

New Games, New Rules, New Strategies

Lester Thurow

When I was planning this lecture several months ago, I was going to talk about something different than I am actually going to talk about this morning. Today, I am going to talk about the falling dollar and how that is an illustration of the fact that we are going to play a brand new economic game with brand new rules requiring a brand new strategy.

Now, if you look at the declining value of the dollar, at one level it is not a mystery. What would you expect to happen when you have a country with a 140-billion-dollar current account deficit and 168-billion-dollar trade deficit? Simple economic analysis indicates that the value of the currency of such country ought to be falling. The mystery comes from the fact that the US has run that kind of trade deficit for the last 15 years and nothing has come about during that 15-year-period. And, the problem is that it is a little bit like when the Japanese stock market was at SIC 40,000 which meant that the PE multiple was more than 100. For the first 5-6 years when this occurred, people like myself said, "This is nonsense. The Japanese stock market will come down." However, after it continues to occur for another 3-4 years, people like me begin to feel embarrassed and keep mouths shut. We don't necessarily change our mind, but we quit talking.

Then, another group of economists will create all kinds of crazy theories as to why the Japanese stock market can stay at

40,000 forever. They argue that the value of land is not on Japanese books appropriately, that Japanese do accounting differently, and that Japanese aren't interested in making money, etc. You will get a million reasons as to why the Japanese economy could defy economic gravity forever. Of course, this was not true. The Japanese stock market eventually fell from 40,000 to 12,000 on the Nikkei and that was a bigger decline in real terms than the fall of American stock market of 1929-1932. If you want to know why the Japanese economy is not recovering, there is a very simple answer. The loss in wealth due to the fallen stock market and by falling real estate value, together the loss in yen terms in their overseas investment, Japan has wiped out something like 6-7 trillion dollars of wealth during the last 6 years. You cannot wipe out 6-7 trillion dollars worth of wealth without having an impact on something and somewhere. The problem, of course, is that if you look at the value of the dollar and the American trade deficit, it looks like the Nikkei Index. For the first 6-7 years that the United States ran a trade deficit, people like me said, "This is nonsense; it won't happen very long and prepare for it to end." Fifteen years later we kind of look foolish and we stop talking.

Now, other economists make up theories as to why the United States can borrow money from the rest of the world and will never change. People state that America never plans to bring the money back into their home currency because (i) their market is so big that they are using their money to move into the American market, (ii) Americans don't care about bringing money into the America and, (iii) they don't care about adding

to the wealth of the country. But, these are all nonsense. We know, as an absolute fact, that no country can run a trade deficit forever. It doesn't make a difference if you are the smallest country or the largest country in the world. The problem is that, as I tell my businessmen friends, economics is good on fundamental forces and pressures. But, it is horrible on timing. There is nothing in economic theories that tells you one clue about when something is going to happen. If I am a business person, I don't care whether the dollar is going to go up or go down. I want to know the timing. I can't make any money, if I don't know the timing. That is exactly where businessmen, economists and financiers don't communicate. Business community wants timing which is precisely what the economists cannot give and economic community give forces which is precisely what the business community doesn't want.

Now, the other part of the mystery has to do with the two ways to look at the currency values. One way to look at currency value is to see whether you are balancing your balance of payments(BOP). From that point of view, the answer is that until America balances its BOP, you can expect the dollar to fall. If it is 80 today, it will be 70 tomorrow. Of course, tomorrow may be one day from now, two years from now or even 15 years from now. But, there is a second way of looking at balance of payments. That is purchasing power. What that theory says is that balance of payments ought to be in balance when the same goods cost the same amount in two countries minus transportation costs. If you look at that, the dollar as today is grossly undervalued. I can buy a Toyota for about half of what it costs in Japan. I can buy a Japanese camera in the

U.S. for about one-third of what it would cost in Japan. Everybody in this room ought to be rich tomorrow, if you pick up a phone and buy Japanese cars and autos in the U.S. and ship them to Japan below the cost of what they cost in Japan. If you believe the world is operated in the way as the textbook says, then everybody ought to leave this room right now and do what I just described. However, I don't see anybody doing that. Why aren't you doing that? There is supposedly riftless opportunity sitting out there for anybody outside the world to grab. Leaving the rest of the world aside and looking at purchasing power parity, the value of the yen to the dollar should be about 225. But, this morning it is about 80. The difference between 80 and 225 means something out there is not working as it is supposed to.

Before I talk about what isn't working and the way it is supposed to work, let me mention something else. If you look at the pattern of trade in the Pacific rim, it is an earthquake about to happen. Like a real earthquake, you don't know when it is supposed to work. But, what does every country in the Pacific Rim virtually do? They run huge trade deficits with Japan which they pay for by having a huge trade surplus with the United States. And, if they couldn't have that trade surplus with the U.S., their trade with Japan would have to stop tomorrow morning because they could not pay their bills. Your neighbor China ran a 50-billion-dollar trade surplus with the U.S. that allowed it to pay for its Japanese and Korean imports. You in Korea thought you were selling things to the Japanese or to the Chinese, but you were not. You were selling things to the Americans because if the Chinese in turn could not have sold

to the Americans, they wouldn't be credit-worthy. If so, they could not pay your bills which means that your exports to China would stop. That is the general pattern all over the Pacific rim.

