subtle about it, but the IMF policies which Korea has adopted are working quite well. Crushing the currency and domestic demand, Korea has tried to rebuild its financial strength quickly enough to generate enough cash on the current account to start paying off debts.

Actually, if you think about it, in the last quarter, there is no net new lending coming into emerging markets from the world's OECD banks. All of the net new money coming into emerging markets is coming through the current accounts. The banks are still reducing their exposure because they're still afraid. For example, in the fourth quarter last year, the international banking system took 4.9 billion dollars net out of Thailand. I give you that example because Thailand has 130 billion dollars in GNP. Imagine if you lose five billion dollars in one quarter. The only way to offset that at this moment and generate more is through a big current account surplus.

So, up until now, you've had this massive turnaround in current accounts in Korea and Thailand. All of the Asian countries are following the same trend, although you are a little bit further ahead. Now, what we need is to keep building the current account, but on the export side. Most of the improvement last year was because imports crashed. The only way that we can build the export side is if we have a lot more growth in the world economy. Because we've had this enormous effort to generate growth—and I think that effort continues through this year—my view is that you have a pretty good global environment out there for the next eighteen months to continue the effort of rebuilding that you've started.

Now, many people say that deflation is the story. I would argue

that deflation was last year's story. I mean, if deflation is the story, why is oil at US\$17 and not US\$7? Why are the prices of copper, pulp and paper, and chemicals going up if deflation is the story? Why are long-term interest rates going up in America? Why aren't interest rates at 4% instead of 5.5% on their way to 6%? Why are long-term interest rates in Germany going up rather than down, if deflation is the story? The reality is that the long-term end of the bond market in OECD countries is already starting to anticipate stronger growth in 1999 and 2000 than most forecasters are currently expecting.

So, I would argue then, that you've got an extremely dangerous over-capacity structural slow-growth equation in the world economy. Those pressures are not yet resolved. But for the next eighteen months to two years there will have been such a massive effort to reflate the economy that those forces will be pushed back beneath the surface. So, I could say that the Bear market is in remission. We've given it massive treatment.

As I come to the conclusion, what are the risks and opportunities that this situation creates as we look toward next year? I think the biggest risk is if Japan goes off-course again. If policies that are in place in Tokyo don't work, if the government falls apart again, it would create a huge new problematic situation.

The second problem is that, in emerging markets, Korea perhaps, people may say, "Ah! we don't need any more reforms. Things are going so well, the world economy is growing, we're generating huge surpluses; this nightmare is over. Let's get on and make some more money. Forget the reforms." If we do that, and a year to eighteen months from now, these underlying pressures in the world economy come back to the surface, Korea is going to be in big trouble again. So, rather than slacking off the effort of reform over the next eighteen months as global conditions improve, I would argue the opposite. This would be a much better environment in which to accelerate

reforms. Go faster, get more done while you've got more lift and it will be socially and politically easier.

A third risk we face is that some may start to say, "Wait a minute. In emerging markets we have devalued currencies, wage costs have come down, there hasn't been a big inflation bubble. There are really attractive places to produce today. The world economy is growing so we should start making new investments." And so, exactly at the wrong time, around the world, people misread signs of growth as encouragement for further expansion of capacity. If we do that, then we're going to have more problems as we go down the road.

But if we resist that temptation, Japan stays on track, and we don't have a new cycle of capital investment, then I think that two years out, we will have reduced debt levels enough and the exposure of the fragility of the global banking system. Then we will not have to come back the global economy's difficult underlying questions because they will be in part resolved and will have a much more stable base.

Beyond all that, one issue will remain problematic for Korea. That is Japan. However you look at the scenario, Japan has got a very difficult ten years ahead of it. Just think of it. Its population is going to age in the next twenty years faster than any population has aged before. Do you realize that by 2020, for every 100 people between the ages of 20 and 60, there will be 63 people in Japan who are retired? Enormous pressure will build on Japanese public policy from that perspective.

