The U.S. and Global financial Market: The Current Situation and Future Prospects[1]

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One of the most interesting things about Korea is how strong, resilient and robust the Korean people and Korean society are in confronting problems and coming out stronger as a result. I come here feeling very encouraged and positive about the environment in Korea.

I would like to briefly describe the "American Economic Model". It may or may not be a model, but there are some elements of the American economic recovery, economic strength, and economic prosperity, which I think are very important. Then I will talk about the events in Seattle. As unpleasant as they appear to be, maybe something good can come out of that.

Let me start out by talking about the American economy and its financial environment. Obviously, those who follow the U.S. economy have seen a generally impressive performance: a steady growth for the roughly the whole decade of 1990s, remarkably low inflation, and an environment in which budget deficit has been turned into a budget surplus. These are all positive elements, along with a very low rate of unemployment, which is particularly impressive in the U.S. Because the U.S. is a much more heterogeneous society than most other countries, high unemployment has enormous social implications: low unemployment is good because employers spend more time and effort training people at the lower end of the labor ladder.

An interesting thing about the U.S. is what I call the "virtuous cycle". If you look at what has happened, first there was an enormous amount of corporate restructuring. It started in the latter part of the 1970s and picked up with great intensity in the mid-1980s. This was partly due to the Reagan Administration's continued pursuit of deregulation of the economy and the strong dollar. many saw the strong dollar as an enormous problem, but it turned out to be a blessing: it forced American industries to become more competitive in light of Japanese and other East Asian competition. If you look at the American auto industry today, it is much more competitive because of foreign competition and the strong dollar was a major element that pressed the American auto industry to become more competitive.

A weak currency tends to make you think that you are competitive when you are not because the weak currency enables companies to compete primarily on the basis of the currency. When the currency becomes strong, you do not have any illusions about your ability to compete: you know your competitiveness depends on your ability to cut costs, restructure the industry, and improve the utilization of inventories. The strong dollar and the deregulatory environment of the 1980s were extremely important elements in U.S. corporate changes over the last fifteen to twenty years.

What happened in the telecommunication sector was very important in the "deregulation-competition formula". In the past, we had a monolithic telecommunications sector for many years: it was three-letters—AT&T. Then AT&T was broken up and many new smaller companies sprang up, creating a much freer environment for new information-technology

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companies to emerge. This information-telecommunications revolution has been very important in the U.S.

Going along with that, there has been a very major change in the capital markets in the U.S. The information-technology revolution and the capital revolution are, in actuality, different parts of the same equation. They are parts of the same equation because in the 1970s, 1980s, and 1990s, we have seen an enormous deregulation of the U.S. financial market. There used to be regulations on the amount of interests that banks could pay, on interstate banking, on investment banking, etc. These things have gradually changed over the last fifteen to twenty years, culminating in the very recent abolishment of the ***Glastigal Act***. Very importantly, the U.S. developed a very active and energetic venture capital market. The venture capital market has been extremely important in providing the financing needed for small- and medium-sized companies, which were the real growth factors in the U.S. for the last fifteen years. There would not have been the high-tech information revolution without a very active venture capital market. The venture capital market has moved from just venture capitalists to individual investors: now an average person is willing to invest in high-tech ventures that will not yield immediate high returns, i.e., Yahoo.Com. A healthy and flexible financial market is necessary to support a healthy industrial society, as seen in U.S.' information technology revolution.

As the capital markets have become more efficient and the government has reduced its role in financing its own debt, the private sector has begun a very strong boom in capital investment. The U.S. capital market has had a steady growth for roughly nine years without inflation because the industrial sector has continued to invest in such a rapid rate that we did not have tightness in the industrial capacity. It is relatively easy to finance new investment, which means the business sector can keep ahead of domestic demands. So, even as domestic demand grows three to four percent per year, fiscal capacity is not strained. There is an inflationary pressure in the workforce: wage is increasing for skilled workers. However, the addition of new technology has enabled productivity to keep up with the wage pressure in the work force.

Can this productivity growth sustain itself? There are many opinions on this subject. It is, by no means, clear to the academic community nor to the Federal Reserve Bank that the growth in productivity will continue on forever. Professor Robert Gordon of Northwestern University has recently published that productivity is sort of a myth: it certainly improves one sector, the computer sector, but rest of the sectors have not benefited as much from the information technology as people had thought. As growth increases, there will be improvement in productivity. However, once the growth weakens, productivity improvements will disappear. It is an ongoing debate as to whether these improvements in productivity are sustainable in the long-run. If they are not sustainable, and there are continued wage pressures, then those wage pressures will lead to either more inflation or major contraction of corporate profits.