What does that tell you if you believe that American trade deficit could not last forever? It tells you that you are going to wake up one morning and that Pacific trade would have collapsed the night before in the sense that it all becomes financially unviable. There again, I cannot tell you whether tomorrow is tomorrow or 5 years from now or even yesterday because one of the questions you have to ask about the falling dollar is: "Is this the end? Is this the equivalent of the Mexican crisis?"

The interesting thing about international currency values is that when we were on flexible exchange rates every economist with one exception, not me, said, "When you go on an flexible exchange rate, you will have many small day-to-day fluctuation and currency values based on what happens to the fundamentals. But, you are not going to have these huge swings up and down." Milton Friedman, Paul Samuelson and I believed that and I suspect you believed that. The only person who did not believe that was an American economist Charles Kindleberger who specialized in the economic history of the Great Depression. He was right because since then we had enormous swings in currency values over- and under-shooting. And, we know why we have those swings because, in economic theory, you are supposed to have economic speculators out there with a 3 to 5-year time horizon who are looking at the fundamentals in productivity and inflation and who are placing 3 to 5-year-bets even if they lose money on paper. In real financial markets,

there is no such human being. All financial speculators have a one-day-horizon at most. There is no such thing as a financial speculator with a 3 to 5-year-horizon. What it means is that people can move massive amounts of money very quickly with modern electronic equipments. Think about the guy down in Singapore at Barings. Twenty-eight-year-old, non-university graduate who placed a 28-billion-dollar-bet in the Japanese stock market losing 2 billion dollars. I can guarantee you that he was not worrying about where the Japanese stock market is going to be years from now. He was concerned about where it was going to the next morning.

Now, what that has done is create a world with enormous instability. Take Mexico for example. Think about what everybody said just 6 months ago, not 6 years ago. They all said that Mexico is the country doing it perfectly. They run a balance in their budget, sold more than 1,000 government-owned firms, deregulated the economy, and slashed quotas. Mr. Salinas is on the cover of every magazine and hero of the Third World. I did not see anybody in the summer of 1994 saying Mexico is a potential disaster. They were people who said that the currency is a little overvalued and they were not saving quite enough, but there was no dissent from the basic view that Mexico was doing it the best. What is true 6 months later is that Salinas is now in exile and the Mexican economy has collapsed. Three-quarters of Mexicans are expected to lose their jobs. The average Mexican family is expected to take a 30% cut in purchasing power. The middle class Mexican family is expected to take a 50% cut in purchasing power. And, business firms, all across in Mexico are going broke not because they

are losing money in peso terms, but because they have borrowed dollars that now takes three times as much to repay. Do you think all of that could be caused by a clumsy devaluation in Mexico City? That clumsy devaluation has nothing or very little with the Mexican problem.

If you want to look at the Mexican problem, think of Europe in the summer of 1992. In the summer of 1992, the Europeans were trying to run the European Exchange Rate System. And, people in the common market were trying to peg their currencies to the Deutsche Mark. Speculators first attacked the Italian lira. Italians were forced to raise interest rates, retreat to austerity and devalue their currency. We all said that we understand why that is happening because Italians don't have the fundamentals. Their productivity is growing slower than the Germans and their inflation rate is higher than the Germans. Then the speculators attacked the British pound with the same result. We all repeated the same answers saying that the British don't have the fundamentals. Then, the speculators attacked the French—the fourth largest economy in the world. In the summer of 1992, the French had all the fundamentals better than the Germans—higher productivity growth rate, lower inflation, better fiscal performance and better trade position. And yet, speculators still attacked and won. They forced the French to raise interest rates, and lower the value of the French franc and retreat to austerity. If they can do that to the fourth biggest economy in the world where they got all the fundamentals perfect, they can do it to any nation in the world, perhaps with the exception of Japan, Germany and the U.S. Of course, people in Korea talk about not opening up the capital market to keep the speculators from

speculating. It won't work. The Japanese tried to stop the trading of derivatives under the Nikkei Index in Toyko, but, they did. So, where was the trading going on? In Singapore where the guy from Barings was trading in the stock market! I can trade the Korean stock market with no permission from the Korean government. That is the fact of the modern world.

The problem is that we have herd mentality. If you have a herd of antelopes, some of them start to run because they see a lion and then the entire herd starts to run. However, herds sometimes start to run because a brush blows in the breeze, to think there is a lion. I think the truth of the matter is that nobody can predict the next country that is going to be attacked by financial speculators. *Fortune* magazine published a list of countries most likely to be attacked which probably means that these are countries least likely to be attacked. On that list, there were two countries in Asia because they have very similar characteristics - Indonesia and the Philippines.

