Reflections on Korean Recovery and Contrasting Present-Day U.S. and Japanese Economic Performances

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This is a world full of economic surprises. In 1997 and 1998, we had very unhappy surprises, certainly in Asia. Now we are having big and very positive surprises in the case of Korea. The rapid recovery of the economy in Korea is very unexpected, and of course, happy news. Somewhat less expected is the surprise that the Japanese still cannot get their act together and that their economy continues not doing very well. They have made some improvements in the banking system but they still have not entered economic recovery and resumed a steady growth path. Perhaps the biggest global surprise has been the continued strength, indeed the boom, of the American economy in which we have had rapid growth, very low unemployment, very low inflation, and a booming stock market. This is something unprecedented for the United States and quite a puzzle. We are trying to figure out how it came about and, more important, how long it will last.

Korean Structural Reform Efforts

I want to talk mainly about the American and Japanese economies. But first, let me present some impressions of the current Korean economic situation from the perspective of an outsider. All I can do is raise questions or note matters which are particularly interesting to me. Of course, the most important thing is how impressive the performance has been over the course of 1998 both in really tackling the structural reform issues and now in the rapid recovery of the economy. I really congratulate all Koreans on that. However, since I am an economist, my job is not simply to congratulate people but to look for remaining problems and difficulties, and I worry that Korea still has problems and difficulties. My greatest fear, frankly, is that the economic recovery is proceeding so fast that it will weaken the efforts to maintain and carry through the structural reforms.

It is very tempting for business leaders, bankers and others to say that things are becoming okay now and that they do not have to continue this reform process because it is very painful. That would be a big mistake because the world economy is a very different economy now. It is a more competitive, open global economy. Korea, a member of the OECD and following the guidelines of the IMF, is now in a different competitive environment. To continue to be a healthy growing economy in the long run, Korea must carry through on these reforms fully.

In considering Korean financial reform, I have been deeply interested and impressed that Korea has progressed much more rapidly than Japan. Japan procrastinated far too long and the problems became worse and worse. They have finally done a number of things to restore the credibility of their banking system, but it has not been nearly as drastic as what Korea has done. Korea's banking reform has been very impressive so far.

I have several worries nonetheless. I think the non-performing loan problem still exists and remains somewhat hidden. It is certainly a problem in non-bank financial institutions. But even in banks, I suspect that the classification of problem loans is not being done with full accuracy. After all, banks have incentives not to classify loans as bad or precautionary. The loan-loss reserves against these loans are too low. For instance, I have been told that for loans that are classified as precautionary, that is, a little dubious but not too bad – and which only require 2% of loan-loss reserves – something like 20-25% of those borrowers actually are technically insolvent. That suggests the bad loan problem is much more severe than reported. Probably many precautionary loans should actually be in the substandard category which would require much higher loss reserves. In addition, for the 84 large companies in which work-out programs are under way, loan terms are being lengthened and with very low interest rates. Those loans are not classified as substandard, but in reality they are a tremendous drag on the future profitability of the banks. I understand also that 50 trillion won of loans to medium and small size enterprises have been rolled over. These loans have not been classified as substandard or precautionary. Surely, some are going to be problem loans.

Thus, my impression is that additional substantial capital injection by the government to banks will be required in order to overcome fully the non-performing loan problem. I do not have any idea how much will be required. Maybe 10 trillion won would be too little, while 50 trillion yen may be more than enough.

My second concern about the banks is whether or not they they will change their behavior. Will they change their way of thinking, and develop the ability to judge borrower creditworthiness? Are they able to insulate themselves from the outside pressures – political, business, and others – that have so dominated lending behavior in the past? Will they focus on profitability or will they continue to be concerned more about maintaining relationships regardless of profitability? Those practices have to change but it takes time and is difficult.

Third, like Japan, a lot of the bad loans have been taken off the bank books and placed, in the case of Korea, with the Korea Asset Management Company (KAMCO). But once that is done, the question is how are those bad loans to be disposed of? My impression is that, so far, only a trivial amount has actually been disposed of by KAMCO. This is going to be an ongoing problem that will require changes in asset securitization, and in collection and resale of real estate and other collateral. This is an important and difficult problem which must be tackled strongly and effectively.

