Challenges for the World Economy: Where Do the Risks Lie?

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Good morning, ladies and gentlemen. It is a great pleasure to be back in Korea. I came here for the first time in 1980 sort of by accident, because I could not get a visa to go to China. I am quite happy it worked out that way because I certainly have made great friends here. I have learned a lot over time. And the Korean economy has never failed me in providing excitement. I think there has been no year where there were not major policy issues, some of which were quite exciting.

I would like to discuss where the hot spots in the world economy are and what the likely environment is lying ahead. You can ask this simple question. Is the world getting more favorable as we look ahead over the next twelve months or is it getting worse? It is a totally decisive question because in this recovery year, what we would like is a very favorable world environment that would encourage more of the same. You really do not want to be tested with financial problems around the world to see just how sturdy your own recovery is.

I tried asking that question of an audience yesterday. I asked them to raise their hands if they thought things were getting better. I did not get a single hand. I do not know whether it was a translation problem. But I think that is the right view. I think the problems ahead are real. They will start in the U.S. and in Asia. Surely, Japan is a big problem country. China potentially is as well, but in my judgement, much less so. So, there is enough ammunition to worry about.

Two scenarios for the U.S. economy

Let me start with the U.S. economy and argue that over the next half year, we are likely to see that these hundred months of uninterrupted recovery will be tested a bit. I want to make two points. First, yes, the Federal Reserve Board (Fed) is coming. Interest rates will rise and the stock market will come down. Of course, that always provides a lot of excitement for world financial markets. But on an optimistic note, when all of that has happened, we are not going to see the U.S. in recession. There will be a slowdown. It may be a little bit bumpy getting there, but beyond it, there is certainly a very stable economy that will continue to grow, but at a much more moderate pace.

Why is there an issue at all about the Federal Reserve raising interest rates in the U.S.? Monetary history in the post-war period has always been the same. Expansions have never died in bed of old age. Every expansion in the end is murdered by the Federal Reserve because every expansion eventually has inflation. When it comes, the Federal Reserve, often too late and reluctantly, arrives on the scene and raises interest rates to the sky. Then we have a recession and start all over again.

Now, the U.S. has a new economy, which has meant that there are five extra years. Even today, a hundred months into the recovery, inflation is very moderate, just 2% year over year. It is also true that we are in a world where high inflation is totally unacceptable by central banks and where price stability is defined as 0~2 %. By that measure, the U.S. is at the upper end on its way to 3%.

Sometimes, there are compelling reasons to admit that we are leaving price stability. There are important circumstances that should force us to accept that fact and that it would be extremely inconvenient to raise interest rates and slow credit growth now. But in the U. S., it would be very hard to find that argument. First, the U.S. is fully employed and growing at 4%, which is far above anyone's estimate of the growth of potential output. It has been doing so for three years already. Therefore, on the side of domestic economy, labor markets and goods markets provide absolutely no excuse. Balance sheets might be another argument. For example, one might say that the whole financial sector is about to fall over dead and, if interest rates rise, it will really die. But our financial sector is in great shape, with very happy balance sheets because we had our banking crisis early and the banks are all cleaned up. There may be some concerns about the leveraged positions of investment banks but even there, after the Long Term Credit Management (LTCM) fiasco, the U.S. has done a little bit of a rehearsal and maneuver.

So, financial markets are not a sufficient argument for raising interest rates. Neither is the world economy because it is turning up. Asia certainly is. Korea is spectacular at it, while Japan is having a good year. Latin America's year is not as bad as had been feared. Europe is picking up a little bit of growth and the U.S. is having 4% growth. In short, the world is having a mini-boom.

Again, there is no argument for the Federal Reserve not to move. If it should move because we are leaving price stability and if there is no argument not to move, then it probably will move. That is what is happening. The first rise of twenty-five basis points has occurred, and I think we are going to have another twenty-five in August and another in September. I would not be surprised if the end of the year will see an increase of 100 basis points relative to the numbers of May. That kind of increase in interest rates is expected to slow growth by about one percentage point. It is not really dramatic, going from 4% to 3%. But of course there is an extra factor, the stock market, which is very aggressively priced, or in other words, overpriced.

The question is what the stock market will do in a setting where the Fed raises rates. One view is that the stock market recognizes the slower growth and tighter credit. It is not an environment that is wonderful for earnings, and as a result, stock prices will fall about

20%. That would help slow down economic growth because consumers will be less ebullient and confident and the stock market would help in slowing the economy. As a result, interest rates would not have to rise so much. That is the soft-landing scenario. If that happens, the world economy would be really wonderful because the one immediate problem, the U.S. stock market, would be resolved very gently. A 20% drop in stock prices, while it happens is not pretty. But in hindsight, it is only the money people made since January. So, it is not a big deal.