Second, Japan has wasted the 1990s. Corporate restructuring is only starting now. So, it's missed the whole technology boom of the 1990s and still basically has an industrial structure that's concentrated on where it was strong in the 1980s. So, it has got huge restructuring ahead of it. That restructuring is not just a capacity restructuring, it is also a financial restructuring for the corporate sector.

Third, its debt level now makes Italy look well managed. This debt

level will go even higher. Yet, with the demographics, it must dramatically reduce that debt level.

Fourth, Japan's main export markets have also fundamentally changed in the 1990s. 42% of Japan's exports go to Asia. Well, the Asian markets, in terms of domestic demand, are going to remain weak for some time. They are going to be export-driven. This is problematic. I could go through many more of Japan's problems, but the real issue is one of money. There's a cash flow at the end of every story.

The question then for Japan is what type of policy mix it will adopt to address these issues. My view is that Japan has virtually no choice but to monetize a large portion of its increased debt. Historically, countries that have seen a very quick run-up of their debt and then monetize it have seen very weak currencies. So, I would expect the yen to weaken quite substantially over the next three or four years—more than most of us expect—to below the levels it has been at in the last twelve months. It will certainly go below 150. Will it go to 175, 200? No one knows at the moment. But certainly, I believe it will be substantially lower than it has been in the last twelve months.

One of the reasons Korea got into its crisis is that there was too much debt and over-capacity. Then the yen went to 130 and world growth slowed. So the weakness of the yen over the next few years is something Korea will have to watch very closely. If Korea doesn't stop the reforms but continues to work as it has in the last eighteen months to "put the house back in order" and the conditions globally will be there for that when the Yen does weaken, Korea will be in a position to move with it.

In a broad sense, this crisis in Asia has been in part one in which Asia has moved from a dollar standard increasingly to a yen standard. When the yen falls, the Korean won falls and the Thai baht falls. When the yen goes up, those currencies go up. Korea's trade is increasingly yen-driven and will continue to be as Korea moves

ahead. So, the other major risk that Korea faces, is that when the yen weakens, as I think it will, there will be great trade tensions with America. Those tensions will spill over into the rest of the region. It is something we have to watch very closely.

If you think of the last ten years in stock markets, the companies that have done well have been fast companies, flexible, open, innovative, quick to adapt, and focused. In this crisis as well, the countries that have done well have been fast countries, running their countries like racing yachts. In this world of the post-cold war era, where the fundamental strategic issue facing most countries is economics, I think we've got to put economic strategy at the center of national security priorities. We've all got to run our countries like racing yachts.

Korea is now in a position to start to do that. If the next couple of years are used to tighten the sails, train the team and watch the world economy, I think that Korea could sail through the coming gales in the world economy with great success and become a model for others. Thank you very much.

Question & Answer

Q My question is about the Y2K problem. I think we've all heard much about the technical aspects of the Y2K problem. They've been very well publicized. But as we get closer to the endgame, capital market participants are likely to start taking precautionary measures, practical steps to limit their potential downside from equity and bond investments. This is the contingency plan for the consequences of the Y2K as it occurs in early January of next year. If you think through that emotional and behavioral pattern of the capital market, it's quite possible that these consequences could be quite larger than any technical or practical problems caused by the bug itself. They

could lead to a massive flight to cash or to other safe equivalents until after the event passes. I wonder if Dr. Courtis could comment on this capital market behavior scenario, as it is a global capital market issue, not a local one.

Also, what kinds of safety nets and circuit breakers can be put in place to prevent a massive meltdown which may be a consequence of this kind of global capital term movement? This movement could be short-term in effect, logical and rational in its own context, but from a global point of view, potentially very damaging.

A I guess we could close the markets for a year. I'm not an expert in this field. I have a colleague who has made his career on it. Obviously, the problems of psychology will start to run in the second half of this year, probably from September or October. The Chinese have come up with a solution. They said that the CEOs of all Chinese airlines have to fly in their airplanes on January 1. Maybe we could tell everyone in Wall Street that they have to invest their bonus in the market on January 1.