The general elements of the way the economy has performed are: relatively low interest rates, relative ease in financing, new capital, growth, and avoidance of inflationary pressures. This kind of environment is sustainable for some period of time to come. Will the economy get a little overheated? My guess is that the Federal Reserve will probably raise the rates again early next year, if the economy continues to grow at four-percent plus. Still, the signs of inflation are relatively modest.

So, then, what are the problems? What are the risks? The stock market increase has led people to spend at a relatively rapid rate; the private sector is in a negative savings position. Over a period of time, there is a wealth effect from the improved stock market: consumers are spending not only their income, they are also digging into their savings as well. The private savings/investment balance, which was positive four or five years ago, is negative, as consumers are investing more in capital equipment instead of saving. So, there is a gap and thus, there is a net private sector savings deficit. This creates a problem; however, it is not a problem in the current environment. In fact, it is one of the reasons why the economy is doing so well. So, the question is, who fills that gap? The answer is, the government and foreign capital.

The current account deficit is financed by capital inflows from Europe and much of Asia. How long can this gap exist? With respect to the federal surplus, it may not be as strong two or three years down the line due to probable tax cuts, which reduces the federal government's ability to finance the imbalance.

Foreign capital has been amounting to about four-plus percent of the U.S. GDP, which is a very large current account deficit for the U.S. If foreigners are less willing to purchase American assets, then that makes the U.S. somewhat more vulnerable than in the past. So far, that has not happened because the return on treasury is still good and the stock market has performed very well. However, the rate of return in the U.S. could decline relative to the rate of return on investment in other economies. That could slow down the inflow of foreign capital in the U.S., which would have the effect of pushing down the dollar and pushing up the interest rates. Though not an imminent risk, this is one of the major risks faced by the U.S. economy. Nonetheless, when you run a current account deficit that is about four to four and a half percent of your GDP, that is quite large. It means the U.S. has to import about a billion dollars a day to finance its current account deficit. That can last for a quite a long time, but it is not likely to last forever. This is the major concern. There are other concerns, i.e., that inflation will begin to pickup more rapidly, which will force the Fed to continue to tighten money supply, which is negative to financial markets. The other concern is that the economy weakens and the corporate profits weaken, which could lead to a downward slope of the stock market, even without a sharp interest rate increase by the Fed. So, there are vulnerabilities in the system: the system is not perfect and the vulnerabilities have to be addressed.

The current account imbalance leads to the next set of subjects I want to touch upon briefly, the WTO meeting. The WTO is a very complicated environment in which to reach an agreement. Let me first try to describe the environment relating to trade in the U.S. because it is obviously important to Korea and to other countries exporting to the U.S. I do not think there is a massive feeling of protectionism in the U.S. today. However, I do think there is a feeling of anti-multilateralism. Most Americans who think about it understand that we are all part of a global economy, that exports are important to the U.S., and that imports are important to the American consumers. Most Americans would not call themselves protectionists. Americans are most concerned with the multilateral system—multilateral trade, the IMF, the World Bank, and other global institutions, which are quite remote from the influence of the individual citizen and from the influence of the U.S. government. Americans see the WTO as having influence over American environmental policy; it really does not, but that is the general impression. The WTO appears to make rules as to what restrictions the U.S. can impose on imported goods. Here is an institution that meets in Geneva, which arbitrates disputes between the U.S. and some other country on bananas or timber. The Americans then think that these rules are more of a constraint to the U.S. than a benefit. They see the U.S. as the big economic superpower and wonder why the U.S. should be governed by rules established by some bureaucrats in Geneva.

That is more of a general view. The more specific view is that the WTO does not address the social concerns of individuals in various parts of the world: environmentalists say the WTO pays too little attention to environmental issues and the problems of laborers, not enforcing the rights of workers to unionize in certain parts of the world. It was never meant to do any of that; it was intended to find ways of liberalizing trade. However, the general view among specific groups is that the WTO should use the leverage it has to improve labor and environmental performances in other countries. The irony is that there are Americans protesting along side people from emerging countries protesting the WTO's interference in those same areas. The U.S. farmers want more open markets for their goods while people in other countries want a more closed market, wanting to keep their agricultural subsidies and disliking cheap American agricultural products. There is a mixture of objectives, and everyone is frustrated that the WTO is not achieving their own objectives. This is a serious problem. Do I think something is going to come out of Seattle? I do think that they will come up with a modest agreement to continue liberalizing agricultural trade and trade in services, to further reduce industrial tariffs and to improve the transparency of the WTO, particularly with respect to the dispute settlement procedures. I think there are some things that the group can achieve, but my worry is that there is no consensus in the U.S. on what should come out of these negotiations.