The alternative and not implausible scenario is that the stock market does not take the Federal Reserve seriously. That surely is what we have been seeing so far. It may say, "Who cares about insurance rates, at most they rise a hundred basis points. The prospects for companies are so wonderful because of technology, mergers, etc…" Then, the stock market would keep rising happily. That, of course, would drive consumption because of the gains people would make in their balance sheets. That scenario results in a much harder landing because the Federal Reserve would have to raise interest rates much more. In the end, just as in 1987, the stock market finally recognizes that there will be a significant slowdown and falls on top. Then, there is a little bit too much restraint and it is necessary to scramble to avoid a recession.

So, the big question ahead in the next six to nine months is which of these two scenarios will occur. I do not really believe for a minute that it is a question as to whether the Fed will raise rates. I take that to be a foregone conclusion. The interesting question is what the interaction between the Fed and the stock market will be. The worst possible thing would be if they do not talk to each other and the stock market does not get the message. As a result, rates would rise further and then the stock market would fall on top. Of course, that scenario is very bad for the world economy. The U.S. is financially very stable. But the same cannot be said of Latin America. High interest rates and a big drop in U.S. stocks will be an enormous disruption to these capital-importing countries. It probably means that the debts will not get paid.

Certainly, in emerging markets around the world, significant tightening in U.S. markets is bad news. It even affects Europe. The European economy is fragile. There is very little downside limitation of risks. There is no monetary policy in Europe because the new central bank is pretty incompetent. There is no fiscal policy because eleven finance ministers have to get into a room to agree on a tax cut. I would like to buy a ticket to see that one! If there are no policies to limit shocks, then shocks are likely to happen. I think it would be pretty tough if the hard-landing scenario in the U.S. were to occur.

Let me stay for a minute with the U.S. to argue that beyond that rough patch, there is reason to really be confident that the U.S. is not going to go into recession and will continue to do well. The reason is that both monetary and fiscal policy are really there to be used. Policymakers are very pragmatic and the public has absolutely no tolerance for poor economic performance. There is a big budget surplus as a result of everybody working and paying taxes, and a strongly declining debt ratio. The U.S. congressional budget office predicts that by 2010, the public debt ratio will have fallen below 10% of gross domestic product (GDP). I do not believe that will happen because, with that much revenue on the table, the politicians can be trusted to get it. Yet, it gives you an impression of a very stable financial situation. If the stock market really got out of hand, I think the Fed would cut rates, just as they did in 1987 after the fact. There would also be big-time tax cuts. That means the U.S. economy is going to be all right even if there were a hard landing first.

Is Japan sitting on a time bomb?

Let me come to the trouble spot of the world economy, Japan, which right now looks a little bit less of a problem. Japan has succeeded in the past year to move out of an atmosphere of very acute crisis. That has had a big impact on public confidence. Banks were tumbling left and right and it was clear that the whole banking system was substantially bankrupt. That threat to confidence and from there, to spending and growth, has been removed by massive infusions of public money. This has been followed up by an even more massive infusion of public money into small corporations, encouraging the businesses to take the money and not go bankrupt.

The public sector has put a huge amount of money on the table to get out of a crisis mode into some normality. It has been successful with that. Since then, they have added three elements to a strategy that is keeping Japan afloat for the time being. The first is huge public sector construction spending, focused in the first quarter of the year, which has produced 8% annualized growth. Essentially, it is a 100% increase year-over-year in public sector spending. Those fifty thousand construction companies that support the Liberal Democratic Party (LDP) in Japan are all very happy with orders. Another year of negative growth numbers has been avoided and, in that way, has supported confidence.

Second, huge budget deficits are being financed by the domestic financial sector simply by persuading banks and insurance companies that there are very substantial exchange risks in going offshore. That message has arrived and the insurance companies and banks now say, "Never, never touch foreign bonds or stocks. Stay happily at home and buy Japanese government bonds (JGBs)." As a result, the world's largest public debt is being financed at extraordinarily low interest rates by captive Japanese finance.

Third, the exchange rate is being held at 120±2, which provides every foreign equity investor with a ticket home without risk. A little restructuring at home and a stable exchange rate are bringing all the world's money into the Japanese stock market. The rise in the market improves balance sheets, which means that the government has to put less money there and the households get a sense that things are a little bit better.

