The U.S.-Japan Economic Relationship and Implications for Korea*

Marcus Noland

It feels like coming home to be here in Seoul at the Institute for Global Economics. As Dr. SaKong mentioned, our book is called "No More Bashing". It's about building a new Japan-United States economic relationship.

Today there is considerable uncertainty about the state of the world economy. Before the horrific events of Sept. 11 the world economy was looking weak. The United States, which had been the engine of growth for a decade, was entering a recession. Japan was in its fourth recession in a decade. Growth in Europe was weak.

Since Sept. 11 there has been a reduction in forecast growth rates and an increase in the uncertainty of those forecasts. The IMF is forecasting world growth of 2.4% for both this year and next. But it admits that making these forecasts is, "like trying to read tea leaves." The IMF is not alone. There has been a general reduction in forecast growth rates. Typically when one looks at these forecasts, their distribution has a single peak (i.e. it's unimodal), and in statistical terms it's tighter than a normal distribution. In other words, there's normally a lot of consensus about these forecasts, if for no other reason that the forecasters use similar models and methodologies. We can see that on Sept. 10, the expectation from most forecasters was for the U.S. economy to grow at a little bit under 3%. There were some outliers, but there was basically strong consensus with sharply peaked distribution.

After Sept. 11 for the United States there are two noticeable changes. One, there's a shift to the left, that is a reduction in the forecast growth rate, by roughly one percentage point. The other striking difference is the big increase in the dispersion of these forecasts. That's an indication of the increased uncertainty post-Sept. 11 with a highly dispersed array of forecasts. That conveys the notion that we have this reduction in expected growth on top of a lot of uncertainty.

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* A presentation at the Distinguished Lecture Forum on November 29, 2001

If one uses the standard econometric models that are used to build these forecasts, they predict a strong rebound in the United States economy in the second half of 2002. Again, if one takes the most typical, the median, forecast, it has U.S. growth in the 3rd quarter getting up to between 4% and 5%. These models predict a very sharp rebound in the United States. But I think there is considerably more uncertainty about that prediction actually being realized than there would be under other circumstances.

The key issue is whether the events of 9-11 are essentially a single, one-off event. As some people have pointed out, the direct impact of the terrorist attack actually would be smaller, for example, than the impact of the Kobe Earthquake. While the Jan. 17, 1995, earthquake in Kobe was a terrible thing and certainly well remembered by people in Kobe, I think most people would ascribe little of today's Japanese economic performance to the aftereffect of that natural disaster.

The other alternative, of course, is that the events of 9-11 unfold in a way that is more like a tax on productivity. One of my colleagues at the Institute of International Economics, Martin Baily, who is an expert on productivity issues, has started to do some preliminary analysis of this. His estimate is that if that is the way events unfold, that tax could be something on the order of, say, 0.2% to 0.3% in terms of reduced productivity. If total factor productivity growth in the United States is going on something like the order of 2.5% to 3%, as it was in the second half of the 1990s, 0.2% or 0.3% is not huge. But its not trivial either if you accumulate that over the course of, say, a decade. But his relatively optimistic argument is that even in that kind of worse case scenario, the impact would not be overwhelming.

Of course the estimates, including the ones I mentioned that showed a very strong snap-back in the second half of 2002, assume that there are no other major incidences. I would like to emphasize that incidences don't necessarily have to be terrorist incidences. One could have another major terrorist attack. But then one could also have another kind of major economic shock that might or might not be directly related to the events of Sept. 11. I know that in the United States a lot of us were nervous about the situation with Enron, the energy company. Many of you probably don't realize that Enron's primary business is essentially as a market maker or intermediary, not actually building power plants, though obviously it still does that. The fear was if Enron failed there would be disintermediation and a collapse of the markets for many products such as heating oil, aviation fuel and so on. It appears that that's this will be avoided, for which we're all quite thankful. I raise this simply to point out that if there were a big shock such as the collapse of Long-Term Capital Management in these circumstances, that it could change these relatively optimistic forecasts for the United States economy.

Setting aside the events of Sept. 11 in the United States, we were already going into recession when this occurred. There was already a debate, covered in chapter two of our book, about what the likely medium run impact of that recession would be. Some people, such as my co-author C. Fred Bergsten, are relatively optimistic and argue that American recessions are typically short-lived and going into this recession the Untied States had a lot of policy tools at its disposal: it was running big budget surpluses, the central bank had a lot of room to cut interest rates, and so on. On the other hand, the sources of this recession in the United States were basically a collapse in investment. In that respect this recession looks more like recessions the United States experienced in the late 1800s, particularly in the 1890s, or that Japan experienced when its bubble collapsed at the very beginning of the 1990s. Those recessions tend to be longer in duration and more difficult to overcome.