There is a company that benefits enormously from trade and the teamsters who run the trucks are trying to shut down trade for a day in protest. And yet, they are the ones who benefit the most from increased imports and exports from the U.S. So, there are some very complicated elements here that do not make sense in an economic point of view, but do make sense from an emotional point of view. I think the emotions of this discussion probably outweigh the substance at this point.

Q & A

Q: In your speech, you mentioned the web effect. According to my research, the U.S. web effect originated from two age groups: youngsters and people aged 65 years or older. The baby boomers are now middle-aged and are practicing high savings. However, the two age groups aforementioned are not saving much: they are overspending against their income. As the two age groups grow older, how would the web effect affect us in mid- to long-term? Also, we are entering a weak U.S. dollar era. How long can the information technology growth continue?

A: Let me first address the second question. The strong dollar has forced companies to become more competitive and unlike in the past, global competition is very strong despite the weak dollar. There is a lot of underutilized capacity around the world. Thus, even with the weaker dollar, foreign exporters are still very competitive in the U.S., in part because there is underutilized capacity and in part because it is a more competitive global environment. So I am not too worried about that. The other thing that I am not too worried about the information technology is these companies know that in order to compete, they have to be globally competitive. The force of global competition makes companies very concerned about allowing costs to rise. It makes them much more energetic with respect to finding new technologies to improve productivity. So, I do not think the weaker dollar is going to have much effect in that sector.

There are sectors that would love a weaker dollar. That is one reason the treasury does not want to intervene to stop the decline of the dollar. Larry Summers, Treasury Secretary, said that the strong dollar is in America's interest. That is true; however, what exactly is a strong dollar? The dollar certainly is not strong if compared to what it was a year ago. In his heart, Larry knows that one way of reducing the current account deficit is to have a weaker dollar. As an economist, he knows that. Yet, as the treasury secretary, if he were to say a weaker dollar is part of the correction process for a deficit, then the dollar would decline very dramatically. So, the U.S. government really is facing a very complicated environment with respect to the dollar. The dollar is probably going to continue to weaken, at least in my judgment against the yen. I think it would probably weaken further against the euro. That is the irony: we say it is a weak dollar against the yen, but it is a strong dollar against the euro. So, my own guess is that over a period of time-- as you see more recovery in Europe and as Japan continues to recover—the dollar will weaken further. I think that some of the industrial companies would like that: apparel companies, textile companies and steel companies will probably benefit from that. But I still think that in the current environment, where you have very low inflation, it will be very hard for these to revert back to the practices of not paying enough attention to productivity or low efficiency.

The question on savings is an extremely interesting issue. The people in the 30-55 age range are savers. They are different kind of savers than in the past. That is why when the stock market goes down, these people buy. They buy on the dips because they have a target: by the time they reach 55 or 60, they want to have enough money to buy a boat, travel, send their kids to college, etc. Those people have a very firm saving philosophy.

The dis-saving tends to take place among retirees and older people who have accumulated money. However, these savers tend to spend their savings in their retirement years. Younger people also have a very low savings rate in the U.S., in part because they are so optimistic about the world and life.

One of the difficulties in the U.S. today is that we have, as a society, a very low savings rate. Most Americans expect social security to provide for them when they get older or they save in the house ownership—the house will go up in value and they can sell the house for a profit and retire comfortably. The problem is that housing values have not gone up very much lately. The average savings for a fifty year old is only about thirty-five thousand dollars; it is a very big problem in the U.S. Now, more and more people are starting to think that they might need something else to depend on besides social security. Those middle-range people are actually trying to save more, but older people are dis-saving and younger people really do not start saving until they are somewhat older.

Q: Recently, with the listing of KOSDAQ and NASDAQ, share prices have jumped enormously and we are concerned about the possibility of a bubble. From an investor's point of view, this is very risky. In addition, government officials in charge of supervising the share prices are not looking out for the interests of the consumers. What kind of governmental protective measures for the consumers are in place in the U.S.?