As for finances directly related to corporate restructuring and refinancing, data I have seen suggest that there are a large number of companies that cannot earn sufficient profits even to cover their interest payments. As the economy recovers, for those companies that are able to restore profitability and earn enough to cover their interest payments, carrying them temporarily is not a bad policy. However, there will be a number of cases of companies that even with recovery will not be able to cover their interest payments because those companies were in trouble even before the financial crisis hit. So, even as I feel delighted about how well the Korean economy is doing in general, these are financial issues I continue to worry about.

How about the big five chaebol? They pose a particular set of important social, economic, and political problems. As I understand it, they are too big to fail, but too expensive to keep alive. Will they keep themselves alive? I think in most cases they will. We can see, chaebol by chaebol, development of business strategies that in most cases will enable them not only to survive but also, five years from now, to be stronger than ever. But there are one or two cases that do not seem to be so clear. The chaebol problems and conditions will require ongoing monitoring and analysis by academics as well as policymakers.

The government effort to require memoranda of understanding between banks and major chaebol borrowers with performance criteria of various kinds, and the selling off of assets and other measures, is a very good approach. But suppose a company says it wants to sell off an asset but sets the price so high nobody wants to buy it. Then the time comes when the chaebol says it could not meet that agreement. Is the bank going to stop lending? Is the government going to have the courage to put severe restrictions on that borrower? I doubt it. This is likely to be a persistent problem for months and even years ahead.

There are many other issues about Korea which I am interested in and know less about and do not have time to discuss here. It is of concern to me that the ownership of most of the non-bank financial institutions – casualty insurance companies, life insurance companies, securities companies, asset management companies, merchant banks – is increasingly concentrated in the hands of a few chaebol. That is not necessarily bad, but there are dangers that once those funds come under their control they will be allocated in ways that are not prudential or desirable. This is another matter requiring careful monitoring.

I was discussing corporate governance with a Korean economist colleague who pointed out that outside directors and transparency are not Asian concepts. They are very Western. I replied by saying that selling shares to the public and having minority stockholders is also a Western concept. The problem is how to protect the minority stockholders in such a market system. These are the sorts of problems to be worked through as we consider corporate governance issues and systems.

Driving Factors of U.S. Economic Growth

Now, let me turn to the United States economy and the Japanese economy, which exhibit such contrasting patterns of performance in the 1990's. I will begin with the U.S. This amazing period of sustained prosperity in the United States is also creating a kind of American hubris. Many Americans believe that the American model is the right model for the world, not just for America. I suspect that we will learn our lesson about that eventually, but certainly not right now.

Trying to understand American prosperity is complicated because we are in the midst of a major technological revolution, the microelectronics revolution and the technology information revolution that it has spawned. We are now obtaining the benefits in the rapid changes in information technology, as you well know. And we are just at the beginning of a biogenetic revolution, which will probably create the most important technological breakthroughs of the first quarter of the twenty-first century.

However, these are very long-term trends. As we consider the United States economy today, I am one of those who believe that some slowdown in the U.S. economic growth is inevitable. We have not outlawed or eliminated the business cycle. So the questions for me are: when will the slowdown come, what will cause it and how severe will it be? In a very real sense, the inflation rate has become both the symbol of and the policy variable for economic performance. The story of the last few years of success has been the ability to maintain stable, low interest rates in the economy, combined with a strong demand stimulus through monetary policy, because of the low, and in fact declining inflation rate. That has been the unusual part of the American story because it has made everything else possible.

Historically, when the American economy reached very low unemployment, workers would demand wage increases and companies would give them and raise prices accordingly since demand for their output was very strong. That has not happened this time. Why have wage increases been so moderate? I think, first of all, that despite prosperity many Americans fear they will lose their jobs somehow if things slow down. The threat of import competition looms very large in the minds of ordinary workers. I think that has been a very moderating force when workers and their unions go to management and ask for a large wage increase. Management replies, "well, if we do that, we'll have to raise the prices and then Korean steel (or whatever product) will come into our country and you won't have a job." That sort of concern has moderated wage hike pressures. Also, labor unions have become weaker in the United States. One of the trends of the past twenty years has been the decline in the membership in unions relative to the total labor force. However, other labor-cost reducing causes have been more temporary. Pension costs have declined for companies because the stock market has raised the value of the pension funds, thus allowing company contributions to be reduced. Medical costs are not rising as fast as they were before, so the fringe benefit costs of labor have moderated. And the U.S. has finally had a surge in productivity growth over the last year that has offset labor costs.

