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THE REPUBLIC OF KOREA AND THE NORTH PACIFIC ECONOMY: AFTER THE GREAT PANIC OF 2008

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The financial panic of late 2008 and the global economic recession that followed has been the greatest economic shock since World War II. While North Asia was caught up in the recession, the process of economic development was not derailed, and the panic could prove to be only a footnote in the twenty-first century history of the region. Growth in line with countries' unrealized potential could bring convergence to a high level of prosperity in the region. The most serious threats to this outcome are that (1) countries within the region and the United States fail to adopt policies to support a rebalancing of the growth process in the global economy and (2) the wrong lessons are drawn from the recent financial failures, leading to a retreat from markets and from globalization rather than better regulation of markets within a global framework. With its role as a member and the 2010 chair of the Group of 20 (G-20), now the key global forum for economic and financial management, Korea can play an important role in avoiding these risks.

The Great Panic of 2008

The scale of the financial panic is documented in market prices and statistics from the Bank for International Settlements:

- The interest rate at which banks were willing to extend three-month credit to one another (the London Interbank Offered Rate, or LIBOR) went to more than 4.25 percent above comparable U.S. Treasury interest rates from a normal 0.25 to 0.50 percent;
- Global cross-border interbank lending shrank by more than 22 percent from the end of 2007 to March 2009;
- Global cross-border debt contracted by more than 12 percent from June 2008 to March 2009; and
- The MSCI global index of equity prices declined 48 percent from May 2008 to the end of March 2009.

The resulting global recession is shown in statistics from the International Monetary Fund:

- World GDP in 2009 was less than in the year before for the first time in more than 60 years; and
- World trade volume contracted by more than 10 percent for the full year 2009, much more at the beginning of the year.

Impact of the Great Panic in North Asia

Korea and North Asia were caught up in the distress:

- South Korea's exports dropped by nearly half in the six months before January 2009. Gross domestic product (GDP) fell to 5.1 percent below year-earlier levels in the first quarter of 2009;
- Japan's exports also dropped by nearly half during the same period and suffered a real GDP decline of nearly 9 percent; and
- China experienced an export contraction of one-third, with growth slowing sharply although it remained positive.

China and Korea responded with strong policies:

- Both countries enacted prompt and large fiscal stimulus packages. They led the world in the scale of their responses.
- China and Korea rapidly eased monetary conditions, with the Bank of Korea reducing its base rate from 5 percent before the crisis to 2 percent by early 2009, and the People's Bank of China lowering its interest rate from 7.47 percent to 5.31 percent and driving a credit expansion of 24 percent in the first half of 2009.

- Korea also took measures to assure markets of the safety of Korean banks, supported by swap lines arranged with central banks of major countries, including with Japan and China.

The process of economic development was not derailed in North Asia. Despite the distress as the year began, China achieved 8.7 percent growth in 2009, only marginally lower than the 9 percent recorded in 2008, and South Korea avoided an output contraction for the year. Expectations in 2010 are for growth of close to 10 percent in China and 5 percent in South Korea—in line with the pre-panic trend growth rates. Japan, too, snapped back from its steep slump, but, like the other mature industrial countries such as the United States and western Europe, its recovery seems likely to follow a slow track.

Future Prospects and Risks

If events unfold along the lines of consensus forecasts, the Great Panic of 2008 will be only a footnote in the twenty-first-century history of North Asia. The weight of North Asia in the global economy will continue to increase and transform the geopolitical landscape. Along this path a rebalancing within the region as well as globally can be expected:

- Japan, mature both economically and demographically, will grow slowly but continue to be a global economic power, with Japanese corporations continuing to expand abroad even if the home economy does not grow rapidly.

- The Republic of Korea, given its middle stage of development, is likely to grow more slowly than in earlier decades; but it still has a long way to go to realize its full potential, and its corporations are only beginning to play a global role.

- China has the capacity to achieve rapid growth for another generation or more. It is now passing Japan to become the second-largest economy in the world, and on present trends it would pass the United States in purchasing-power-parity terms well before this decade is over. At that point, China's real output per capita would still be only about one-quarter that of the United States or Japan. There will still be a huge potential for catch-up.

Hanging over this prospect are two political questions—the future of Taiwan and the future of North Korea. The increasing engagement of Beijing and Taipei give reason to hope that cross-strait tensions will be managed in ways that do not disrupt the pursuit of prosperity on both sides. North Korean behavior gives more reason for concern, but the others in the North Pacific share a common interest in keeping North Korea from destroying their security. They should have the capacity to achieve this.