This three-part strategy, public sector construction spending, keeping the banks and insurance companies funding the JGBs and providing implicit deficit and exchange rate guarantees for foreign investors in the stock market is maintaining the Japanese economy. I think it will continue to do so for the next few years. But do not exaggerate what is happening because the growth rate is zero, not 8%. The second half of the year will have negative numbers and there will be an extra budget to produce good numbers for the first half of next year, just in time for the election. Then, there will be negative numbers for the second half again. Averaged out, there is zero growth in Japan.

Zero growth is good news because what comes afterwards will be negative. The big public sector spending and this relative gain in confidence are not catching on because of two big negatives. First, in the business sector, restructuring means cutting down on investment spending. Of course, that translates into less growth in the economy. Second, for households, corporate restructuring means you lose your job, which does not create an environment in which to start spending big time. This results in an offset to the government construction spending, with very slow consumption growth and declining investment spending by the business sector. Between the two, there is zero growth in GDP. Whether growth is +0.1% or -0.2% is really uninteresting. Round it to zero.

That is the near-term picture for Japan. It looks stable, it is not actually growing, but at least it is not falling out of bed. But I think you have to look beyond that and be significantly more pessimistic because Japan has a formidably bad balance sheet situation. It is not just the banks, insurance companies and the under-funded corporate pensions, but also the whole public sector. Japan has a public debt ratio of 140% of GDP, which is the largest of any developed country. It also has unfunded public sector pension liabilities of another 110% of GDP. The two together amount to 250% of GDP in debt in an economy that has zero growth and a demographic problem that will arrive twenty years ahead of anywhere else.

If it were not Japan, one would suggest junk bonds. But Japan is special because of the substantial domestic captive finance. These things can be rolled over seemingly forever at 1%. Japanese institutions are very shy to take advantage of the liberalization of capital markets to take money offshore. That creates an environment where it is not obvious that tomorrow morning will bring a financial crisis. But even though a crisis does not happen tomorrow, nobody should believe that 250% of GDP in debt plus a 10% budget deficit this year, next year and every year, is somehow not adding up to such a formidable amount of debt that it just cannot be paid.

The Japanese answer to this is that soon they will have a 10-year consolidation plan. Remember, they just cancelled their five-year consolidation plan. Moreover, their consolidation plan consists of a huge increase in personal income taxes on the argument that in Japan, personal income taxes are the lowest in the world as a share of GDP. Well, I would assume that the people who are going to be taxed blue in the face are not going to be big-time spenders. In that case, my argument about zero growth forever becomes even stronger. The other answer to the deficit problem is their claim that the numbers for the unfunded pension liabilities are totally exaggerated because every year the government plans to cut entitlements. Well, I expect that would induce those people to start saving a lot more since they are not going to have any pensions. Of course, this will not be good for consumption growth. And if consumption growth is not big, companies will not add to capacity, rounding out the picture.

I think Japan is a time bomb. The balance sheet situation is way beyond the ability to repair. One can pretend that it is all right until further notice, but the focus has to be on what comes after that. There are two ways that it can go. One is the biggest financial crisis of post-war history. The second is that the bureaucracy in Japan understands that a crisis is on the way and instead introduces capital controls and managed finance so that rolling the public debt for the next thirty years becomes the central objective of the financial market, just as it was until recently. I think that is the more likely course of events. The interesting question is how Asian economies in the neighborhood of Japan will behave in that context. Will they become part of the same situation or opt for being out of it? My guess is that becoming part of the same situation is the easiest answer.

Looking ahead a few years? not necessarily a year or two, it may take longer than that? there will be a formidable problem around Japanese public debts. They are so far out of line with any reality and any ability to bring them under control that they will dominate international finance. The easy answer, the obvious answer to a bureaucrat, is just to abolish choice, and with that, have the high savings of Japan as captive finance for an ever-rising public debt. That is a huge deal for the world economy.

Financial crises like that always take longer to come than one would think and when they do, they happen faster than one would have predicted. So, it is possible to be wrong twice. Watch the rating agencies, as they look at Japanese public debt and do 'archeology,' which means digging holes to see if there are even more hidden liabilities. Archeology in Japan has proven a most fertile field, because every time someone looks, they find another US$500 billion of unfunded liabilities. The last one was the private corporate pension funds? US$700 billion under-funded. A little footnote? it is widely expected that the government will assume a large part of these liabilities. Well, it cannot do that forever.