The danger is that all of these are somewhat temporary in nature. We do not know that productivity improvement will continue to grow so rapidly as it did last year, and cannot expect it to. Certainly, low import prices are a temporary phenomenon. Why are American import prices so low and accordingly beneficial in holding down the inflation rate? It is because of the Asian crisis, stagnation in the Japanese economy, and slow growth in Europe. America has benefitted from the relatively mediocre economics or poor economic performance of the rest of the world. As the rest of the world economies pick up, inevitably their export prices will rise and thus U.S. import prices will rise, both directly for manufactured goods, and probably more important, for commodity prices. The recent rise of the price of oil over the last few months is indicative of the potential changes and inflationary pressures that are likely to develop.

Why is inflation so important? As I have suggested, if inflation starts to rise due to the overheating of the economy or the ending of the special benefits of cheap imports, then there is pressure on the Federal Reserve Board (Fed) to raise interest rates. In its decision on May 18, 1999, it decided not to raise rates but indicated a concern about possible future inflation. In other words, the Fed is sending a signal that it may tighten in the future. The fact that the Fed sends this signal does not mean that it will necessarily raise interest rates. One of the interesting comments on CNN this morning was that the last fourteen times the Fed has sent a signal like this indicating it may have to tighten because of inflation, it actually raised interest rates only once.

So there is no guarantee that interest rates will necessarily rise. The April rise in U.S. prices reported in mid-May 1999 can be considered in two ways. It may just be a one-month blip. One month is not enough information to base policy on. However if it turns out to be more than that, if prices continue to rise in the next couple of months, you can be almost certain that interest rates will rise, thus slowing down investment and growth in the United States. It probably will have adverse psychological effects around the world. Such a process is one channel for a U.S. slowdown.

A second channel for slowdown would be if, in fact, the business cycle does finally peak out and business investment slows as profits decline and corporations see fewer worthy investment opportunities. Consumers are now, according to the national income statistics, spending more money than they earn, so that American households have a negative savings rate. That happens to be a statistical artifact. Under U.S. law, when people realize capital gains by selling stock at a profit, those capital gains are not counted as earned income. However, the tax they have to pay is subtracted from their earned income. If the capital gains that people received last year are included, the saving rate in the United States last year was probably 8%, not -0.5%. This is a statistical problem. From the viewpoint of most Americans, we are in the best of all worlds. We can spend everything we earn, enjoy life, and still have our wealth increase 8-10% every year because of the stock market boom. In the coming months consumers may not continue to spend so aggressively; consumption and investment will probably slow down a bit. That would be one way in which the economy could slow down to a more sustainable, normal rate of growth of around 2-2.5% a year. If the slowdown were to be more severe, I think we would see fiscal and monetary policy responding rather expensively and quickly. If the slowdown seems to be too abrupt, macroeconomic policy can readily offset that.

The third channel for slowdown in the American economy is a sudden sharp decline in the U.S. stock market which would shake investor confidence in the United States, and probably also in the rest of the world. We do not know exactly what would set off a major drop in the stock market. I find it fascinating that many professional economists and money managers seem to expect that the stock market will peak and then decline this year. But ordinary people do not. So far, those predicting the stock markets will decline have been wrong. During the last two years, I have been predicting that the stock market would go down within a year. I have been wrong, obviously. I still think my view is correct, so I have not changed my personal portfolio adjustments.

Any discussion of the U.S. stock market has to take into account several divergent trends. The prices of large companies, blue chip companies, have gone up very rapidly; most now have very high price/earnings ratios. On the other hand, the prices of smaller companies have lagged. This imbalance in the market seems to be changing gradually. Perhaps the most startling aspect of the American stock market has been the extremely high increase in the prices of high-tech companies. Internet stocks - in fact any company named Dot-Com seems to have very rapid increases in its prices and very rapid drops, 30-40% up or down in a week.

There are two ways of interpreting that phenomenon. One is that Americans are greedy and ignorant, and have created a speculative bubble. Perhaps investor behavior is somewhat different, though. Maybe we should analyze the high-technology stock market the same way we analyze a lottery. The chance of winning is very small, but the winner wins enough to change his or her lifestyle. It seems to me to be the high-tech game. An investor buys some shares in a high-tech company, and hopes to become a millionaire. But if you lost that money, it does not change your life so much. It is that kind of risk-taking that is now driving the high-tech stock market.