At the same time there are positive forces at work. In fiscal policy, there's a lot of room to spend and the U.S. Congress has no hesitation about that. The central bank can cut interest rates and they've been doing that. The expectation, for example, is that interest rate cuts could lead to $100 billion of mortgage refinancing in the Untied States and spur consumer expenditures. Every morning when I wake up my wife tells me the 30-year mortgage rate and bugs me about refinancing. Oil prices have been falling. My colleague Martin Baily estimates that this could be something in the order of a $50 billion positive supply shock to the U.S. economy. The conclusion— not to be the typical two-handed economist—is that the challenges facing the U.S. economy today are great, but the United States has considerable resources and capabilities that it can draw on.

The situation is considerably gloomier for Japan, as we discuss in chapter three. In broad terms Japan faces three great challenges. First, it has a very weak banking system. Second, it is the first large industrial economy since the Great Depression to experience deflation. Third, it is in need of structural change.

Estimates of non-performing loans in the Japanese banking system vary widely. (I almost feel as though I can skip through this very quickly in front of a Korean audience because you have a lot of experience with this.) In the past decade Japanese banks have provisioned for ¥60 trillion of non-performing loans, a figure greater than the size of the South Korean, the Canadian or the combined Dutch and Belgian economies, just to give you a notion of scale.

The FSA, the Financial Supervisory Agency in Japan, estimates that the bad loans net of collectable collateral are ¥34 trillion. Non-official estimates typically are on the order of ¥40 to ¥170. There is one estimate from Goldman Sachs that we discuss in the book that puts it at ¥237 trillion, or about 50% of GDP. We're talking about a bad loan problem in Japan of roughly similar magnitude as what was faced here in Korea at the depth of the Korean crisis, but in an economy that is much, much larger, as you all know, than the South Korean economy.

Policy response over the past decade has been problematic. In 1999 the government re-capitalized the major banks. We go through this in some detail in chapter three of the book, describing the whirling series of financial problems in different parts of the banking sector, which is quite fragmented in Japan. It started out with local credit associations in the early 1990s, moved on to housing finance companies in the middle of the decade, and eventually hit major city banks at the end of the decade.

In 1999 the government re-capitalized the banks, but the problem is they basically put in money but didn't replace the management and they didn't do anything about management practices or incentives. In this situation, where one still has the same management, the same practices, the same deflation and the same weak growth, you still get non-performing loans. The problem now is loss of face. The head of the FSA, Mr. Hakuo Yanagisawa, is basically unwilling to admit that they didn't fix the problem in 1999. My co-author, Takatoshi Ito, is absolutely scathing with respect to the FSA at this point, regarding them as just being concerned with their own bureaucratic interests rather than the national interest of having a sound financial system.

As discussed in the book, on several occasions the government has "shot thee messenger": first ING Barings, then Goldman Sachs, and, most recently, the IMF. Rather than taking their criticisms and their analyses seriously, when outsiders points out problems or inconsistencies they are attacked. Taken together, confusion about the numbers, apparent unwillingness to deal with problems for internal political reasons, and a tendency to lash out at outside observers undermines market confidence and actually exacerbates the problem.

We estimate it would take another decade for Japan to climb out of this, if it could, through this "just provisioning" strategy. The problem is that it is unclear whether it can because of the two other difficulties: the problem of deflation and the challenge of weak demand. In conclusion, I would simply say that Japanese banks exhibit the most extreme divergence when the rating agencies rate the intrinsic financial strength of the banks and the actual ratings due to the implicit guarantee provided by the government.

The second problem is deflation. As I mentioned, Japan is the first major country since the Great Depression to experience deflation, though admittedly Japan's is on a much smaller scale than the kind of deflation experiences in the United States and Europe in the 1930s. BoJ policies have been incompetent and now threaten its attainment of legal and political independence. What happened is that the Bank of Japan, which had been a lap dog to the Ministry of Finance, was given independence. The first thing that they did was go out and engage in monetary policy mistakes. This puts you in a bind. If you rectify the mistakes, it appears as if you're bowing to political pressure and you lose your independence. Alternatively, you can demonstrate your independence but at the cost of continuing down the wrong path. In essence, the Bank of Japan has done the latter. We argue that the answer is inflation targeting, that the Bank of Japan should identify a modest number—two or three percent annual inflation—and essentially print yen until they get it.