Now, let's think about the dollar from the Americans' point of view. What should we Americans, if anything, do about the dollar? There are three things we can do. We could export more. But the problem is that you got Japan out there with a 130-billion-dollar current account surplus and a 143-billion-dollar in trade surplus. What would happen tomorrow morning if the United States, however it did it, cured its balance of trade problem by exporting more? Somebody else in the world would have to hold the 130-billion-dollar trade surplus as their deficit. That is what the U.S. is doing—we pay for the Japanese surplus. Who in the world is going to pay for it? If nobody can pay for it, then the United States cannot solve its trade problem by

exporting more unless it exports directly to Japan.

The United States could import less. That would be very easy to do in the United States because we could easily gear up to replace imports. We import about 8% of the GNP. For such things as cars, the American car company would be glad to build facilities and keep out the Japanese. And, of course, if we were to do that, what would happen to the rest of the world? The answer is that you would not only be in a recession, but also have enormous structural problems because you have all built industries to serve this 145-billion-dollar American deficit that would no longer exist if we imported less. If that were to happen, your industrial structure would become obsolete and you would have billions of dollars of losses in your books.

The third possibility is that the U.S. raises interest rates and makes holding dollars a little bit more attractive because you can earn a higher rate of return. That is what the Europeans would like us to do because if you ask who does the falling dollar crunch, the answer is Europeans. The current value of the dollar puts current Airbus industries out of business. There is no conceivable way they can sell Airbus industries at this value of the dollar without enormous subsidies, as the U.S. is already running a slight trade surplus with Europe. This value of the dollar, if it were to cure the problem, would be basically the same as saying that the U.S. is going to run a huge trade surplus with Europe and Europe will be given the Japanese problem of 130-billion-dollar surplus.

The other problem is that inside the U.S., we run a very peculiar economy. In most countries, when the value of the currency falls, there are three big groups that demand the

government do something. First, there are companies and banks that have foreign-denominated loans, like in Mexico, and they would go broke if the government doesn't hold up the value of the currency. So, they are in the national capital lobbying to hold up the currency. Every bank in Mexico has gone broke. They borrowed a billion dollars and they lent it out as three billion pesos. They pay back three billion pesos but they owe seven billion pesos which they cannot pay. However, nobody in the U.S. borrows in anything other than dollar terms.

The second reason why a country worries about a fallen currency is that it normally leads to inflation because the price of imports go up. That doesn't happen in the U.S. In the last ten years, the real trade weighted value of the dollar from 1984-1994 went down 43%. Over the same period of time, we had domestic inflation of 31%. What do you think happened to the prices of imports in that period of time? Plus 10. Import prices kept inflation down despite the fact that the value of dollar was plunging because the fact of the matter is that the Japanese are not going to raise the price of Toyotas in America even though the Japanese yen appreciates. If they would do so, they would lose the sale of 2 million automobiles overnight. They would have empty factories and employees they would not know what to do with. They are losing money on every car they sell in the United States, but that is better to lose 500 dollars than not build the car and lose 6,000 dollars. That is the choice the Japanese have. So, there is no constituency in the United States to support doing something about the falling dollar because the falling dollar doesn't cause inflation in the US. The American market is just too big and too important for

anyone to give up.

The third thing that leads foreign countries to do something about inflation is that many of their citizens take vacations in foreign countries and many complain that they can't go to the beaches in Spain and Italy. But, here again the United States is a peculiar place. Nobody, with the exception of a few strange people such as myself, leaves the United States. In the U.S., we have a ten-year-passport. If you don't have a passport, you can not travel to Mexico or Canada these days. How many out of the 260 million Americans do you think have a passport? The answer is 9%—one out of eleven. Ten out of every 11 Americans will be born and die without ever leaving the U.S., not even visiting Mexico and Canada. If you want to go to the Arctic, you go to Alaska; if you want go to the tropics, you go to Florida or the Virgin Islands; if you want to go skiing, you go to Colorado; if you want to go to the beach, you go to Cape Cod. And, even though I have not seen it, I would bet a lot of money that if you were reading a Kansas City newspaper, a city of 2-3 million people, found anything about the fallen dollar in the paper, it would be buried somewhere in the back pages of the business section. I can guarantee you that it would not be on the front page or not even the front page of the business section. Now, in that kind of environment, how is Bill Clinton going to do anything painful about the dollar when there is no political constituency for doing so? The answer is that he is not. The problem, of course, is that the falling dollar might be the final blow that breaks up the post-World War II trading system because there is an enormous amount of money in dollar terms and there are people who in the past 3 months have

taken enormous financial losses relative to what they would have if it had been other currencies. At some point, they would have to panic and start selling. When this happens, the interesting thing is that they will have more impact on the rest of the world than they would have in the United States. They will, for example, bring trade in the Pacific rim to a halt. It will be inconvenient for the United States, but a disaster for other places.

