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Shared Prosperity and Harmony

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Edited by
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The following are papers that were presented at the APEC Forum on Shared Prosperity and Harmony in Seoul on March 31-April 1, 2000. In order to preserve, to the furthest extent possible, the intentions of the speakers, the papers have been modified to their presented form. However, in cases where the contents of the presentation vary substantially from the original paper submitted by the speaker, the original paper has been attached in the annex as a reference.

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PROCEEDINGS by Kyung Tae Lee

I. APEC Forum Structure

Background

In the wake of the financial crisis of 1997 in East Asia, rapid signs of recovery have started to surface as the crisis-affected economies have actively pursued structural reforms and liberalization of their respective economies. However, the need for closer cooperation among economies has become, more than ever before, crucial in preventing the recurrence of future crises and in stimulating renewed growth in the region. In particular, with the deepening interdependence among world economies in this era of globalization, such need has become increasingly important.

In order to prevent the recurrence of economic crises, it is essential that we grasp a better understanding of the economic systems of APEC member economies and share the lessons learned by each economy from the crisis, so as to search for desirable directions for future policy. Moreover, income and wealth disparities between and within economies that have emerged in the process of overcoming the economic crisis are challenges that must be resolved in order to achieve sustainable economic growth and social stability.

In this context, President Kim Dae-jung of Korea proposed, at the APEC Leaders' Meeting held in Auckland, New Zealand in September 1999, that APEC members hold a policy dialogue in Seoul, in 2000, to discuss ways to prevent the recurrence of future crises by sharing the experiences in overcoming the recent crisis, and further to seek ways to alleviate the economic and social disparities among them.

In turn, the Leaders of the APEC member economies recognized the need for such a policy dialogue to promote common prosperity and harmony, and welcomed President Kim's offer to host the Forum in Seoul.

Objectives

The objectives of the APEC Forum on Shared Prosperity are to exchange views on the current status, strategies and future directions of the structural reforms and liberalization, pursued by individual economies in overcoming the economic crisis so as to explore ways to coordinate the policies of the member economies, and present policy directions for sustainable economic growth in the Asia-Pacific region.

From a future-oriented perspective, the Forum seeks to explore desirable financial and foreign exchange policy directions that should be pursued by individual member economies at the domestic level to prevent the recurrence of future crises, while discussing ways to improve the financial architecture at the international level. With regard to international financial architecture, the Forum will focus on hedge funds and the movement of short-term capital, which were primary causes of the economic crisis.

Further, as income and wealth disparities between and within economies have posed challenges to social stability in the process of overcoming the economic crisis, the Forum seeks to exchange views on a desirable welfare model and to provide a new paradigm for APEC in this regard. As the gap in knowledge among economies is expected to become a key component of disparities in the knowledge-based, digital economy of the 21st century, cooperation measures to reduce such a knowledge gap will be discussed at the Forum.

Ultimately, the Forum aims to provide a long-term vision for prosperity and harmony through policy dialogues, so as to allow APEC to maintain its momentum and develop into a truely cooperative organization. The Korean government plans to report the conclusions of the Forum to the next APEC Leaders’ and Finance Ministers’ Meeting as a basis for future discussions and hopes that they will provide invaluable foundations for various APEC Meetings in the future.

Format and Participants of the Forum

The APEC Forum on Shared Prosperity will consist of a total of three sessions, with each session being comprised of two sub-sessions. Separately, 1999 Nobel Prize Laureate Robert Mundell and renowned futurist Alvin Toffler will each deliver a special lecture during the Forum. The topics of the lectures will be "Globalization: Past, Present and Future" and "What is a 'Third Wave Information Society'?", respectively.

At each session of the Forum, senior government officials, including ministers and vice-ministers from the 21 APEC member economies, along with prominent experts from both academia and international organizations, as well as key distinguished figures will be invited to serve as moderators and speakers.

The participants consist of recognized and accomplished individuals from the broadest spectrum of society, including APEC senior government officials, scholars, business people, journalists and public interest group representatives. A total of 300 foreign prominent figures, including foreign representatives residing in Korea, as well as a diverse and distinguished collection of notable Koreans will participate in the Forum.

In addition, the Forum will be broadcast live, in real time, over the internet (www.apecforum.go.kr) for those who are interested and all materials related to the Forum will be available on this website.

II. APEC Forum Summary

The Importance of Structural Reform and Trade & Investment Liberalization in Overcoming the Economic Crisis

The moderator, Prof. Robert Barro of Harvard University, stated that it has been established, by evidence, that free trade and foreign direct investment help economic growth. He also stated that when it came to capital account liberalization in general, we are witnessing a rise in growth but with some danger of crisis. Therefore, the question as to what is the correct economic structure needed to achieve superior economic performance still needs to be resolved. He hoped to gain some insight on this issue during the session.

Supachai Panitchpakdi, the Deputy Prime Minister of Thailand, stated that first of all, one should understand that the Asian crisis was a systemic one in the sense that it had to do with economic structures. Therefore, reforms to address structural weaknesses should be the essential component of the crisis-overcoming measures. Implementing reform measures proved to be politically difficult and economically painful. The early recovery of the region was possible due to the rebound in external demands, which reaffirmed the importance of liberalization and reform. Second, international cooperation is important in dealing with crises. The Asian crisis was contagious and, therefore, required an internationally coordinated response. Third, the recovery is not yet complete and still remains fragile. These facts emphasize the necessity of maintaining the resolve with respect to reform and liberalization.

Indonesia's Minister of Finance, Bambang Sudibyo, delivered a paper via proxy. He stated that Indonesia's experiences with liberalization have shown that liberalization is good for growth, but should be accompanied by internal reforms as well. Indonesia began liberalizing its economy decades ago. Deregulation gave rise to an increase in capital inflows and employment in the industrialized sectors. However, the remaining structural weaknesses increased the vulnerability of the economy and finally brought about the crisis. Indonesia's goal for the future is to achieve sustainable and equitable growth. In spite of the crisis, Indonesia's strategies to accomplish this goal has not been changed. The economy needs to be transformed into one fully integrated with the global market.

Lim Swee Say, the Minister of State for Trade and Industry, Singapore, stated that Singapore's top priority in overcoming the recession provoked by the Asian crisis was to minimize unemployment and preserve the production capacity. Wage cuts, fees and tax rebates were utilized to boost the economy. At the same time, Singapore implemented measures to enhance the information infrastructure and upgrade workers' skills for the purpose of improving the fundamental capacity of the economy. Singapore recognized that the post-crisis world economic landscape will be driven by two main forces: globalization and technology. To meet the challenges in coping with these forces, Singapore's long-term strategies are twofold: first, transforming the Singaporean economy into a knowledge based one; and secondly, deregulating the service sector.

Korea's Minister of Finance and Economy, Hun-Jai Lee, reported that Korea has made a swift recovery from the crisis. The recovery was spurred by three main factors: timely macroeconomic policy adjustments, implementing sweeping reforms to restore market stability and strengthening the social safety net to preserve national cohesion. In addition to these three factors, market opening and investment liberalization also played important roles in the overcoming of the crisis through the provision of financial resources, job opportunities and the transfer of technology. In the case of Korea, structural reforms were crucial because the crisis was caused by long-standing structural weaknesses in the economy rather than by a temporary shortage of foreign reserves. Korea needs to pursue simultaneous reforms in all sectors, since the structural problems were present throughout the economy and were closely interrelated. Some future challenges remain. First, Korea is prepared to deal with widening income gaps by establishing a "productive welfare" system, and will address increasing fiscal deficits and government debt by instituting a plan to achieve a balanced budget by the year 2003.

The moderator concluded by commenting that in Korea's case, tight fiscal policy was initially undertaken at the advice and direction of the IMF. However, the policy response was a mistake considering that the crisis was not caused by fiscal deficits. Hence, the change in stance, taken by the Korean government in 1998, to an expansive macroeconomic policy, was the appropriate choice.

APEC Trade and Investment: Finding Effective Ways for Substantial Liberalization Session Summary

The moderator, Ippei Yamazawa, President of Japan's Institute of Developing Economies, stated that APEC contributed to the successful conclusion of the Uruguay Round. He highly praised APEC's liberalization initiatives and noted its continuing momentum in spite of the Asia economic crisis. He also commented that APEC supported the launch of the WTO New Round in Seattle.

James Sutton, Minister for Trade Negotiations from New Zealand, pointed out that trade and investment liberalization is the most important agenda vis-à-vis Asia-Pacific Economic Cooperation and expressed his satisfaction with APEC's performance over the past 10 years. Minister Sutton categorized APEC's liberalization efforts in three ways: unilateral, multilateral, and sub-regional. The APEC member economies have continued their reform and market opening measures at the domestic level. On the multilateral level, APEC should make every effort to launch a new WTO Round at the earliest possible stage. On the sub-regional level, the attempts at creating sub-regional free trade areas are flourishing. These efforts should be looked upon as building blocks on the path to achieving the Bogor goals and should conform to APEC's liberalization initiatives.

Felipe Medalla, Secretary of Socio-Economic Planning for the Republic of the Philippines, suggests that liberalization positively impacts economic growth. He, however, also pointed out negative aspects of trade liberalization, in that it can lead to a reduction in tax revenue, deterioration of the current account, as well as adverse income redistribution effects. To promote trade liberalization, continuing economic growth and sound economic governance are required. Furthermore, liberalization should be pursued in a consistent manner in the presence of overall development goals.

Rosario Almenara, Vice Minister of Economics and Finance for Peru, explained the economic relationship between Peru and the other APEC economies. She also introduced Peru's economic reform program. Peru became an APEC member in 1998. Of Peru's total trade, 50% is carried out within APEC. Peru has vigorously pursued FDI inducement and FDI accounts for 30% of total investment at the moment. Peru targets an economic growth rate of 6% and national debt reduction and poverty alleviation are its primary policy goals.

Peter Drysdale of Australia National University commended APEC's recent performance and successes, including the active participation of the 3 Chinas, the holding of the Summit, and for its contributions to the successful conclusion of the Uruguay Round. However, APEC is facing challenges on three fronts: the delay in the launch of the WTO New Round, flourishing sub-regionalism among APEC member economies, and opposition against liberalization inside the individual economies. To launch the WTO New Round at the earliest possible stage, APEC should proclaim its support for the New Round to the world. The formation of free trade areas among APEC member economies should be carried out in a manner consistent with both the Bogor goals and the multilateral goal of the WTO. To expand the constituency for APEC's liberalization initiative, each member economy should display political leadership in its own domestic political process.

Moderator Yamazawa lauded the domestic reform efforts of the Philippines and Peru. He reiterated the point that the formation of free trade areas should only be carried out if both APEC's and the WTO's goals are fully taken into consideration.

Financial and Foreign Exchange Policies for Preventing the Recurrence of Economic Crisis

Tarrin spoke of four essential elements to avoiding future crises: a floating exchange rate regime, sound monetary policy, sound fiscal policy, and improved transparency. He then illustrated the work in Thailand on all four points. First, Thailand moved to a free floating exchange rate regime after the crisis. Second, Thailand created a new Bank of Thailand Act, to strengthen the bank's independence and accountability, especially by maintaining price stability and safeguarding systemic stability. Third, Thailand has been reducing the government deficit, and with the new Bank of Thailand Act, banks will no longer be able to lend to the government to finance budget deficit. Tax efficiency is being improved and public expenditures are being controlled, while allowing the investment budget to increase in areas critical for the long-term growth and competitiveness. Fourth, Thailand now follows the IMF's Special Data Dissemination Standard for its release of macroeconomic data, and the Bank of Thailand regularly discloses its net international reserve position. The new Bank of Thailand Act will require preannouncing monetary policy direction and disclosing financial accounts on a weekly basis. Tarrin mentioned several tradeoffs in policy making: the tradeoff between a completely free-floating and managed floating exchange rate system; long-term fiscal prudence vs. stemming immediate crises through deficits; and the balance between inflation and interest rates and output.

Lastly Tarrin discussed financial and corporate sector policies undertaken. First, the financial sector governance has been improved including the new Financial Institutions Act to standardize the regulatory framework for banks, finance companies, and credit fonciers. Second, legal reforms for effective debtor-creditor regime have been pursued by amending the Bankruptcy Act to provide clear bankruptcy proceedings and financing for distressed debtors and establishing the Corporate Debt Restructuring Advisory Committee (CDRAC) to monitor and facilitate debt restructuring. Third, long-term stability of the financial sector has been strengthened through recapitalization, liberalization, and consolidation. Finally, corporate sector governance has been strengthened by improving financial disclosure, board oversight, and shareholder rights, including best practice accounting standards and amending the Public Company Act and Securities Exchange Act. Tarrin pointed out tradeoffs in financial and corporate sector policies as well. Thailand chose to take a middle ground in the tradeoff of regulatory forbearance, phasing new regulations in gradually during the crisis. In addition, Thailand chose a middle way in recapitalization, with safeguards to reduce future moral hazard. Lastly, the tradeoff of NPL resolution must be noted, as public “carve-outs” could create moral hazard, a massive fiscal burden, and a much-delayed final resolution of the problem. Thus, Thailand has pursued a multiple approach aimed at the final resolution of NPLs: auctioning assets of 56 closed finance companies through the Financial Sector Restructuring Authority (FRA); reprivatizing intervened banks to acquirers who are responsible for resolving NPLs; pursuing market-mediated mechanisms for resolving NPLs.

McDonough cited two building blocks to reducing systemic risk of crisis: creating strong financial systems and making stable macroeconomic systems both nationally and globally. He noted that the Asian recovery had been remarkable and had defied expectations, with a solid V-shaped trajectory, recent domestic demand increases, bank recapitalization, and fundamental enhancements to the financial infrastructure. However, optimism should not lead to complacency and reform fatigue.

On the microeconomic level, several cautionary lessons had been learned: clean-up must be fully completed at the institutions or would cause future problems; fundamental bank improvements were essential; protracted forbearance for the sake of sovereignty was not good, although some forbearance may be necessary; the government was never a good long-term asset holder and the delay of the privatization of banks inhibits reform; foreign investments provide relief and benefits, including a diversified funding base; that the financial sector is only as healthy as the borrowers; and that an economy unduly dependent on banks was very vulnerable.

McDonough noted three pillars of stability: sound corporate governance, effective market discipline, and strong prudential regulation. A sound a stable macroeconomic environment was necessary, with the central banks achieving long-run price stability. He posited that there was no set of monetary and exchange rate regimes that would be correct at all times. These matters depend on the conditions of the economy, and it was best for national economies to make these decisions by choice, rather than necessity. Since authorities cannot target everything, they must choose one policy anchor. Large-scale intervention would only inflame a currency crisis into an external debt crisis, and so the move of many Asian countries to a floating exchange rates seems now, after initial discomfort, to have been a good one. In the future, Asian economies may have to restrain growth and constrain the growing public debt, while also improving transparency, but on the whole they have very bright prospects indeed.

Kolotoukhin began by suggesting that the Korean experience in overcoming its crisis could be very helpful to all APEC countries, including Russia. The Crisis in Russia was profound and comprehensive, bankrupting most banks, devaluing the currency and high inflation, causing drastic production output and GDP decline, forcing the entire collapse of domestic capital markets, and bringing to a standstill on current debt repayments. The Causes of Crisis were the slowness of financial consolidation and structural reforms, insufficient and inadequate public and external sovereign liabilities management (including huge short-term borrowings at high margins), preserving a pegged exchange rate despite deteriorating fundamentals, and a substantial budget deficit (up to 8% of GDP). Immediate Reactions to the Crisis included switching to a floating exchange rate, employing realistic and responsible sovereign liabilities management, and reducing the budget deficit and steady fiscal consolidation. Consequences of Amendments have been increased GDP and production output growth, sharp reductions in inflation, and a budget primary surplus. Remaining Vulnerabilities include slow investment growth, partial isolation of Russia from international capital markets, unsustainable external debt and debt service and high level of budget contingent commitments and government commitment to social protection system, capital outflows, and dependence on the export of commodities.

Lessons of the Crisis are following: the transition from regulated to liberalized systems is the most vulnerable period; sound macroeconomic management is necessary but not enough to prevent crisis; any exchange rate system can be workable but that good economic policy does not prevent vulnerability; capital inflows before the crisis and outflows after are the major factor of the crisis, so flexibility in regime switch is unavoidable but policy credibility is essential; and public and external sovereign debt management in maturities and costs are required. Monitoring and benchmarks for the private sector are essential. Policies to be pursued include choosing an appropriate exchange rate policy, managing public and sovereign liability consistently and prudently (maintaining stable macroeconomic and political environment, prudent and transparent fiscal management, development of domestic capital markets, obligatory public debt control and management, steady elimination of distinction between local and external capital markets, comprehensive and profound sovereign liabilities management system, flexible capital controls), maintaining consistent and responsible fiscal policy (reduced budget deficit, increased efficiency of public spending, eliminating unimplementable budget commitments, social security reform, reducing monetary budget financing), and reforming tax system so that it provides a better investment climate with a comparatively low level of taxation with an extended taxation base.

In his discussion of international architectural reform, Ian Bannett observes that the desire for international stability and the need to reduce moral hazard are at odds. He suggests that although the stability offered by the rescue packages of the IMF are beneficial, the global economy must develop policies to reduce the severity and frequency of crises without needed to resort to large assistance packages. This is especially pressing, he notes, as neither the IMF nor other lenders will have sufficient funds to maintain current lending rates or practices. Bannett argues that Korea was an especially successful IMF project and offers two reasons as to why this was. One, the Korean government eagerly embraced domestic financial reforms, rather than simply complying with the IMF's demands. Two, the private sector was involved in work-out plans, reducing the governmental burden. Bannett suggests that these two components are key to maximizing the effectiveness of our reactions to future crises.

Lastly, Bannett discusses the role of the newly-formed G-20, which is designed to perform the functions of the G-7 (improving participant's economies both through policy discussion and the voluntary self-improvement of members) for a body that is more representative of today's global economy. The G-20 is composed of 19 members from both advanced and emerging economies, as well as the IMF, World Bank, and the President of the European Union, and represents 87% of world GDP and 65% of world population. Current issues being discussed by the G-20 focus on reducing vulnerability to crisis through exchange rate arrangements, financial sector regulation and supervision, prudent liability management, and creating best practices standards.

Recently, The Meltzer Report on how to reform the international financial institutions and strengthen the international financial architecture has been issued in the United States by the International Financial Institution Advisory Commission. But while the report provides a detailed list of steps needed to strengthen banking systems, it offers only a cursory discussion of the exchange rate problem. He pointed out that the commissioners do not say how high the penalty rate would have to be to filter out countries with deep structural problems without at the same time deterring those with liquidity problems. The reality is that national policy makers are uncertain about the extent to which their country's problems reflect a sudden disruption to liquidity or poor long-term fundamentals. In addition, most politicians care about short-run outcomes – they have high discount rates. It is not clear, in other words, that a high interest rate will deter them. Thus, the idea that the Fund can filter out these cases by charging a penalty rate and ensuring that its claims enjoy seniority ignores political realities. The Meltzer report skates over several important issues. For one, it ignores the lessons of the attempt with prequalification learned from the IMF's experience with its recently established Contingent Credit Line. The worst thing that can happen under such a system is for a previously prequalified country to be dequalified; an investor panic and adverse macroeconomic consequences are almost certain to follow. If the IMF cannot bear the prospect of decertifying the previously certified, it will set a high standard for certification. The population of certified countries will then approach the null set -- as it has under the CCL program. Another difficulty is that structural problems that can set the stage for a crisis are not limited to the banking system. An unsustainable fiscal position can also heighten crisis risk. Thus, the report also contains a recommendation that countries, to prequalify for IMF assistance, must satisfy unspecified fiscal conditions. Inevitably, the implication of heading down this slippery slope is to reintroduce the discretion into IMF conditionality. A third objection is that hard-and-fast rules for prequalification would prevent the IMF from responding to exceptional events that threaten the stability of the global financial system or inflict acceptable collateral damage on innocent bystanders. Acknowledging this reality, the report contains an opt out, citing “unusual circumstances, where the crisis poses a threat to the globl economy.” It renders unavoidable the idea that IMF disbursals will decided, in the end, by the discretion of its Executive Board and management, and not by any set of hard-and-fast rules. Finally, the Fund’s shareholders will come under pressure from investors and from those who want to limit the pain and suffering in the crisis country. The pressure to bail out will remain. The only way to avert it is to create more efficient, preferably market-based mechanisms for encouraging debt restructuring. The Meltzer Commission acknowledges this logic, but the Commission did not make specific recommendations in this area.