There have been absolutely ludicrous public statements on this topic. The governor of the Bank of Japan, the minister of finance, and eventually the prime minister himself have basically said that if you try to go from deflation of four or five percent a year to inflation of two or three percent a year, that would send the economy into hyperinflation. Some of these statements that we quote are truly astounding. We've ended up with Mr. Heizo Takenaka, the minister of economics, and Mr. Masajuro Shiokawa, the minister of finance, actually getting into public disputes over this topic. The Bank of Japan is slowly being brought toward a more sensible policy but has taken far, far longer than it ought to have taken.

Finally, there is the issue of fiscal policy. Japanese fiscal policy is fundamentally opaque and the Ministry of Finance bears responsibility for this. I will not, in the interest of time, go into detail. I want simply to say that it was a very interesting experience for me to find, even with a man as sophisticated and knowledgeable as Takatoshi Ito, my co-author, that he didn't seem to understand that in most countries you don't have a small cottage industry of analysts trying to figure out what the actual fiscal position of the government is. *Mamizu*, or clear water, is not a term of art used in countries other than Japan. Again, part of the problem is that there's simply such confusion over the real state of play.

The numbers are bad. In the book, simply to avoid getting into fights with people about trying to twist the numbers one way or another, we tried to rely on international public organization sources as much as possible. The IMF estimates that the gross debt to GDP ratio will reach 150% in a few years, which would be the worst of the G7. Sovereign debt has been down-graded to the Spain-Italy level, and is getting worse. The fiscal problem is in a large part due to fallen tax revenues, which, again, reflect the weakness of overall demand and nominal deflation. The fall in tax revenues is actually quantitatively more important than the crazy public works projects with which we're all familiar. Some of these projects are discussed with a certain degree of irreverence in chapter three of the book.

Now Japan faces a very nasty squeeze. On the one hand, the Japanese have to get their deficit down, especially given the demographic trends in Japan which will mean a huge increase in social welfare expenditures over the next couple of decades. Fiscal consolidation will encourage economic contraction in the short run. Koizumi arguably made things worse by issuing his "debt pledge". For example Gillian Tett of the Financial Times has written a series of articles that I thought were really quite acute. One of these recently discussed "governance through sound bites." Prime Minister Koizumi, like the Bank of Japan, has put himself in the position of either doing the wrong thing, which is holding himself to the pledge and maintaining his political credibility, or reversing himself and adopting a more sensible policy and loosing his political credibility. What the government has done is try to finesse the issue with a sort of two-stage supplementary budget. They're going to have one supplementary budget, which they just passed, and now they're talking about another. But they can't really talk about another because it's not really going to happen yet, but everybody knows that it is going to happen. It's a confusing thing.

With respect to the events of 9-11, these have made things even more difficult in Japan. While the direct impact is not that big on the Japanese economy, it has opened up divisive issues in Japan that we discuss at some length in chapter six of the book. Japan, as everyone here knows, still has unresolved issues, both internally and externally, having to do with its own history and its own place in the world. One of the things we go into in the book is the really terrible experience Japan had with the Gulf War. They were asked to do a series of things and were unable to do so. In the end they engaged in a type of checkbook diplomacy, giving $13 billion to the allied coalition against Saddam Hussein. Never has $13 billion bought so little good will.

These events have the possibility of playing out in a similar way. Having gone through the political trauma of the Gulf War, Prime Minister Koizumi moved to try to expand the scope of activities Japanese self-defense forces can play. The problem is, that issue is politically divisive, and the Diet gets tied up in security debates, a distraction from the more central economic policy issues that they confront.

The point is simply that we don't know how this so-called war on terrorism is going to play out. It could be that the Taliban and al Qaeda and so on collapse within the next few days and soon things are more or less back to normal, and it doesn't have any lasting impact on Japan.

However if this turns out to be much more protracted, involving other states and so on, this could require a continual investment of political capital by senior Japanese leaders to manage these problems both internally and externally. That will certainly distract from dealing with these very difficult economic issues that they face as well.

Is there any sunshine in this forecast? The answer is absolutely yes. The book is called "No More Bashing" and I have emphasized the macroeconomic matters which are basically in chapters two and three in the book because this is a Korean audience and I'm not sure how interested you are in some of the bilateral issues between the United States and Japan. There is one overall theme that is very, very important. It is really taken up mainly in chapters five, six and seven of the book. It is as follows.