So, if you think about this problem, I think it would be important to think about this in the bigger context. The bigger context is that we are, in fact, coming to the end of the post-World War II system. The real problem is that we have to create a new system that corresponds to the new reality. Post-World War II system was the GATT, Bretton Woods trading system. Suppose I had taken you to Bretton Woods, New Hampshire in 1944. World War II was not quite over, but the Allies were confident that they were going to win. It was the first of the two great post-World war II conferences where the agenda was—how do we build the world economy given that we will win the war? What would you have done if I had made you one of the delegates of Bretton Woods? Well, you would have done approximately what they did. You would have looked around the world and figured out how to put Humpty-Dumpty back together again because a combination of the Great Depression and World War II had completely blown up the system. What do we have to do?

Well, the reality is that probably on the day World War II ended, 75% of the world GNP was in the United States. When you talked about the world economy, you were talking about

the U.S. economy because as late as 1960s, 50% of the world's GDP was inside the United States. There was one wealthy, rich dominant place and we built a world to function in this single polar world. America played the locomotive to the world and if there were a financial crisis it was America's job to stop it because there were no such thing as a financial crisis involving the dollar. Up until the Mexican crisis, when some country got into trouble and the U.S. announced they would support that country, the crisis instantly stopped. This time, with the Mexican crisis not only did the crisis not stop, people even said that the extra burden of helping Mexico was a reason to attack the dollar.

The problem is that we are living in a multipolar world. It is a brand new world in terms of electronics, but it is not a brand new world in terms of financial crises. We had financial crises long before anybody invented a world economy or electronics. The only difference is that now financial crises can reverberate around the world. If you look at the GATT-Bretton Woods system, let me argue that it is dead in three senses. First, it is dead in the sense that there is no dominant economic power or combination of powers capable or willing to design a new world economy that has to be built. In the Uruguay Round, we established this new regime called the WTO which is supposed to design the new rules. If there ever was an organization designed not to work, it is the WTO. If I gave you a pass for building an international organization that wouldn't work, you could not have done it better. The WTO has one vote one country meaning that Jamaica has as much influence as the United States which is absurd. One-hundred-thirty

countries, one vote for one country is not going to write the rules to play ping pong much less write the rules for the world economy. And the old rules are over.

People are kidding themselves diplomatically. If you look at the Uruguay Round, which was negotiated in Geneva and signed in Marrakech, there is nothing there. There are two ways to look at this. The basic principle of GATT was MFN. Which is the heart of GATT. If you cut it out, there is no GATT. MFN says that you give all the countries in the world all the privileges and rights you give to your most favored trading partner. However, that is what everyone in the world is not doing. The world is going in to regional trading blocs, and that is not GATT.

As people at the World Bank and IMF argue, the GATT would make the world economy 274 billion dollars richer than it would be otherwise. Now, 274 billion dollars sound like a lot of money until you start your brain to work. How big is the denominator? How big is the world GDP? What do we divide by? The answer is that the world GDP is something over 30,000 billion dollars. So, the GATT agreement is going to raise world output by less than 1% over a 9-year-period of time: A little less than 1/9 of 1% per year. That is not even rounding error. We don't even measure numbers that accurately. Nobody could conceivably know if the GATT is going to have a positive effect; if the estimated effect is that small. It is down at the micron level when economics is concerned.

That brings me to my final topic that relates to my final issue of the falling dollar; the need to build the new economy. It is sometimes called the 'deer and python' problem. A python

swallows the deer whole and falls asleep. There is a big bulge in the python as the python digests the bulge gets smaller. When the bulge goes out the back end, the python wakes up and looks for a new deer. Sometimes, a python will swallow something like an oil barrel that is not digestible. It falls asleep and it gets very sick. The barrel in this case is Japan. Let me give you statistics that illustrate the problem because if you can not do something about Japan, some country or a combination of countries has to have a 130 billion trade deficit to counterbalance their 130-billion-dollar surplus. And, if you can not tell me who it is and who is going to do it, if it is not the United States, then you are telling me that the world economy cannot work. The problem with Japan can be summed up in one set of statistics. In the United States, 17% of our GDP is produced by majority foreign-owned firms. Foreigners own 17% of production facility in the United States. In Germany, majority foreign firms produce 24% of GDP. What fraction of the Japanese GNP do you think is produced by majority foreign-owned firms? The answer is 0.5, essentially zero and half of it is owned by IBM Japan. If it were not for IBM Japan, there would be essentially no successful Japanese company foreign-owned in Japan.

How does the world economy work if the second biggest economy in the world is playing a game at home that nobody else can play? The answer is that the world economy doesn't work. Somebody asked me yesterday at a press conference; "At what value of the yen would the Japanese have to change their economy? Is it 100, 80?" My answer was zero. When the yen has infinite value, the Japanese will have to do something. Until

that time, there is no evidence that they are going to do anything. So, what you have is a very unstable situation.