The report recommends that, in order to qualify for access to IMF facilities, countries should be required to publish information on the maturity structure of their outstanding sovereign and guaranteed debt and off-balance-sheet liabilities. The adequacy of the data needs to be evaluated, and the results of that evaluation published to invigorate market discipline. Similarly, companies with traded liabilities must use internationally-respectable auditing and accounting standards, and someone has to evaluate their compliance. Antiquated bankruptcy and insolvency procedures need to be modernized, and someone has to be responsible for evaluating whether this is being done. The premise of the report, it would appear, is that if banking systems can be strengthened, then these other problems can be left to sort themselves out.

Since legitimate global standards can only be set by a global institution, the IMF would seem to be the most eligible available candidate. Its specific recommendations for reforming the operating procedures of the international financial institutions, the IMF in particular, are unlikely to prove operational. In a sense, the commission's failed attempt to move from entirely justifiable dissatisfaction with the status quo to a new set of rules points up the intellectual dilemma that faces anyone confronting these issues. It reminds why an attempt to make the world a safer financial place by reforming the IFIs without at the same time reforming the broader economic and financial environment in which they operate is unlikely to succeed.

Horiguchi termed the Asian financial crisis a currency crisis, an external debt crisis, and a banking crisis. He declined to choose one of the three as a cause, as they were simultaneous. To prevent crisis, all three elements must be dealt with. All three elements related to the high-growth strategy by Asian economies that spurred growth through massive investment in priority sectors, typically export oriented industries, under tight government guidance. This was successful at first but led to major balance sheet weaknesses, putting macroeconomic stability at great risk. In the future the growth strategy should be changed, focusing on faster total factor productivity growth, with more reliance on market forces and less on government intervention. To reduce Asian vulnerabilities, the following steps are important: 1) Restore the health of balance sheets in the financial sector, especially in banking, 2) Strengthen the balance sheets of the non-financial corporate sector through market discipline, with improved regulatory, legal, and institutional infrastructure, 3) Avoid macroeconomic imbalances, including unsound fiscal positions, excessive external debt, and unsustainable exchange rate policies.

Recently there have been many changes in the global economic structure, including large, highly sensitive capital movements and the integration of developing countries into the world economy. This has meant increasing risks for Asia, which were exacerbated by the *de jure* or *de facto* adopted currency pegs. Floating exchange rates should be the new choice for most economies, especially those in Asia. In these new regimes, there should be considerable freedom for the rates to move, although there should still be some intervention, without tight regulation, to prevent crisis. With a floating exchange rate, there must be a new anchor for low inflation. He suggested an inflation targeting framework. Regarding the role of capital controls, he suggested that there may be a place for price-based capital controls to address market failures, especially in preventing herd behavior panic among investors, but he argued that these should only be temporary, as capital controls lose their potency if they are maintained for too long. They should be used only with a well-defined timetable for prudential regulations and supervisory systems, and they should not be an excuse to delay needed macroeconomic policy and exchange rate adjustments.

He concluded by suggesting that a new financial architecture should be the next topic of discussion, especially in considering ways to "bail in" private creditors in a crisis situation, to discourage reckless behavior by private creditors.

New International Financial Architecture: Focusing on Hedge Funds and Short-term Capital Flows

As a moderator, Andrew Crockett, the Managing Director of the BIS and Chairman of the Financial Stability Forum, presented a few of the challenging issues confronting New International Financial Architecture while focusing on Hedge funds and short-term capital flows.

He emphasized that the best approach for stability in International Financial Architecture was to identify factors that have brought instability to the financial market and to adopt proper measures that could resolve these problems. He pointed out that the Financial Stability Forum has been playing an important role in designing international financial architecture by taking into account hedge funds as well as other highly leveraged institutions and short-term capital movements.

The first speaker, Stephen S. Roach, Chief Economist of Morgan Stanley Dean Witter, started by quoting the report of the Council on Foreign Relations – "Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture." He pointed out that restructuring momentum has slowed down and that there is a lack of political constituency for restructuring. According to Mr. Roach, systemic risks in the international financial markets still exist and new crises are inevitable. For regulating hedge funds, he added, commercial and investment banks are also highly leveraged institutions and should be regulated. For regulating short-term capital movements, he suggested a Chilean style holding-period tax system

The second speaker, Paul C.H. Chiu, the Minister of Finance for Chinese Taipei, emphasized that capital inflows from financial market liberalization could cause asset price bubbles and external imbalances. He suggested that emerging market economies should be cautious of current account balances and should consider limiting independent monetary policy caused by financial market liberalization. He concluded that Taiwan's case of overcoming crisis can be considered a benchmark model of a flexible approach to cope with financial turbulence.

Yoshimasa Hayashi, the State Secretary for Finance at the Japanese Ministry of Finance, pointed out that indirect regulations on highly leveraged institutions and short-term capital movements suggested by the Financial Stability Forum was appropriate. However, he added that if these suggestions are not realized or not effective, direct regulations are deemed to be appropriate. He mentioned Hong Kong and Malaysia as examples of these approaches. He complimented the Malaysian measures. He also added that Japan's gradual approach to financial market liberalization could be a benchmark model.

Shafie Mohd. Salleh, Deputy Minister of Finance for Malaysia, mentioned that the new international financial architecture (IFA) should aim for achievement of a global agenda for the benefit of all and address the fundamental weaknesses of the free market system. He claimed that firstly, the IFA should be able to avoid disruptive destabilizing capital flows in order to maximize the benefits from globalized capital markets while minimizing risks. Secondly, it should contain the adverse impact of currency trading especially on small economies. Thirdly, it should mitigate the occurrence of future crises and limit the contagion effect of any crisis. Lastly, it should aim to achieve symmetry in good behavior in government and private sector.

He concluded that given the present environment and the potential effects of sharp reversal of capital flows, Malaysia believes that safeguards and protective policies be put in place until there is assurance from the international community that vulnerabilities in the system could be overcome and a framework safeguarding individual economies from the adverse consequences of capital movements can be set up.

Andrew Crockett, in his concluding remarks on the sub-session, observed the following. The key to international financial architecture reform is to recognize the private entity as a principal actor in adjusting external discriminatory problems that may arise. To solve these, first identify the problems, and then try to correct them within the financial market through institutional activity. Markets and infrastructure that operate in the international financial architecture are much more complex than the domestic level. Thus, to manage this, it needs a broad range of management, including efficient allocation of resources, codes which adopt standards across jurisdictions. Codes cannot be enough unless the mechanism, such as incentives rewarded through the market mechanism, is established. From these key components of concern, financial fora are held. In these fora, capital flows and highly leveraged institutions (HLIs) are the source of concerns. Hedge funds are described as big players in small emerged markets. Regarding short-term capital flows, countries are vulnerable for a number of reasons, such as imprudent management of the government, currency mismatches, and excessive debt in the non-corporate sector. Thus, financial stability forum working groups are required to address these.

Regional Cohesion for the Alleviation of Social and Economic Disparities

In the Session III, under the theme of "The Search for a New Welfare Paradigm," the experts exchanged views on how to develop a sustainable welfare paradigm in step with current and future dynamics, and to identify ways to cooperate with an aim to resolving the socioeconomic imbalances in the APEC region. To this end, various new social welfare approaches, including the "Productive Welfare Model" of Korea, and the "Shared Capitalist Model of Work and Welfare" for the US, have been examined and discussed. All the experts agreed that the recent socio-economic disparities are not just the concern of any one country and they are issues of grave significance to all the member countries of the Asia-Pacific region. They also agreed that close inter-regional cooperation is needed to address the worsening income distribution situation within APEC and to link economic development and market freedom, through appropriate welfare policy measures, in the developmental process of APEC.

The first speaker, Professor Richard Freeman of Harvard University, explained how the traditional model of the labor market and welfare state has changed in the 1990s. In the job market, variable compensation systems, including stock options, strengthened the tie between workers' well-being and that of their firms. As for the welfare state, social benefits have become more tied to work in order to enhance work incentives, at the expense of the social safety net. He defined these changes as the "Shared Capitalist Model of Work and Welfare," and emphasized that this new model has enabled the US to reduce its welfare rolls by unprecedented numbers, and resolved much of the incentive problems associated with traditional systems. He also pointed out that the new model, by reducing social insurance and income security in bad times, may not be well-suited for dealing with severe economic recession.

The second speaker, Professor Emeritus of the University of Wisconsin-Madison, Glen

G. Cain , examined the new welfare reforms regarding Aid to Families with Dependent Children (AFDC) in the US. The new reforms essentially require that most welfare mothers obtain market employment to support their families. He concluded that wage growth is essential to reduce poverty and raise living standards among families with dependent children.

The third speaker, Kim YooBae, Senior Secretary to the President for Welfare and Labor, explained the concept and policy directions of "Productive Welfare," which the Korean government now pursues. He also discussed ways to construct a global welfare paradigm for the new era and to cooperate with an aim to resolving the socio-economic imbalances in the APEC region. To this end, he proposed a 'welfare policy cooperation channel' though which the outcome of this APEC Seoul Forum will be organized and used in cooperative discussions. These talks will focus on social safety nets, social insurance, services for the underprivileged and a preventative plan to address the worsening income distribution within the APEC region and to link economic development and market freedom, through appropriate welfare policy measures, in the developmental process of APEC. He added that, in order to achieve this, the 'APEC Social Safety Net Task Force' should be actualized and Economic Committee (EC) programs should focus on the alleviation of socio-economic disparities. Furthermore, the funds for cooperative programs in the social and welfare areas within APEC must also be reviewed to enable them to be developed and utilized more efficiently.

The last speaker, Professor Irma Adelman, of the University of California at Berkeley, emphasized that President Kim's "Productive Welfare" solution enables Korea to adopt the Western ideal of more flexible employment, by making it consistent with Korea's communitarian values and with the reality of the continued globalization and marketization of the economy. She also expected that the "productive welfare" approach will not only reduce poverty and income inequalities, but also lead to greater social cohesion and generate greater degrees of economic and social participation.

Reducing the Knowledge Gap through Regional Cooperation: Cyber Education, Human Resource Development and the Transfer of Technology

As the moderator of the session, Asian Development Bank's Vice President Peter Sullivan stressed the importance of knowledge and said that he hopes for intensse discussions to reduce the knowledge gap.

Futurist Alvin Toffler started the session by noting that the education systems have a covert purpose other than provision of knowledge. In the past, in industrialized “second wave” societies, education had to provide workers suited for working in mass production, or typical office work. Thus, education, in addition to providing knowledge, instilled the concepts of punctuality, discipline, and rote memorization designed to facilitate working in such mass production factories. As the role of education is to prepare students as members of the future labor force, this type of education was very effective in providing workers suitable for the industrialized “second wave” societies. This process was not as evil as it sounds, since it also democratized the students by bringing students from all classes together. However, such educational methods are no longer appropriate in an information-based “third wave” economy where each person must be treated as individuals, to unleash the maximum amount of creativity within each person. The role of education must change to equip students with the ability to question, think individually, and innovate. While in the past, it looked like there would be a digital divide between people or countries which had wide access to information and those who did not, that worry now seems to be unwarranted since the digital divide is not as deep as it seemed, and there are signs that the differences are narrowing.

Le Thi Bang Tam, Vice Minister of Finance for Vietnam, expressed bright global economic picture as the US economy adheres to a record high growth rate, the EU economy sustains its stable development, and particularly, the Asian economies steadily recover and regain their momentum for growth. However, she also conveyed that in order overcome the economic hardships and attain sustained growth, Vietnam plans to implement the five following measures:

- Firstly, creating fovarable conditions and more effectively support production and business sectors, completing the comprehensive legal framework and taking appropriate policy measures to support economic sectors.

- Secondly, liberalizing markets and actively participating in international intergration process by continuing to issue regulations for opening securities market, operating the real estate market, developing further the labor market, etc.

- Thirdly, improving the investment efficiency by effective implementation of the institutional and policy reform, restructuring capital investment by the State and implementing reforms in credit policies …

- Fourthly, continuing reform and realignment of banking and financial system and state own enterprises to improve the efficiency. Implementing debt restructuring by setting up debt trading companies.

- Finally, addressing imperative social issues such as hunger elimination and poverty reduction, job creation. She stressed that reducing the knowledge and economic gap in the liberalization through regional cooperation is an important component to sustain the global economic development in the future. She presented the following as the tasks ahead:

- Firstly, further liberalization should come along with paying more attention to the equality issue and putting more efforts to bridge the gap among economies at different development levels

- Secondly, liberalization should be used as a vehicle to obtain economic recovery after crisis as well as to prevent recurrence of the crisis in the future.

Korea's Minister of Education, Moon Yong Lin, in his speech on "Strategies to Reduce the Knowledge Gap in the APEC Region," stated that as the new millennium, characterized by revolutionary changes in information technology and its impact on our knowledge-based economy, demands a paradigm shift in ways of managing government, industry, and other sectors of our society, knowledge and information have become the most valuable resources in a nation's economic growth and development. In view of these developments, he stressed that the leading economies are placing the highest priority on educating their people to be better equipped to work in the knowledge-based economy. He stressed that APEC must be very specific and more practical when devising strategies to close the knowledge gap. He stressed that cyber learning, which has been made possible due to the rapid development of information and communications technology, is a new mode of education that will help to enhance the learning process with formidable speed and convenience. In addition, Minister Moon proposed to launch a volunteer service program, named the APEC Internet Volunteers Program, and an education initiative that will foster growth in the number of qualified IT experts, as a means to implement an e-Education Project proposed by President Kim Dae-jung at the Auckland Leaders' meeting last year.

The fourth lecturer, James Wolfensohn, President, World Bank, through a video message, proceeded to address the issue of overcoming the poverty gap through modern technology.

He stated that the key to the future, in terms of peace and prosperity for our planet, is no longer by charity but by the way in which poor people are able to be exposed to opportunities which they will be able to grasp through communications and information. He entirely agreed with the notion of 'productive welfare' which was raised by President Kim Dae-jung in his speech to the World Bank in November, 1999. With regard to the transfer of knowledge, the World Bank is managing a number of programs, such as 'World Links' and the 'African Virtual University,' which are aimed at fostering and developing a global distance learning network. The adoption of technology, by any country, is not a matter of choice, but is, in fact, a matter of survival. It's only a question of when the countries, not meeting this challenge, will clearly fall behind. They now have, in their hands, an unprecedented opportunity to affect the lives of hundreds of millions of people and to encourage those people to help themselves.

PART I : Surmounting the Economic Crisis through Liberalization and Reform

1. The Importance of Structural Reform and Trade & Investment Liberalization in Overcoming the Economic Crisis

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

Last time I was in Korea was in 1996. And I was also here several times before that. I should note, that was all before the occurrence of the Asian financial crisis, though I don’t really mean to suggest there was some causation about my having been here in 1996 and the financial difficulties that occurred thereafter.

An interesting question is what prediction would one make for the effect of the financial crisis in recession in Korea and elsewhere on the demand for my services here. If I’m useful and my advice is helpful for economic performance, then I think that one would predict that the demand for my services would go up at a time of economic crisis. On the other hand, if I serve mostly as a consumption good, one would predict that the demand for my services would go down in the face of such an economic crisis.

Sadly, I have to observe that I have not been invited back to Korea until now, the year 2000, when, of course, the Korean recovery is already dramatically underway. So I would not presume to suggest that my presence here would propel the economic growth of Korea or the Asia-Pacific region, more generally. I would say it is a very good sign for the region and, particularly, for Korea that I’ve been invited back here, but certainly, at least a symptom that things have been improving and doing very well lately.

This session will focus on the roles of structural reform in financial, legal, corporate systems and on liberalized trade and foreign investment in the recovery and economic growth process. There’s pretty clear evidence across countries that free trade promotes economic growth and I find that’s especially true for poorer countries. It’s also pretty straight forward that foreign direct investment is a positive element for economic performance of a country. Open international capital markets, more generally, have a lot of good aspects. But there can, it's true, be problems, particularly involved with short-term portfolio investments when these interact with a system that's weak in terms of legal and regulatory structures. On these matters, I'd say it's harder to find direct empirical evidence about what the overall desirable structures are in terms of fostering good economic performance. Therefore, I, particularly, hope to learn more about these issues from the present session and from the conference overall.

Our first speaker will talk about the experiences in Thailand. Dr. Supachai is Deputy Prime Minister of Thailand and he will give the first presentation.

Supachai Panitchpakdi
Deputy Prime Minister
Thailand

Thank you, Mr. Chairman.

Professor Barro has been discussing about the demand for economists' services, whether that would rise or fall with the crisis. But let me confirm one fact, which is a fact of life. There is definitely a demand for more politicians, particularly, those who are responsible for economic policies because most governments which have been in a crisis have been making a lot of uses of different ministers, changing them ever so often, making them responsible for some of the past wrongs or present wrongs that they are being blamed for.

I have also lost most of my old friends at the central banks. There's a great demand in my own country for a lot of central bankers – colleagues and co-workers from the same period that I was at a central bank. They have now left the scene and we are sort of in short supply of central bankers at the moment in Thailand. So, there's a great demand for a new breed of central bankers, as well, at the moment.

Before I go on, let me take this occasion, on behalf of my own country, Thailand, to thank President Kim Dae-jung for having the foresight, the vision in taking this initiative to organize this important APEC Forum on a theme which is so nicely phrased – shared prosperity and harmony. It's a nice phrase and I hope it's a phrase we can also use at the World Trade Organization, the WTO, because that's where we badly need harmony and shared prosperity, as well, in order to get everyone to be part of the multilateral trading system.

As Thailand being one of the leaders going into the crisis, I actually have a quite of few things to relay as of our personal experiences in getting through the crisis and dealing with the crisis and how we are coming out of the crisis. But I look at the many of the real experts, those who will be talking after us on financial affairs, and I thought it might be a better idea to leave them with the discussion on the details.

I would touch upon something which I hope would be more of a practical value, which would deal with how we can survive the present adjustment process and be in time to put all the reform wishes into practice and get our economic conditions into normal health again, as to what kind of practical measures and cooperation we would be needing. And I would like to concentrate on those issues.

But again, first of all, let me emphasize that the crisis really has taught us thorough lessons. But there are a few that I would just like to leave with you – a few lessons that I have learned. First is that crisis, such as the one that we have been experiencing and still experiencing at the moment, is a crisis that I would always say is a systemic crisis. It can happen in spite of the successes that we had in Asia, not because of the successes, because it's part of the system that would need adjustment at the right time. And if one doesn't execute adjustment at the right time, then this is a kind of adjustment to be forced upon us. And so, I would say that I wouldn't worry too much about the crisis as a big deal. It's part of the system. It will stay with us. It can reoccur in the future.

Number two, it can come and it can go. We should not lose our hope and I've said this all along since 1997 – we would see recovery, we've gone through the depths of the crisis and we will recover. There is great chance and some of us are doing that – showing the way – particularly, our host country, Korea.

Number three, we would never have been successful in our recovery process without the kind of international cooperation that we have had in the past few years. In the first year, when we entered into the crisis, I tried to cry out loudly for international coordination of policies because we found out, to our great worry, that the crisis was highly contagious. And that contagion has been, I would say, smoothly controlled because of the timely implementation of international coordination of, particularly, macroeconomic policies, with the U.S. economy in the forefront.

Number four, another lesson is that one should not move to this final conclusion too soon that we have already recovered, that this recovery process is already final. I would say that we are still in the midst of only the initial phase of our recovery process. And the recovery, itself, is still highly fragile. I wouldn't say that it would follow the kind of V-curves, U-curves or any kinds of curves. If we become complacent too soon and if we ignore the kind of things that President Kim Dae-jung has just emphasized, which is structural reform and liberalization, we may never have the real recovery. And we may really run the risk of falling back into the depth of the crisis again with different reason.

All of us have been told – actually, we need not be told, but we have been told times and again – that we have to go through all these reforms. And I think that all of us crisis-hit countries are doing exactly just that. We have been obediently following all the reform path – financial reform, the reform of our production structures, industrial reforms, agrarian reforms. We have been told, also, to upgrade our legal system. So, Thailand has never before been so diligent in the carrying out of our legal amendments. We have executed at least a wholesale reform of our 11 economic laws, bringing everything up-to-date to international standards, ranging from bankruptcy cases to international investment in Thailand that has been fully liberalized. We have also been embarking upon social reforms.

Social reform is much needed with or without any crisis. We don't need any crisis to impose upon us that we, in Asia, need to spend more time, money or effort on social reforms. We have been achieving a little bit too much on economic successes and, maybe, ignoring some of the pressing needs in the social area.

So, actually, we are doing all four reforms – financial reform, real reform, legal reform and social reform. I would just like to point out this basic fact that these reforms are all necessary, but they are very painstaking and very hard to execute. Every time I introduce a bill into the Parliament in Thailand to introduce a reform to enhance foreign participation in our banks, in our insurance firms, in our production units, I don't have smooth sailing. I never had smooth sailing. In fact, I had to come back times and again to prove my cases. And some bills have returned from the Senate back into the Lower House. They told us that there is need for us to prepare ourselves even better – "Are you sure about letting foreigners take part, take 100% share ownership of our banks and insurance companies?" We have to confirm that and send it back to the parliament again.