We argue that over the last 15 years or so, by a whole series of measures, Japan has become less different. It looks more and more like the other major economies of the OECD. In the earlier book I wrote on U.S.-Japan relations with Fred Bergsten we had table and charts showing Japan relative to the United States and European countries. Nowadays we're putting charts in the book that show Japan relative to the United States, European countries and South Korea. What's interesting is the amount of dissimilarity between Japan and the other countries has really declined. It's not been eliminated. Probably never will be. But it has been reduced.

We argue that that undercuts the intellectual case for treating Japan differently or treating Japan uniquely. What we would all like to see is Japan undertake a whole bunch of reforms out of its self-interest. But as we know, for historical and possibly cultural reasons, Japan seems to have trouble doing that and to a disturbing extent tends to rely on foreign pressure, typically the United States government, to encourage internal reform. We argue that this pattern of what the Japanese call *gaiatsu*, or foreign pressure, is really not healthy either for Japan or for the United States.

It would be preferable to the extent that Japan needs foreign encouragement or foreign pressure to undertake reform, that the locus of that pressure be moved away from the bilateral relationship with the United States and into a multilateral forum in which Japan voluntarily participates. Obviously one of the central organizations for that would be the WTO, but there are other examples such as the OECD, the IMF, and so on.

In this respect the agreement in Doha to launch another WTO round is a great success. Most immediately, hosting this meeting in Qatar, an Arab country, was a good thing in terms of general relations between the Arab and Western worlds. Secondly, we argue that a reinvigorated WTO—and we lay out some specifics on the agenda that we would like to see the organization pursue in this next round—would be very good for everyone, Japan in particular. As I was mentioning to Dr. SaKong during the breakfast, when we were in Japan last month to launch this book—we gave a number of presentations like this one—the thing that we were really struck by was the virtual obsession of Japan with China. To be a little crude or pejorative about it, today the Japanese talk about the Chinese the way the Americans talked about the Japanese back in the 1970s. And some of you might say we talked about Koreans in the 1980s. There're stealing our manufacturing industry. They don't play fair. They're stealing our intellectual property. They have to revalue their exchange rate. That was the mantra that we got in Tokyo.

Earlier this year, China and Japan got into a series of fairly serious trade disputes. When the Japanese imposed protection on *negi*, that is, leeks, *tatami*, rushes, used to make tatami mats, shitaki mushrooms, the Chinese retaliated completely disproportionately by banning Japanese mobile telephones, air-conditioners and cars.

Before this happened there were delegations of Japanese coming to Washington to the IIE and we would talk to them about this. And after this happened, we talked to them as well. We said you shouldn't have been surprised. After all last year Korea imposed protectionist barriers on Chinese garlic. What did the Chinese do? Ban Korean mobile telephones and air conditioners.

Getting China into the WTO, or having gotten China into the WTO last week, is a good thing for both Japan and China, and by extension Korea. It will do two things. First of all getting China into the WTO should help the "good guys" in the Japanese government and restrain the little, unimportant agricultural lobbyists who have a disproportionate impact on the Japanese policy. Now you will have international policy obligations vis-à-vis China. You simply can't impose ban on *negi*, or a ban on *shitaki*. At the same time the Chinese have shown a proclivity in dealing with Korea and dealing with Japan for disproportionate retaliation; retaliation on huge amounts of trade over small agricultural products. Once in the WTO, the WTO will act as a means to try to resolve these disputes. And in the end, if Japan wants to put a ban on, say, *tatami*, and they refuse to open up the market to China, and the WTO authorizes retaliation, it will be proportionate retaliation. We argue that this would be a very good thing for all countries concerned.

In conclusion, the world is in a difficult and highly uncertain period. I think, really, the best thing we can say is that under such circumstances we should really try to act cooperatively. That's one of the reasons why I think launching this WTO round in Doha was such a good sign. As the American patriot Benjamin Franklin observed at the time of the signing of the American Declaration of Independence, "We must all hang together, or assuredly we will hang separately." Thank you.

Questions & Answers

Q: This goes a little bit away from the present subject, but you did talk about "No More Bashing". It seems that Americans were very much involved in so-called "bashing" activities. I don't know exactly what those were, except that I saw some Sony TVs smashed on the Capitol lawn by some representatives of Congress. The real question is this. Economists never dispute the merits of free trade. Whenever we have free trade, it's one subject upon which all economists can agree. Now the question is, when it is practices by only one side, how optimal is it? For example, if the United States has open borders and allows all the Japanese goods to come into the United States, and Japan on the other hand does not return the courtesy. Now the question is, at that point, is it in the benefit of the U.S. economy to retaliate? Emotionally and politically you will do it, but economically are you better off to keep on opening your border, because after all you are pursuing your side of the optimally advantageous economic position? What is the economic theory, if any, about when free trade is only practiced by one side? What is the optimal path?