To summarize, I have suggested three ways in which the American economy will probably slow down. One is inflationary pressures which lead to a tighter monetary policy response. A second is normal business cycle slowdowns in domestic demand. This can be offset by expansive fiscal and monetary policy, but probably with a lower target of growth. No one thinks that 4% growth is sustainable; 2-2.5% growth is more reasonable. And the third is a stock market crash. In all of these scenarios, there will be some decline of stock prices. My hope is that we will have a combination of the second and third. There will be some slowdown in domestic demand and a rather sharp decline in U.S. stock prices – maybe 20-25% – as the U.S. had early last fall. At that time, people will continue to be fundamentally optimistic about the U.S. economy and consider it a good time to buy stock. The stock market will pick up again. And there will not be any serious adverse effects on the American economy and thus on the world economy.

Thus, my prognosis for the American economy is about the same as it has been for the last two years. I have been saying that within the next eighteen months, the economy will slow down. At present I do not see any evidence that it will slow down substantially this year. It may start to slow down early next year. If it does, for domestic reasons – as in Korea, the United States has an election next year – we will probably see some budgetary stimulus in 2000 to help the politicians – or for the politicians to help themselves, and that will be a moderating force against severe economic slowdown.

Japanese Stimulus Efforts

The contrast between American economic performance and Japanese performance is profound and, in a sense very shocking. It is a sad state of affairs when the Japanese state that a 0.5% growth rate this year would amount to success. That is an extraordinary definition of success. It indicates how difficult Japan's economic situation is. There is no single explanation of the Japanese recession and poor economic performance. Fundamentally, it is due to some policy mistakes, economic mismanagement and slowness of everyone, both government and corporate policymakers, to respond to the bursting of the real estate and stock market bubbles of the early 1990's.

Part of the problem is that we are very used to having high expectations of Japan. Japan's performance during the 1990's was mediocre, but up until 1997 Japan experienced positive growth, though low. Japan's performance was not so different from the European economies. It was not until the spring of 1997 that Japan entered into the long, slow recession that it is only beginning to emerge from now. There has been a big debate in Japan and among foreign specialists about what it should do to get out of this economic mess. Obviously, the first thing Japan has to do is fix the financial system. They have undertaken substantial reforms. There is not going to be a financial crisis in Japan. While the systemic crisis is over, many problems remain for individual banks, insurance companies and others, including many industrial corporations.

In terms of how to get the economy moving again, people are debating three options. One is continued stimulative fiscal policy, another supplementary budget this fall and for the next couple of years. Many realize that in the long-run, this is not a sustainable policy, but for the next year or two it certainly can be continued. This is in large part because Prime Minister Obuchi wants to stay in power and he must deliver positive growth in the short-run. That is one policy route.

A second choice is a more aggressive monetary policy. It is difficult to think what that would be when overnight interest rates are zero. The cost today of borrowing one million dollars overnight, including the transaction costs, is about fifty cents. That is extraordinarily low. This, of course, shapes the entire interest rate structure. What then can be done on the monetary side? It is probably not interest rate policy so much as an expansion of monetary aggregates and efforts to achieve positive announcement effects. There is major debate as to what the central bank should do. Since inflation is a bad word, the Japanese invented the word "reflation." For example, the Bank of Japan might announce: “we will have a reflation policy of 2% a year rise in the CPI for the next five years." That would be a bold act which might break the pessimism of consumers that exists today. Many consumers are cautious both because they are anxious about the future and because they also think that the prices of apartments, cars, and other durables will go down. They are postponing purchases, which is not unreasonable behavior under current conditions.

The third option is a much more thorough and comprehensive set of deregulation policies, not only in the financial services, where indeed the Big Bang is working its way through, but in a whole range of service sectors where all kinds of regulations and restrictions persist, reducing opportunities for new, profitable investment. Economists think of alternative choices: do either this or that. I do not think such an approach is appropriate for Japan today. Japan needs both fiscal expansion and monetary expansion along with deregulation all at once. The question is whether Japanese policy makers will have the will, the courage, to make the difficult decisions needed today.

In the long-run, I am more optimistic about Japan. It will come out of this recession eventually; it will recover and prosper once again. The difficulty lies in trying to figure out whether the economy will pick up this year or later. Most of the foreign projections and private Japanese projections are that this will be a year of slightly negative growth and that next year will be flat, maybe slightly positive. I am somewhat more optimistic, not for economic reasons but for political reasons. The Upper House elections in July 1998 were a resounding defeat for the Liberal Democratic Party (LDP). It sent a clear message to all politicians: clean up the banking mess and get the economy growing again or we will vote you out of office. Politicians respond to those incentives. I expect the LDP to be quite aggressive in trying to expand demand stimulus and doing what it can to get the growth rate increasing sooner and more rapidly.