I have given a view of Japan that is not optimistic. I think that in the near-term, there will be huge emphasis on keeping everything, including the yen, quiet and stable through the election. But a look behind the scenes will reveal debt amounts that are unmanageable.

China: despite rumors, not likely to devalue currency

Let me turn to China, the third place in the world economy that is critically important. I am much more optimistic about China than the Wall Street Journal or the Financial Times. There are two critical issues. One is the exchange rate issue and the second is the reality of Chinese adjustments. I do not believe that China has an interest in devaluation. China is a very closed economy and as a result, it would take a very large devaluation to get a significant increase in growth. A very large devaluation means that the rest of Asia will fall out of bed. As a result, China would have to ask how far ahead it would be after it devalued and the rest of Asia had their resulting financial crises. The answer is 'who knows?' Well, 'who knows' is not good policy. On the domestic side, a very large devaluation will teach even the last Chinese that there is a big difference between the yuan and the dollar and that what they should be getting their hands on is dollars. That is a mobilization that the Chinese do not want, along with the bank runs that would come in a situation where the banks have real problems.

I do not believe that policy-wise, there is an interest in a big devaluation. I also believe that it is not a big emergency, simply because growth continues to be significant. It does not make much difference whether it is 5% or 7%. It would be very hard to argue that 5% growth is so deadly small in China, while everywhere else it considered really good. But even if I am optimistic about the exchange rate side and do not believe that the Chinese leadership would make that mistake, of course, there are serious problems. I think the banking problem is the lesser one. China has no public debt to speak of. The cost of cleaning up the banks, which is probably on the order of 25% of GDP, would be a big-time increase in public debt. But it still leaves public debt far below where it is anywhere else in Asia. Yes, it costs something but when it happens, Chinese public finance will still look better than anywhere else in

Asia, including Korea.

The big problem in the Chinese banking system and throughout Asia is the lack of a credit culture. People need to learn that banks exist to give loans that ultimately have a real prospect of being repaid rather than functioning as gas stations where people pump on credit with no expectation of ever repaying. I think that is being learned everywhere in Asia, though slowly. Japan, Korea, Thailand and Indonesia do not have that yet. Simply because it understands that a financial crisis inside would be an enormous problem for the communist leadership, China is very vigorous in pursuing the creation of a banking culture with the accounting and supervision that goes with it. The legitimacy of the leadership is stability, stability, stability, and it would be very bad if they lose that on the financial side. So, they take the banking issue more seriously and have the advantage of a history of good public finance that allows them to pay the bills without risk of much instability.

The second huge problem is the one of restructuring the state-enterprise sector. That is progressing far more slowly than the leadership had ever imagined. I think it is a ten-year issue, not a three-year issue. There, too, a lot of intelligence is going into the project. I see that particularly in the liberalization of very labor-intensive service sectors for private initiative. Old-age care, child-care, housing and schooling are increasingly being privatized. Those are very labor-intensive sectors, so as the state-enterprise sector sheds labor, this is the place to go. With a bit of an inborn sense of greed and making money, I think that is working pretty nicely in China.

I believe China has huge problems. It surely is not going to go back to 12%-per-year growth rates. It will occasionally look very wobbly but I think that China is not the big risk to Asia just yet. Ultimately, it will be on the security side, but on the economic side I do not believe that we should look forward to that.

Korea should stop bailing out the chaebol

Let me lastly ask what to make of Korea. Of course, it is a total lack of humility to lecture Koreans on what I think is happening in Korea. One has to say how disappointing it is that Korea has chosen not to restructure, even with the good excuse of an enormous financial crisis. Amazingly little has happened. It is easy to understand that a political transition makes it harder. Korea has an economic populace that spreads throughout the institutions and politics. The government does not want to be irrelevant and thinks it has a lot of money and wants to be there to help everyone at a time where the best help would be to look the other way and let the market take care of things.

Surely, there are some stories of restructuring, but I would not exaggerate them. I think from the rest of the world's perspective, remarkably little has happened in Korea. The biggest problem surely was that the current account turned around so fast that dollars were no longer the issue. The moment dollars disappeared as an issue, everything else disappeared with it. It is very difficult to get another chance to do this, short of having another crisis.