We run the risk of committing ourselves and remaining committed to all international trade agreements. And yet, we need to do that because I want to also emphasize that getting out of this crisis wouldn't have been possible if our friends across the world have not kept their markets open for us. You can look at the Korean experience, Malaysian experience, Thai experience. They are all pointing at the same direction. Although part of the recovery process could be attributed to its domestic public expenditure, trying to stimulate the economy, I would say the real stimulus did come from the side of our export expansion. And that has already been possible because markets throughout the world have been kept open for us. In the midst of the reform, we all are saddled with high and rising unemployment rates. Thailand used to know unemployment rates of only 2% or 3% of our labor force. Now, we are having to cope with 6% of our unemployment rate. And the same thing in countries which saw their unemployment rates double in the last few years. And that pressure from unemployment actually, sometimes, motivates the government to reconsider some of their commitments. My advice and advices that have been taken up by all Asian governments is that we must remain committed to all the commitments to still toe the line of liberalization, not only of trade, but also investment, so that countries like Korea can guarantee the huge inflow of FDIs that are the main driving forces behind real recovery.

So, I would say that reform will take a lot of pains. It's not easy to carry it out. It costs also some casualties in the Cabinet. It costs a few years – we're talking about 3 to 5 years of reform. In the case of Thailand, we are thinking in terms of, I would say, 3 to 5 years for financial reforms. It would demand from us that we remain committed to all our international agreements.

In order to meet all of these painstaking adjustment process, I would like to propose that we work together, according to the theme that we have to discuss at three different levels. First, at the national level, I have already discussed the fact that we need to do painstaking adjustment and that we must resist backsliding at all costs. This is a definite necessity to maintain the momentum of trade expansion without any untoward disruption. We need to remind ourselves and our friends. And I think APEC serves that purpose very efficiently. We would come under tremendous pressure from unemployment and bankruptcies to retract our commitments. But I think we cannot do that. The moment we go back along the path of liberalization, we would be enticing some other backsliding that would be probably induced by our own vindicative attitude. Now other countries might follow. We might be retaliated. And the kinds of things we are doing might have to be repeated times and again to make them successful. In order to maintain multilateralism and make it work, I don' t think there should be any thought in the mind of any national government in crisis to retract on our commitment for liberalization.

We must not only maintain the path of liberalization, but I would also advise that, if possible, there should be a process of autonomous liberalization – meaning that, in spite of the fact that we might not be obliged to forge ahead with our liberalization because of the international commitments, we need to do so on our own. In the case of Thailand, we have accelerated the pace of investment liberalization, ahead of any agreement because we believe that we not only need the expansion of trade volume, but also the inflow of foreign investment into our country. So our own foreign business law, which has awaited final agreement from the Parliament for the last 6, 7, 8 years, has been finally approved by the Parliament this year, which is a tremendous reform on our side. And I would recommend that not only reform to keep liberalization on the trade account going, but we need also more reform on the investment side. That is at the national level.

Secondly, at the regional level, I don' t think we can let up our efforts to pursue the goal of free trade areas. And so, I look at APEC as a prime model, again, to advance our course of FTAs. Therefore, I would recommend that, at the next Summit of APEC in Brunei – although, we may not be pushing ahead on some of the new proposals because APEC has already done two proposals on Accelerated Tariff Liberalization, the ATL, which have been submitted for the consideration of the World Trade Organization, so I don' t think there are more initiatives in that direction for APEC to embark on – we should definitely take stock of all the efforts to put up our individual action plans of whether they are all being implemented and whether they are all moving in the direction of the free trade agreement towards the year 2010 and 2020. And, in order to help urge the process of liberalization at the world level, maybe it might be conducive for APEC to move a bit faster ahead. 2010 is not too early and it is not too late. But it seems, under the present circumstances, that if we can move the process ahead a bit and if we can achieve the year 2010 a bit earlier, I would like to leave this for our member countries in APEC to consider. I don’t mean to shift 2010 to 2005, but maybe we can send the right signal to the world economy by moving this final date a bit earlier ahead.

I think that we at APEC also would need to take this time, at the time when, at Geneva, our ambassadors are trying to make preparations, to build confidence and move into a New Round. In order to build confidence for a New Round, maybe APEC should be concentrating upon the things that APEC has been performing so well, which is trade facilitation. And I think we should move in that direction more so at Brunei Darussalam. I think we should be concentrating more on the facilitation of our customs procedures. We may need to work more to establish mutual recognition of our standards, so that when we have the free trade agreement, then the standards would not be prohibitive, inhibitory factors in moving trade forward.

We should emphasize the need to make our APEC food system work better. This is a food system that we have agreed upon at our Auckland Summit last year in New Zealand. And I think that is one of the prominent successes of the New Zealand Summit. And I think that the APEC food system can help narrow down the gaps of prosperity among APEC countries by advancing the cause of world development, at the same time trying to pave the way for larger trade expansion for farm products. So, I would say that the APEC food system can be promoted further.

I would like to end, thirdly, by emphasizing that, at the multilateral level, we need to move towards a New Round, which should be a development round. And in that new development round, I would say that, in order to get each and every one involved, particularly developing countries, the down payment to move developing countries involved should be done on behalf of the developing countries. Maybe APEC should spend some time and effort, like last year, instead of thinking of how we should structure a New Round, maybe as a preparation for a New Round. APEC should emphasize what are the needs of the developing countries, what they should be given first as a down payment to move them into a New Round. And so, with all of these countries participating, we’ll have a full New Round. And, at this level, I’m sure that APEC would be most conducive because we cover more than half of world trade.

Thank your so much for your attention.

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

I was particularly intrigued by the idea that the crisis has increased the demand for central bankers and politicians, even if not economists. It certainly would be interesting to put this to empirical test. I think, in general, in making reforms, there are two steps one has to go through. One is knowing what are the right things to do economically and, secondly, how to implement things at a political level. I think in some areas, the first is obvious as to which economic policies would be favorable. But in some areas, including financial and legal reforms, which we're currently discussing, I think it's not that clear. To begin with, what are the best things to do from an economic, legal and social standpoint, even if one did not have problems implementing things politically?

The second speaker will be Noor Fuad, who is Vice Minister of Finance from Indonesia. He'll be talking about the Indonesian perspective.

Noor Fuad
Vice Minister of Finance
Indonesia

Thank your, Mr. Chairman.

First of all, on behalf of the Minister of Finance, Republic of Indonesia, I would like to convey his deepest apologies for his cancellation to attend and to be the speaker in this prestigious forum. Yesterday, the Minister was ready to leave for Seoul, but suddenly, due to urgent matters, Mr. President instructed all economic ministers not to leave the country. It is mainly because of the deal with the IMF.

Excellencies, distinguished speakers, ladies and gentlemen.

It was with great pleasure that I accepted the invitation to address the APEC forum on

"*Shared Prosperity and Harmony*" in this wonderful city, Seoul. First of all, I would like to express my sincere gratitude and high appreciation to the Government of the Republic of Korea for its initiative to hold this important forum.

I have come here today because I believe it is important that we have a clear understanding of the role that structural reforms, trade and investment liberalization will play in the resolution of the economic crisis that continues to plague a number of Asian countries. Let me state at the outset that I do believe that a more open economic system is essential to harmonious global development. The structural reforms in the areas of trade and investment that Indonesia undertook provided great benefits to the nation. However, we have to aware that not all citizens shared in these benefits. Liberalization measures should be properly carried out and supported by a strengthened domestic supervisory and regulatory framework. Otherwise, it would bring calamities to some small open economies, as indicated by latest experience.

The focus of my address today is to review the impact of liberalization on the Indonesian economy. I conclude that while we need to improve the management of our domestic economy as well as seek improvements in the global economic system, active participation in the world economic trading system still offers us the best chance of improving the lives of our peoples.

It is now almost universally recognized that we live in a global economy. A much larger share of world production now enters international trade than was true even a decade ago. Goods, services, financial capital, labor, technology, and ideas all flow across national borders more easily and in greater quantities than ever before.

Indonesia began the process of transforming itself into a modern economic state at a time when the traditional policy prescription was based on the development of import substituting industrialization. Indonesia realized that insulating industries from the competitive pressures of international trade resulted in slow growth, slow employment creation, and high-cost production. A major example of what could be achieved through an export oriented development strategy came from Korea, one of the first developing nation to reorient itself from import substitution strategy to export promotion strategy. In the case of Indonesia, we moved toward a closer integration of the domestic economy with the world economy about two decades back when we instituted a series of reforms that lowered trade restrictions, opened up our financial sector, and liberalized foreign direct investment laws.

Following the adoption of these measures foreign direct investment rose rapidly, bringing with it much needed new technology. Much of the foreign capital, certainly during the initial period, went to development of new manufacturing and export-oriented activities. Between 1973 and 1997, share of non-oil manufacturing rose from less than eight percent of GDP to nearly one-quarter of our national product. Non-oil exports rose from US$5.09 billion in 1985 to US$42.0 billion in 1997, increasing roughly by 18% per annum over the decade, three times faster than the growth of world exports.

Accompanying this structural transformation, modern sector employment increased rapidly. Jobs in the manufacturing sector grew at an annual rate of 5.6 percent over the period 1971 to 1985, rising to an annual rate of 6.2 percent in the 1985 to 1993 period. The increase in employment was accomplished by as rise in real wages that helped improve the lot of some of our workers. Indeed the number of Indonesians counted as poor declined that is those with incomes below the official poverty line.

The apparent soundness of our macroeconomic policies and the rapid growth of our economy created an undue level of confidence among investors. We now know that neither domestic nor foreign bankers and investors took adequate account of the structural and political problems that characterized the economy. Many investors, lulled by the relative modest exchange rate movements over the years failed to adequately protect themselves against exchange rate risk. Foreign investors and banks continued to lend to our domestic corporations even though it was widely know that political favoritism often influenced investment decisions and that there was only a limited and very imperfect mechanisms for any orderly debt workout. Investors, domestic and as well as foreign, failed to recognize the institutional weaknesses that underlay our apparent economic success.

Excellencies, distinguished speakers, ladies and gentlemen.

Let me talk about the future; what role will globalization and deregulation play in our recovery? I would answer in two parts. *First,* we need to raise the growth of our economy. *Second*, we must do so in a way that will create not only growth but growth that creates sufficient jobs for our growing population, that can help us eradicate poverty, and growth that is sustainable. I believe we can only achieve these goals through a closer integration of the Indonesian economy with the global economy. But it is important that we put in place mechanisms that will harness the benefits of globalization for all segments of society, not only for a few.

Let me continue with the executive summary for the *Progress of the Current Economic Development and Prospects for the year 2000*. First, the real GDP recorded another annual positive growth of 5.7% in the fourth quarter of 1999, as compared to 3.0% in the third quarter of 1999. As a whole, the real GDP in 1999 is estimated to have grown slightly more than 0%. Last year, when the recession hit the Indonesian economy, our GDP growth was –13.2%. The reasonable price stability has been restored and annual inflation, as measured by the CPI, dropped markedly from 77% to now only 2.0% within the year of 1999. The HBI rate, the Bank of Indonesia's interest rate certificate, continued to decline around 11% and the Jakarta Stock Market Index continued to surge at a level of 500 in the second quarter of 1999 to above 600 in the end of 1999.

Ladies and gentlemen.

That is the progress of the current economic Indonesian development. I would say, in this Forum, that, right now, based on the democratic new government, it tries to promote trade and investment and, more realistically, to attract more investors and also to improve the Indonesian economy.

Thank you very much.

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

I was happy to learn here another problem with the IMF. Mainly, it keeps speakers from coming to attend the APEC Forum. I was disturbed sometime back, when it seemed that the main interest in policy in Indonesia was about implementing a currency board. And that that was suppose to be the only policy that really mattered. Particularly, as a supporter of currency board type of arrangements, I was disturbed by that because it didn't seem like it would, even then, be a magic bullet. So I was pleased to hear the array of kinds of policies that were being considered in a productive way in Indonesia today.

Our next speaker will be Lim Swee Say, who is Minister of State for Trade and Industry in Singapore. He will be discussing matters from the perspective of Singapore.

Lim Swee Say
Minister of State for Trade and Industry
Singapore

Thank you, Mr. Chairman.

Distinguished panels of speakers, ladies and gentlemen. Good Morning.

The speed and severity of the regional economic crisis took many of us by surprise. Fortunately, the worst of the storm is now over. The region is back to growth path again.

I am delighted to be here this morning to share Singapore's experience in overcoming the economic crisis in the way forward in repositioning our economy.

Singapore could not escape the crisis unharmed, given that two-thirds of our GDP are driven by external demand. As a result, our GDP growth in 1998 slowed to an anaemic 0.4 %. Even though the recession was brief, it could have been far more severe had the Singapore Government not taken decisive actions to improve Singapore's costs competitiveness. This helped to cushion the economy from the effects of the regional contagion, and prepared it for the eventual rebound.

Our top priority in overcoming in the crisis was to save jobs to minimise unemployment and to preserve our production capacity. We reduced business cost through wage cut and various fees and tax rebates, amounting to US$7.4 billion, or about 7% of our GDP. The whole idea was to buy time for eventual upturn.

At the same time, we turned the excess capacity and manpower in our economy into investment for the future. We implemented various measures to improve our economy's capabilities during the crisis. We enhanced our national information infrastructure, upgraded workers' skills, broadened our export markets, and stepped up our efforts in promoting foreign direct investment into Singapore.

Our strategies of cutting wage costs and upgrading skills were possible only because of the excellent tripartism co-operation between the public, private and people sectors in Singapore. Once the severity of the crisis became apparent, the Government worked closely with the labour movement and business community to determine the best way forward. We were able to reach consensus between Government, unions and employers because of high level of trust among us. We all realised that painful but necessary measures were needed for Singapore to ride out the storm.

These measures allowed us to quickly seize the opportunity when external demand rebounded in 1999. Boosted by the strong upswing in the global electronics industry and gradual recovery in the regional economies, the Singapore economy staged a rapid recovery and grew by 5.4% in 1999. Unemployment rate, having reached a peak of 4.4% in 1998, has come down to 2.9%. This year, the economy could grow by 6% to 6.5%.

We aim to sustain our economic growth at 4% to 6% a year over the medium term. We recognise that the post-crisis world economic landscape will not be business as usual. This fundamental change is driven by two main forces: globalisation and technology. We need to quickly adjust our economic strategies to face this new challenge.

We are speeding up the restructuring of our economy, to ensure that it remains nimble and in shipshape condition for the New Economy. We are pushing ahead with a comprehensive set of long-term economic strategies, to transform Singapore into an advanced and globally competitive Knowledge Based Economy, or KBE in short.

First, we strive to make a fundamental shift in our mindset, and transform our economy from a "value adding" economy to become a "value creation" economy. In a "value adding" economy, productivity and quality mean reducing costs, or finding ways to make incremental improvements to an existing product or process. Value creation is however a vastly different proposition. It is about the ability to generate revenue through innovation. It takes creative thinking and a certain amount of boldness to experiment with bright and untested ideas in order to make such transformation possible.

To create this new mindset of value creation through innovation, we charted out a comprehensive set of action plans to nurture new capabilities. These include entrepreneurship development (Technopreneur 21), technology and innovation development (Industry 21), manpower and talent development (Manpower 21), and national information infrastructure development (Info-communication 21). We hope to enhance our pro-business environment into one that is pro-enterprise development as well.

Next, we are also taking pro-active steps to deregulate our services sector. We have a world class manufacturing sector because we opened up our manufacturing sector to foreign direct investment very early on. We will continue to strengthen the competitiveness of our manufacturing sector to account for 25% of our GDP as a long term economic strategy. At the same time, we recognise that globalisation and technology will break down barriers to competition in the services sector, and we need to brace ourselves for that. We have therefore decided to speed up the opening up of our services sector in a pro-active manner.

The financial sector leads the way. In the past two years, we have progressively allowed more foreign competition into our domestic banking sector, demutualised the stock exchange, and take on a lighter touch in our regulatory approach. In telecommunications, we have removed the limits on foreign ownership, and brought forward the full liberalisation of the telecommunications market by 2 years, to 1st April this year. Within two months of announcements, we have issued 58 licenses. Over the next three years, we expect to attract US$1.7 billion worth of investment, and create 2,500 jobs.

We are also in the process of opening up our utilities sector. We began to corporatise the incumbent utilities provider in 1995, and have systematically made preparations for further deregulation. Within the next 2 years, we will open up the contestable parts of the electricity sector fully. We will also introduce competition in the natural gas industry, as well as the supply of water through desalination.

Besides undertaking structural reforms in our economy towards value creation and deregulation of services sector, Singapore will continue to advocate a free and open global trade and investment regime. We believe that trade and foreign direct investments are major engines of growth in both developed and developing countries.

We believe that a more open market is a source of competitive strength. Exposure to international trade is a powerful stimulus to efficiency, which in turn contributes to economic growth and rising incomes.

In this regard, Singapore is disappointed with the failure of the Seattle Ministerial Conference to launch a New Round of multilateral trade negotiations. This was an excellent opportunity to further bring down needless barriers to trade and investment, and generate wealth for all economies.

Nonetheless, we are happy to see the recent shift in mood among WTO Members. In our own small way, Singapore will play its part to help move the WTO process forward. Hopefully, we will see the launch of a New Round in the not too distant future. As a parallel effort, Singapore will pursue bilateral FTA with our trading partners, participate in new age multilateral initiatives such as e-Asean with our neighbours, and further the cause of multilateral trade liberalisation to achieve the APEC Bogor goals of free and open trade and investment by 2010 for developed economies and 2020 for developing economies.

The Asian crisis is receding, but in its place, a new global economy is taking shape. We must quickly undertake the structural reforms and liberalisation measures necessary to embrace this New Economy, so that we will all emerge from the Asian crisis stronger and better prepared for the future.

Thank you.

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

I was a little surprised to hear the idea that Singapore would stress more openness to exports and foreign direct investment because I thought Singapore had already been champions in these areas. I didn’t know there was that much more scope for further expansion in this desirable direction. I was also interested in the idea that trust was important in Singapore, coping with the crisis and getting back into a rebound position. This idea that trust matters for economic performance or, more generally, the idea of social capital has become very current in terms of research efforts. A lot of people think it might be significant, but it’s unclear yet whether this feature of trust, social capital, will actually be quantifiable and perhaps amenable to policy intervention. I think that’s something that’s yet to be decided in terms of research. Also, that Singapore experience illustrated, more generally, the process of convergence. The kind of perspective economic growth that was outlined by our speaker was something on the order of 3% per year, looking into the further future beyond next year. Whereas, previously, Singapore has achieved per capita growth rates of something on the order of 5~6% per year. Implied in that is some kind of diminishing returns, where it’s hard to maintain growth rates that high forever. And I found interesting the idea of trying to avoid these diminishing returns by moving even more into high-tech sectors, by having less regulation, by trying to promote more competition. These seem to me to be all good ideas. But I suspect, in the end, one hits the process of convergence, even with these off-setting policy forces.

Our next speaker is Hun-Jai Lee, who is Minister of Finance and Economy of our host country, Korea.

Hun-Jai Lee
Minister of Finance and Economy
The Republic of Korea

Thank you Professor Barro,

It is an honor and pleasure for me to participate in this forum today with such distinguished fellow panelists.

This morning I would like to talk about Korea’s experiences in crisis management. I will focus particularly on the roles that economic reform and liberalization have played in our strong economic recovery.

As you no doubt know, Korea has made a remarkable recovery from the crisis. The nation's foreign reserves have steadily climbed, surpassing for the first time US$ 80 billion this month. The real GDP grew 10.7 percent in 1999, at the backdrop of a record low inflation rate of 0.8 percent. Meanwhile, the unemployment rate has dropped from its peak of 8.6 percent in February of last year to 5.3 percent in February this year.

Many people are curious about the factors which spurred such fast recovery and transformation. I would like to point to three main factors: the government's timely macroeconomic policy adjustments to facilitate a quick rebound, implementation of sweeping reforms to restore market stability and to prevent recurrence of a future crisis, and strengthening the social safety net to preserve national cohesion in carrying out reform programs. I should add that our progress would not have been possible without support for our reform and recovery efforts from the international community, including the APEC members.

At the onset of the crisis, our first priority was to resolve the foreign exchange shortage and regain access to the international financial market. To this end, the government closely cooperated with the international financial institutions, including the IMF, the World Bank, and the ADB. In addition, the government quickly initiated negotiations with private lenders who had large exposures to Korea, and successfully extended the maturity of most of the nation's short-term debt. With these measures, Korea was able to overcome the external liquidity crisis and restore the foreign exchange market stability.

In the course of the financial crisis, Korea already faced massive corporate bankruptcies and domestic credit crunch. The heightened systemic risks and ensuing bank runs deepened the financial distress. Also, the tight monetary policy that was designed to stabilize the foreign exchange market inevitably resulted in adverse spillover effects to local markets.