In the longer run, once recovery has occurred, Japan will then be growing at an OECD rate, not a super-fast rate, after it overcomes its current output gap, similar Korea’s output gap. In the very long run Japan faces a very different set of problems. There are many contradictions between the short and long-run in Japan. In the short-run, there is labor surplus; in the long-run, there is labor-shortage. In the short-run, interest rates are very low in order to stimulate the economy; in the long-run, they are far too low for an effective international interest rate structure. In the short-run, Japan must run a huge budget deficit in the government budget, while in the long-run it has to be eliminated. How to handle these contradictions between the short-run and the long-run is the challenge that policymakers face.

Clearly, the most immediate priority is to get the economy growing again. However, once the economy is growing, the political and bureaucratic pressure will probably be to reduce the budget deficit. That would be a mistake. What Japan should do then is raise interest rates to a more normal, reasonable level, and to address the budget deficit issue only after that's in the far longer term.

A Fundamental New Issue for Korea?

Let me end with one fundamental issue or lesson of the Japanese experience that may soon become relevant for Korea. About twenty-five years ago, Japan shifted from being an economy in which savings could barely keep up with business investment demand, to an economy in which the investment demand slowed down even more than the savings rate slowed, creating a savings surplus in the economy. Japanese government and business policymakers have done various things to try to adjust what has been a profound change for financial markets, the trade surplus, the exchange rate, and macroeconomic policy.

The question for Korea as I look ahead to the next five to ten years is what is going to happen to business investment demand? Is it going to become more cautious, more profit-oriented? Is it going to be a substantially lower percentage of GDP than it has been in the past? I doubt that the Korean household saving rate will decline sharply. If so, then Korea five years from now may be facing a very different set of problems. Korea may have more savings than domestic investment needs, easy money, low interest rates, a current account surplus, a cheap won, expanding foreign assets and worries about adequate domestic demand. That would be a very new world for Korea. I think this fundamental structural change is likely to occur. The question merely is when.

Questions and Answers Session

Q: The Japanese economy has been in recession for ten years. We are interested in knowing the real cause of the "bubble." Some years ago I read one report which said that the low interest rate policy of the Japanese government was the cause of the bubble today. The low interest rates caused excessive demand for the last ten years.

My second question refers to the size of Korean banks' non-performing loans. According to one source, it amounts to US$60 billion, while the size of Japanese banks' non-performing loans is about US$600 billion and that of Japanese insurance banks is another US$600 billion. This means that Japanese institutes have twenty times as much non-performing loans as Korea. What is your view on this?

Also, around two years ago, Japan proposed the idea of an Asian Monetary Fund (AMF) with a capital of US$100 billion. At that time, China was opposed to the idea, maybe because of their sense of rivalry with Japan. Korea also opposed this idea simply because the American government told Korea not to agree on this. What is your view on the desirability of the concept of an AMF?

Finally, you mentioned that Japan started to have a savings surplus problem. I would like to know what year the savings surplus started.

A: The causes of the continued poor performance of the Japanese economy were indeed substantially due to the creation of the bubble which was in turn due largely to the fact that the interest rate policy stayed too low for too long. The Bank of Japan instituted that low interest rate policy in 1986. It was good then because the economy was slowing down at the time. It continued in 1987 and was still good because it helped stimulate housing and other investment. But it continued too long in 1988-89 and created a bubble. So, it is quite clear that there was a mistake in monetary policy at that time, causing a bubble. Subsequently, that bubble created many problems, including the huge non-performing loan problem.

A second reason for the bubble was that in postwar Japan, the price of urban land and real estate had never gone down. So, real estate was considered the safest collateral. Banks and others made loans, including some very risky loans, with major misperceptions of risk. Indeed, this is one of the problems in relying excessively on historical evidence in trying to predict future trends. That was the problem for the U.S. Long Term Credit Management Company hedge fund fiasco in September 1998. Such fundamental errors in expectations are well recorded in history. The Japanese made such a fundamental error.