One must assume that Korea will pay for the lack of adjustment that has taken place and for the choice of staying with an industrial organization and a corporate structure that are not really the most productive that the country could have. I think that working very hard and saving a lot of money to force economic growth is a very unimaginative way of solving a problem that could be resolved by working a lot less, consuming a lot more and having a structure that is far more congenial to prosperity. That resolution will not take place in Korea because the country is doing too well with a bad structure. It is like someone who walks backwards, but is really good at it. Korea may just choose to keep doing that. I myself am like that. On the airplane, people always stand around and say, "Look at that man, he types with one finger but he's incredibly fast." I think Korea is a little bit like that. My students come and say, "Of course, you are pretty old, but even you could benefit from learning to type. There are another ten years left."

I think Korea must take far more seriously the chance for aggressive restructuring with big participation from the rest of the world. The very worst outcome would be for the government to rush in to help corporate emergencies. As a result, the restructuring that would have happened on a market basis is so politicized that it is not allowed to happen any more. I see situations like that in Korea on the horizon.

It is wonderful that growth is back and much of the social stress of the crisis is going away. However, not using a wonderful crisis like that as a lesson is surely very regrettable. Nobody should really harbor the thought that now they are out of trouble, they do not have to do all these hard things. Failure to do them will cost and will mean harder work and less consumption.

There is a great demand in Asia to fix the system, so that what happened last time will not happen again. My impression is that the amazing thing about the Asian crisis is how long it took to happen since it had very little to do with the international system and everything to do with very bad domestic financial architecture and very bad cross- border borrowing habits. In the U.S., real estate has a crisis every six or seven years. There is a Fed tightening; they all go bankrupt. Then there is a recovery and they all overbuild and borrow short. Finally, the capital gains are huge and everybody gets frantic and the interest rates rise again and they all go bankrupt again.

Asia did exactly that. With financial liberalization, everybody built up phenomenally bad balance sheets with short-term liabilities, dollar liabilities and huge leverage. It was no surprise, because the moment very high growth and a very stable financial environment disappear, everybody goes bust. It has nothing whatsoever to do with the international financial system, but everything to do with the huge value at risk in leveraged-foreign-currency-denominated, very liquid balance sheets.

The answer to the problem is to have good balance sheets, not to expect that the world economy never has any bumps and not to stop the people who want to take money out. I think there are three ways to do that. The first way, which would be easier in Latin America or Eastern Europe because of trade concentration, but certainly as plausible in Asia, is just to close the central bank. There is no question that central banks are the problem. A central bank that allows itself to run out of reserves is fantastic. Central banks that manage the exchange rate and allow disequilibria in the exchange rates and fail in their supervisory functions are terrible. That is true of every country that has had a financial crisis from Brazil to Asia. Close the central bank and create a currency board. A currency board means less flexibility from the exchange rate for relative prices. It means more of the flexibility has to come from home. It is certainly not the case that countries have used the exchange rate for flexibility of relative prices. They have used it to get an overvalued currency.

With currency boards, at least that would not happen. In exchange, of course, there will be a far better financial integration with the world economy and there will not be the speculative attacks that come from an expectation of a realignment in exchange rates. So, close the central banks, get rid of the currency, peg the dollar and be done with it.

Second, a banking system that the domestic political system cannot get itself to supervise requires a banking license and offshore lender of last resort. They will do the inspection for a fee, which will be less the better the balance sheet is. That is exactly the discipline that a financial system wants. Just as one can hire offshore accountants, one can hire offshore supervisors in that way.

Third, it is necessary to have a routine in financial contracts and rollover provisions, which come as a standby contingency at a fee that depends on the reliability of the client. If those three private market institutions existed: a currency board that takes the central bank out of business, offshore bank inspections with a lender of last resort function and a contingency plan for rollovers, I think financial crises can be eliminated. That also gets rid of all the room the government has through the banking system, special private subsidies and provisions through the central bank to create the potential for crisis.

If you cannot create a currency board, what should you do? Well, the answer is create a currency board. There is absolutely no reason not to have one. The long list against currency boards is totally ridiculous. They are options for Switzerland. For example, "We do wonderfully in our central bank." Other than Switzerland, who can say that? "We would lose the money from revenue creation." Yes, but in exchange, every five years there is a big financial crisis. That costs money too. "We would lose flexibility on relative prices." Yes, but there is a far better lower average real interest rate, and that means lower capital costs for firms and a great advantage for growth. So, I believe that is the direction to go. Failing that, do I believe a flexible rate is the answer? I have never seen a central bank that allows a flexible rate.

Do I believe a currency basket is a great solution? Yes, if there never are changes in equilibrium rates and if it is just for trade balance and not the capital account. So, in the end, I think the deregulated worldwide capital markets and national central banks just do not fit in that setting anymore. It is like national airport controllers who speak national languages but the pilots cannot understand them. That is not really a good idea. Sure, some guy will be on board to tell the pilot not to land. But the system is not good. Get rid of it the sooner the better. Being on the dollar is pretty good, even if for trade it is not the perfect answer.