I understand we have many ambassadors with us this morning. Economically, it would not be hard to correct these problems and design a program. For example, if you look at the instability on the Pacific rim, the right answer is for Japan to be gearing up to buy products from Korea that the United States is now buying. Even people in the Japanese economic ministries know that is true. However, how do you do that in Japan? We know the kind of things we in the U.S. ought to do is more exporting and less importing, which is part of the answer to the problem. But, there is not anybody in the world who would really like it, if Bill Clinton solved this problem at home.

Let me tell you what I think Bill Clinton would have to do to solve this problem. I have suggested my idea publicly because American negotiation with Japan is a model of how not to do it. We go to Japan and we attempt to rebuild the Japanese economy and open some sector. First, we don't know enough and we are not smart enough. Second, we don't vote in Japan and we don't have the political power. The only thing America can do is run America, not Japan. What I have suggested we do is that we simply announce our rules. We have made a study of world trade and we think that in the balanced multilateral world, and Japan being an open market, the United States should run a 10-billion-dollar deficit with Japan because we are a raw material exporter and we tend to have a trade surplus with Europe. So, if everything was being balanced, you would expect the United States to have a modest deficit with

Japan. So, what we are going to do is that we are going to sell off import-tickets. You cannot import or export from Japan to the United States without buying a ticket. Every year, we will auction off 10-billion-dollar more than Japan bought from us the year before. So, the tennis ball is in Japan's court. But, that tells Japan how much they will have to buy because if Japan buys hundred billion dollars from us you can sell a hundred and ten. We are not limiting your exports. Rather we are telling you something about reciprocity. That is a violation of GATT, but sort of doing something like that, I think there is no such thing as negotiating with the Japanese. It just makes everybody mad.

So, where are we? This is where the basic term in biology comes in. One of the things I am borrowing from biology is the period of 'punctuated equilibrium' because most of the time evolution is slow. Dominance of the fittest species becomes stronger. But, every once in a while in biology something radical happens and biologists call this a period of 'punctuated equilibrium.' The dinosaurs die out and something completely different takes over. The best example, of course, was the dinosaurs that ruled the world for 2 million years. Then, as far as we know, every single dinosaur dies less than in a million year and they make room for mammals. A new game gets played. The periods of punctuated equilibrium are both optimism and pessimism; pessimism if you are a dinosaur and optimism if you are a mammal. So, you have to decide who you are. So, during this period of transition, it is not at all clear what the rules are and how the game is going to be played. I think what we see with the falling dollar is that the period of

punctuated equilibrium. The game is changing. In theory, the right thing, diplomatically, is for the world to hold another Bretton Woods conference and set a new set of rules in this multipolar world economy. However, this is exactly what the world cannot do, and the world economy is not going to stop for the rule writers. Consequently, for a period of time, we are going to run an economy where the rules are not at all clear. Then the question is how you are going to play a game whereby the rules of the game are not clear.

Thank you very much.

Discussions

Q **Amb. Thomas Harris** (British Ambassador to Korea)

I am one of the ambassadors professor Thurow referred to. I was provoked by your references to the WTO because it seems to me that there was a misleading description on two grounds.

One is that you suggested that the WTO works on a one country-one vote system. That is not, in great respects, how the GATT has worked since it was first created. As you well know, all GATT negotiating grounds have been completed in a smoke-filled room and the last time essentially it was completed by three players — EU, U.S. and Japan. So, I would suggest with great respect that it is misleading to suggest that all countries have the same influence.

The second respect was in suggesting that France has greater trade access to Germany than the U.S. is a breach of the MFN principle. It is not so. The Bretton Woods agreement and the GATT agreement, from the very outset, was designed to encompass things called “custom union.” The other major party of the Bretton Woods was the United Kingdom. The UK representative ensured that the international institutions envisaged, encompassed and permitted customs unions which were based on a regional basis. Again, with great respect, I think it is misleading to suggest that the creation of regional customs unions or free trade agreements are necessarily damaging to the overarching success of the multilateral trading system.

A Professor Thurow

Well, they are clearly damaging to world trade whether they are clearly legal or illegal. Now, I am very aware that there are those exemptions in the rules. But, the exemptions clearly say that you only have the right to do this if the ultimate plan is to unify and become a country. So, if the British interpretation of the common market is correct, then the Common Market is in technical violation of the rule. If you are really going to become a federation, then the common market is really not a technical violation of the rule. The fact of the matter is that when the big players — which the Europeans are — start not to obey the spirit, even when you legally have a loophole, then the system collapses.

If you look at the North American Free Trade Agreement, nobody is even talking about a common market or any integration other than being a free trade area. Once you start doing that it means that countries don't play the game on a level playing field, and you break up the system regardless of legalities. This is a perfect example of a diplomat. A diplomat saying something that is legally correct, but economically irrelevant. There is no question that you are legally correct and there is no question that I am economically right.