The more serious questions hanging over the future of the region are two matters of economic management. Although the global Great Panic has not derailed the economies of the region from the courses they were on, it has highlighted the need for a transition that was probably overdue, and it has raised the risk of a mistaken lesson being drawn from what happened in the developed markets.

Rebalancing and Transition

First, the central question overhanging the outlook for continued growth and development—not just in Asia, but globally—is whether the much-needed great rebalancing that the G-20 has called for is achieved on a lasting basis. Going forward, the debt overhang of both households and government in the United States and governments in the European Union means that one cannot count on sustained strong consumption growth or fiscal stimulus from these countries to drive global demand as they did before the panic. The previous global expansion, in which the United States bought imports with U.S. Treasury debt and financed a housing boom by selling agency securities to foreign central banks, came to a bitter end. A new sustained expansion will have to be more balanced, with the United States much more nearly matching imports with exports of goods and services. The U.S. trade deficit cannot be displaced to Europe or non-Asian emerging markets without risking another crisis. This means the brunt of the U.S. adjustment will have to be borne by China and, to a lesser extent, by Japan. The combined current-account surpluses of these countries reached well over $600 billion or seven-eighths of the U.S. deficit in 2007, when the panic began. Korea will also find export markets more challenging, but it has a greater proven adjustment capacity as it has moved from surplus to deficit and back again more than once.

Three things must happen for this rebalancing to take place:

First, the United States must reduce its saving-investment imbalance, which precisely matches its external deficit. This means that households must save more, the government must dissave less (that is, reduce its deficit), or there must be less investment. Adjustment will need to involve some of all three. The increase in household saving that occurred during the crisis is eroding already and will have to be, at least, maintained. The government will not only need to reverse the huge deficits being run now but also aim toward a balance once again. Smaller housing investment will make a contribution, but other investment cannot (inventories, for example) or should not (productive investment, for example) remain at low current levels.

Second, others must save less or invest more. China is well placed to accomplish this. The government went into the postpanic period with a budget surplus that gives it scope for sustained spending without financial risk. Corporations were also increasing their saving and can distribute more of their earnings to shareholders. And households are finding an appetite for consumption. A shift of income from profits to wages would bring down business saving and enable households to increase consumption without becoming financially reckless. This adjustment by China would complement adjustment by the United States.

The government of China responded forcefully to the collapse of exports by boosting spending on infrastructure and accelerating the strengthening of health care and pensions. The important thing is to convert the short-term responses into sustainable expenditure patterns, and further strengthening of the social safety net is one way to do this.

Japan faces a tougher challenge. Government debt and deficits are already unsustainably high. Household saving rates have come down considerably. Japan's best choice would be to undertake restructuring to address another imbalance in the Japanese economy—the imbalance between its world-leading tradable goods sector and its much less developed and less efficient (by global standards) nontradable services sector. This would produce both expanded investment and expanded consumption opportunities, which would reduce the saving-investment imbalance.

Third, there must also be expenditure switching on both sides—in the United States from imports to domestic goods and services and in China and Japan from domestic products to imports. And there must be reorientation of production—in the United States toward tradable goods for export and to reduce imports, and in China and Japan toward nontradables. This will encourage and create the capacity for the trade shifts that must take place alongside the shifts in saving and investment for the trade balance to change. Without these shifts, changes in the saving and investment behavior will translate into a lack of demand and chronic high unemployment in the United States and into overheating in China.

Exchange rate changes—depreciation of the dollar and appreciation of Asian currencies—are what will drive these behavioral changes, not overnight but over time. Exchange rates not only have an immediate effect on prices but also alter the relative profitability of producing for export and producing for the domestic market, and this shapes where investment in future capacity goes.

The Japanese *yen* has strengthened, and this is creating pressure that is weakening the economy and makes shifting the saving-investment balance all the more urgent. Korea is coming off a period of *won* weakness and will very likely have to deal with renewed strength as the Korean economy demonstrates its success in recovery. China will need to accept renewed appreciation of its currency, consistent with what has always happened when countries gain economic strength, or it will face recurring domestic overheating and a further buildup of excess capacity in exporting industries. Deferring a greater accommodation of market pressures also raises the risk of a protectionist backlash as domestic imbalances translate into job losses rather than external adjustment, not only in the United States but also in Europe.