The bubble was only part of the problem. The government made a series of poor macroeconomic policy judgments during the course of the mid-1990s. Finally in 1996, they successfully stimulated the economy so that recovery was underway. The government then made a tragic mistake in thinking that recovery was complete enough that they could shift from fiscal stimulus to fiscal tightness in order to reduce the budget deficit. That choked off the recovery and instead created a recession. That was a government policy mistake influenced very much by the Ministry of Finance, which in Japan as in every country always wants to reduce the budget deficit. It was a major error, and the Japanese economy is in its longest recession in the postwar period.

On the second question regarding the relative size of non-performing loans in Korea and Japan, I suppose it would be very nice for Korea if Japanese loans were twenty times as bad, because then Korea would be relatively less badly off. But Korea has to worry about its own problems and solve them. Private estimates of Japanese banks' bad loans may be too high, though private government and bank estimates are still too low. The insurance companies fortunately still have some hidden reserves in terms of unrealized capital gains, but certainly some are in real trouble. The magnitude of non-performing loans that have to be written off is very large in the Japanese case and perhaps more severe than in Korea. Remember that it is a bigger, stronger, and richer economy and it is more capable of absorbing those losses.

Remember that for bad loans, the issue is really a reallocation of losses that have already occurred. The real question is who is going to bear that loss? Is it going to be the depositors? Of course not. Is it going to be the shareholders of the bank? Yes. Is it going to be the taxpayer? Probably. So, we have to recognize this is a process of the reallocation of existing losses.

On the third question, the AMF proposal by Japan in the late summer of 1997 was a good idea at the time. When it was initially proposed, the legitimation was that its terms would be much more lenient than those of the IMF. The US thought that would undermine the effectiveness of the IMF. That was the initial reason the United States opposed the proposal. Then the Japanese and others agreed that the conditions and terms be the same as the IMF's. The U.S. still opposed, but for narrow reasons. Frankly, the U.S. government was worried about Japan's excessive power and expansion in Southeast Asia. In my mind, that was a mistaken view. We should not worry so much about Japanese power. If it is going to happen, it will happen and the U.S., rather than resisting should consider how such power could be utilized constructively.

Also, at that time no one understood how severe the Asian crisis was going to be and how strong the need was going to be for additional money. That was a mistake, now we see the effect. The funding is coming about in a different way, not as an Asian Monetary Fund but as the Japanese Miyazawa Fund, and the recent Japanese government proposal to insure government bond issues of other Asian countries. The dilemma always is if an Asian Monetary Fund is set up in the future, what will the terms and conditions be and how rigorously and effectively will it be managed in practice?

I am not so opposed to a new Asian source of funding, but there are many technical and policy problems. Where would the money come from? Not only from Japan. Would China put money in? Would Korea put money in?

Fourth, the savings surplus in Japan showed up around 1974-5, at the time of the first oil crisis. Business investment dropped very sharply while savings went up during that crisis. Over the longer run the saving-investment gap was due mainly to the sharp decline in business investment as businesses came to realize that the economy was not going to grow at 10% a year forever. It might grow at 5-6%. But because that was a cyclical period of adjustment to the oil crisis as well as other kinds of structural adjustment, we did not really understand the longer-run implications of the developing gap between savings and investment.

A small economy such as Singapore or even Taiwan can run a current account surplus of 10% GNP and nobody really will care. Politically it is not possible for Japan to run a current account surplus of 10% GNP, the adjustment pressures on the industries in the rest of the world would be too great. If the same pattern happens in Korea, the future problem is whether the rest of the world would tolerate Korea running a current account surplus of 5-10% of GNP on a sustained basis. I suspect not. That is going to be a potential future dilemma.

Q: Regarding investment in high-tech industries, the difference between the U.S. and Japanese economic performance is due to the extent these two countries invested in high-tech industries. In the U.S., much investment was made. But it was not the case in Japan. What is your view on this?

Second, what are your views on the three policy options which are usually recommended to Japanese economic policymakers. Are these three options also applicable to Korean policy? The recommendations are first, stimulation of the economy through fiscal policy, and also more aggressive monetary policy and deregulation. Are all these three policy recommendations applicable to Korea today?

A: In the case of high-tech industries, in both the U.S. and Japan large high-tech firms are engaging in a great deal of investment in R&D. So, that is not so different. What is different is that the United States has so many small start-up companies, venture capital-based companies, some of which have become extraordinarily successful. That seems to be something that can occur most efficaciously in the American social economy. To have a successful venture capital industry, several things are necessary. There should be some people who have a new idea and a new product that is technically sound and potentially commercially applicable. Then, there must be people who will finance and help manage the start-up company.