Q Amb. Hans Grönwall (Swedish Ambassador to Korea)

It would be interesting to hear about the former Soviet Union and what the prospects are according to your view.

A Professor Thurow

I think that is an especially interesting question in this part of the world where you have communist China next door that is doing so well while you have Russia and Eastern Europe that are doing badly. There, however, is middle Europe, such as the Czech Republic that is starting to turn around and look very good.

Let's compare China and Russia. I would argue that China has three great advantages over Russia that explains their economic success and Russian economic failure. First, the Chinese have effective government that can make and enforce decisions. For all practical purposes, government has collapsed in Russia. Mr. Yeltsin sounds like a government, talks like a government, but he is not a government in the sense that anybody obeys his proclamations or that there is any consistent policy. You can't move from communism to capitalism if you don't have a government that can make, take and enforce decisions. For example, take the issue of privatizing housing. Why would anybody in a communist country ever buy their apartments? On day number one you have the same lousy apartment that costs 30-40% of your income. In the long-run, it may be a good decision, but on the short-run, it is most foolish decision you can make. On the other hand, if you want capitalism you have to have private housing. The Chinese authorities have basically said you will buy your house. And, they are enforcing the rule. I was with a group of Chinese diplomats not too long ago and they were all being forced to buy their apartments. They were grumbling like nothing, but

they were told, "buy your apartment, or lose your job." Now, they were buying it for one-third of construction cost which made it a great buy in capitalistic terms, but it was going to lower their short-run standard of living. They are all sorts of examples that show that the Chinese government has been able to take and force the very decisions that have to be done if you want to make that transition from communism to capitalism.

The second great advantage is something that in turn reflects negatively on Western Europe. It is the fact that overseas Chinese have played a very important role in the success of China which is something western Europe has not been able to do in eastern Europe. If you run a communist company back in the old days, it was a mistake to think that person as a businessman. The person was a colonel in an economic army. There was a central plan in Beijing or Moscow and you had your marching orders. The communist party sent you necessary manpower and money. They told you what to build and you never did any negotiating. You were simply an army colonel. Now, I don't know about Korea or about Sweden. However, I know it is impossible in the United States to make army colonels into businessmen. It is simply a different mentality. What you have in China was simply replace the army colonel with overseas Chinese. If you went into the first round of those factories in Guandong, you would find that all of the factory managers were from overseas. These were people who knew the game and who, in turn, taught local people how the play the game. You see the Koreans doing the same thing in northern China. Having a group of outsiders who are capable and acceptable for a quasi-inside role as factory managers is terribly

critical. China has it through overseas Chinese, but Eastern Europe and Russia did not get it from western Europe.

The third thing is the accident of history. It really is an accident involving the minds of two people who built the two economies. I am going to ask a rhetorical question. Where did Stalin learn his economics? The answer is Stalin learned his economics from a Ford Motor company in the Delrouse Plant in the 1920s. In the 1920s, when Stalin took over the economy and was designing the Russian economy, the place where everybody took you to show the wonders of the capitalist world was the Ford Delrouse Plant in Detroit, Michigan. Iron and coal went in one end and a hundred people worked in one facility and cars came out the other end. Stalin thought that was the secret of capitalism: Integration and gigantic factories. So, 77% of all products and 280 million people were at one factory. This is impossible to privatize. Even if you did privatize it, what would happen if you gave it to a capitalist? He would shut it down because we learned that those big factories don't work.

On the contrary, where did Chairman Mao learn his economics? The answer is that he learned it from the Japanese army. Do you remember his famous statement of the middle of World War II when it looked like the Japanese were going to win? He said, "Let's think about this for a moment. Suppose the Japanese army were to put one Japanese soldier in every Chinese village. That would still mean that half the villages in China had no Japanese soldiers. They can't win." He believed in complete de-centralization and small-scale industry for military reasons. This is equally crazy because this is enormous diseconomies of scale because this means every town with a

bicycle factory and every town with a backyard steel mill.

The Chinese have few of these facilities, mostly given by the Russians, but they are very small compared to the economy relative to their size in Russia. Therefore, it is an economy that is very easy to privatize because it is an economy of small-scale industries. Above and beyond that, the Chinese had the right strategy. It is a right strategy because the Chinese started with agriculture. Moving to a market economy is much easier when the food markets are full than when the food stores are empty. For the first five years, all they did was hand over every hectare in China to a peasant family. The Russians have not even started to deal with land reform. And, in China, in the next 10 years, agriculture tripled its production with no fertilizer, no transportation, but just better incentives. So, if you look at the difference between China and Russia in their move from communism to a capitalistic market, I think it is perfectly understandable.

The question historians will ask is why the Western Europeans did not play the role to Eastern Europe and the old Soviet Union that the overseas Chinese and Korean played in this part of the world. Now, I think there is an answer to this. The people who had to play this role were the Germans. But, they were so involved integrating eastern and western Germany that they had no time, money and talent left over for the rest of Eastern Europe. I think the interesting thing in Europe is going to be the next five years because east Germany has clearly hit bottom and is going up and growing somewhere between 10-13%. The Germans now have time, talent, and money to spend on Eastern Europe and the old Soviet Union.