Indeed, there will be a run on cash. The central banks all around the world are already preparing for that. People may already be building inventories in anticipation of difficulties. And so, we have a little stronger economic numbers at the moment because we're bringing growth forward from the second half of this year.

Many big companies and financial markets believe that they've got their systems corrected. We've now gone through dry runs to check all of our equipment and we've even tried to test what would happen if we were okay but others weren't. The real problem is that there is so much coming into your company from other companies. If their data is wrong, then it has a ricochet effect.

We could see in the second half of this year some psychological panic starting to grab the markets. But I'm one who believes that this problem is way overdrawn. People told us when the euro started

that we would have a catastrophe in the European markets and actually, it went pretty easily. We did a lot of preparation and went through a lot of practice runs before we got there. In the end, it went fairly smoothly. So my sense is that the real problems are going to be outside the financial markets. They are going to be in sectors like utilities and distribution of goods. I think the preparation there has been slower. We've been trying to work a little bit faster on it in the financial markets. For me, it's a black box, and I don't have any better answer than that.

Q First, what is your opinion on the new global financial architecture? Second, as exchange rate uncertainty is a real problem for the world economy, people like Fred Bergsten have been advocating target zones for many years. Another option is to fix the dollar/yen exchange rate at a certain level. Japanese consumers will never consume and Japanese investors will never invest unless they see some stable exchange rate between the yen and dollar. Now, with the introduction of the euro, this exchange rate uncertainty becomes even more complicated. That is why recently, the target zone idea is coming back. Schroeder and also Blair mentioned this scheme some time ago at the G8 meeting. What is your view on this? How do you see the development of the dollar/yen/euro exchange rate?

A As to the first question about the new financial architecture, I personally believe that we will not build a new palace on a mountain-top. We won't have a big reorganization of the world's financial institutions. Rather, we're going to fix the holes in the roof and we're going to fix the plumbing. I don't think we're going to do much more than that. I think in effect, if I'm right in what I said earlier, that we have a fairly successfully engineered reflation of the world economy. With these interest rate cuts, tax cuts and fiscal policy, in twelve or eighteen months people will be much less concerned. They

will have already forgotten about the problems. With the Mexican crisis at the end of 1994 and early 1995, the G7 Summit in June that year was on the new financial architecture. That was the last we talked about it until this crisis. I tend to think the same thing is going to happen again.

As for the dollar/yen/euro question, my sense is that we are in a long-term bull market for the dollar, driven essentially by a third industrial revolution that is centered on America for the moment. It seems to be in many respects like what happened in the 1910s and '20s when we invented so many of the products that are commonplace in our homes and offices today. Much of this new telecommunications and information technology is really now at the phase of where the car industry was at the beginning of the 1920s. We are just into that phase now, a very quick expansion of those sectors. Considering the diffusion rate for product after product, we get an "S curve." We are right in that accelerating phase of the diffusion now. So, I think there is huge growth potential left in those sectors. Because it is centered for the moment in America, there are all kinds of investments moving into America to try to participate in this.

Second, in America we had a massive baby boom from 1945 to 1960. People enter into their peak income and spending when they are in the range of 45 to 50 years old. Well, for the baby boom generation, which was massive relative to the size of the U.S. population, that generation just now, and for the next 7 to 10 years, is at its peak spending. So, we've got a few things happening. There is a huge wave of technological innovation that is like nothing we've seen since the '20s. Also, that baby boom generation, which for the next ten years will be at the peak of its spending capacity, has a massive capacity to spend.

Third, that baby boom generation is one of radicals, entrepreneurs, and people who want to create things. Typically, we go from a generation of innovators to a generation of conformists. The Henry

Fords were the innovators, and then in the 1950s and '60s, we had people who were great at running big companies but weren't great innovators. So, you have those three things coming together. I think that drives the long-term bull market of the dollar.