To remedy these problems, the Korean government put special efforts into adjusting its macroeconomic policies. Adjustments included easing interest rates downward while pursuing intensive front-loaded financial restructuring programs. This helped to relieve the severe credit crunch and acted as a stimulus to the stock market and domestic demand. A similar adjustment was made in the fiscal policy to promote recovery and more importantly, to preserve national cohesion by expanding the social safety net.

In other words, the decisive banking sector reform gave a convincing signal to the market, and thus set the stage for policy adjustments toward greater market stability. This in turn provided an enabling environment for the implementation of the government's broad reform measures. Overall, a mutually reinforcing process was created for structural reforms and macroeconomic policies.

The economic reform drive has been underpinned by what may be called the "four plus one" approach. The "four" means comprehensive reforms in the financial, corporate, public and labor sectors. And the "plus one" represents our strong commitment to market opening, particularly the liberalization of the capital market and the promotion of foreign direct investment.

In the financial sector, non-viable financial institutions have been closed or merged. Viable institutions cleaned up their balance sheets through recapitalization and the settlement of non-performing loans. Through this process, Korea's financial sector has been positively reshaped and regained soundness.

In the corporate sector also, non-viable corporations have been pushed to exit at the initiative of creditor banks. For financially distressed but viable corporations, workout programs were established in partnership with creditor institutions and management.

Special emphasis has been placed on reforming Korea's big conglomerates – or chaebols. Chaebol reform aims at ending fleet-style management. In this way, each individual subsidiary becomes an independent and competitive unit with a sound capital structure. Also, with the enhanced management accountability and transparency, business credibility and confidence can be increased. To date, chaebols have undertaken fundamental changes in accordance with the restructuring agreements made between chaebols and their creditor banks. This means improved debt leverage structure, reduced excess capacity, upgraded corporate governance standards, and greater concentration on core competence.

Concerning the labor market reform, Korea has achieved substantial progress since the inauguration of the Tripartite Commission and revision of the Labor Standard Act which legalized layoffs for managerial reasons. Labor's traditional militant stance is changing, particularly in terms of disciplined respect for rules and laws.

In the public sector, the government has eliminated red tape and_streamlined its organizational framework. The government is also moving ahead on privatizing many state-owned enterprises.

As I stated earlier, comprehensive and decisive reform in major sectors of our economy has been one of the most important factors for successful management of the crisis in Korea.

Let me also emphasize the importance of market opening and investment liberalization. In addition to the structural reforms, we have greatly liberalized and opened Korea's markets. Our goal is to draw foreign investment and competition under the principle of national treatment. Indeed, foreign direct investment into Korea surged to a record high of US$ 15.5 billion in 1999, up from US$ 8.9 billion in the previous year.

Liberalization of the foreign investment regime has been contributing to the Korean economy in a number of ways. Benefits include the provision of productive financial resources, the creation of value-added job opportunities, the transfer of technology and management know-how, and the expansion of export markets via new strategic alliances.

In short, both structural reform and liberalization have proved pivotal in Korea's overcoming the crisis.

Distinguished guests,

In considering the lessons to be learned from Korea's experience, a question that naturally arises is: "Are structural reforms and market liberalization actually essential for overcoming a crisis in any country?"

I believe that the answer to that question will be different depending on the causes of the crisis. In other words, in any particular country, the actual causes of a crisis should determine the optimal strategy for overcoming it.

In the case of Korea, the government correctly recognized that the economic crisis was caused more by long-standing structural weaknesses than a temporary shortage of foreign reserves.

The government-led high growth strategy that had been applied since the early 1960s – which constituted Korea's part of the Asian miracle – did contribute to the transformation of this underdeveloped agricultural economy into an advanced industrial state. However, such success was not achieved free of some serious harmful side effects.

These included the overall lack of market discipline in the economy, excessive borrowing and investment by the corporate sector, imprudent provision of loans by financial institutions funded by short-term borrowing in the international market, and lack of transparency in the accounting and management of financial institutions and corporations.

These problems in key sectors of the economy, coupled with mismanaged macroeconomic policies, made the Korean economy highly vulnerable to the financial turbulence in Southeast Asian countries in late 1997.

Given this situation, if we had simply replenished our foreign reserves with the help of the outside world and international organizations, we would have only been able to ease the crisis temporarily. Likewise, if we had simply changed the direction of our macroeconomic policies without correcting the root problems in our economy, we would not have been able to overcome the crisis on the most fundamental level. And we would not have been able to regain the confidence of foreign investors. In other words, a recurrence of the crisis would be unavoidable some day in the future.

Recognizing this, the Korean government decided to undertake sweeping reforms across all sectors to establish a new economic paradigm. This paradigm is based on President Kim's governing philosophy of the "parallel development of democracy and market economy." Korea's economic reform was not intended merely as a form of short-term crisis management. Rather, our reform goals have been far-reaching – with the dual purpose of preventing recurrence of economic crisis and achieving sustainable economic growth in the 21st century.

The next question that may arise is “What is the optimal sequence and speed of reform?” In the aftermath of the crisis, we have seen a great deal of debate on this issue. In my opinion, however, debate on this issue is not particularly relevant since all sectors have shown serious structural problems. Moreover, these problems are closely interrelated among sectors, thus requiring simultaneous and quick resolution.

Therefore, decisive and comprehensive reform efforts in all areas were crucial in preventing any further deepening of the crisis, and for accelerating economic recovery. The speedy containment of systemic risk and the domestic credit crunch were particularly important. In this regard, the injection of substantial public funds for bank recapitalization helped to normalize the financial system and market.

Ladies and Gentlemen,

Korea’s resolve does not stop at the achievements of the past two years. We have a number of key challenges facing us. Most important, we must address two inevitable adverse consequences of the crisis resolution process: the deteriorated income distribution, and the increased fiscal deficits and government debt.

The income distribution problem came about with the rising unemployment during the crisis. With economic recovery, however, we are seeing an opposite effect. There is a burgeoning of new small- and medium sized-firms and venture businesses. The middle- and low-income classes are already experiencing benefits from this new growth. Thus, it is only a matter of time before the income disparity problem is likewise improved. Indeed, we expect to recover the pre-crisis level by the end of this year.

The government has also proactively worked to address this issue by establishing a new work-based social welfare system.

“Productive welfare” measures include improving the tax system, expanding further the social safety net, and increasing investment in human capital development. I am confident that these measures altogether will result in a fairer distribution of income, in line with the standards of advanced countries.

The government has been faced as well with the challenge of a large jump in the fiscal deficit. This was the unavoidable fallout of increasing expenditures for social programs, financial restructuring, and measures for boosting the economy. To restore fiscal soundness, the government has instituted a plan to achieve a balanced budget by the year 2003. It is worth noting that Korea's ratio of the government debt to its GDP was 22.3 percent as of the end of 1999, which is much lower than the OECD average.

Building a solid economic foundation for the new century is also one of Korea's key policy objectives.

First, there is the issue of deepening and completing the ongoing reforms. The government-driven reforms must be extended to self-generating reforms by the private sector. In this way, Korea's economic system and business culture can be transformed at the most fundamental and operative level.

Second, we must quickly shift our economic orientation toward that of a knowledge-based economy and information society. This involves upgrading and expanding Korea's information infrastructure as well as promoting the growth of venture businesses and information technology industries.

Ladies and Gentlemen,

Korea has been transforming itself through substantive reforms across all sectors of the economy. Our progress has been very good, but we have much work still ahead of us. No doubt yur continued interest, support, and participation in our economy will prove advantageous to us all.

Before closing, let me say that the continued cooperation of APEC members is crucial in addressing current issues related to the new global financial system. As you know, this is one of the key topics scheduled for discussion later today. I look forward to your invaluable input in this regard.

I am sure that all such enhanced understanding we gain at this forum will help us reach our shared goals of prosperity and harmony in the 21st century.

Thank you.

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

I think we have time for one or two questions if people have questions they might want to address to the panel.

I do want to make one remark about the fiscal situation in Korea and the reaction to the crisis. My understanding was that, initially, there was a lot of fiscal restraint, particularly, advanced as a good idea by the IMF and some other international agencies, which I think was quite an error as a response to the crisis. Particularly, in the context of a country that has a record of fiscal discipline and a good fiscal structure in place, the reasoned response to a recession and a financial crisis was, in fact, to run a fiscal deficit. So, I think once Korea moved in that direction of fiscal expansion, I think it was quite a reasonable component of the economic recovery plan. And, although, that has meant that there has been some build-up of the public debt, I think that's not that large a problem. And Korea does seem to be moving in the right direction in terms of moving back a fiscal balance in response to the rapid recovery of the economy. So, I think after a false start, with respect to the fiscal response, Korea has been doing the right thing in that dimension. That was one of the topics that was just discussed.

Question from Floor

This question is about what you said on the fiscal policy of the IMF. What you said was that in late November of 1997, in the outset of the impending crisis, what should have been done was to expand fiscal policy and loosen monetary policy. Please elaborate.

Robert Barro
Robert C. Waggoner Professor of Economics
Harvard University

I thought that the initial response was too much in the direction of restraint. I would have a different form of advice, if I were talking about a country such as some in Latin America that had a history of fiscal deficits and where it was important to establish credibility on the fiscal, monetary side. In the Korean context, particularly, I did not think that that was an important issue. And, in that context, I think it's quite appropriate to be expansionary on the macro side in the face of recession and crisis. So, I would not have the answer to that question for all countries. I was thinking specifically in the context of Korea and countries that had fiscal discipline in place as a structural matter.

2. APEC Trade and Investment: Finding Effecitve Way for Substantial Liberalization

Ippei Yamazawa
President
Institute of Developing Economies, JETRO

Good morning, distinguished participants, ladies and gentlemen. I appreciate your invitation to this important Forum and it's my great honor to moderate discussions between the distinguished panelists in this sub-session.

First, let me introduce our panelists from my immediate left – Mr. James Sutton, Minister for Trade Negotiations, New Zealand; Mr. Felipe Medalla, Secretary of Socio-Economic Planning, Republic of the Philippines; Madame Rosario Almenara, Vice Minister of Economy and Finance, Peru; Dr. Peter Drysdale, Professor, Australian National University, Australia.

The main theme of this sub-session is trade and investment liberalization. Trade and investment liberalization and facilitation is one of the two major track of actions of APEC. The current state of APEC liberalization can be summarized as forth. First, APEC's liberalization, together with facilitation, have been implemented in parallel with the Uruguay Round liberalization. Second, APEC members' liberalization efforts have been continued, in spite of the Asian crisis. Third, now all APEC economies support the New Millennium Round of the WTO. They will enhance the APEC liberalization and facilitation effort, which will contribute to an early successful launch of the New Millennium Round.

Now, I'd like to invite my panelists. Distinguished panelists, I will give each of you 15 minutes for your presentation. I believe that good citizens such as ministers and professors observe traffic signals. Thank you very much. Now let me invite Minister Sutton.

James Sutton
Minister for Trade Negotiations

New Zealand

I would like to thank the Korean Government for the opportunity to address this distinguished audience.

As Chair of APEC last year, New Zealand welcomed President Kim Dae-jung's initiative in hosting a discussion of the many issues which faced the region in the aftermath of the economic crisis of 1997-98. New Zealand too was affected by the crisis and we firmly believe that closer cooperation is important to avoid a repeat.

We have a new Government in New Zealand now, but I can assure you we have the same commitment to trade liberalization. To me it seems self-evident that trade liberalization removes economic inefficiencies and promotes economic growth. In this way it provides the resources for governments to adopt policies that support social harmony. By increasing trade we increase prosperity and enhance the prospects for harmony in the region.

As Kofi Annan said recently "the main losers in today's very unequal world are not those who are too much exposed to globalization. They are those who have been left out."

Trade and investment liberalization lies at the heart of the APEC agenda.

At only their second meeting, APEC Leaders in Bogor in 1994 agreed the 2010/2020 goals for achieving free and open trade and investment in industrialized and developing member economies.

This could have been a hollow commitment, politic at the time but then quietly forgotten. But it has been continually reiterated at successive Leaders meetings, including by all the economies which have joined since then.

Last year APEC economies, with help from the Pacific Economic Cooperation Council, took a good look at progress being made towards the Bogor Goals. This examination revealed that we are broadly on track.

The progress which has been achieved has been a combination of three elements:

unilateral liberalization; multilateral liberalization under the WTO; and liberalization in the context of sub-regional initiatives.

With continued commitment and political leadership, I see no reason why the momentum of the past five years should not be sustained.

Many APEC economies have undertaken autonomous programs of domestic reform and opening of markets. APEC's shared commitment to common goals provides a supportive environment for policies which economies implement in their own best interest.

Korea is a good example of an economy pursuing such a three track approach to liberalization. Following his election at the onset of Korea's financial crisis, President Kim took the courageous step of initiating unilateral liberalization of Korea's previously highly protected trade and investment markets.

Korea then did its best to advance multilateral liberalization by supporting a package of Early Voluntary Sectoral Liberalization proposed by APEC. It is further supporting regional trade liberalization by pursuing a Free Trade Agreement with Chile and studying other potential FTA partners in the region.

New Zealand and Australia have pursued broadly similar trade and investment liberalization programs since the 1980s when we concluded a Free Trade Agreement which we call Closer Economic Relations. Since opening our borders to each other and the world our economies have recorded historically high levels of economic growth.

There are other significant sub-regional examples of liberalization. To say, as some do, that trade and investment liberalization within APEC has run out of steam is to overstate the case. In fact, in Asia, reform efforts have been boosted in the aftermath of the economic crisis.

It is true that some APEC economies have done less than they might have in terms of unilateral liberalization. But there is far more to achieving the Bogor Goals and to having a competitive economy than simply cutting tariffs at the border.

APEC Leaders in Auckland stressed that "open, transparent and well-governed markets, both domestic and international, are the essential foundation of prosperity". The only system which APEC's founders rejected as being inconsistent with the organization's goals was the creation of exclusive trading blocks.

Open regionalism was, and still is, seen as the best way forward. Hand in hand with this approach went an enduring commitment to strengthening the multilateral trading system.

Support for a new Round of multilateral trade negotiations under the WTO was a key feature of the "Challenge" issued by leaders last September in Auckland.

But we all know what happened at Seattle.

Leaders and Ministers are entitled to be disappointed that their challenge was not taken up. There was instead a failure of vision and political will.

The challenge now is to rebuild momentum for the launch of a new Round at the earliest opportunity.

Fortunately not all was lost at Seattle. Some progress was made in narrowing differences on most of the outstanding issues. Negotiations on agriculture and services are underway in Geneva.

The bulk of economic activity in most developed economies is now in services. But agriculture is one of the main areas where traditional barriers to market access are concentrated. It happens also to be an area of comparative advantage for many developing economies.

Liberalization of the world's agricultural markets would make a huge contribution to shared prosperity and harmony. It would also contribute to food security in a world where this is mainly threatened not by welfare but by natural disasters like floods, droughts and cyclones.

APEC and the World Trade Organization need to push in the same direction. Progress in the WTO could make a huge contribution towards the Bogor Goals.

But at Auckland and more so since Seattle there has been a proliferation of new regional and sub-regional initiatives between widely diverse groups of economies.

This perhaps signals an impatience to get on with the job of liberalization. It is worthwhile considering how we can best harness this energy to our common good.

I see two ways in which regional liberalization agreements can contributed to the realization of the Bogor Goals. Top-down, or bottom-up.

The top-down approach would involve the negotiation of an FTA amongst the APEC membership which goes further than the WTO achievements.

Meanwhile we should consider the potential of a bottom-up approach.

As I have noted, there are many sub-regional liberalization initiatives underway - such as New Zealand's negotiations with Singapore, and the initiative we and Australia are exploring with ASEAN.

As well, Korea is negotiating with Chile, while undertaking studies with New Zealand and Japan; and Japan is studying an agreement with Singapore.

To harness the energy of the bottom-up approach, we should envisage these initiatives as building blocks. Clearly it would help if the architecture of the individual agreements is consistent with that of the Bogor Goal in key respects such as comprehensiveness and the outer timeframes of 2010/2020.

As you can see, I am optimistic that effective ways to achieve substantial liberalisation exist. But the seizing of those opportunities requires political commitment and leadership. Perhaps, here in Seoul, some of that leadership will emerge.

Thank you very much.

Felipe Medalla
Secretary of Socio-Economic Planning
The Republic of the Philippines

Thank you very much, Mr. Chairman.

First of all, I would like to thank the government of the Republic of Korea and the organizer of this Forum.

The government of the Philippines is in full agreement with the Forum organizers that prosperity must be shared and that we must find effective ways for substantial liberalization. These themes are appropriate, given their implication and the sustained growth of our respective economies and the region as a whole. But they are quite timely, as well, as our economies recover from the crisis.

Both trade theory and empirical evidence suggest that trade liberalization and investment liberalization will stimulate international trade, investments and production, and promote overall growth and welfare. By improving market access, more efficient use of resources will result in faster increase in productivity and higher incomes. Through the removal and reduction of economic distortions and import barriers, there will also be lower prices in domestic markets and increased imports. The cheaper imports, in turn, will lead to lower production costs for many domestic industries which were previously stunted by the protective policies of many of our economies.

Expansion of developing economies in trade in recent years reflects the positive impact of market opening measures. For instance, for the period of 1989~1997, developing countries' exports grew by 9.7% annually, while imports expanded by 10.6%. In our country, recognizing the adverse impact of our past protectionist policies, we acutally started liberalization in the early 1980s. Of course, the liberalization process was interrupted may times by both economic and political crises. Still, if one compares our economy now with what it was 20 years ago, clearly remarkable progress has been achieved. These refroms are among the most basic reforms aimed at obtaining global competitiveness, improved resource allocation and sustained economic growth. By getting rid of market distortions, liberalization led to greater reliance on market, fostered competition, leveled the playing field and encouraged the development of industries with real comparative advantage. In case of tariffs, we, in the Philippines, aim for tariffs of 5% or lower for 2004, with a few exceptions, of course, mostly in agriculture. And with respect of ASEAN, two thirds of our trade will have zero tariffs and, particularly, all of our trade will have tariffs of 5% or lower by 2003.

Just recently, Congress passed legislation, opening up the retail trade sector to foreign investment. This sector has been closed to foreign investments and foreign nationals since the 1950s. I think, the Philippines being a member of APEC helped tilt the domestic political balance in favor of those who favored liberalization of our retail trade sector. So, I guess, this is one good lesson where APEC has contributed to reforms.

Now, looking back, fear of massive shut down of plants and massive layoffs in the protected industries stand out to be exaggerated. On the other hand, there was a significant increase in the number of firms, the vast majority of new entrants entering the states with relatively small-scale plants and firms in the electronics and semi-conductor industries. But, if liberalization has so much benefits, why is there so much hesitancy in further undertaking reforms? In many economies, the Philippines included a number of sectors and expressed objections to liberalization. This was also echoed during the so-called debacle in Seattle. I’ve been told that such concerns has been recognized in APEC, itself. Thus, there has been activities in communicating the impact of liberalization, both globally and in our own domestic politics.

Now, let me identify some of the issues that have been raised. While trade liberalization may lead to loss of tax revenue as tariffs and other trade taxes are cut, the best way to move forward is actually to improve domestic governance and administration of the tax system. There’s also the concern for short-run dislocation. Locating resources to more productive uses usually involves temporary adjustment costs. Indeed, the large trade surplus that we are running now, as a result of rapid growth of exports and slowing down of import growth, has resulted in a foreign exchange rate where many of the uncompetitive industries feel they will be unable to compete, especially in the agricultural sector. So, it’s very important that the short-run costs be addressed.

The beneficiary of globalization and liberalization are the best educated workers, especially, those who can speak English in our country. So, the public sector can help facilitate job transition, including the provision of job training, as well as provision of temporary unemployment assistances as a safety net. In addition, trade liberalization will increase imports in the short-run and aggravate the trade balance. This tendency, however, has been more than offset by the fall of imports or the slow down of imports brought about by the Asian crisis. But, as imports recover with economic growth and, to the extent that the widening trade balance occurs, we should respond by better macroeconomic management and correct exchange rate policies, which are clearly superior to quotas and non-transparent trade restrictions because these measures, besides failing to generate revenues, also create all sorts of ransacking and other undesirable activities.