Q Dr. Bonho Koo (Professor, Hanyang University)

It seems to me that you underestimate the influence of the American government and that you tend to overemphasize the multipolar system. I have no evidence, but it is my feeling that Americans, especially the Federal Reserve Board, are enjoying the strong yen and the falling dollar. Americans, I think, are pained a little by this, but they are enjoying the Japanese's pain in a sort of sadistic way. I wonder when the Federal Reserve Board and the Department of Treasury will overcome such sadism.

A Professor Thurow

As you know, the U.S. is a big country and I am sure you can find people in the U.S. who can feel anything. There are undoubtedly some who take great pleasure in seeing the dollar fall and the yen rise no more in the automobile industry. I suspect there are people in Washington who understand that if the dollar falls too much it runs against the dollar as an international reserve currency which changes, in subtle ways, America's position in the world. I think the real problem in Washington is different. Mr. Abovtov at the Soviet Institute of the Study of the United States used to run around the world when the USSR was collapsing saying that the Russians are going to do the worst thing that Russians can do to Americans. The Russians are going to deprive America of an enemy and without an enemy you Americans are not going to know what to do. I think he was precisely right because if you look at the

American foreign policy—the political and military area—I do not know whether it is good or bad because I don't know what the strategy is. You can only say actions are good or bad if you know what the strategy is. You can agree or disagree with the strategy. I think the problem is that the Clinton administration doesn't have a strategy and I suspect the administration itself doesn't know whether the falling dollar is good or bad. I mean this seriously because I think Mr. Clinton made a serious mistake with the Secretary of State. Mr. Christopher is a perfect good guy, but he is a perfectly good number two person. He might have been a perfect Secretary of State in the 1970s or 1980s. The problem is that American foreign policy after World War II was containment of the Russians and the American management of the world trade system. In a multipolar world, Americans cannot be the manager of the trading system. What Mr. Clinton needed was some Democratic equivalent of Mr. Kissinger who is a strategic thinker. Mr. Christopher has never had a strategic thought in his life. Tell him what the strategy is, then he is a good operator. The problem is if you are a smooth operator you will never hire a strategic thinker as your number two man because strategic thinkers make things messy. If you look at the United States State Department, there is not one strategic thinker in the top echelon, either. Who has a strategic thought. The Clinton administration has not told me what their strategy is, not because they want to keep it hidden from me, but because they don't have one.

Q Dr. Bohn Young Koo (Vice Minister, Ministry of
Science and Technology)

In this period of uncertainty, is there any advice to a country like Korea which is opening up its markets and trying to play a small role in the international financial world?

A Professor Thurow

Well, I think in the world of uncertainty, you need more contingency planning. You need to try out these scenario planning where you try and say, "Let's just take wild scenarios and play them out." I think this is the only thing you can do in this kind of world. Try and play out all the scenario-contingencies you can think of, so when they happen you will not have to think because you already know what to do. For example, what would happen if somebody started to sell a lot of stock market derivatives on Korea and collapse the Korean market in Singapore? What is the answer? I don't know the answer, and I suspect that the Korean government doesn't know the answer. But, I know that the Korean government ought to know the answer. I don't think this would happen, but it is these kinds of things we should be thinking about. I certainly hope that those in Washington are doing this and thinking what we in the U.S. should do, if this really is the end of the dollar era and at some point you see the massive movement out of the dollars as the reserve currency.

Suppose you are Columbus and you plan to sail to Japan. You are sitting in Spain and you have a map. The problem is

that half of the map says terra incognita (unknown territory). So, how do you build a ship to sail into a unknown world to reach a familiar place, but through a different route? The historical problem is that Columbus was smart to know that the world was round, but was stupid in the sense that he got his math wrong. He thought the world was only one quarter of its real size. With the amount of water Columbus loaded onto his ship, they could not have possibly made it to Japan. If the Americas had not been there, they would have all died of thirst. Now, Columbus goes down in history as the world's greatest explorer because something he didn't expect was one third of the way to Japan which happened to be full of gold—the Americas. Probably the moral of the story is that you need to be smart, but it is also nice to be lucky.

Q Dr. Young Sun Lee (Professor, Yonsei University)

Very recently, I read Paul Krugman's book, 『The Peddling Prosperity』. In it, he was very critical of your concept of competition among nations. I remember he specifically states that there is no such things as competition between nations. What is your reaction to his statement?