I think the yen is in a long-term bear market. If the yen were fixed at 130 to the dollar, given the debt level that is building up in Japan, it would mean that the Japanese could not monetize their debt. Consequently, it would mean that they would have to have very high real domestic interest rates, which would in turn make it even more difficult for them to rebuild their companies and their financial sector. I think people in power in Japan, in other words, people in banks and corporations, have very little real interest—although people talk about it—in fixing the yen at the moment. I think the Americans have equally little interest.

As for the euro, there is a lot of talk in Europe among some politicians about a currency zone globally. Certainly, if you have a currency zone, you take the independence away from the central bank. Once you fix the currency, the central bank has to drive its monetary policy in reference to that fixed currency, which would be fixed in some political agreement. So, in effect, it takes back the independence of the central bank. Of course, they are dead against it. My sense is that while it may be a good idea in theory, I don't see it happening any time soon.

Q First, regarding the Japanese monetization, it seems like there is no alternative. Yet, a weaker yen will make the U.S. trade deficit even higher, which will bring trade protectionist sentiments back in the U.S. Considering this along with the BIS capital adequacy ratios, how would Japan be able to monetize its debt? Second, since the world economy faces enormous problems, the G7 efforts to tide it over may not be sufficient. In your view, what is the possibility that these reflationary policies by the OECD can work out? Isn't there a

risk that this monetary policy will produce higher global inflation without successfully lifting global demand?

A It is quite clear that if we get a weak yen we will have more trade problems, particularly if the U.S. continues to grow faster than the rest of the world. Given the U.S. financial need to borrow money from the rest of the world, the current account deficit this year in the United States will be around 300 billion dollars. At this rate of growth, the United States' net external debt by 2002 or 2003 will be over 2 trillion dollars. So, it's quite clear that at some point, we could have lots of volatility in the currency markets and an increased politicization of trade relations. To me, that is very clear. The U.S. today has the lowest unemployment levels since World War II and yet, we're seeing increased tensions in the steel industry, increased tensions between America and Europe over agricultural products and other areas.

My view on the monetization is that, effectively, the Japanese don't have much choice. They won't do it in one simple way. It will be stop-and-go as it has been in the last months. They will try to camouflage what they're doing. They will try to talk the market up to slow the decline of the currency. Today, they're talking the currency down again. At the moment, they are clearly trying to drive the currency into the low 120s as part of an effort to get the economy moving. But if the economy starts to show a few signs that it's doing better, and if the process of restructuring Japanese companies continues, we could then get a move later this year of a lot of foreign investors buying into the Japanese stock market. A whole wave of new money could come into Japan. That would give us a stronger yen for a few months. So, my sense is that the decline of the yen is going to be very choppy. You can't just buy the dollar today and forget about it. It's going to be very difficult to follow. But the broad trend is lower. Yes, there will be more trade problems. I think that's

inevitable. I don't know how it is going to be dealt with. It obviously will lead to lots of conflict. It also will have a spillover effect on Korea. So that's an important thing to watch for.

Second, it's interesting that the BIS numbers are partly driven by what stock markets do as well as the currency. So, my view is that the next several years will not be very good news for Japanese growth. We just won't see much of it. But it will be a very good period to invest in the Japanese stock market because companies will be restructuring. My view is that the Japanese stock market will probably continue to slowly go up through this period with lots of easy money flowing into the stock market, companies restructuring, and foreigners buying into the Japanese stock market. And I would see also, in spite of the monetization, a little bit higher interest rates which will pull people into Japanese bonds, but which won't be high enough to kill the stock market. On the whole, I think that the rise in the stock market could largely offset the decline that the yen implies for the equity base relative to the international assets of Japanese banks. From the BIS, I think they finesse it, largely driven by the stronger stock market which offsets the weaker currency.