Now, on the timing and pacing and sequencing of trade reforms, it's also very important to note that our experience in the 1990s was that the Peso appreciated, rather than depreciated, as we reduced trade barriers. Of course, the lesson now is that it's very dangerous to peg the exchange rate – the central banks actually pegged the exchange rate, no matter how they deny it. Nonetheless, we benefited greatly from direct investment, in spite of the over-valuation of the currency, although this meant that practically all growth of exports was focused on the electronics and semi-conductor exports. The pacing of liberalization and tariff reduction is very important. There might have been calls to postpone much of the tariff reductions. In my country, there have been calls to calls to postpone much of the tariff reduction until the final year of our commitment. In our country, this kind of pattern is called "sudden death," like, say 20% in 2000, 20% in 2001, 20% in 2002 and all of a sudden 5% in 2003. And sometimes, politicians tend to give in to this kind of pressures. One positive exception, in our case, is the motorcycles industry, which asked for a more gradual and more realistic reduction of tariffs in our CEPT ASEAN commitment. Perhaps, the lesson here is that Japanese companies, which have spread production all over ASEAN, have also much to gain from more gradual and more credible liberalization since they're producing motorcycles all over ASEAN. An interesting contrast is our automotive industry which asked for the "sudden death," although the presence of Japanese companies in that same industry is also noted.

Finally, sectors which benefit from liberalization are not as organized, compared to those that are hurt. Most of the times, the beneficiaries remain quiet, so that the positive impacts of the benefits of liberalization are not well ventilated. On the other hand, those who are hurt make the loudest noise. They are mostly more organized and have the resources to ventilate their position and make political lobbies. APEC, through the Economic Committee, undertakes and studies assessing the impact of trade liberalization in the region. Initiatives such as these are important to better explain the impact of trade liberalization to stakeholders and to the general public, as well.

One also has to deal with political aspects of the liberalization process. Openness and liberalization in economies over the long-term build up further pressure for further liberalization in politics and civil society. Liberalization of the beginning stage is relatively easier than liberalizing at the penultimate stage. Sectors left to be liberalized are either politically sensitive – for instance again, agriculture – or have been highly protected for a long time. There will always be pressures for delay or the extension of the *status quo* of the protection of the sectors. Opening up the sectors to foreign competition will mean the demise or, at least, significant contraction and loss of jobs. Unfortunately, the people that would be laid off in these sectors will least likely to be employed in the globalized section of our economy.

There has been a concern on the distribution effects of trade liberalization. Private cost adjustments arise not only as a result of transitional unemployment, but also, when some workers or even entrepreneurs find the skills, talents and investments worthless after liberalization, compared to before, as a result of the permanent changes in the allocation of production in the entire economy. On the other hand, other entrepreneurs in the export and globally competitive sectors find the resources worth more but may not be active or vocal supporters of the reform process.

So, two conditions have to be considered in facilitating further trade liberalization. It' s much easier to reform than it is to sustain growth and, as I already mentioned, better governance, in particular, better tax and spending policies. Sustained growth eases the social adjustment costs by trade liberalization. As explained by Deputy Prime Minister Supachai of Thailand, it would be very hard for us to sustain liberalization if markets of developed countries are not open. Growth generate employment opportunities that absorb labor from the adjusting or contracting sectors. On the other hand, good governance, which largely means improving the tax system and improving allocation of public government expenditures can reduce the social costs of liberalization, making sure that even those who do not directly benefit from the liberalization process indirectly benefit.

The public sector can play some role in reducing the cost of job transition arising from shift of production. Education is considered as one of the key ingredients, since workers with higher levels of education are usually better able to make the transition from on job to another. It may also facilitate the adjustment process by promoting the structural reforms domestically. The public sector can also play direct role in facilitating job transition and putting up safety nets for the most vulnerable groups adversely affected by the liberalization process.

Reforms supportive of sustained growth are similarly important – acceleration of social development through comprehensive modernization program, including rural development; delivery of basic social services, especially in health, nuitrition, education and housing; sustained infrastructure development, especially in rural areas – will make people see that everybody can benefit from liberalization. Continued regulation, on the other hand, and strengthening of regulatory and supervisory institutions are essential for preventing the recurrence of crisis. In short, resistance to liberalization can be reduced significantly. If we can improve tax effort administration, improve the allocation of public expenditures and upgrade the capabilities of our regulatory institutions.

There is similar need for improved policy coherence in developed countries, not just developing countries, both domestically and internationally – in particular, the policies on tax, subsidies and fiscal policies, and their own policy advice to developing countries. A reduction in tariff levels and simplification of tariff structure would also help developing country exports. Subsidies, in developed countries, especially to the agricultural sector, can affect the relative competitive position of developing economies and have strong distorting and discouraging effect in the liberalization process.

Beyond trade liberalization, there is need for effective mechanisms to compensate losing sectors and allow them to benefit from liberalization. These mechanisms include the well-functioning tax and expenditure system, as I' ve already mentioned. There is a need to strengthen international cooperation efforts to improve the existing international financial system to prevent the recurrence of the crisis by providing mechanisms for better crisis management and making it more conducive to trade and development.

In mobilizing external resources for development, the challenges ahead include the following: mobilizing enhanced and more stable sources of international investment flows towards a larger number of recipient developing economies reversing the decline in official development assistance (ODA) and ensuring effective targeting and use of

ODA as a catalyst for sustained economic growth and sustainable development and finding lasting solutions to the debt problem of developing economies. The Challenge ahead lies in sustaining and, where needed, elaborating the sustainable economic framework to attract direct investments. In the area of mobilization of internal resources, it requires increased domestic savings and ensuring the efficiency of our own domestic financial markets.

Trade policies and trade liberalization should be made more consistent with overall development objectives. In developing economies, ways and means need to be sought to ensure that trade makes a more decisive contribution to alleviating poverty. The role of trade for stimulating economic growth, the distribution of the benefits of growth, and sectoral policies, and in the longer term the diversification into industries and advanced services also require further attention.

In our country, liberalization enabled the government to keep the economy afloat and protected it from the harsh effects of the 1997 crisis. At the height of the crisis our exports were growing at nearly 20%. And this really helped us to survive the crisis. Yet, the various issues heard against liberalization had led some people in our country to think they can still keep protectionism alive. And, not a few see the globalizing world economy as a source of greater instability and inequality. So, if we want to sustain liberalization, we must address inequality both at home and abroad.

Rosario Almenara
Vice Minister of Economy
Ministry of Economy and Finance
Peru

Dear Mr. Chairman and gentle participants. It is and honor for me to participate in this APEC Forum on Shared Prosperity and Harmony. My thanks to Minister Hun-Jai Lee, Minister of Finance and Economy of the Republic of Korea.

I am sure that our presence and views in this forum will be key factors for the success of this meeting. I also would like to express on behalf of our Minister of Economy and Finance Mr. Efrain Goldenberg his best wishes in the successful outcome of the Forum.

Peru's Participation in regional and multilateral agreements, has enhanced access to international markets so as to generate economies of scales and specialization. In November 1998, Peru incorporated the Asia-Pacific Economic Cooperation forum(APEC). Through its participation, Peru is seeking greater access to APEC markets in order to attract Asian and Pacific investors.

APEC is the most important commercial trade partner of the Peruvian economy. In 1999, Peruvian trade of goods with the economies of APEC reached 55% of its total trade. Exports to APEC represented more than 50% of the total, and our imports around 60%.

Before expressing some ideas of how to achieve the Bogor Goals or how can APEC contribute to global liberalization, I will explain some of the main elements of the Peruvian economic program.

Since 1999, the pillars of stabilization and growth, have been strong macroeconomic policies and a far reaching structural reform program.

Major reforms in recent years included:

- Generalized liberalization of trade and capital flows
- Equal treatment of foreign and domestic investment
- Flexible labor market
- Aggressive and transparent program of privatization
- Financial sector reform
- Social security and pension reform
- Far reaching and well-targeted poverty reduction strategy

As a result of these policies:

- Real GDP has grown at an annual average rate of 5.7% between 1993-1999. Growth was led by investment and exports. Peru has achieved one of the highest growth in Latin America.

- Inflation was brought down from over 7000% in 1990 to 3.7% in 1999, the lowest in the past 40 years.

- Strengthened external balances have allowed international reserves to raise to US$ 8.8 billions in February of this year, equivalent to around 15 months of imports of goods.

Economic Sectors in PERU have increased as a result of an external trade and exchange rate liberalization, sound fiscal policies, and a comprehensive set of structural reforms.

In 1998-1999, Peruvian economy was affected by consecutive external shocks: lower export prices that resulted of the Asian Crisis, the effects of EL Niño climatic phenomenon, a liquidity squeeze linked to the turbulence in international financial markets of the Russian Crisis and the Brazilian Crisis.

A number of measures were adopted in late 1998 and 1999 in response to these shocks.

In 1999 the Peruvian economy has begun to recover, because of the strong expansion of agriculture, mining and fishing. In this last year the domestic demand shows a reduction. Since late 1999, there are signs of a wider improvement of economic activity and the domestic demand is getting better.

In the 1990s, fiscal discipline combined with increasing current revenues reduced the overall deficit in the non-financial public sector. In 1999, there was a temporary increase in the fiscal deficit, mainly because of a Central Government's revenue shortfall arising from weakness in domestic demand.

From 1993 to 1999, our exports grew from US$ 3.5 billions to US$ 6.1 billions. In 1998 the drop of Peruvian exports is mainly explained by adverse exogenous factors : a deterioration of terms of trade resulting from lower prices for Peru's principal exports; and EL Niño climatic phenomenon which lowered export volumes of fishmeal and fish oil.

Peru's generally open trade regime has contributed to a significant increase of trade flows since 1994. Between 1993 and 1999, total merchandise trade grew at an average annual rate of 7.6%.

The process of structural reforms and stabilization of the Peruvian economy, along with the establishment of a legal framework for the promotion and protection of investment, have resulted in substantial foreign investment inflows in recent years. The stock of registered foreign direct investment (FDI) increased from US$ 1.9 billions in December 1993 to US$ 8.6 billions in December 1999; at this date, accrued foreign direct investment pending registration amounted to US$4.4 billions. Also as of December 1999, holdings of foreign investors registered at the Stock Exchange (CAVALI) reached US$2.7 billions, which represented 32% of the total Stock Exchange value. Between 1992-99, foreign direct investment flows were principally directed to communication, mining, energy, industry and finance.

An important aspect in our economic recovery, in the 1990's has been the normalization of relations with external creditors and debt restructuring.

Economic recovery has also coincided with improved social welfare as measured by a broad range of indicators including poverty rates; literacy rate; access to safe water, electricity and sanitation services; life expectancy ; and infant mortality.

For this year it is expected that real GDP will grow by 4 to 5%, inflation will remain in the range of 3.5 to 4%, and the external current account deficit will be about 4% of GDP. The privation and concessions programs will continue, aimed at enhancing efficiency and competitiveness of the economy. The Government is also committed to continue giving priority to improving the social indicators.

Our medium term objectives are:

- Sustained economic growth at rates above 6% annually
- Reduction of inflation to international levels
- Reduction of the current account deficit.
- Further reduction in poverty levels.

The economic program in order to achieve sustained growth in the medium term will maintain macroeconomic stability and strengthen structural reforms.
Within the context of the macroeconomic and structural reforms implemented since the early 1990s, Peru's trade policy has sought to consolidate the process of deregulation and liberalization of its trade regime. As such, the stated goal of trade policy

formulation has been to create non-distorting incentive that allow an efficient allocation of resources and promote the development of economic activities according to market signals.

Our standards and technical regulations aim to contribute to the free flow and use of goods and services in external and domestic transactions.

Peruvian economic policy during the last decade has been guided toward a more open economy with macroeconomic stability. The strengthening of our economy has been a key factor so that the liberalization reached has not been affected by external shocks. Since 1999 the export sector recovered its previous levels and our economy as a whole is improving.

The government has recently enacted a Law on Fiscal Responsibility, as a commitment to fiscal consolidation and prudent fiscal conduct over the medium and long term period. The principle is to ensure fiscal equilibrium in the middle term, generating surpluses in favorable economic periods and allowing moderate fiscal deficits and non recurrence of them in periods of slow economic growth.

The government will persevere in macroeconomic stability and reinforce domestic savings. We are sure, after our recent experience, that economies that advocate to these principles are better prepared to reduce external shocks and provide enough confidence for domestic and foreign investors.

Our export sector will reach a more dynamic growth. We have to make efforts to increase and diversify products and markets. At the same time, we are sure that an export sector with those characteristics will allow more satisfactory overall rates of growth to of the economy and positive effects on domestic income and employment.

In the area of global efforts we expect from all the economies to strengthen market access. This, coupled with a number of cooperation measures, like technical assistance, will increase the possibilities of improving liberalization measures in our domestic economy.

We are making efforts to increase foreign investment and this is one of our main objectives of participating in APEC. Other of our objectives is that our total exports increase in the future, from 11% GDP in 1999 to around 16% of GDP in the year 2006.

From my point of view to approach the theme of how to achieve a substantial liberalization of trade and investment through APEC, implies as a precondition the establishment of a solid domestic economic framework. This will enhance the possibility of individual and common actions of all the APEC economies toward the Bogor Goals.

Peru is a very open economy. We have an open trade regime, that is reflected in its low level of trade restrictiveness, consistent with Peru obligations as a member of the World Trade Organization (WTO). Our average tariff level is around 13.2%. Capital and other resources moves freely and national treatment is the general norm.

Peru advances firmly towards the Bogor goals. One of our principle issues is to reinforce our domestic efforts to support an expanding world economy and open multilateral trading system. Economies with a flourishing export sector and with their benefits widely spread in income and employment will be increasingly interested towards free trade.

With regard to the mechanisms to attend the Bogor's goals there is lot of work in the future. Into the analysis we will have to bring new ideas. I think the discussions of methods to attend the Bogor's goals will be facilitated, if we persist in the stabilization and reform programs of our economies, in order to reach sustainable high rates of growth based upon an open oriented economies and ensure that our people share the benefits of economic growth.

We have to continue with our efforts to strengthen market liberalization and increase investment. We also have to develop our human resources, with especial emphasis in the development of its capabilities. We need to develop technology in the areas of information and communication and promote the participation of small and medium businesses.

From our experience in APEC we recognize the efforts to find cooperative solutions to the challenges of our rapidly changing regional and global economy and to support an expanding world economy and open multilateral trading system.

A permanent evaluation of the results of the multilateral system among our economies accompanied with measures for a more accelerated openness of all the economies will be a contribution to global liberalization. This will facilitate us the issue of showing once and over again the benefits of trade liberalization to our community and it must be a permanent effort.

The individual action plans (IAP' s) and the principle of non discrimination will progressively lead all members of APEC to contribute to trade and investment liberalization. Current voluntary evaluations of the individual action plans (IAP' s) could lead us to advance to a more determined liberalization.
Again, ad I mentioned before, strengthened efforts for sound domestic economic policies towards a stable growth will help toward that goal. APEC is in that direction and this Forum on Shared Prosperity and Harmony, is a good example.

An adequate combination of individual and common efforts of all the APEC economies is a good approach to address domestic opposition towards liberalization. We have to reinforce economic cooperation among our economies and, when needed, find cooperative solutions to the challenges.

Each economy has to work in the following issues:

- Macroeconomic stability and stable growth as necessary conditions, towards liberalization.

- Export growth and diversification of exports towards more value added products. Governments, entrepreneurs and employees have to participate of the positive effects of liberalization.

- As a complement, we have to improve education and training, link our economies with better telecommunications and transportation and use our resources efficiently.

- Increase domestic and foreign investment to reach higher levels of employment and significant reductions of poverty and ensure that our people share the benefits of economic growth.

So, as a final word, it is important that our people can link the benefits of trade and investment liberalization of our economy with better opportunities. In that way our goal of achieving the fullest liberalization within the global context would be facilitated.

Also, it is important to ensure that the private sector of our economies have an active participation in all these efforts, as a way to consider its point of views or opinions and new ideas of cooperation can arise. In the case of Peru, recently was created the APEC – Peru Entrepreneurs Commission.

I will like to express my gratitude on your attention and I hope my views and ideas will contribute in this APEC Forum on Shared Prosperity and Harmony.

Thank you

Peter Drysdale
Professor
Australian National University

Developments over the past four years have raised many questions about the prospects for East Asia's economic growth. But the force of East Asian industrialisation over the last few decades has already transformed the contours of world economic power and influence in a way that will not change beyond the crisis from which the East Asian economies are now rapidly emerging. This was the premise on which APEC was built as it sought to encompass the effective representation of East Asian and Pacific regional and global interests at the end of the 1980s.

Trade and investment liberalisation was from the beginning, and still is, at the core of APEC's economic policy agenda.

Why is this so?

East Asia's economic and political ambitions are ordered critically around the goal of modernisation. Trade liberalisation and reform are the leading instruments of East Asia's industrial transformation through the deeper access they provide to international markets and capital. As 'catching up' economies, East Asian countries have had a profound and strategic interest in a trade regime that eschews discrimination in trade treatment because a central feature of their trade growth involves taking over market share from established suppliers to international markets, initially for labour-intensive goods and later for an increasingly sophisticated range of industrial products.

This is why the organising idea for APEC was open regionalism and why APEC has sought to promote trade liberalisation on a multilateral basis.

Yet APEC is not simply a trading arrangement, and certainly not a preferential one, although defence of an open trading system is the most important shared interest of Asia Pacific economies. The Asia Pacific is a vast zone of economic development, and economic and technical cooperation focussed on market strengthening in the course of economic transformation, are essential complements to APEC's trade policy agenda.

While APEC's foundations were economic – successful East Asian economic growth and the development of East Asia's role in the international economy – the political objective was to accommodate East Asia's growing power without disturbing the balancing role played by North America in regional economic and political affairs. There was a happy coincidence of economic and political interests, encouraging regionalism based on a distinctly global agenda, at the end of the Cold War.

In little over a decade, APEC has an impressive record of achievement.

Through APEC, East Asian and Pacific countries have worked to define a strategy for trade and economic diplomacy – liberalisation and reform organised around the principles of open regionalism – particularly suited to the development objectives and diversity of the Asia Pacific region. APEC has provided a framework for the accommodation of the three Chinese economies into mutually productive economic relationships, despite the diplomatic tensions across the Straits of Taiwan. It has progressed from official and ministerial level institutions to regular meetings of Asia Pacific leaders in a forum in which tensions can be diffused and calmed and political energies mobilised to deal with priority issues in each of its member states. It influenced the outcome of the Uruguay Round of trade negotiations and revealed its potential as a major coalition within the WTO. These are the important results of Seattle, Osaka, Manila and even Mahathir and Gore in Kuala Lumpur as well as

Auckland. At the same time, it has established a new mode in international trade liberalisation through the commitment to free trade and investment by 2010 and 2020 at Bogor and moved on, though the Osaka Action Agenda and its implementation, to provide a vehicle for carrying reform forward independently of formal international negotiations.

Despite the economic crisis in East Asia, and currency turmoil and macro-economic instability in 1997 and 1998, there is no sign of retreat on APEC's core agenda for trade and economic reform – it has been extended to encompass financial and other market strengthening programs.

APEC has already become more than just a loose community of like-minded economies encouraging each other in a process of multilateral trade and investment liberalisation. It is also a structure, an umbrella, under which economic, and to an extent, political tensions within the Asia Pacific region are managed.

Yet APEC now faces some enormous challenges in the heartland of its trade policy agenda.

The collapse of the WTO ministerial meetings in Seattle was a significant setback for APEC's trade liberalisation goals in the Asia Pacific region.

The expectation was that a new round of WTO negotiations would provide momentum, in dealing with the 'hard issues' in liberalisation – agriculture, textiles, anti-dumping – and assist with steady progress towards the Bogor goals for free trade and investment. The failure on early voluntary sectoral liberalisation in Kuala Lumpur in 1998 (as Japan fumbled because of weak political leadership at home) underlined the lesson that these issues could only readily be resolved in multilateral negotiation. Hence, in 1999, APEC went back to basics, with re-commitment to the Individual Action Plans and putting trust in the launch of a new round – the only context in which the United States and Japan can be expected to make their required contributions to the achievement of APEC's liberalisation goals.

How can APEC respond to the vacuum created in Seattle?

Over the past few years East Asia has been an economy in apparent disarray. One perception was that APEC was a mere bystander as the drama of the East Asian crisis unfolded. From a longer term prospective, the East Asian economies were becoming more important to each other. East Asian intra-regional trade is a growing share of East Asia's trade. This had encouraged some in Japan and elsewhere in the region to think of more exclusive arrangements in East Asia, cutting loose from traditional commitments to broader multilateral arrangements. The study of a Japan–Korea free trade agreement and contemplation of broader Northeast Asian arrangements as well as proposals for an Asian Monetary Fund and regional currency arrangements and the formation of the ASEAN plus three group are related developments.

There has been a plethora of proposals for sub-regional trade arrangements that would see important APEC members shift trade policy priority to negotiation of 'free trade' agreements of a potentially discriminatory nature. Apart from Japan–Korea, Japan–Korea–Taiwan, AFTA–CER, Japan–Mexico, Japan–Canada, Korea–Chile, NAFTA–Chile, Singapore–Japan, and Singapore–New Zealand are among those that have been mooted. For Japan, the only major economy in the world other than China and Korea not a member of any free trade agreement or economic union, to choose a strategy of closed regionalism would have considerable reverberations within East Asia and the Pacific and within world trading systems and mark an historic turning point in its economic diplomacy. Only during the imperial period has Japan chosen this course. The failure of Seattle has been used to lend legitimacy to this shift in the direction of trade policy thinking.