A Professor Thurow

Well, like a lot of things, Paul Krugman is someone with a very high IQ and not much wisdom. His statement is not true because we live in countries. If we lived in a one world economy, there would be no such thing as competition between

Massachusetts and California because we would all pay the same tax and there would be no impediment to this relationship. As long as you and I pay different taxes and use different currencies and as long as you and I get different education and benefits and have our standard of living go down if our currency goes down, then the answer is that you and I have to worry about our nation's competitiveness because they can affect me personally. The United States' current account deficit has the impact to lower Lester Thurow's wages. I didn't cause the deficit which has an impact on me that doesn't have an impact on you.

The same thing is true in Korea. We don't actually compete as nations, but we compete as companies and individuals. However, as long as we have national governments, there is an inevitable national component that has an impact on me. Why would I as an economist in the United States get paid three times as much as an economist in Oxford? Am I three times as good? Little better, but, not three times as good. The answer is he lives in England and I live in the U.S. As long as those borders have an impact on my standard of living, those impacts matter. In that sense, Paul is wrong.

Q Dr. Il SaKong (Chairman & CEO, IGE)

We are looking forward to the 21st century and at the same time, people would like to have some optimistic views towards our future. However, according to your presentation today, what one can expect is uncertainty about the future. My question is why can't a scholar like you come up with a policy

recommendation by which we can have better predictability and more certainty regarding the future? In other words, if you are so certain about the uncertain variables, why can't you propose some kind of remedy?

A Professor Thurow

Let me answer that question in two ways. One is that we are going through a period of punctuated equilibrium and confusion, but we are going to come out the other side. However, we will not experience uncertainty for the whole century. Let me give you an example of human punctuated equilibrium in the past. Napoleon's army existed almost two thousands years after Caesar's army. However, they could not move one bit faster. They both used horses and carts. For two thousand years, transportation had not changed. After Napoleon, steam trains were able to go at 100 miles an hour and the Industrial Revolution went into progress. If you look at the first half of the 19th century, it was a period of punctuated equilibrium and confusion. By the time you enter the mid-century, the period of punctuated equilibrium led to the most wide-spread rise of human standard of living that ever happened. But, if you look at the early 1800s, there was great discontent. Armies of people were roaming around Europe, although it came out well in the end. So, there are great opportunities. Somebody out there is going to be a mammal and regard today as the best period in human history because it allowed them to become the dominant human species, economically speaking.

The problem in organizing a world trading system is that

economically it is relatively easy, but politically it is fiendishly difficult. You don't have to coordinate the world. Two countries today are as big relative to the world's GNP as the US used to be in the 1960s. These two countries are Japan and the U.S. You just need to coordinate the two of them. And, if you can coordinate Germany, you are in business. So, you don't have to have WTO negotiations with 120 nations. But, I guess the negative thing is that these countries up until now, have not done what is necessary. I don't blame these three countries, and I don't blame one more than the other. This problem partly comes to the nation-state. Each of the three leaders is elected to represent his country. To manage the world, each of the three from time to time would have to do things beneficial to the world, but damaging to their own nation. None of the three is willing to do it when it comes to those key issues. Therefore, what we have is a mismatch. We have national governments in a global economy. If you don't have one dominant power, a subset has to manage the global economy and they never have absolutely identical interests. If there is something out there the three could agree on, that would be better for all three than doing nothing. The question is how you get there politically and since we have many political experts in the audience I will let them negotiate to that nirvana.

Q **Amb. Jorge Lapsenson** (Argentine Ambassador to Korea)

During your presentation, you mentioned two or three times about the Mexican economy. Being the only Latin American representative here, I don't want the audience to think that the

whole of Latin America is sinking in the same ship with Mexico. I would specifically like to know your thoughts on the future of Latin America in the context of the common market among Argentina, Brazil, Uruguay and Paraguay.

A Professor Thurow

Historically, the problem with Latin America is that the countries were mirages. They do well for even a relatively lengthy time and somehow it falls apart. For instance, from 1968-1978, the fastest growing country on the face of the globe was Brazil. It was faster than Japan, faster than Korea and then it fell apart. You know better than I that Argentina and Chile were some of the richest countries and were First World countries at one point in time back when it was more of a natural resource-based economy. So, I think the real issue is about putting some stability together. If you look at Germany, Japan and the United States, the interesting thing is that they have all had a hundred years where their decade growth rates have never been less than 3%. You win by being an economic marathon runner, not by being a sprinter. What we have is many countries that are good at economic sprints, but like Brazil, they fall and don't run for the next 90 years. It took Japan 130 years to catch up with the U.S. per capita GNP. No matter how well China is managed, it will take China 130 years. It takes a long time and incredible consistency. Look at your country. It has had a phenomenal growth for three to four decades and yet it has a GNP a quarter of Japan's. It just takes a very long time. In principle, there is no reason why Latin

America cannot do the same. It is lightly populated, has many natural resources. In that sense, it is better off than Asia and the question is can you put in the stability and long-run mentality. The two great things that Asia has had that Latin America has not had are the much higher savings rate and much better education system than Latin America. This can be explained in many ways, but the fact of the matter is if you go to China, you find a population much better educated than Brazil on average.