As for the risk of inflation of monetary policy, my view is that we could well see oil go to US\$25~27—that's a very unpopular view—over the next couple of years. But I don't think it would go much higher than that because I think that the underlying forces in the world economy of deflation will still be there. The underlying implications for prices of the technological innovation will also still be there. I think we're going into the most competitive environment in the world economy that we've seen in a very long time. There's just not going to be a lot of room to raise prices.

Q How do you foresee the U.S. economy in the coming 2 to 3 years? Will the boom continue? Second, how do you foresee the Chinese economy and its implications for the world economy as a

whole?

A As for the U.S. economy, my broad view is that for the next couple of years we will continue to be surprised as we have been over the last couple of years by the strength of the U.S. economy. It won't be even. My sense is that we're probably pretty close to another messy correction again in the stock market. This will create new fear which will make consumers more conservative for a little while. As we move through the summer and fall, if the market moves down 15-18%, as I think it could, that could surprisingly lead Greenspan to make a new interest rate cut. I think that, whoever is the new president, there will be tax cuts on the agenda. Markets, consumers and companies will anticipate that. I put all of that together and I think that on the whole, we'll have a stronger U.S. economy than most of us expect.

As for the Chinese economy, it looked like it was starting to bottom in the fourth quarter of last year. Consumer spending looked like it was starting to go back up, new credit started to expand again, the inventory cycle looked like it hadn't bottomed but was approaching bottom. Then in the first quarter, things have started to roll over again. The Chinese have become very Keynesian in how they manage their economy. They've adopted very aggressive monetary policy this year and last year, and the year before. They've adopted very aggressive fiscal policy. In the last six months of 1998, fiscal spending increased at an annual rate equal to 8% of GNP. So, there is probably a statue of Keynes in the head office rather than Marx. In fact, Keynes said there are three types of lies. There are lies by mistake, lies by commission, and government statistics. China has become completely Keynesian because its numbers don't compute with the numbers we have coming out every week on the economy.

The real problem is how to finance reform. Because of the trouble in Hong Kong, most banks have left the region, making the listing of

state companies impossible. Therefore, there is little likelihood of new money coming into the country. But I think markets will all do very well over the next eighteen months in this region. We will see China list a number of new state companies. China National Petroleum Corporation, China Metals Corporation would be likely candidates. When that money starts flowing back into the country, then we will see a bottom on the economy. But weak, slow growth remains. By the end of 1999, I think that China will start some more aggressive indirect devaluation of its currency. I don't think they'll do it this year for a lot of reasons. But next year, I think you'll start to see them increase subsidies for exporters and use other indirect methods to devalue the currency by 10-15%. I think they'll be very clever about it. You'll have to watch it very closely. But that's broadly my view on China.

Q Recently Alan Greenspan testified in the U.S. Congress. He said that perhaps we are writing a new textbook for Economics 101 but we don't have the textbook on the shelf yet. In other words, the existing theories and textbooks do not explain well what is happening in the U.S. In your view, the U.S. economy will be quite strong for the next two or three years, with some adjustments. What is the main factor here? Is it the so-called New Economics, in other words, the new technology, or the clever policies by Greenspan or Rubin?

A I think it's a mix of things. Technological innovation is changing the way we work, what we do, and the relationship between consumer and producer. It's going to change where we live. I think it is also the demographics I mentioned earlier. Also, we have to remember that in the 1990s, Japan hasn't grown. That's kept a lot of deflationary pressure on the world economy, and kept prices under pressure. Europe hasn't grown either. In the 1990s so far, Europe has had one year where growth was above 2%. It is extraordinary. So

that has kept prices under control, and has affected the world economy.