Money is not really the problem. There is a great deal of Japanese venture capital money available that is going to Silicon Valley, not to Japanese firms. The Japanese have two problems. First, the key role of the venture capitalist is not just to provide money but to provide very careful evaluation of the projects and to decide which ones to finance and which ones not to finance. Typically, a venture capital firm will consider fifty or a hundred projects and decide to finance maybe ten. Financing is not just money, it means becoming constructively involved with the management. Of those ten, five companies will fail, two or three will sort of break even or barely stay alive, and one or two of them will be extraordinarily successful. Accordingly, the total deal is very profitable. But it takes a special kind of ability to evaluate projects. There are not many Japanese institutions or individuals who can provide that expertise.

The second problem is the career path of failed entrepreneurs. The attitude that if one fails, he or she can move on and try again, is very much a Silicon Valley and American attitude. In Japan, if you fail once, if you leave a large company, you are dead – not literally dead, but in terms of your career your future opportunities are very limited. So, the cost of leaving a large Japanese institution to start up your own company is extraordinarily high. In America, it is very low. I think Korea needs to worry about whether it is creating high or low costs for people to become entrepreneurs.

As for the policy recommendations, the short answer is yes, Korea should do all three. And Korea is doing them. Korea is engaged in fiscal expansion, which is necessary, and implementing an easy monetary policy, which is also necessary. Both policies should continue cyclically until the economy's output gap is eliminated and Korea once again achieves steady growth. Deregulation and reform are long-run structural issues that are even more important for Korea and indeed every participant in the global economy.

Q: During your discussion, the exchange rate question was not mentioned. I would like your views on this issue. As we all know, Secretary Rubin has resigned from his post and Larry Summers will take over his post soon. One of the very conspicuous policy lines pursued by Secretary Rubin was a strong dollar policy. A strong dollar means a weak yen. Of course, Larry Summers has made a good team with Rubin. So, many speculate that he will continue the strong dollar policy, even though in earlier days, Larry Summers had different views on this. How much do you think the exchange rate policy affected the performance of the U.S. economy, particularly on the inflation front and the performance of the Japanese economy? For instance, and I am not arguing for any fixed exchange rate regime, but because of the uncertainty in the exchange rates, Japanese investors and consumers will not invest or consume until they see that the forward market is stabilized. What are your views on this?

A: Incidentally, I interpret Mr. Rubin's resignation as an indication that he thinks financial markets are calm and the world situation is calm. He has been wanting to retire for more than a year, but so many things happened that he felt he couldn't. So in a sense it is a sign that things are not so bad. However I cannot predict how Larry Summers will behave in terms of his views on exchange rate policy.

It certainly is true that the strong dollar policy of the United States helped in keeping import prices low and helping hold down inflation. As long as the economy was growing well, it did not cause any problems of unemployment or lack of competition for American firms. That was in contrast with 1985-86, when the strong dollar undermined a number of American companies and was a very difficult situation. It is really remarkable how our policy thinking changed to be able to accept a current account deficit of US$200-300 billion without it being a debated issue. Because we are saying that is the margin that is helping us continue our rapid growth. A strong dollar means not only a weak yen, it means a weak won, baht, and many other currencies. I am not sure that it means a weak euro. I do not understand the euro/dollar relationship very well, frankly.

By definition, if one currency is strong, other currencies that counter are weak. Clearly, from the viewpoint of Korea, you benefit from the strong dollar in the sense that you can export more easily to the United States, but you are hurt by the competition from Japan and the weak yen. So, I think the most immediate issue for Korea is what the yen is going to be. The policies that Japan is pursuing of stimulus suggest that the yen ought to be weakening from 120 to 130-135. People start getting nervous, not just Koreans, when it gets close to 140. The Chinese, the Southeast Asians, even the Americans worry. So, it is not clear to me what is going to happen in terms of the policy stimulus but it does imply that, for Korea, there may be the danger that the won has been appreciating too rapidly. I think that is a kind of policy issue.

It would be very nice if we lived in a world of stable exchange rates where we did not have to pay the price for that stability. The reason we have volatility between the major currency exchange rates is because each country wants to pursue its own macroeconomic policies. Each country has its own objectives and is not willing to give them up to some international authority. Now, the Europeans are on a different path in which they are preparing to give up national autonomy for the sake of a European strength. We will see how that works out. But I do not think the United States is prepared to have a fixed exchange rate system with Europe or the yen.