Learning Lessons

The second risk to the economies of North Asia is that the wrong lessons are drawn from the breakdown of developed financial markets. What happened in the U.S. markets, as excesses in homebuilding and escalation of housing prices were fed by increasingly reckless credit expansion and then the deflation of this bubble threatened to overshoot catastrophically on the downside, underscored the need for supervision and regulation of markets, for the authorities to act to curb financial excess, and for central banks to provide a liquidity safety net. These are old truths that had come to be widely ignored as prosperity was sustained and smaller excesses like the dot-com bubble were relatively easily absorbed.

Authorities in the United States and around the world are re-examining financial regulation and market oversight to address these failures. But it would be a great mistake to reverse the global trend of the past 30 years toward opening and freeing markets for goods, services, and investment, which has sustained strong global growth and investment, with North Asia leading the way.

It is crucial for the continuation of the spectacular economic development of North Asia—which began in Japan, was then taken up by South Korea and Taiwan, and is now centered in mainland China—that governments not turn away from building strong markets and allowing markets to play the central role in directing economic development. And it is crucial that the countries in the region remain strong voices for open global markets for goods, services, and investment. Although there is no doubt that the great panic showed that markets can fail, markets have over time and around the world created the strongest economies by far. Heavy-handed state direction has, by contrast, universally failed. The choice is not between market and nonmarket economic development; it is between markets that are regulated to ensure transparency, consumer protection, and curbs on activities that create risks for others and economies that are increasingly rigid and distorted by political decisions.

The risk of drawing the wrong lesson is greatest in China, where implementation of market approaches is more recent. In Japan and Korea, the institutions of a market economy are more deeply entrenched and survived severe financial shocks in the 1990s. Indeed, government officials and business leaders in Japan and Korea could play an important role by engaging their Chinese counterparts in discussions on the lessons that they learned from their own financial crises. In the past, Americans (as is our nature) have been most vigorous in offering economic policy advice to China. Right now our credibility is diminished.

Two Implications of the Risks in the Outlook for Korea

Korea has good prospects for continued strong growth in an environment of global economic recovery, but this cannot be taken for granted. Korea needs to do two things to ensure that growth continues.

First, Korea must be agile in a world where new shocks are likely. It has done this since 1997, when it responded too slowly to the developing Asian financial crises and was caught up in it. Its flexible exchange rate has been an effective shock absorber even if large movements in both directions have carried costs. The government moved rapidly to augment liquidity as the Great Panic spread in 2008. Korea went into that difficult time with low inflation and a government surplus, which enabled the authorities to provide monetary and fiscal stimulus without the risks, especially with respect to sovereign debt, that have surfaced in Europe. And Korean firms have moved to the cutting edge of innovation in autos, consumer electronics, and other sectors, enabling them to react more quickly than competitors to rapidly changing markets. This agility will continue to be important, especially with continued rapid change in an increasingly dominant Chinese economy next door.

Second, Korea is now in a position to play a key role in global economic management, and it is important that it do so. The establishment of the G-20 as the global forum for addressing economic and financial issues has belatedly given Korea and other emerging Asian economic powers seats at the table. With its chairmanship of the G-20 summit in 2010, Korea will play an important role in establishing this body as the central forum for dealing with global issues. The G-20 was effective in generating broad national actions across many countries in the midst of the crisis. Now it faces the need for globally coordinated efforts to build a stronger and more stable global financial system, avoid the creation of national financial silos, sustain flagging momentum for trade and investment liberalization, and promote coherent responses to global threats—most notably the need to reduce dependence on carbon-intensive and insecure sources of energy.

Looking beyond its chairmanship, Korea can play a special role in making the G-20 effective. Korea has a special understanding of its North Asian neighbors, China and Japan, which are the world's second- and third-largest economies. And it has close and deep ties with the United States. This equips Korea to play a mediating role within the G-20 among the three giants. It is a role that Canada often played within the Group of Seven, where its officials often understood the perspectives of Americans and Europeans better than they understood each other. Indeed, Korea and Canada could work together in a common effort to bring others into a global consensus.

The decade that is beginning can be one of economic stability and convergence to a high level of prosperity in North Asia; but it will take appropriate policies in each country, increasing cooperation within the region, and global engagement to ensure that this promise is realized.

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