A: The answer is there are none. That is one of the issues. The "dot-com" companies have done so well that virtually every time there is an APL, the stock goes up. Though no one knows exactly why it happens, there are several factors. First, when these companies sell stocks, they do not sell too many; the float is very restricted. The scarcity value works very well, forcing the share prices up.
Secondly, the internet has an enormous potential and will become *the* vehicle for virtually all communications in the future. People see this and want to jump on the bandwagon. The internet is going to explode, but it does not mean that every single company involved is going to make a huge amount of money. So, what the market is doing is placing its bets: every time it sees a new technology and bets on it, the stocks tend to do very well. Individual investors are behaving like venture capitalists, buying companies before the commodities have a proven track record.

Many will strike it rich believing themselves to be brilliant, while more will lose money and blame it on anything but themselves. That is the reason why the debates on whether social security should buy stocks and whether people should have their own investment account for the future instead of giving the money to the government are so interesting. This is where this issue becomes very important. Let's just say that a Joe Smith buys stocks in IBM and the stock triples in ten years. That is good: he will be provided well for the retirement years. Let's say that a John Jones invests his money in an Internet company and he loses all the money. What does he do then? He goes to the government and expects it to provide for him. It is risky for individuals to invest on their own because they have no safety nets. Things can get complicated when the government gets involved in these kinds of issues. That is why the Greenspan keeps saying, "Be Cautious!"

Q: Do you see bubbles in the U.S. stock market? If there are bubbles, if and when the U. S. stock market makes adjustments, will that make a real impact on real economy in the U.S.?

A: I really do not think there is a bubble in the stock market in general. I do think that there are some companies in the stock market that are experiencing a huge bubble. But in general, if you take an economy which is growing at a three-to-four percent range and you assume that the Federal Reserve has enough wisdom that if it feels inflation is going to get out of control, the Fed will stop it before the situation gets out of control. I think you have to assume that the stock market is in extremely good shape. One can argue that some stocks are somewhat over-valued and it is probably true. However, many small and medium-sized stocks have not gone up, but have gone down in the past year. Certainly, there are some bubble stocks at some point, but when interest rates tighten, which I think will, those bubble stocks will be "corrected".

The broader point is that the market is always susceptible to a "weakening". If there were a lot more rises in interest rates than most anticipate now or profits were to be constrained dramatically, then the stock market will be certainly weakened. There will be some impact to wealth, but not too much. If this happens gradually, I suspect that it would be something the Fed would actually welcome. The Federal Reserve cannot come out and say that; however, if the stock market were to weaken by about five to ten percent, then Americans would save more. People would be less secure about the value of their stocks, which would probably increase the savings rate and decrease the growth rate--a very good thing in the Fed's point if view.

The Fed would appreciate some changes to the stock market. If it were a long and steep decline, then there would be a contraction in the domestic demand, slowing the growth rate to between one and two percent.

Q: With regards to Malaysian Prime Minister Mahathir bin Mohamad, was it just luck that his short-term capital outflow control appeared successful or was his policy correct? In that context, what is your view on controlling short-term inflows and outflows?

A: I do not think it was just luck and nor do I think that the policy would have worked in Korea or in other East Asian countries. However, it worked in Malaysia because it was able to reinforce investor confidence through banking system improvements and internal structural reforms, as well as imposing capital controls. While investors were upset about capital controls, investors were more positive about the internal reforms the Malaysians were making. To a degree, those internal reforms offset some of the negative environment of the capital controls. The other thing is, the capital markets have a very short memory: if they see new investment opportunities while they are still upset about a particular policy in the past, they are willing to move back into the same environment if they see profit. I think Malaysia is the only country to impose capital controls. The countries that did not impose capital controls, such as Korea, have comeback stronger than Malaysia. Obviously, capital control was certainly not an option for Korea.

I do think there are some arguments for a Chilean policy where short-term deposits in banks are required and not in interest-bearing securities. That tends to slow the inflow of certain kinds of short-term capital; therefore, such programs are very useful. But again, the Chileans did that in conjunction with very positive reforms of their financial, banking and social security systems.

So, the answer is that capital controls on outflow of capital are to be avoided; capital controls on inflow of short-term capital can be useful. However, in either case, the key to stronger economies in the future is domestic restructuring of the banking and the financial systems to make them more market-oriented and vibrant.