Question & Answer

Q I would like to ask a simple question relating to the U.S. economy. In the U.S. today, unemployment is low and so is the inflation rate. Can you suggest other explanations for this besides productivity growth? Also, how will the economic story of the U.S. develop in accordance with these new developments? Second, as you mentioned, interest rates, inflation and economic growth are low in Japan. People are reluctant to spend because of job loss and uncertainty about the future. Another reason is the age structure: older people are even more uncertain about spending. With all this, how would the Japanese government finance government spending? Third, why is China not likely to take a big devaluation in the near future, despite the rumors that they will do so sooner or later to remedy the big current account deficit or economic situation?

A Let me start with the China issue. China does not have a current account deficit. It has a surplus, increasingly tight current accounts, capital controls and substantial reserves. So, this is not a situation where George Soros can come and say, "Hi, let's have a crisis." And, it makes all the difference because it means the government has to choose whether to devalue. They sit there and say, "Remind me why devaluation is so good?" One guy replies, "Well, you'll have a far more competitive situation." Another guy says, "and a bank run." A third guy says, "Well, you know, I don't really know what will happen to the Japanese stock market if we devalue by 40%. If it falls out of bed, I don't really know about world economy." So the first guy says, "Let's have this conversation again next month. It didn't seem so convincing."

I invite you to look at the articles in the Financial Times and the Wall Street Journal that have as a headline, "Yuan devaluation increasingly imminent." Notice that 'increasingly imminent' is a strange phrase. Either it is imminent or it is next year. Always in the first paragraph, there is the phrase "next year." That has been the case for two years already. Then, they will always find some minor official in some state bank who, in some publication, said "some more flexibility." That little bit is the substantial fact that produces a six-column article about the rapid deceleration in growth that now is only 7%. Well, it has been 7% for the last three years. So, there is no deceleration of growth. As for the little man who said it, nobody knows who he really is. I think there is a compulsion to have a big article every three weeks about the yuan where everybody scours this huge country, China, to find someone who said something that remotely sounded like that.

I am impressed with the officials at the bank of China? and I am sure you have had the same experience. They say, "You know, I don't think it is a great idea to devalue because it could be a real mess." I think the Chinese are very afraid of creating circumstances where they do not control events. Surely, the very first result of a devaluation would be the loss of Hong Kong. Now, is that really interesting? Well, the story is that they do not really like Hong Kong. But it is theirs. They may not like that baby, but it is theirs and cleaning up Hong Kong would be a big problem. So, I cannot persuade myself that they are so dumb. I doubt devaluation will happen.

In the discussion of Japan, I did not mean to say that they should spend on public sector construction, I say they do. And they will. That is the leading party's trick to keep just enough growth. It does create the problem of a near 10% budget deficit every year. It adds to the public debt. But the LDP does not look to the next 30 years. I think they do not expect to be there in 30 years. They are really looking to Obuchi's re-election and how to get there safely. They have the unending belief that somehow, everybody saves a lot so it must be possible to sell them these bonds. What they do not really look at is that everywhere else in the world you can get 5%, but on these bonds only 1%. What makes these bonds so wonderful? That is not part of the mentality. I believe that in the end, the bureaucrats will say the moment you want to exercise the option to buy foreign bonds, that option goes away. Do they say that? No. Would they say that if the issue arose? Yes. They are doing it implicitly today. You cannot hear Kuroda or Sakakibara without them saying there are substantial exchange rate risks in putting money offshore, just to be sure that every banker and insurance person hears it. Well, that is a sort of homemade capital control by intimidation. If that is done, the debt can be rolled over for a while, but not forever.

The U.S. question is the hardest. Does it have a new economy or is it just a year or two that look strange in the numbers? I think that the U.S. has a new economy because there are six to eight ways in which it is functioning differently than in the past, all coming down to the same position that the economy is far less segmented, closed and administrative. The U.S. has a wide-open economy both in fact and in people's minds. Technology enhances that very substantially, including all the internet competition that is on now. Unions have disappeared for all practical intents and purposes in U.S. wage price-setting, including even in the federal government. We have stockholders that beat up on CEOs who do not restructure, because they want their money. That is done competitively, by asking who is the best at that sort of thing. All of this means that the bottlenecks which in the past have characterized wage price-setting are pushed very far out. That has given us five extra years. But of course, in the end, you run out of bodies. When that happens, there will be a little inflationary pressure in the labor market.