Because Europe and Japan haven't grown and have run large current account surpluses, that money has been recycled to the world economy. So, it has been possible for America to meet all of its financial needs and still keep low interest rates because Japan and Europe have had huge amounts of money to recycle. Finally, I think that we've had a pretty good team in Rubin and Greenspan. Basically, Clinton has gotten out of the way. Good thing we had Monica otherwise he would have been bothered with the economy. And who knows what would have happened. He might have managed it like Kosovo. So, my sense is that it's a combination of those three or four things. It's the technology, demographics, the global environment and the actual execution. Those things come together.

Q I agree with the long-term view of the depreciation of the yen and the demographics assessment. This statistical and econometric approach analysis would be right except that this morning, newspapers report that Kitty Hawk will go to the Kosovo area. If Yugoslavian affairs gradually escalate - as the Vietnam Conflict budget grew to 36.5 billion dollars, around 100 million dollars per day - I think the Japanese yen will not reach 200. Conversely, the U.S. dollar will come down and eventually, the price of gold will go up. What is your opinion on this?

A My sense is that Kosovo will not lead to a Vietnam situation. But who knows? Certainly what is going on today was not what they were planning for. When they started two weeks ago, they didn't expect it would lead us to where we are today. If we go in that direction, of course the currency that would be hit hardest would be the euro or the Greek drachma. I could fully well see over the next few weeks or months that the euro could go to one-to-one

parity with the dollar. The fall of the euro since the beginning of the year continues. If this were to become a bigger war and spread from the Balkans to the Middle East and Iraq, it would drive up prices of oil and other commodities, including gold, would bounce. There has been a lot of bad news. Right now, gold isn't really falling very much. It fell ten days ago when the U.S. said that the IMF should sell some gold. But gold has been surprisingly stable, given what's been going on in the world economy. However, if gold and other commodities were to bounce in the context where you have a messy situation in South Central Europe, I think the biggest victim would be the euro.

As Japan is an importer of all its commodities, I would also see the Japanese current account surplus also getting smaller. That mid-term would also be negative for the yen. But if we go into a very complex Vietnam-type situation—which again, I don't see happening—we will have to revise a lot of projections.

Q There are two schools of thought on control of short-term capital flow. Of course, no control is one option. But in the control school, there are two divisions. One is Mahathir's control at the outflow side. The other approach, by Chile, is control on the inflow side in case of difficulty or crisis. There seems to be a consensus view that short-term capital volatility is the problem, even though we don't have consensus on how to deal with this issue. Do you see any necessity of controlling short-term capital flows in terms of the new global financial architecture?

A I've tried to think how this could work. My sense is that what's likely to happen, and it may actually be the most practical option, is not to impose controls on capital movements per say, but to impose them on the banks themselves, in terms of what they can lend. I mean, any of us could this afternoon get on an airplane and

go to Luxembourg or Switzerland or almost anywhere, say Hong Kong or Singapore, and open an account. The bank will give you a trading line of ten times your equity to trade currencies. If you put a million dollars in, they'll let you trade ten million. If you're a hedge fund, they'll let you trade 25 million dollars. So, all of us could become little hedge funds.

The most practical way to deal with these issues would be to set out criteria for banks, like we do with other forms of bank lending, so that they could not have so much exposure to this type of lending. That would sharply reduce the amount of money that's available for highly leveraged investment. I think the BIS is going in that direction. Basically, that position would have the support of the G7 countries.

Second, I think it is unfair—you would feel the same—if you gave someone money and then change the rules afterwards. It happens sometimes in life, but you never feel happy about it. So, I think that, of the two approaches, the Chilean one is better. It puts a limit on how much short-term money can come into your market. You see that Mahathir has basically withdrawn his capital controls. Since he imposed them, Malaysia has not done particularly well compared to other Asian countries. Thailand has done better, for example. Actually, in spite of the mess in Indonesia, Malaysia hasn't done that much better financially and economically than Indonesia has since the controls were put in place.

So, it hasn't been terribly successful. I think the controls were put in place largely for domestic political reasons. So, what we need are 1) enforced controls on lending categories for the banks; and 2) limits on how much money can come into a country before the fact rather than after the fact.