How can APEC respond to the confusion in trade policy ideas that has emerged after the East Asian crisis?

Finally, during the 1990s there has been a growing political backlash against globalisation. This backlash is most potent in Europe and the United States but it is present in the polity of all industrial democracies and in other countries that have committed to internationally-oriented economic reform. The battle on the streets of Seattle against the WTO symbolised the many dimensions of this movement in North America against policy agendas that are supportive of the deeper integration of international markets. More importantly, Seattle left a huge question mark over the role of the United States in world trade policy.

What role can APEC play in allaying domestic opposition in its member states to deeper involvement in open international markets?

These are the three questions around which the argument of this presentation is ordered.

APEC offers a way forward for Asia Pacific economies out of the impasse in the WTO. There is immediate interest in pressing ahead with APEC's multilateral liberalisation agenda, providing the direction and leadership on trade policy that is desperately required. There is potential for mobilising a powerful coalition in APEC to define the way forward in multilateral negotiations through a new round. This will need to involve sorting out important differences among key players in APEC itself. The Trade Ministers Meetings in Darwin later this year provide an important opportunity to make progress on all these fronts.

The circumstances in which APEC finds itself today, after the aborted launch of the new round in Seattle last November, has some parallels with that in the early 1990s. Then, APEC developed its unique approach to trade and investment liberalisation, based on the idea of open regionalism in response to the twin dangers of a collapse of the Uruguay Round and a resurgence of regionalism which threatened to divide the world into a small number of warring trade blocs. After these dangers were averted and the Uruguay Round was successfully concluded, APEC was able to turn its attention to 'adding value' to what had been achieved in the WTO.

The world trade system again looks vulnerable and regionalism is resurgent. Once more APEC needs to calculate what it can contribute to restoring a sense of purpose to the multilateral negotiations and ensuring that the pressure for regional arrangements is channelled in constructive directions.

Much has changed since 1994. APEC's targets for trade and investment liberalisation are in place. The Osaka Action Agenda and APEC's Individual Action Plans provide a vehicle for carrying reform ahead independently of formal negotiations in the WTO or under other arrangements. This is a useful, if not entirely certain, platform from which to keep the momentum of trade and investment liberalisation moving forward. Without APEC, for example, there would have been no ready international platform for delivering substantial trade reform and liberalisation and establishing China's credentials on the way towards accession to the WTO. There is scope for making this process more certain —for streamlining and strengthening the process of unilateral liberalisation within APEC under the Individual Actions Plans and scrutiny of APEC members' programs of reform on the way towards achieving the Bogor goals. Now is surely the time to raise the profile of APEC's independent trade liberalisation agenda both as a way forward while the new round is on hold and as a beacon in encouraging commitment to multilateral negotiations.

APEC's 'concerted unilateral' approach to trade liberalisation can, in this way, be both an effective complement to, and useful lever for, progress in the WTO.

But it would be unrealistic to claim that APEC's goals will be delivered independently of negotiations in the WTO. Neither the United States nor, unfortunately, Japan will deliver their part of the APEC bargain unless the 'hard issues', such as agriculture and anti-dumping, are negotiated within the WTO. In its own interest, therefore, APEC needs to consider how it can contribute to re-starting the negotiations towards a new WTO round.

There is no pretending that this will be an easy task. Two of the issues that derailed the launch of the new round —agriculture and an inability to bridge the gap between developed and developing countries in setting the agenda —also have the potential to divide APEC.

Despite the endorsement of the new round in Auckland, APEC had little impact on the outcome at Seattle. Some APEC governments took positions in Seattle contradictory of the position reached by APEC leaders in Auckland. So APEC has a lot of ground to recover if it is to become a credible coalition for getting the WTO process under way again.

Yet, more than any other group of economies, APEC embodies a structure of interests and a tradition of consensus-building and cooperation that give promise that it could find a way forward on these issues in the WTO.

Most APEC members sympathise with developing country resistance to American and European demands that labour, environmental and other so called 'new' issues be included in the agenda of the new round. They support developing country demands to curb the abuse of anti-dumping action and to tighten implementation of the outcomes of the Uruguay Round. There is also growing support in APEC for an integrated approach to the food trade problem, in the proposal for an APEC food system, linking trade liberalisation to rural development, the transfer of agricultural technology and food security. This provides a framework within which agricultural trade issues might be addressed more constructively.

To weld an effective coalition in the WTO, APEC members will have to confront these issues carefully but purposefully. This is not without risk, particularly because of the divisiveness they bring to relations between the United States and other APEC members. But the stakes are high and the risk worth taking if APEC can help break the Seattle impasse, since APEC needs an effective WTO if its own ambitions for trade and investment liberalisation are to be realised successfully. The United States would want to think hard before it shunned such an endeavour, because to do so would corrode the strategic framework of links with East Asia through APEC, encouraging East Asian economies to find their own and different solutions to the trade policy choices they now face.

APEC also offers a way forward through the confusion in trade policy arising from the various proposals that have been put forward for regional trade arrangements. Regional trade arrangements need to be shaped consistently with multilateral objectives and APEC's own commitment to the goal of free trade and investment by 2010 and 2020. It is not yet clear whether all the proposals that have been suggested meet these tests. APEC's Economic Committee will look at the impact of sub-regional trade arrangements in APEC over the coming months and there are other proposals for gathering information on the nature and coverage of these arrangements throughout the region. APEC needs to develop a consensus on how sub-regional arrangements relate to the regional and global trade policy interests and strategies of member economies. Again, the upcoming Trade Ministers' Meetings in Darwin provide a timely opportunity to begin the work that is necessary in APEC on this issue.

The logic of open regionalism as the organising idea for Asia Pacific economic cooperation is embedded in the experience of East Asia's integration into world markets. The proportion of East Asian trade going to and coming from partners outside the region is much higher than for either North America or Europe. The region is large, and both culturally and geographically as well economically diverse. The region is driven by its powerful development ambitions, and development, it is widely understood, requires commitment to opening up and liberalisation of economic activities in a global marketplace.

APEC' s new form of regionalism is *open* in a number of ways. It is open in that it is non-discriminatory; liberalisation is encouraged on an MFN basis. It does not involve the negotiation of legally binding treaties. It is premised on strong support for the WTO. This is particularly important in a region where a succession of economies is committing to progress with internationally-oriented industralisation, and the trade and economic reforms that success in this ambition requires.

APEC' s open regionalism has a fundamental economic rationale: concerted unilateral MFN liberalisation does not cause trade diversion; countries enjoy the benefits of liberalisation both with the rest of the world and with other countries in the region.

It also has a political rationale. Put mildly, any negotiation to form a preferential trading bloc in such a diverse region would be enormously complex and time-consuming, and above all, politically divisive. Could even China, a leading APEC player, be easily included in the near future? This would be just the first question to be asked in considering a preferential trading arrangement within APEC.

But what of new sub-regional trade arrangements among APEC members? Are they stepping stones along the way to achieving APEC's regional and global trade policy objectives? Or will they entrench discrimination in regional trade and frustrate the goals of open trade and investment for 2010 and 2020?

The answer to these questions is clearly that it all depends.

Context is everything in assessment of the value of regional arrangements which extend preferential treatment to participating economies. Whether preferential liberalisation is undertaken in the context of formal commitments to multilateral liberalisation, whether preferential arrangements significantly extend competition from, or maintain protection against, imports of goods or services, and whether it provokes defensive reactions elsewhere are critical issues. Motives matter and, while there is no problem in principle with sub-regional trade arrangements, there is no question that some kinds of arrangements could seriously damage the APEC effort, economically and politically.

It is difficult yet to judge which among the many proposals that are under study in the region might meet the conditions for Bogor and WTO consistency. There is simply too little known about what might be involved in most of them. But it is possible to outline some essential features if these conditions are to be met.

Three points need to be made in this context. First, it should be said that any 'free trade agreement' that involves no element of exclusion or discrimination is perfectly Bogor and WTO consistent. It may well turn out that some of the arrangements that have been floated (maybe that between Korea and Japan?) include no element of discrimination and automatically meet the Bogor/WTO tests. Second, sub-regional agreements that incorporate commitments to multilateralisation of liberalisation on schedules consistent with achieving the Bogor goals would meet the conditions required. Most partners in the ASEAN Free Trade Agreement have committed to multilateralisation of liberalisation under an agreed time frame in this way. The Osaka Action Agenda enjoins APEC to extend liberalisation under sub-regional arrangements to all APEC members on a voluntary basis. Note that the Bogor/WTO conditions are more stringent than the Article 24 requirements for the establishment of a free trade arrangement under the WTO which provide no discipline in setting a comprehensive liberalisation goal. Third, there is a high risk that sub-regional arrangements of any other kind, negotiated outside the context of a new round of WTO negotiations, would not be likely to meet the conditions for Bogor/WTO consistency.

These are some initial reflections on the issues that need to be given consideration by APEC Ministers and leaders over the coming couple of years.

APEC was founded on commitment to reform and change. The way APEC works requires that the political leadership in member economies accept ownership of policy agendas for reform and change. Reform and change encounter opposition and resistance in any polity, but in one where the political leadership has direct and obvious ownership of the process, and credibility at home and abroad depends upon delivery, there is incentive to carry opposition forward with reform. The APEC agenda is not imposed under supra-national agreement; it is entirely the responsibility of independent member governments. This is a considerable strength in the way in which APEC operates, in dealing with opposition to change.

The gains from commitment to the APEC agenda are clearly more demonstrable in some members then in others. And in some political processes – particularly the more mature industrial democracies – reciprocity in political dealings values sectional over social goals when political leadership is weak. But APEC members are encouraged to action in trade and investment policy reform in the knowledge of belonging to a community of like-minded nations, each understanding that, as it opens its own markets in its own best interests, markets are also being opened in partner countries around the region.

In some countries (such as Australia), APEC targets and commitments are already key reference points in the political process of managing policy reform – a self-imposed, bipartisan discipline on political leaders. APEC can now sensibly build on the constituency for reform it has established, more or less deeply, across its member economies throughout the region.

In countries, like Korea, which were seared by the experience of the East Asian crisis, there is a special opportunity for taking ownership, within APEC, of the reform agenda that is now essential to sustaining recovery and economic growth in the long term. Liberalisation of key service sectors and continuing reform of governance systems are priorities in Korea's transformation to a first rank industrial economy. Korea is in a position to play a leadership role in policy cooperation on these issues in control of its own policy agenda for change, beyond the policy strictures imposed during the crisis, shaping liberalisation and reform in cooperation within APEC.

The 1980s and 1990s were a period of unprecedented growth in East Asia and saw the emergence of APEC, importantly designed to secure East Asia's development in a political arrangement encompassing the shared economic objectives and priorities of the plurality of societies within the Asia Pacific region.

Does APEC continue to provide the appropriate framework within which to manage the challenges it now confronts?

APEC does offer a way forward for Asia Pacific economies out of the impasse in the WTO and a way forward in shaping regional arrangements consistently with multilateral objectives and with APEC's trade and investment liberalisation commitments.

One final question. Does the growing importance of East Asia (and particularly China) to the East Asian economies recommend a change in direction?

The APEC framework and its core agenda of open regionalism remain crucial to the successful management of the evolving relationships between China and the other major powers in Asia and the Pacific, including the United States.

China's (and East Asia's) best choice remains the global choice and a regional framework which is structured like APEC to deliver on global objectives. That is why China's accession to the WTO is so important.

The avoidance of exclusive, discriminatory arrangements in East Asia is important to China's ability, for example, to manage the development of its relationships within East Asia (of course with Taiwan, but also with Korea, Japan, ASEAN and the Indochinese economies). Asymmetry in China's relations with its neighbours has the potential to bedevil them unless they are part of an open trade and economic system globally. China's involvement in any tight arrangement linked exclusively to the East Asian economies, including Japan, presents economic and political difficulties because of both the perception and the reality of asymmetry between China and its partners in the region. China is already a big economy and a big power and will have more comfortable relationships with other major powers and with smaller economies and polities, the more open those relationships are.

APEC has been of particular value to China in the pursuit and projection of its interests in the global system. The APEC meetings in China in 2001 will be an important opportunity for solidifying this framework for cooperative partnerships between China and its major partners in the Asia Pacific region, especially the United States and Japan but also significantly the ASEAN economies and Korea.

Ippei Yamazawa
President
Institute of Developing Economies, JETRO

We have listened to the presentations of our four panelists. Ministers Medalla and Almenara conveyed their own experiences in liberalization and restructuring efforts, including their political aspects. The difficulties in implementing liberalization and restructuring are shared by all APEC members. And it is important for us to get informed of each other's efforts and difficulties in implementing these policies.

On the other hand, Minister Sutton and Professor Drysdale focused on the external aspects of liberalization. Both discussed all three aspects of our liberalization efforts – multilateral; regional, namely APEC's liberalization; and sub-regional or bilateral FTA approach.

We certainly appreciate your insightful overviews and suggestions for future course of APEC's liberalization. Nevertheless, it is interesting to notice some difference between Minister Sutton and Professor Drysdale in their expectation for the bilateral FTA approach. In this respect, let me respond to Professor Drysdale's warning against our study of Japan-Korea Free Trade Agreement. Since we are still working on it, I can not speak much about it at this stage. But I will assure you that our FTA will be consistent with the APEC open regionalism and it encourages Japan and Korea to take broader initiative in the liberalization of APEC and WTO.

I think it is time conclude this sub-session with your applause to the panelists.

Thank you very much for your participation.

PART II : A New Financial Architecture for Preventing the Recurrence of Economic Crisis

1. Financial and Foreign Exchange Policies for Preventing the Recurrence of Economic Crisis

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

Thank you very much.

I' m extremely honored and delighted to be chairing this session and to be a part of this important gathering. And it' s a particular delight to be in Korea, when it' s doing the usual thing, which is being perhaps the fastest growing country in the world – which is how we think of Korea in general, not as a country in crisis. So this is a very fitting time for this symposium.

We have an outstanding group of speakers from all over the world and a very important topic. We heard this morning about the process of liberalization and reform. This afternoon, we' re talking about the global system. And, in particular, we want to ask the question, "Is there a new financial architecture that might actually prevent the kind of crisis that was experienced in 1997~98 in this region from occurring again?" And I think this is a very much an open question. It depends, first of all, on what we think the causes of the crisis were. And I' m not sure that we' ve really reached the bottom line on understanding that. Them, it comes to the question of whether we really have designed a new international set of institutions or international set of procedures that could somehow solve the weaknesses that were exposed .

I think there were, to just be very brief, two kinds of hypotheses, or maybe I think it' s even fair to say three kinds of hypotheses that were raised about the Asian crisis. One view, which quickly came up said, "The world preceding the Asian miracle was a kind of myth anyway, so it' s not surprising that it collapsed." If you took that view, I think you have to be surprised at the speed of recovery and the rate of growth throughout Asia. That kind of view really said that the problem in Asia was deeply fundamental. It was the whole society not well organized or industry not productive enough and so forth. And I think, personally, that that view is being disproved pretty fundamentally. Asia is a very dynamic part of the world and it is, again, in my own guesses, going to be a fast growing part of the world in the years to come.

There were two other hypotheses that were less fundamental than the first one. The second one said, "Yes, Asia's underpinnings of high growth, technology, education, flexibility are all good, but the domestic financial systems are a mess – banks are poorly regulated, crony capitalism and so forth. And you have to clean up the financial sector." And this was, of course, the Washington view, if I could call it that because the official view of the system was that the problems all lay in Asia and Asia has to fix itself up to restore growth.

There's a third kind of view which says that while the second view is true, it's only a part of the story, maybe not even the major part of the story, and that what the problem in 1997 reflected was the instability of global capital markets, as much as the problems within any particular system in Asia. That view says that we live in a world of highly volatile capital flows and that the problems are not specific to Asia. They really reflect the fact that, in our new global economy, we have not gotten adequate rules of the game and adequate behavioral norms to keep stable capital flows. And I think there's some evidence for that proposition because the East Asian crisis quickly became the South American crisis. It quickly became the Central European crisis. It wasn't specific to Asia, it was a reflection of emerging markets relations to the world economy, not anything specific to an individual country.

In any event, that's what we have to understand in order to be able to make prescriptions. And I'm sure each of our six panelists will give us their own view of how to look backward and how to look forward. Since I won't have the chance, I'll tell you my own view in advance, just to provoke the panel, because I would like to provoke the panel. I'm often told that it's impossible for me to be a moderator because I'm anything but moderate. I'm a provoker, not a moderator. So, let me provoke the panel just for a moment.

My own view is that this third element of high unstable capital is a major part of the story. Given that, my own view is we haven't addressed it yet. What I see is a lot of investment bankers with a time horizon that has shrunk from 3 weeks to about 15 minutes. And it worries me that we're living in a time of very highly speculative capital. And I think that a good place that the next crisis could occur is the United States, itself, because we certainly have the most remarkable rise of the stock market that anyone has seen since Japan in 1989 – and we know what happened there.

So, I'm going to stop now and turn it over to our panel. And I promise to shut up for the balance, so we'll listen to real wisdom now. Our first panelist is Minister Tarrin, Minister of Finance of Thailand, who we know as one of the truly remarkably successful reformers of this period. In very tough circumstances, Minister Tarrin came to power as Finance Minister and has guided Thailand through a tremendous amount of financial surgery with a huge amount of bad debt in the banking sector and financial closures and so forth – somewhat familiar in Korea, but I would say it was a tremendous challenge, taken with great success. And so, we have no better way to start in thinking about the global architecture than listen to you, Mr. Minister.

Tarrin Nimmanahaeminda
Minister of Finance
Thailand

Mr. Chairman, Distinguished Guests,

It is a great pleasure for me to address this APEC Forum. I am especially pleased to participate in this session on "Financial and Foreign Exchange Policies for Preventing the Recurrence of Economic Crisis" because the topic is of particular interest and relevance to policy makers.

The first area I would like to discuss is exchange rate and macroeconomic policy. The Asian crisis painfully highlighted the inconsistency of having a regime with fixed exchange rates, free capital mobility, and an independent monetary policy. Thailand – like Indonesia, Korea, and the Philippines – dropped its *de facto* exchange rate peg to the dollar and moved to a floating exchange rate regime. The floating exchange rate regime provides more protection for our economies against current account imbalances and volatile capital flows.

But with free capital mobility, however, adopting a floating exchange rate regime by itself is no guarantee against a future crisis. It must be accompanied by sound monetary policy, sound fiscal policy, and improved transparency.

On sound monetary policy. In Thailand, we have drafted a new Bank of Thailand Act to strengthen the Bank of Thailand's independence and accountability. Objectives of the Bank of Thailand will be limited to maintaining price stability and safeguarding the stability of the financial system. As part of this effort, the Bank of Thailand is considering adopting inflation targeting, which is in use in several countries such as the United Kingdom, Canada, Australia, and New Zealand.

On sound fiscal policy. We are attempting to reduce our government deficit steadily to return our long-term fiscal position to balance and reduce our public debt. The new Bank of Thailand once the act is enacted, will not be able to lend to the government to finance budget deficit. Also, we are improving the efficiency of our tax system and carefully managing public expenditures by controlling recurrent expenditures while allowing our investment budget to increase in areas critical for our long-term growth and competitiveness.

Third, improved transparency. Thailand subscribes to the Special Data Dissemination Standard of the IMF with regard to the coverage, periodicity, and timeliness of macroeconomic data. The Bank of Thailand also regularly discloses its net international reserve position. To further enhance transparency, the new Bank of Thailand Act will require the Bank of Thailand to preannounce its monetary policy direction and past performance in conducting monetary policy; report its operations to Cabinet and Parliament; and disclose its financial accounts on a weekly basis.

While this policy mix of flexible exchange rates, sound monetary and fiscal policies, and improved transparency will help to prevent a future crisis, it presents policy makers with several difficult tradeoffs.

First, as we have seen from the crisis, capital flows react—and overreact—quickly, leading to excessive exchange rate volatility. Such volatility affects trade flows, debt service, and the real economy. What is the appropriate tradeoff for policy makers between a completely free floating exchange rate and a more managed float?

Second, we have had to incur higher public debt to stimulate the economy and restructure the financial sector. What is the appropriate tradeoff between maintaining long-term fiscal prudence and resolving the immediate crisis through massive government deficits?

Third, targeting lower inflation promotes price stability, but at the cost of other macroeconomic objectives. What level of inflation should be targeted? What is the appropriate tradeoff between inflation and interest rates and output?

The second area I would like to discuss is financial and corporate sector policies that we have undertaken to prevent the recurrence of economic crisis.