For a year, the Asian crisis may pay for it with very low consumer price index (CPI) inflation, so people can get their real wage gains without big money wage gains. But I think that is over too, now. So, in a much smaller way, we are back to where we used to be. But we are going from 1.5 to 2 rather than from 4 to 12. That is the advantage of the new economy. There is vigorous job creation and a budget that provides insurance so that things will not go wrong. There also is a central bank that has a relatively small task. If it were not for the stock market, everything would be glorious. But the stock market is 'new economy' too and maybe a little bit overdone. That is what complicates what otherwise would be easy lending.

Q What is the future of the yen-dollar exchange rate for the next six months to one year?

A In the six-months to one-year horizon, think 120. It is totally essential to making the Japanese mirage go on. If the yen goes to 100, companies die. If it goes to 140, the stock market dies. 'No death' is the strategy. Keep everything really calm and the money comes into the stock market and pushes it gently up and everything looks really wonderful and then Obuchi gets re-elected because he is so wonderful. The yen is very much part of that story. So, I would be surprised if you saw the yen moving much away from 120. It does not fit into a picture of just keeping it afloat and defusing all the trouble spots. Can it be done? Yes. You could ask about JGBs. Will the rates rise a lot? It is not a good idea because it hurts balance sheets. The post office will be there as a residual buyer.

Q You have talked a lot about the Northern Hemisphere today. What will happen to South America?

A They think about that a lot in the Northern Hemisphere too. I think there are two sides to the South American story. One is that there is dramatic progress in accepting a very market-based economy. I would look at Chile, Argentina and much of what happens in Mexico. It takes a long time for economies that in the 1930s closed down, went totally statist and created the worst public finance and the worst inequality in the world, to make that transition.

Argentina has probably been the one country that has been most radical in doing that. The greatest triumph I know is when they sold the post office. The Argentine post office had the peculiar characteristic that in the morning, the mailmen would come and pick up the mail at the head office and then go around the corner and throw it away. It was not an area of great satisfaction to the public. They would use Federal Express instead. Finally, the government, having sold everything, decided to sell the post office as well. That is an intriguing thought to begin with because they thought nobody would buy it. But they decided to have an auction with three conditions: 1) No one can be dismissed. 2) Mail carriers have to deliver the mail. 3) The postal rates cannot be raised.

So, they had an auction. Five consortia bid for the post office. They received a huge amount of money for it. What happened? Well, they say the post office is really wonderful because it is a distribution center with wonderful retail locations. Now, the former Argentine post office has a tourist office inside, Federal Express, United Postal Service (UPS), an internet connection service and the mail. These guys are talking to Chile now, saying, "Can we buy your post office?" That is one side of Latin America. The other side is Venezuela, with a totally crazy politician, who, when he sits anywhere has the seat on the right free. The seat on the right is for the spirit of Bolivar, the great liberator of Latin America. He is nuts. He is mobilizing the streets. He wants to change the country in the direction of interventionist, statist control. The worst you can imagine. Latin America is not there yet. Brazil is the same, with a president who has unbounded vanity and almost no competence. Wait for another crisis. If the U.S. stock market goes down, watch Brazil that day, because the money will not be coming. So, both sides are right. I think ten years from now, it will be a solidly reformed area. It will take one more crisis in Brazil and the one that is about to happen in Venezuela. So, I am more optimistic than I am about Japan, where there is total cover-up. There are huge problems behind the scenes, which are not facilitated by demographics. Latin American demographics are very favorable.

Q Economists prescribe a lot of wonderful medicine but the government makes all the decisions. In Korea, the restructuring issue is sometimes very deeply related to regional interests. So, how can you make decisions which are opposed by a number of people?

A You asked me an impossible question. The starting point is that in Korea, people have really not accepted that the government should be out of business. There is the notion that the government must solve these problems as opposed to the market solving them. So, who has failed? I think the failure is that much of the intellectual leadership of Korea is working for the government. It is sort of like in France. They rush the government to the scene and tell it to get in there and do something. Well, the moment the government is in, politics is on. They say, "There's an election coming, so we really have to save this steel mill. We have to save this construction yard and this bank." The next thing, the government is saving everybody only to let them keep doing the wrong thing.