A: That has been *the* question for the United States in the post-war period and became very acute in the 1990s after the end of the Cold War. Analytically, the theoretical economic cases are ambiguous. There are cases where it is in your interest to pursue free trade even if the other country doesn't, where that is how you get the best outcome. There are also cases where that is not the case. Typically for small countries, pursuing free trade is the best. For large countries, there is greater scope for strategic action. That's in the textbook.

The problem is the application of this in the real world. What my own study of these issues indicates, is that the application of trade policy in the real world is typically not determined by any kind of economic logic. It's politics. It's rent seeking. It's hard to imagine any economic model that will tell you that Japanese economic welfare is increased by protecting leeks. So I have come to the conclusion, and my work in the White House convinced me of this, is that at least in the American context (things may be different here in Korea), we are better by erring on the side of non-intervention. We are better off erring on the side of adhering to rules about openness. Although in theory it may be the case that we may make interventions that might increase our national welfare, either unilaterally or in response to what some other country has done, the fact of the matter is that our political system is unlikely to deliver that outcome. The political system, once you open it up to this kind of intervention, is much more likely to deliver ridiculous outcomes. For example, in the new multilateral trade rounds, one of the things we're going to be discussing is cutting industrial tariffs. For the most part our tariff levels are very low, and it's not much of an issue, certainly in the case of Japan.

Not entirely, though. One of the issues that the Japanese are concerned about is that the U.S. tariff on a kind of small truck is actually fairly high. And the reason it's fairly high has nothing to do with small trucks, per se. The reason it's very high because of a tariff war we got into with the EU in 1963 over chickens. In 1963 we got in a fight with the then EEC over chickens, and in retaliation the United States raised tariffs on these small trucks. Now, in 2001 we're talking to the Japanese about cutting our tariff from 25% as a legacy of something we did almost forty years ago. I would say that while one can write down theoretical models in which countries pursue all types of sophisticated policies, in my experience reality is that the political system typically does not deliver these with any great subtlety.

Q: I'd like to ask two questions. I think they fit into the same space. The first one. You touched upon the demographics of Japan, and you pointed out there will be more old people which forces a burden on the economy in general. But at the same time I believe that Japan's demographics imply that it will in fact, in the future, be less people in an absolute sense. Secondly, that there'll be less working people in an absolute sense. Therefore you have a sort of triple hit. Going into an environment like that, where you also have all these burdens, seems to me to be a recipe for massive sustained contraction for a long time. My twenty-year perspective on Japan is that it's difficult to imagine a growth rate over twenty years that is in the positive range.

The second question, as Korea sits in between Japan on the one side and China on the other, with for their own reasons a tendency to do big things to each other, how should Korea position itself in that region to avoid on the one hand getting bruised by the rocks that are flying and on the other hand find a positive opportunity for itself amidst those two big neighbours?

A: The Japanese population is predicted to fall in absolute terms in about 30 years. But you already have a shrinking of the labour force, though that may be a little confused now because of the current cyclical state of the economy. There is also a rapid increase in the dependency ratio.

What the secular growth rate for Japan would be over the next, say, 10 or 20 years is an interesting question. I know that my co-author Takatoshi Ito has thought a lot about that. You could basically assume that you get a modest negative impact from the demographic effects you identified and then you have some modestly positive impact from capital deepening if you maintain your investment rate. The real key issue—and the issue that, because of time constraints, I didn't discuss in my remarks—is what to do about productivity.

The first thing the Japanese have to do is address these very basic issues of macroeconomic management having to do with the banking system, monetary policy and fiscal policy. In the long run, they have to continue the process that is underway, which we cover in chapter four of the book, of deregulation, liberalization, and of doing the things that raise productivity. Because in the conditions which you accurately identified, where the demographics look really pretty bad, it's going to be increases in productivity—getting more out of each of those workers—that is going to be absolutely essential, not only to maintain the aggregate growth rate but to be able to afford the social welfare expenditures without absolutely crushing the working age population.

On Korea, there is a big lesson in both the military and economic spheres, discussed in a certain amount of detail in chapter six of the book. Many people would describe Korea as a kind of middle power. It's not the Untied States. It's not China. But it's not, say, Ghana either. It's in the middle, kind of with Australia and Brazil, and these kinds of countries are significant, but aren't globally dominant.