First, we have improved financial sector governance across a variety of dimensions. We have revamped our entire prudential framework. Loan classification, provisioning, and interest accrual and capital adequacy rules were tightened and brought up to international standards.

We have also drafted a new Financial Institutions Act to modernize the regulatory framework. With financial liberalization, the scope of operations of different types of financial institutions has increasingly overlapped. The new Act will standardize the regulatory framework for banks, finance companies, and credit fonciers. It will provide a legal basis for the consolidated supervision of financial conglomerates. The Act also tightens regulations significantly in a variety of areas, including interconnected lending; disclosure standards; and penalties and prevention against fraud.

In terms of institutional capacity, we are also reorganizing the Bank of Thailand in line with the recommendations of a group of central bankers from G-4 countries with a view towards strengthening the Bank of Thailand' s supervisory capacity.

Second, we have put in place a much more effective debtor-creditor regime. Legal reforms underpin our improved debtor-creditor regime. Amendments to the Bankruptcy Act provide legal protection for new financing for distressed debtors and allow voting on reorganization plans by classes of creditors. To facilitate bankruptcy proceedings, we have established new bankruptcy courts with specialized judges. We have also introduced legal measures to strengthen foreclosure procedures.

The objective of these legal reforms is to provide a clear and predictable court process to act as a reference point for encouraging out-of-court settlements. For this reason, we have complemented these legal reforms with an institutional framework for monitoring and facilitating debt restructuring by establishing the Corporate Debt Restructuring Advisory Committee, or CDRAC. Chaired by the Bank of Thailand, CDRAC consists of the heads of associations from the financial and corporate sectors. It has developed two key civil contracts — the Intercreditor Agreement and the Debtor-Creditor Agreement — which provide an enforceable, time-bound framework for speeding up restructuring proceedings.

Third, we have undertaken a variety of measures to improve the long-term strength and stability of the financial sector. The capital support facility which we announced in August 1998 has helped financial institutions to recapitalize both on their own as well as with government assistance. We have also allowed foreign ownership of Thai banks to promote competition and long-term efficiency. Furthermore, the sector has become more consolidated as a result of restructuring.

Fourth, we have strengthened governance in the corporate sector. To this end, we have improved financial disclosure, board oversight, and shareholder rights. We have adopted accounting standards consistent with international best practice. All listed companies are now required to have an audit committee of the Board of Directors. We are also in the process of amending the Public Company Act and the Securities Exchange Act. These amendments will improve the process for appointing directors; reduce thresholds for the exercise of minority shareholder rights; increase the accountability and liability of directors; and introduce shareholder approval requirements for major or connected transactions.

Implementing these financial and corporate sector policies has also presented us with difficult tradeoffs in several areas.

First, regulatory forbearance. Strict prudential regulations benefit the long-term health of the financial sector. But in a crisis situation, rapid implementation of stricter guidelines run the risk of creating a credit crunch as well as requiring the state to intervene in even more institutions. In Thailand, we chose a "middle ground" whereby we gradually but transparently phased in the implementation of the new prudential requirements according to an explicit timetable.

Second, public support for recapitalization. Using public funds to recapitalize financial institutions can obviously help to resolve the immediate crisis faster. But bailing out bank shareholders and management also creates substantial moral hazard and increases the likelihood of a future crisis. In Thailand we again chose a "middle ground" whereby we provided a public capital support facility, but accompanied by clear safeguards to reduce moral hazard.

Third, resolving non-performing loans. A system-wide, "carve-out" of non-performing loans — or NPLs — by a public asset management company could quickly restore the health of bank balance sheets, but at the cost of much moral hazard and a massive fiscal burden. Furthermore, it postpones the *final* resolution of the NPL problem. NPLs would simply be transferred from the private to public sector, where they are less likely to be effectively managed.

In Thailand, we have pursued a multiple approach aimed at the final resolution of NPLs. First, we have auctioned assets of 56 closed finance companies through the Financial Sector Restructuring Authority (FRA). Second, we are reprivatizing intervened banks to acquirers who are subsequently responsible for resolving the NPLs of these banks. Third, we have pursued private, market-mediated mechanisms for resolving NPLs among private financial institutions.

In closing, I should emphasize that there are a whole host of other policies to prevent the recurrence of an economic crisis — including early warning systems and policies to manage short-term capital inflows — which I have not addressed. My comments were not meant to be comprehensive, but rather to illustrate what we have done in Thailand, as well as provide some examples of the difficult tradeoffs that we have faced.

Thank you very much.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

Thank you very much for the quite comprehensive reports for the parts that you talked about in the amazing range of achievements in restructuring the financial sector of which you can be very proud of what's been accomplished. I hope that other speakers will touch on the short-term capital flows issue because I think it is crucial that we consider that. I also want to appeal to everybody here. Everybody here has hours of interesting things to say. We have an hour together collectively, so basically twelve minutes each. And if we want some participation from our colleagues on the floor, if I could urge you to hold back a little back below the twelve, then we can save some time for the end.

Our next speaker, William McDonough is the President of the New York Fed. And, of course, in that capacity, he is one of the absolutely key policy-makers in world finance. I think he played one of the most decisive and constructive roles in the East Asian crisis, if I might say. I was not a fan of everything that was done from Washington in the crisis, but I much did like what was done from New York. What, in particular, I'm referring to was what I personally regard as the turning point of the whole crisis, which was the roll-over of Korea's debt after the bad Christmas weekend in 1997, when the commercial creditors agreed to roll-over the debt and extend it. And from my dating point, that's the bottom of the crisis, in terms of the real beginning of the ending of the panic and getting some order into this. And Mr. McDonough was in charge of all of those discussions, so he really played a tremendous public service. I hope from his position as President of the Fed, he will give us some guidelines from the view of the Fed and the view of Wall Street, also, of how our new global capitalism can work to prevent future financial crises.

William McDonough
President
Federal Reserve Bank of New York

Thank you, Mr. Chairman.

It is my pleasure to discuss with you today the issue of preventing future economic crises and reducing systemic risk that affects developing and developed countries, alike. My remarks, today, will focus on the two essential building blocks of crisis prevention –

A strong financial system and a sound and stable macroeconomic environment, both nationally and internationally. My remarks are particularly colored by the experience of East Asia that reflect lessons that are more broadly applicable.

The Asia recovery, on the whole, is remarkable, given the depth of the problem a little more than two years ago, and has largely defied initial expectations that the crisis would cast a long shadow over regional growth prospects. Regional recoveries increasingly exhibit solid V-shape trajectories on the back of strong performance in the external accounts, but with more recent improvement in domestic demand. Banking sectors faced with unprecedented crises two years ago have been sured up through substantial capital injections and problem asset carve-outs. At the same time, authorities have initiated a wide range of fundamental enhancements to the financial system infrastructure, including strengthening prudential regulation and supervision, bolstering bankruptcies and collateral recovery processes, and improving disclosure requirements. With the full implementation of these measures, standards in Asia will closely approximate international norms. In light of these achievements, there is much to be optimistic about. But we must all guard against complacency and reform fatigue, which, on the whole represent the largest risks to sustained recovery.

Indeed, while the recovery is impressive, a number of vulnerabilities remain both at the micro and macroeconomic levels. At the microeconomic level, the weak conditions of regional financial and corporate sectors remains a key vulnerability – the real threat to medium-term stability. Restructuring and reform must adequately address both the current stock of problem assets, as well as the flow of new problems attributable to deficiencies in the broader financial system infrastructure. Lack of adequate action on either front can lead to a continuation of the substantial costs of a weak banking sector, sometimes well beyond the immediate crisis, itself.

The international experience with financial sector reforms suggest a number of questionary lessons, including clean up efforts must be sufficient to the task. Half done measures that leave financial institutions with significant levels of impaired assets, at best, postpone the reckoning and potentially create incentives for excessive risk-taking.

Second, fundamental improvements in bank corporate governance are critical. Risk management and internal control processes usually need to be thoroughly overhauled. And more often than not, so too does management.

Third, protractive forbearance to preserve the appearance of solvency is not a solution. While some degree of forbearance may be unavoidable and even appropriate under the right conitions, it is at best a temporary measure. It is critical that forbearance not become institutionalized, but be tied directly to actions by both bankers and supervisors to address underlying problems.

Fourth, governments are not good asset managers over the long-term. Prolonged government holding of impaired assets is not likely to enhance their value, nor aid in restoration of market liquidity. First, governments are not good commercial bankers. Delayed privatization on nationalized banks always means higher future costs and usually inhibits fundamental reform. Next, government-directed lending means future fiscal losses. Similarly, efforts to stimulate growth by non market forces, in the context of a banking crisis, at best, buy additional time. But they usually dig a deeper hole. Foreign investment in domestic financial sectors can yield important benefits. Foreign direct investment in the banking sector can provide much needed capital resources, technology and knowledge transfer, and a more diversified capital and funding base in the event of future economic instability.

Financial sectors are only healthy as their borrowers. Without corresponding corporate sector restructuring, financial sector rescue efforts are likely to be repeated in the future. Unbalanced financial systems create vulnerabilities. Financial systems that are unduly reliant on banks for financial intermediation are likely to be more vulnerable and slower to recover form the onset weakness. The lack of a capital market spare tire delays the recovery of financing to the real sector.

While these challenges can be daunting, recent experiences, both within and beyond Asia, confirm that a dedicated commitment to financial reform contributes to greater crisis resilience. While financial sector rehabilitaion most remain the first priority for authorities in the region, if only because it’s something they can get at themselves, longer-term measures are also needed to ensure success in the increasing complex and dynamic international financial marketplace of the 21st century.

The potential threats to financial stability are many. And no one set of measures can be expected to ensure against the recurrence of future problems. Financial stability ultimately can only be served by the coherent interaction and constant upgrading of the three pillars of sound corporate governance, effective market discipline and strong prudential regulation and supervision. Sound corporate governance is the first bulwark against financial system instability and begins with capable and experienced directors and management, a coherent strategy and business plan, and clear lines of responsibility and accountability.

The execution of overall objectives must be supported by a rigorous internal control environment and effective risk measurement, monitoring and management. Financial systems' stability begins with each loan. And here, I would especially highlight the importance of a strong institutional credit culture, the foundation of a safe and sound banking system.

The second line of defense is effective market discipline, an increasingly important ally of bank supervisors in a complex, diversified and global marketplace. Of course, market discipline must be supported by good disclosure, sound accounting standards and an efficient and credible legal framework. Our effective bank level management and meaningful market discipline are crucial elements of an overall strategy for promoting and preserving financial stability. Neither can substitute for the critical role played by official supervision. The Basel Committee's core principle methodology identify the necessary ingredients of sound supervision. Against the background of an increasingly complex financial system, however, supervision must apply these principles within a more dynamic, risk-based and process-oriented framework.

A sound and stable macroeconomic environment is also crucial for financial stability and more generally for promoting sustainable growth. The converse macroeconomic overheating raises the likelihood of an eventual crisis, first by promoting excessive and, eventually, unsustainable external and internal borrowing, and then by leading to inevitable collections for the real economy, interest rates and/or the exchange rate that can sharply worsen asset quality and suddenly expose the accumulated weaknesses in the financial system.

A central bank's most important role in achieving a stable long-term growth involves promoting price stability. Achieving long-run price stability is a difficult and continuous challenge, as it requires constant efforts to detect and, then, to correct the build up of internal and external imbalances. However, because of time lags and policy effectiveness, authorities often have to take action based only on partial evidence, well before adverse symptoms are fully evident. The principal reward for forward-looking policy is the changes in policy and associated stresses they engender are generally smaller and more easily assimilated by markets.

The effectiveness of these monetary policy tools naturally brings us to the question of monetary and exchange rate regimes. I am of the view that no set of monetary and exchange rate arrangements is ideal for all countries at all times. If we look across the world, we see that the factors determining the choice of monetary and exchange rate regimes are complex. Countries generally have significant investments in the credibility of their current regime. And change can be costly due to the need to establish confidence in any new framework. However, for countries that establish track records of credible monetary and exchange rate management, adjustments are more easily done by choice rather then by necessity.

In the United States, we are committed to a floating exchange rate regime and to market =based adjustment mechanisms. Our experience and history, more generally, suggests that flexible exchange rates do not discourage increased trade in global economic integration. On the contrary, our experience within the NAFTA region shows that increased financial and trade linkages have benefited from reduced inter-regional trade barriers and from clear market determination of prices.

Regardless of the monetary and exchange rate regime chosen, a key factor determinig its volatility is the existence of adequate mechanisms that facilitate smooth adjustment to changing domestic and international conditions. In choosing a regime, authorities need to recognize that they can not target everything. On the contrary, policy is most effective when due recognition is given to the fact that policy is limited to preserving a single anchor. If a nominal exchange rate is chosen as the anchor, as in a fixed rate regime or currency board, adjustments will need to take place in some combination of the prices of financial assets, the money supply, domestic wages, prices and potential fiscal policy. Where fiscal policy, domestic wages and prices are slower to adjust, asset prices and domestic liquidity conditions inevitably will bear the immediate burden of sustaining the fixed exchange rate.

If a float is chosen, the exchange rate provides an additional mechanism for adjustment to changing circumstances. Official reserves can, at times, play a helpful role in the equilibrating process under either fixed or managed floating rate. But considerable caution is needed here. Clearly, large scale sterilized intervention has a poor track record as a crisis avoidance tool. On the contrary, recent experience shows that open-ended intervention often helps to inflame an incipient currency crisis and to broaden it into an external debt crisis, as well.

As you are aware, much of the emerging world has moved towards floating rates in recent years. For those countries that have made the changes in East Asia, it would appear that the new monetary exchange regimes, despite their very difficult starts under the most inauspicious of circumstances, now appear to be serving countries well.

Inflation is in the very low single digit range in all of the newly floating economies and, in many instances, the successful effort to re-establish monetary credibility has been reflected in short-term interest rates that have declined to historically low levels. Moreover, modest nominal exchange rate appreciation has allowed for gradual and inevitable rebound from the earllier real exchange rate depreciation, with minimal inflationary consequence.

Important challenges remain in the region if the recent track record of low inflation is to be maintained. For many countries, monetary policy, ultimately, will need to swing back from considerable ease toward a more neutral or even a restraining stance. Much attention also has been critical in many countries in establishing the credibility of the monetary authority' s commitment to the anchor of price stability and financial stability overall.

The historical record provides convincing evidence of the linkage between greater control bank independence and long-term price stability. Clearly, crisis prevention through promoting stable and sustainable conditions in the macro-economy is not solely the province of central banks. Sound fiscal policies are needed to complement the effectiveness of even the soundest monetary policy. As a rule, tax and expenditure policies need to be adaptive to th4e state of the macro-economy, particularly in cases where monetary policy faces difficult competing objectives.

For the countries of East Asia, the public sector's generally low initial indebtedness provided important latitude for dealing with the recent crisis. Governments have room to stimulate aggregate demand recovery through fiscal ease. Moreover, extensions of public guarantees in capital helped to contain the banking crises. However, public debt has now risen markedly in a number of countries and contingent liabilities often remain significant, raising some concern about potential future debt growth. In this context, governments face the challenge of moving to re-tighten fiscal policy, while preserving growth and stability, and over the longer-term, gradually restoring their previously strong net debt positions. Moreover, these considerations further underscore the importance of quickly completing the process of banking sector rehabilitation and of attracting new sources of capital. Such decisive action would allow the banking sector to again be an engine of growth, capable of offsetting the withdrawal of fiscal stimulus.

Achievement of the goals of financial restructuring and macro-economic stability is fostered by improved transparency. When authorities clearly explain the objectives or concerns that lies behind their policies, they greatly increase the likelihood that markets will move in a direction that supports and, even, favorably anticipates the authority's goals. Transparency is most effective when it is an established element in a clearly articulated goal-oriented process.

Sensitivity to the changing needs of the marketplace for information, both statistical and qualitative, can be developed only through an on-going dialogue with market participants. In particular, experience suggests that in a fast market, authorities are well advised to speed up their disclosure and explanation of their actions and intentions.

In closing, after the devastating financial storms of two years ago, Asia is now in calmer waters. The strength of the regional recovery and the depth and breadth of reform efforts to date provide renewed optimism for Asia's bright economic prospects. I do agree with Professor Sachs. This area has some very found fundamental strengths which will serve the best interest of the people. The recovery also provides much needed breathing room to address the damage done by the crisis and the fundamental fragilities that become manifest. While this crisis has demonstrated the need for broader international efforts to promote increased financial stability, the importance of pushing ahead with a rigorous domestic restructuring and reform agenda can not be stressed enough. Smooth sailing is never assured and storms no doubt lie ahead. To confront the inevitable challenges, regional authorities will need good instrumentation, on-going vigilance and a firm hand on the tiller.

I'm confident that you will rise to the challenges ahead and I very much hope that those of us in the industrialized countries will respond equally to ours.

Thank you.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

Thank you very much.

Let me, this time more emphatically, remind the participants and I invite Mr. Horiguchi to use traditional IMF discipline because you're going to be the last residual claimant on the time, so you may want to jump up and tackle the speakers when they exceed the lime limit. You can see why I would not be suitable for the IMF role. But, I'm going to warn the speakers to please watch the lights. We're down to 10 minutes per speaker.

We turn next to a gentleman that has certainly one of the toughest jobs in assignments in the world in the Ministry of Finance of Russia, the Deputy Finance Minister Mr. Sergey Kolotukhin. Russia is on a rebound as well right now. It's achieving economic growth and you have a new president. We're very much looking forward to hearing your report about the prospects in Russia.

Sergey Kolotukhin
Deputy Minister of Finance
Russia

First of all I would like to thank Korean hosts for the very well-organized possibility of discussing essential matters of preventing the recurrence of future crisis. Let me avail myself of this pleasant opportunity to convey the genuine friendly feelings of the Russian people to the Korean nation.

The Korean experience and example in overcoming the economic and financial crisis is of great value to all APEC states, including Russia.

The crisis which hit Russian economy in August 1998 was profound and comprehensive. It was the deep banking crisis, which led to the bankruptcy of a major part of Russian banks. It was the monetary crisis, causing sharp devaluation of the national currency and high inflation. It was an industrial crisis which caused drastic production output decline and decline in GDP. It was a crisis of domestic capital markets, causing their entire collapse. It was a public debt and external sovereign debt crisis, which led to the standstill on current debt repayments.

The fundamental reasons for the crisis were the following:

- Slow pace of financial consolidation and structural reforms in economy;
- Insufficient and inadequate public and external sovereign liabilities' management, including huge external and internal short-term borrowings at very high margins;
- Inconsistent monetary policy of preserving pegged exchange rate system despite deteriorating economic fundamentals;
- A substantial budget deficit (up to 8% of GDP).

Immediately after the crisis occurred the Russian Government amended its policy as follows:

- Switch to the floating exchange rate policy dependent on the macroeconomic fundamentals;
- Realistic and responsible sovereign liabilities management, prudent approach to further external and internal borrowings in terms of maturities and costs, sharp reduction of the short-term borrowings;
- Reduction of the budget deficit and steady fiscal consolidation.

Consequences of the financial and monetary policy amendments were:

- GDP growth of 3% in 1999 and 3,2% projected for this year
- Production output growth of 8% in 1999, 1Q 2000 – about 12%, Y2000 – 7-15% according to different estimations;

- Sharp reduction in inflation: January – 2,5% in monthly terms, March – about 0,5%, Y2000 (forecast) – 10-15%.
- Budget primary surplus in 1999 – 2,2%, 1Q 2000 – 5,5% of GDP.

Major current vulnerabilities of the Russian economy are:

- Slow growth of investments in economy (1999 – 4%, 1Q 2000 – 4,5%);
- Partial isolation of Russia from the world economy and international capital markets;
- Unsustainable external debt and debt service (external debt/ annual exports – 100%) and rather high level of budget contingent commitments and government commitment to support social protection system;
- Capital outflows though at lower pace;
- Dependence on the commodities' exports.

What have we learned from the recent crisis?

Lessons to be taken from the crisis are following:

- The transition from regulated to liberalized financial systems is the most vulnerable period, when the instability is inevitable.
- Sound macroeconomic management is necessary but not enough. Financial imbalances and financial sector weaknesses are highlighted only when markets become skeptical to the respective countries and, thus, should be tackled constantly.
- Any exchange rate regime is workable provided that it is backed by the right economic policies, but good economic policy is not a guarantee from vulnerability in the monetary sphere.
- Capital inflows before the crisis and outflows after are a dominant factor of the crisis. Flexibility in smooth switch to from one regime of capital controls to another, as well as from one exchange regime to another, is unavoidable. The policy credibility is also an important question. Capital account issues should be taken into account when choosing the exchange rate regime.
- Public and external sovereign debt management in maturities and in costs are required. Monitoring and benchmarks for the private sector are essential.