I understand what you say but I do not know how to get out of it. The answer may be to use a crisis. Argentina was so statist, there was absolutely nothing the government was not doing. Everybody had stopped working, including the government. From the steel industry to the airline, to the hotels, mail and military, everybody was working for the government. Nobody was paying taxes. The government was borrowing the money from some idiot in the world who was still lending to them. How did they get to an economy where the government has absolutely nothing? They closed the central bank. The finance minister is in New York to teach people that it is really good to abolish the government. They used the crisis relentlessly to admit that they were poor compared to the 1900s because the government had made it impossible for anybody to have incentives, initiative and responsibility. The government had borrowed the people's children's, grandchildren's and great-grandchildren's money to keep wasting resources. This admission brought results.

In the U.S., the crisis of the late 1970s, the Carter years, the malaise, the loss of confidence was enormously well used by Reagan to say, "Look, you ought to be proud of yourself and get up and do something." People said, "Okay, you're right. That was good. Let me go and hustle." The U.S. has deregulated for fifteen years since. As it starts working, you do not have to say anything anymore. Perhaps one option is to keep saying every morning, "Government is bad. Bureaucrats are awful." If everybody says that every morning, maybe there will be a better atmosphere. But it is extremely hard because the money seems to be there and keeping the status quo seems to be much better than uncertainty. That is what the government can do wonderfully. Give that question to your students on the exam.

Q Tell us more specifically, what advice would you give to Japanese policymakers, bearing in mind that one of your colleagues, Paul Krugman, advised policymakers to keep printing money, targeting inflation?

A It is not good advice to tell the central bank to make inflation. First, they might not listen. Second, ultimately, the Japanese problem is not just the gross problem. It is also how to deal with public finance, an issue that is totally left to the sight, though it is the harder one. I think the only answer there is very aggressive deregulation. The U.S. in the early 1980s had public finance problems thought to be totally out of control, with budget deficits as far as the eye could see, and somehow, nothing happened. So, it is worthwhile asking how the problem was solved in the U.S. Certainly, it was not solved with oppressive taxation. It was solved by everybody working and paying taxes. That was possible because of the enormous deregulation that opened up business opportunities left, right and center and made it really easy for everybody to go and do something. When they do, they pay taxes, so then the budget is balanced.

Japan has to get there. But that option has, of course, totally disappeared. It is politically unattractive, it does not work fast and it is much easier to cover up and keep going. In that sense, no advice is even worth giving. It is a non-starter.

Q Generally speaking, the chaebol issue is in the papers nowadays. More specifically, the Daewoo problem is under serious discussion. As a friend of Koreans and a very close observer of the Korean economy, what advice would you give to the government, the chaebol leaders and the Korean people in general? You warned of the so-called complacency trap. In fact, since the macroeconomic picture is improving so fast, giving people less of a sense of urgency and crisis, people might feel that structural adjustments might not be so necessary. So, how would you convince the Korean people that it is absolutely necessary to take a bitter pill at this moment?

A Bitter pills are called vitamins. I think it starts with the least immediate answer. Korea wants institutions that solve these problems rather than the government. If there were effective bankruptcy procedures, then the creditors would take over the assets and try to make the most money out of them. Then, they would do whatever restructuring that is market-based which the previous management failed to do. Having good bankruptcy procedures does two things. One, it provides a market solution, where a management before may have not found the right one. Second, it makes totally sure that the government is not really the default answer to it. As it is today in Korea, the government is the default answer to everything because there is no other process. The moment that the government sits in there, the answer perforce is not the market solution, but the market solution tempered by politics or entirely politics. If it is an election year, it is really politics. Unless the institutions are created, that issue will remain. The moment there is a problem, the government moves in because the market has been left out since the institutions are not there. But that is not going to be an answer tomorrow morning.

So, what should the government do? Well, the government has two things in mind. One, elections and the other, that maybe they will be held responsible for failing to restructure Korea at some future point. Elections are a wonderful opportunity to 'pig- out', be a part of the whole problem and ask, "What is the good thing for the election?" And then, one makes that critical mistake.

The other answer is to limit the extent to which we pig out and try to move the economy more nearly in a market direction. That means looking away if there are real problems. While the government looks away, the chaebol will have to do the inevitable, which means aggressive asset sales and restructuring, all the impossible things that the government would not be able to do. That is my point. The government is not going to be able to do all the aggressive things which, under pressure, the chaebol may do. So, go away and put the pressure on. Go away and hope that in the next half year, they do a formidable amount of things which the government never would be able to do. Then, try and organize one more round of restructuring without announcing it beforehand, otherwise nothing will get done. The worst outcome is one in which the government becomes part of the solution, politicizing it. Then, there will be an even worse industrial structure than before.