For countries in the middle there is a great interest and desirability to, in all spheres of external relations be it the military or economics, to try to emphasize multilateral management of issues—rule based systems, coordinated action—because that is a way you can leverage your degree of influence. So I think in economic spheres in the book we talk about not only the WTO, which I've mentioned, but we also talk about APEC and these bilateral regional free trade agreements, which personally I'm not a great fan of. But I think that in the economic sphere, that's one of the things that Korea can be doing.

Politically and military, which we also discuss to a certain degree in chapter six, Korea obviously has a lot of issues. Later this morning I'm going to go over to the government to talk about North Korea. The issues just here on the Korean Peninsula are quite difficult in and of themselves. I think in the longer run the traditional strategy in this kind of situation is to try to ally oneself with another foreign power. The trick is to find a foreign power that is sufficiently interested that they will help you, but sufficiently disinterested that they will not take advantage of you. I think, one could argue, that in the early part of the century Korea tried to do that with respect to the Untied States and it didn't work. The United States was not sufficiently interested. And that led to the really unhappy experience we had here in the first half of the century.

In the second half of the 20th century, it's been a better balance, where there's been a greater U.S. interest. In the future, the relationship between the United States and Korea is key -- Korea doesn't want to be left exposed between Japan and China. But you shouldn't want to simply play balance of power politics. You want to get Japan and China together and try to use multilateral means of intermediating their disputes in a whole range of areas.

Q: First, in essence you're saying that in the medium run, at least, the Japanese economy is doomed. Therefore no bashing is necessary. You're saying that there is the coming collapse of the Japanese economy. What would be the doomsday scenario you have in mind? In what form will the Japanese economy implode, and what kind of external shocks would the Japanese economy impart to other countries such as Korea.

Secondly, as you are very well aware, Koreans and Japanese are very seriously considering the possibility of entering into an FTA with each other. Would it make any sense for us to enter into an FTA with an economy like that, which is collapsing right now?

A: On Sept. 10, I was invited by the Bureau of Intelligence & Research at the U.S. State Department to a program on Japan and I was asked to give an analysis of the Japanese-American economic situation. I went through it in greater detail than I have this morning, and then I got to the end of my talk and I said that the problem is that one could have given this talk any time in the last three years. In fact, I pinched much of my notes from a previous presentation I had done.

The issue is, "What's different?" One could have argued that the coming collapse of the Japanese economy should have happened a year ago. The problem is this, and in an odd way the events of Sept. 11 may actually have helped the Japanese avoid such a crisis. If you believe that one of the impacts of the events of Sept. 11 is going to be this increase in a kind of global risk premium and a tendency for capital in particular to stay at home, that means that Japanese policy makers are going to have more domestic capital, more water behind the dam, to play with as they try to sort out these financial matters. Oddly enough, it may have given them a few extra months.

What you have to do is identify what would be a trigger that would set off a kind of collapse. Some of us thought that a possible trigger would be the announcement of the market accounting by the Japanese banks. My co-author Takatoshi Ito has since written a number of pieces that have come out after the book that argue that if the Nikkei, which is now at around 10'000, fell to about 8'000, he actually goes through the number of Japanese banks that would then be insolvent. This could be a kind of trigger. Well, you know, that hasn't happened. I read a column in the Financial Times last week in which the author identified forces coming in March that could drive an enormous depreciation of the Japanese yen. He mentioned the yen at 200 or even more to the dollar. It's certainly possible that the Japanese house of cards could collapse. The difficulty, from an analytical standpoint is that it hasn't, and that they have been able to successfully muddle through. So I'm hesitant to say that I am predicting a collapse of the Japanese economy because these conditions have existed for a considerable amount of time and a collapse has not yet occurred.

What would be the impact were conditions in the Japanese economy to really worsen significantly? Well, many of us were very surprised by the ability of economies elsewhere here in Asia—Korea's a good example—to recover from the financial crises of 1997 and 1998 without robust growth in Japan. We though robust growth in Japan would be a prerequisite for the regional recovery, and that turned out to not be the case. Japanese financial linkages with the rest of the region now are less than they were in 1997. The amount of Japanese lending here in Korea is considerably lower than it was then. So through certain channels the impact would actually be less.

The problem of course is the situation that I laid out at the very beginning of my talk. The world economy could be right now on the verge of a confluent of factors that somebody I know at the IMF likened to "the Perfect Storm." (This described a really bizarre situation that happened about 10 years ago, where there was this meteorological freak accident in which three storms converged on each other and created absolutely unprecedented environmental conditions.) What you have now is the United States economy not only entering the first recession in ten years, but a recession in which the situation really looks a little different. This is an investment collapse, not the typical post-war U.S. recession where consumer growth got too strong, inflation rates started to rise and the Central Bank pre-empted inflation by raising interest rates. This is an investment collapse driven recession. We've now got these terrorist incidents and this war on terrorism that introduces a lot of uncertainty. The EU remains weak, and then you have this situation you identified with Japan. I would be hesitant to predict a collapse of the Japanese economy. On the other hand, with other major parts of the world economy weak right now, a bad outcome in Japan could be a really bad outcome for all of us.

On your second question about the FTA, we actually discuss the Korea-Japan FTA in the book. I believe the discussion is in chapter six of the book, and we cite not only estimates done by KIEP but we cite the results produced by Mr. Yamazawa for the Japanese government. It would be fair to characterize the basic results as follows. If you take these models at face value, with the caveat that these models may not do a particularly good job of representing all the aspects of an FTA, they suggest a couple basic problems. First of all, the welfare gains for Japan and Korea would be very small. In fact, the typical result of these CGE models is that there would actually be welfare losses in Korea. I actually don't believe that, as an actual state about the economy, but it is what you get with these kinds of computable general equilibrium models because of certain aspects of the way they're built. You actually get a fall in welfare here in Korea.

You also have, of course, a very, very basic problem, which is that I personally do not see how Japan and Korea could conclude a free trade agreement that would be WTO consistent, because of the requirement that any free trade area cover substantially all sectors. I don't see how you could do that in the case of Japan and Korea given the agricultural situations in both countries and given the strength of the agricultural lobbies in both countries. If I were a policy maker in Japan or a policy maker in Korea, I would be very, very hesitant about going down this road, especially if you're Korean. The WTO system is very important for you. It's a rules based system in which you can get a semi-fare shake out of the United States, Japan and the EU. To put that in jeopardy by pursuing a non-WTO consistent free trade area with Japan strikes me as unwise.

Finally, from the stand point of the United States, my recollection—and I would really have to look at the details of chapter six because I don't remember all of it off the top of my head—is that a free trade area which excluded agriculture actually lowers welfare in Korea because you end up diverting resources *into* the agricultural sector, a sort of odd result. But you could also really get some resistance from the United States.

The idea that you could assume away the agricultural sector is just nonsense. The Japanese have gone around talking about free trade areas with all these different countries, and there's only one country with which they've even gotten close to having a free trade area with, and that's Singapore. What is the characteristic of Singapore? It's a city-state. It has no agricultural sector. Even in the case of Singapore, gold fish were a problem. People like my co-author Takatoshi Ito were really embarrassed by this. The guys at the Ministry of Foreign Affairs were really embarrassed by this. They argued that this new age economic agreement with Singapore was going to be a different kind of agreement, in that the importance was not the reduction in tariffs and so forth—because Singapore is basically free trade anyway—but the importance was that this was going to be a new type of era. By entering into an FTA with a more liberal economy than theirs, the Singaporeans were somehow or another going to force them to change their labour practices, their professional accreditation, and so on and so forth. That is how people like Takatoshi Ito and the Ministry of Foreign Affairs portrayed the agreement.

We now know that these progressives got their heads handed to them. The Ministry of Agriculture, Forestry and Fisheries stomped on them. They got things like gold fish excluded. In the end, the idea that a city-state of some 2 million people was going to leverage a significant influence on a societal organization of a nation of 150 million did not come to pass.

You really have to deal with the fact—and it's just not just Japan, it's China as well—that until you can deal with the agricultural sector, talking about these free trade areas is a strange thing to do.

Q: We couldn't let you get away without turning to a topic that is of particular interest to this audience. Forgive for doing so. Would you care to comment on the collapse of the recent ministerial talks between North and South Korea, and the second question is, where is North Korea going in the next twelve months?:

A: North Korea is a kind of professional Rorschach test. I was at this conference in Kyoto yesterday, and if you ask political scientists about North Korea they were really impressed because these guys have parlayed a hole in the ground into a multi-billion dollar aid program that the rest of us are paying for. They think these guys are real geniuses. Then you ask the economists about North Korea, and they start using words like "policy barbarism".

My impression is that North Koreans don't understand democracy and as a consequence they're always a half-step slow in dealing with democratic countries. For example, President Clinton sent former Secretary of Defense William Perry to Pyongyang as a special envoy with a pretty good deal for the North Koreans. It took the North Koreans, for whatever internal reasons, fourteen months to respond to Perry. They tried to close this deal on missiles in October of a presidential election year with a lame duck president and then they were surprised when it didn't work. Anybody could predict with a probability of roughly 50%, that a more conservative government than the Clinton Administration was going to take office in the United States in January of 2001. Now the North Koreans are taking the position that the Bush Administration has to adopt the policies of the Clinton Administration before the North Koreans will talk.

I get the impression that they're not a lot better on Korean politics. It is impossible for me to imagine a president of the Republic of Korea that would be more forthcoming, generous and magnanimous than President Kim Daejung. You know that President Kim Daejung is going to be out of office in February 2003. You know that there's a roughly 50% chance that the next government is going to be a significantly more conservative government. But even if his own party gets reelected as president, I can't imagine a president with as much power and commitment to dealing with North Korea as Kim Daejung. And the North Koreans have sort of wasted away this opportunity. The window of opportunity is closed. The National Assembly vote on Mr. Lim during the first week of September basically ended it.

We're now at a situation where it's just tactical. The issue is the return trip of Kim Jongil to South Korea. It is in Kim Jogil's interest to visit South Korea while Kim Daejung is still president. The reason is the real game now is between Kim Jongil and Kim Daejung's successor. To that extent, Kim Jongil wants to be in the position of the one hosting the next summit because that puts him in a greater position of control.

So, if I'm Kim Jongil, I would engage in a lot of tactical maneuvering and kind of string Kim Daejung out for another six months—and I'm not

Korean so I don't have the timing down exactly—until you get to the point where it would be the maximum amount of goodies that Kim Daejung would be willing to give you to get you to come here. You come here for a day or two, you pocket Kim Daejung's concessions, you go back to Pyongyang and you wait for a successor. This is just tactical. I expect there'll be more of this kind of "noise", and then at some point these guys will get serious. My guess is that he will in fact come to South Korea before the end of the Kim Daejung presidency, basically to set himself up in a more powerful position to deal with Kim Daejung's successor.

Q: Can Korea ever have a relationship with the U.S. like Japan has with the U.S.? Secondly, how will Japan deal with its non-performing loans? And thirdly, the CIA believes that China's economy will be three times the size of Japan's in 2020. Why is that so, and do you agree?

A: Relations between different countries are unique. They are based on unique historical circumstances. They are based on unique national cultures, political institutions. Whether Japan and Korea can ever have a similar relationship to that of between Japan and the United States, I don't know. I doubt it. I'm not sure it would be desirable. I'm sure in some respects the relationship between Japan and Korea is preferable to the relationship between Japan and the United States. I think they're all unique.

On the issue of non-performing loans, the Japanese strategy of dealing with it through provisioning won't work because the water is coming into the boat faster than they can bail it out. Under even the most optimistic scenario, it would probably take about 10 years to write off all these loans at the rates that they are provisioning. I think that it's just a very deep problem, that we go into a fairly amount of detail in the book. We agree that something much more dramatic has to be done.

In fact, the Japanese can learn a lot from the situation here in Korea. We've had people who were experts in the U.S.' S&L crisis going to Japan. If I were Japanese, I would have people coming over here and trying to find out what Korea did a few years ago.

Finally, with regard to China, will the Chinese economy be three times as big as the Japanese economy, or whatever, in 2020? I don't know. The basic story about China to me seems to be two fold. You still got 800 million peasants, which is to say that the process of shifting people out of extremely low productivity work in the agricultural sector into much higher productivity work in the modern sector could continue on for at least three decades. I think the basic trend that has gone on in China for the past 20 years can go on for another 20 or 30, which would lead to very much higher levels of productivity and national income in China. That's the good news.

The bad news is that China is in a race against time with respect to its own macroeconomic situation. They have a two-sided problem. Their banking system is in even worse shape than the Japanese banking system. Chinese banks are basically all broke. They have all these gigantic non-performing loans to state owned enterprises. China has to restructure its state-owned enterprises. They've actually done a fair bit of restructuring. There has been at least 15 million people shift employment out of the SOEs and into either private sector employment, foreign invested employment or some less-state owned type firms over the course of the past few years. That restructuring is going on.

But can you do the restructuring, can you get the banking system under control, before the state finances just blow up? That is an issue that I can tell you, from personal experience, that there is no consensus even among people who talk to the U.S. CIA. So how the U.S. CIA decides that China will have a $15 billion or trillion economy in the year 2020, I'm not exactly sure. Thank you.