The choice of the exchange rate policy could be in favor of any exchange regime model (floating, peg, fixed, intermediary). The issue is whether this or that regime meet overall economic policy targets, whether this regime is sustainable under the current economic policy and within the current economic indicators and whether it is consistent with other policy setting.

Consistent and prudent public and sovereign liability management is one the most essential issue for preventing crisis. In our opinion liability management could be based on the following principles:

- Maintenance of the stable macroeconomic and political environment, friendly for investors;
- Prudent and transparent fiscal management to preserve reputation of reliable issuer;
- Development of domestic capital markets as an alternative to foreign borrowings;
- Obligatory public debt control and management, direct (licenses, permissions, obligatory benchmarks) or indirect (setting maturities and benchmarks for sovereign debt);
- Steady elimination of distinction between local and external capital markets in terms of maturities and yields;
- Comprehensive and profound sovereign liabilities management system, comprising of prudent foreign and domestic borrowing; borrowings management in terms of maturities, costs, currencies, instruments, future fiscal risks; prudent contingent liabilities management; accurate and comprehensive public and sovereign debt data; specialized agency or governmental body responsible for the public and sovereign debt management;
- Flexible capital controls are to be established.

Consistent and responsible fiscal policy is essential for preventing future crisis. This policy presumes the following principles of the financial consolidation:

- Reduced budget deficit;
- Increased efficiency of the public spending;
- Elimination of budget commitments which cannot be implemented;
- Social security reform;
- Reduction of the monetary budget financing.

Tax system reform is also an important issue for preventing future budget risks and crisis. In general, tax reform should have the following underlying principles:

- Creation of the better investment climate;
- Comparatively low level of taxation with extended taxation base.

The above-mentioned policy principles could vary from country to country, the pace of their implementation being dependent on the concrete economic, political and social environment of each respective country.

My presentation will not be complete if I do not mention the importance of international financial organizations for preserving the world economic stability. I would like also to underline the ultimate importance for preventing occurrence of economic crisis in the systemically important economies. The reliance on the responsible and realistic economic policy of the largest economies represents one of the major vulnerabilities of the world economy. In this respect the best practices and major principles of policy for preventing economic crisis, including information transparency, should be general guidance for emerging as well as developed markets.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

Let us turn now to the Associate Deputy Minister of Finance of Canada, Mr. Ian Bennett, who now, in his position, heads the deputies of the G-20. And I hope you'll give us a report about that. I assume you won't talk about Canada's economic crisis.

Ian Bennett
Associate Deputy Minister of Finance
Canada

I am very pleased to have the opportunity to participate in this session of the APEC Forum.

All of us with international responsibilities know that our topic this afternoon – *how to prevent a recurrence of financial crises* – is among the most important and complex challenges we face.

We need to be realistic in addressing this issue, however. As my Minister, Paul Martin, has said *"financial crises are as old as money and as certain as taxes*". Perhaps, one day, we will find the right formula to prevent crises. But until then, our focus must be on limiting the frequency of financial crises and reducing the severity of those that inevitably do occur.

This goal has taken on greater urgency with the explosion in private capital flows. World flows of goods and services, at $10 trillion *a year*, are impressive enough and grew enormously in the latter half of the 20th century. But that amount is tiny in comparison with gross flows of international capital, which now amount to some $2 trillion *a day.*

A defining characteristic of a sound international financial system is thus the way in which it ensures that these international capital flows contribute to stability and prosperity, rather than financial crises.

We face a fundamental dilemma in dealing with this issue. On the one hand, global financial stability is a key international public good.

But on the other hand, providing official resources to help resolve financial crises can contribute to the problem by, in effect, sheltering investors from the consequences of bad decisions.

Finding the right balance between the benefits of official assistance and the moral hazard it can create is a difficult challenge. This dilemma is at the heart of current discussions about IMF reform.

No doubt the debate about the Fund's role will be interesting, and where exactly it will wind up is hard to predict. One thing, though, I think is quite clear.

Markets, which have come to routinely expect IMF-led assistance packages on the order of $40 or $50 billion, will have to plan on a very different future.

In our view, continuing to provide massive assistance packages is undesirable as a matter of policy, because it would further distort the assessment of risk and return in international capital markets.

Whether one agrees with this assessment or not, as a *practical* matter it is unlikely that the international community would be able to mount a package of this size in the future given the increasing limits -- both fiscal and political -- on the availability of international finance.

At the same time, the IMF must still be able to deliver significant financial support during times of crisis. We do not agree with the extreme view expressed by some that this can be left to the market alone.

One way to help ensure that the IMF has adequate resources is for it to focus on short-term lending.

As well, we must also begin seriously addressing the problem of "serial programs" at the IMF: in the past 15 years, almost 30 borrowers have had Fund programs ongoing for 5 years or more.

A good place to start is by learning from the Fund's successes. And one of the most notable of these is Korea. It took the opportunity of its financial crisis and IMF program to implement comprehensive reforms and is, as a consequence, now recovering strongly.

A key lesson from the Korean experience is that when governments are truly committed to policy reform, the results can indeed be impressive.

Another important lesson from Korea is the need to find the right framework for private sector involvement in crisis prevention and resolution.

The Korean crisis, like those elsewhere in Asia, was driven largely by the capital account, rather than the current account. And the amounts at stake in such crises are far larger than in the more traditional current account crisis.

The size of the balance of payments gaps associated with these crises means that their financing requirements will far outstrip the resources that the official sector could reasonably be expected to provide. And the domestic economic adjustment needed to close these potentially massive gaps could be very severe indeed.

That is why we must establish mechanisms to involve the private sector in crisis prevention and resolution.

The international community involved the private sector during the early stages of the Korean crisis by asking international banks, which had been engaging in a panicked rush for the exits, to "rollover" their deposits with their Korean counterparts. This strategy worked because the number of bank creditors was relatively small. Whether such an ad hoc strategy would work in other situations, particularly when bonds form an important part of the total debt, remains to be seen.

To summarize: the central issues we need to address are, first, how to strike a balance between financing and moral hazard, and second, how to involve the private sector in crisis prevention and resolution.

Conferences and seminars to debate these issues are already a growth industry. Indeed, if we could incorporate, I'd suggest an IPO on the NASDAQ!

Today, however, I'd like to talk to you about one group – the G-20 – and some of the work that it is engaged in. It was set up in response to the need for informal dialogue among systemically significant economies on the issues facing the international financial system.

The need for this new body was first recognized by APEC Finance Ministers at their meeting last year in Langkawi, Malaysia. It was subsequently endorsed by G-7 Finance Ministers in their Report on the International Financial Architecture last June.

In important ways the G-20 is modelled on the G-7. The G-7 has no Secretariat and no formal rules. Yet most would agree that it has been effective – if not always loved!

A desire to replicate these strengths in a body more representative of today's global economy led to the establishment last September of the G-20. In it are represented 19 industrial countries and emerging markets, plus the Presidency of the European Union, as well as the IMF and the World Bank.

Together, the G-7 countries represent 65% of world GDP and 12% of world population. The G-20 represents 87% of world GDP and 65% of world population.

G-20 Ministerials will be held once a year, with an on-going officials process.

The first meeting of the G-20 was held last December in Berlin, chaired by Canada's Finance Minister, Paul Martin. At that meeting, Ministers and Governors considered ways to reduce the frequency and severity of financial crises.

In particular, they agreed that each country would do two things.

First, have the Fund and Bank conduct an assessment of its financial system to determine whether it is well managed, capitalized, and supervised.

Second, each country agreed to have the IMF prepare what is called a ROSC -- a report on their observance of key internationally-accepted standards and codes, in effect "best practices" for such things as data dissemination and economic policies more generally

Now, few would argue that these measures are themselves enough to banish the risk of crises for all time. That is why the G-20 will also be considering ways to help ensure that when crises do occur, private investors and borrowing countries face the right incentives, and institutional arrangements, to achieve a co-operative resolution of their problems.

This is likely to include a new focus on the part of the IMF and the international community more broadly on requiring program countries to involve the private sector appropriately in Fund programs.

As well, we need to explore mechanisms that help overcome practical difficulties in doing this, such as encouraging the wider acceptance of Collective Action Clauses in international bond contracts. This would make it easier to restructure these instruments at times of crisis.

Certainly, the fact that we are discussing these issues today is testimony to the continued sense among the public and policymakers alike that reform of the international financial system must remain a top priority.

But we cannot simply assume that this sense of urgency will continue forever.

According to the Institute for International Finance, net private capital flows to emerging markets will rise this year to $190 billion, up from $150 billion in 1999. This is good news. It is evidence that emerging markets have, indeed, done much to address underlying economic problems. It should not, however, deflect our determination to increase the resilience of the international financial system.

Rather, we in the official sector must redouble our efforts to achieve a more stable international financial system capable of delivering prosperity to all countries of the world. This certainly will be Canada's goal, through its chairmanship of the G-20, and in other on-going work with our international partners, including most particularly our Korean hosts.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

It's very painful for me to limit your time when you're talking about the reform of the IMF. I can assure you. And I very much welcome your observations and I would like to draw people's attention to the fact that this concern over the serial programs of the IMF that go on for 5 or 10 or 20 years was at the center of recommendation also of the Meltzer Commission Report which came out 2 weeks ago in Washington, which said end the long-term lending programs of the IMF and restore the institution as a short-term lender. So, I very much appreciate and happen to agree, as a member of that commission, what you said Mr. Minister.

We turn next to the certainly one of the world's leading, if not the world's leading historian of the international monetary system with a remarkable collection of historical studies on the evolution of global finance in the 19th and 20th centuries, as well as one of the most important academic commentators on global economic reform. Mr. Bennett mentioned the collective action clause as a way to get private sector involved. Barry Eichengreen, Professor at University of California, Berkeley, has been one of the leading proponents of this and I'm sure that he will tell us about the important reform agenda that he has been advocating in recent years.

Barry Eichengreen
George C. Pardee and Helen N. Pardee Professor of Economics
University of California, Berkeley

It is now more than two years since then U.S. Treasury Secretary Robert Rubin gave his famous speech calling for a a "new international financial architecture." Since then, many of us have used the conference circuit to describe our visions of what such an architecture would entail. Since neither the problems nor our proposal have changed, we are constantly danger of running out of new ways of making our familiar points.

Fortunately, there is a major new report on how to strengthen the international financial architecture, the Meltzer Report that our chairman just mentioned, that was issued in the United States earlier this month. For freshness of presentation, it comes in the nick of time. So I hope our chairman, who was a member of that commission, will excuse my use of the pedagogic device.

The report has much with which one can agree. I hope this part of my remarks will not count against my time. It argues for deep reform of the World Bank, something that I would subscribe to, as well, although it's not the topic of this session. It argues that the IMF should focus on the crisis problem, which is, of course, the focus of this session and something that I will return to momentarily. It identifies weak banking systems and soft currency pegs as the principal threats to stability in our financially globalized world. And it argues for strengthening prudential supervision and abandoning intermediate exchange rate arrangements in order to make the world a safer place.

To this, I can only say "Amen." I agree with the report in that respect. I disagree with those including some previous speakers on this panel who have said that any exchange rate arrangement, backed by appropriate policies, can be made to work. I'm skeptical that this is true in our financially globalized world. In addition to respond to Professor Sachs further, I would have liked to see in the report, an endorsement, rather than a rejection, of Chilean style holding period taxes as a way of dealing with the instability of international capital flows. I think this is something Stephen Roach will come back to in his presentation in the next panel.

While assuming that most countries, in the short run at least, will prefer to float, the report offers few recommendations about how to formulate policy in the absence of an exchange rate anchor. ASound and stable budget and credit policies@ that avoid both excessive inflation and excessive deflation are desirable, it writes, but beyond that it offers few specifics.

This is exactly the problem. It has been precisely the failure of domestic monetary authorities to adopt a clear, coherent framework for the formulation of monetary policy, in place of the previous exchange rate anchor, that has undermined the credibility of post-peg policies, weakened investor confidence, encouraged capital flight, and accentuated the recessionary effects of abandoning currency pegs. I think the IMF could have done more to help emerging markets develop such a strategy. For a long time it resisted endorsing the obvious alternative, inflation targeting. And here, , too, would applaud the new approach. In fairness, the Fund's attitude is now changing, as is evident in its endorsement of inflation targeting in the Brazilian program, and in its March 2000 conference concerned with inflation-targeting experience in emerging markets. But unless the IMF and the international community consistently advocate an explicit, operational alternative, it is unlikely to be effective in lobbying countries to move away from unstable intermediate exchange-rate arrangements.

The report criticizes IMF rescue packages. The Mexican and Asian rescues, it argues, encouraged international investors to pour money into Russia and more generally undermined market discipline. The conditions attached to the IMF's programs were inappropriate, it argues. There is little evidence from cross-country studies, it argues further, that conditionality leads to an improvement in economic performance. Where conditionality runs roughshod over domestic sovereignty, it makes it harder for the citizens of the crisis country to achieve the social consensus needed to undertake necessary reforms.

We have heard these criticisms before. What we have not heard is the conclusion that

IMF lending practices should be reformed not just to limit moral hazard but also to eliminate invasive, counterproductive IMF conditionality. To this end, the commission proposes that the Fund prequalify eligible countries and then lend to them unconditionally.

The problem is that lending unconditionally would mean lending to those who would make least sensible use of the proceeds. The commissioners propose to solve this problem by adapting a formula, Bagehot's rule, from the literature on central banking. Bagehot's idea was that central banks, in order to stabilize domestic financial markets and institutions, should lend only at high rates and against good collateral. If the authorities lend exclusively at high interest rates and against good collateral, only solvent banks whose problems are of a short-term, liquidity-based nature will wish to borrow. Banks with more serious balance-sheet problems would only weaken their financial condition by incurring additional liabilities that they have to repay at a penalty rate, something that their existing creditors would oppose. Because the obligation to the central bank is fully collateralized, it is effectively senior to these other obligations; it subordinates other debt. Thus, the high-interest-rate rule and the seniority of IMF loans suffice to distinguish cases of insolvency (where suspending payments and restructuring existing obligations is the only way of putting the distressed entity back on its feet) from cases of pure illiquidity (where a short-term loan from the IMF will resolve the problem). Indeed, the Fund is relieved of the responsibility of having to distinguish the two cases. The indebted government will decide for it, so long as the Fund charges a penalty rate and ensures that its loans enjoy seniority.

There are a number of difficulties in transferring a formula which has performed admirably in the domestic central banking context to the international domain. The reality is that national policy makers are uncertain about the extent to which their country's problems reflect a sudden disruption to liquidity or poor long-term fundamentals. More than two years after the outbreak of South Korea's crisis, two rival interpretations of its plight in 1997-8 continue to compete: one which attributes it exclusively to investor panic, and another which cites "soft rot" in the banking and industrial sectors. If the experts can't agree after two years, how can we be confident that a modest penalty will deter uncertain policy makers faced with an immediate crisis?

Even if a government is certain that the country is experiencing a problem with fundamentals, will an interest rate even several hundred basis points above normal commercial borrowing rates and seniority for Fund claims prevent it from approaching the Fund? If the government and other members of society have the same discount rate, then, yes, it will stand to lose by borrowing from the IMF on senior terms at a penalty rate. Borrowing from the Fund subordinates existing debts, exacerbates the deficit (through the high borrowing cost), and makes it harder to repay private debts. But the reality is that governments have finite lives. Politicians therefore care about short-run outcomes C they have high discount rates. It is not clear, in other words, that a high interest rate will deter them. Nor will they be deterred by the prospect of subordinating existing debts if there is only a finite probability that they will still be in office when the bill comes due. Like inadequately capitalized banks that gamble for resurrection, government officials will find it irresistible to borrow from the Fund in order to scrape by for a few more weeks in the hope that good news turns up in the meantime. The idea that the Fund can filter out these cases by charging a penalty rate and ensuring that its claims enjoy seniority ignores these political realities.

The unavoidable implication is that it will still be necessary to attach other conditions to IMF lending. The commission proposes moving away from ex post conditionality – that countries which borrow should be required to implement certain policy reforms – to prequalification as a way of limiting the discretion the Fund has to apply those conditions. Only countries which satisfied a list of necessary preconditions, whose intent is to ensure that their fundamentals are in order and any problems they are experiencing are of a short-term, liquidity-related nature, would be permitted, under the proposal, to borrow from the IMF. The core preconditions have to do with the regulation of national banking systems, which should be adequately capitalized, face hard budget constraints, and forced to compete freely with foreign financial institutions. With their own capital at stake, faced with the chill winds of foreign competition, and forced to swing without the safety net offered by explicit or implicit government guarantees, banks will be forced to upgrade their prudential practices. Countries with strong banking systems, the argument goes, are unlikely to experience anything other than liquidity problems arising for reasons beyond their control.

This proposed solution skates over important issues. For one, it ignores the lessons of the attempt with prequalification learned from the IMF’ s experience with its recently established Contingent Credit Line. The worst thing that can happen under such a system is for a previously prequalified country to be dequalified; an investor panic and adverse macroeconomic consequences are almost certain to follow. If the IMF cannot bear the prospect of decertifying the previously certified, it will set a high standard for certification. The population of certified countries will then approach the null set.

Another difficulty is that structural problems that can set the stage for a crisis are not limited to the banking system. To be sure, if countries strengthen their banking systems and abandon unstable exchange rate pegs, the frequency and severity of crises will be reduced. But they will not be eliminated. An unsustainable fiscal position can also heighten crisis risk, and the last thing anyone wants is for the Fund to lend to countries unwilling or unable to put their fiscal houses in order. Thus, the report also contains a recommendation that countries must satisfy unspecified fiscal conditions. But imagine how hard it would be to settle on a single set of fiscal conditions that could apply to more than 180 IMF members. Inevitably, the implication of heading down this slippery slope is to reintroduce the discretion into IMF conditionality.

A third objection is that hard-and-fast rules for prequalification would prevent the IMF from responding to exceptional events that threaten the stability of the global financial system or inflict acceptable collateral damage on innocent bystanders. Acknowledging this reality, the report contains an opt out, citing "unusual circumstances, where the crisis poses a threat to the global economy," under which the Fund would be able to lend more widely to protect the global financial system and innocent bystanders. This is the inevitable implication of the fact that the world is a fragile financial place, but it renders unavoidable the idea that IMF disbursals will decided, in the end, by the discretion of its Executive Board and management, and not by any set of hard-and-fast rules.

Finally, even where collateral damage and systemic stability are not at issue, the principal shareholders of the Fund, faced with a country with problems with fundamentals that prevent it from servicing its debt, will find it politically unacceptable to simply stand aside and let the consenting adults clean up after the problem, this being the implication of the commission's prequalification proposals. Under present institutional arrangements, restructuring is painful and difficult to achieve. Countries that suspend debt-servicing payments suffer an extended period of lost capital market access and economic stagnation. Investors suffer through an extended period when no interest is paid and no principal is repatriated. The Fund's shareholders will come under pressure from investors and from those who want to limit the pain and suffering in the crisis country. The pressure to bail out will remain. The only way to avert it is to create more efficient, preferably market-based mechanisms for encouraging debt restructuring. The Meltzer Commission acknowledges this logic, but when addressing it adopts an uncharacteristic posture of caution. As one member has put it, "In the interest of 'doing no harm' the Commission did not make specific recommendations in this area."

The veiled reference here is to ideas like the introduction of collective action clauses (sharing clauses, majority voting clauses, representation clauses) into loan contracts, mediation services to deal with asymmetric information problems, and standing committees of creditors to facilitate negotiations. The specifics of such proposals may be controversial, but their linkage to the commission's reform agenda is undeniable. If other changes to institutions and procedures in financial markets are made to facilitate market-based solutions to crises, then it will be possible for the Fund to let the consenting adults resolve the problem. Without such changes, however, recommending that the Fund stand aside is patently unrealistic. The report's emphasis on the advantages of market discipline and market solutions is admirable, but there is a tendency to assume that the necessary infrastructure exists even where it does not.

A final context where this same tension arises is in the report's discussion of data dissemination, which everyone agrees is desirable and important. The report recommends that, in order to qualify for access to IMF facilities, countries should be required to publish information on the maturity structure of their outstanding sovereign and guaranteed debt and off-balance-sheet liabilities. This will invigorate market discipline and prevent problems with the public finances from festering. But inadequate or inaccurate data will not invigorate market discipline. The adequacy of the data needs to be evaluated, and the results of that evaluation published. Similarly, companies with traded liabilities must use internationally-respectable auditing and accounting standards, and someone has to evaluate their compliance. Antiquated bankruptcy and insolvency procedures need to be modernized, and someone has to be responsible for evaluating whether this is being done. Another agreed lesson of the Asian crisis is that financial stability will remain elusive in the absence of significant progress on all these fronts. The premise of the report is that if banking systems can be strengthened, then these other problems can be left to sort themselves out. This both assumes a solution to one problem (the banking problem) and minimizes the severity of all other sources of instability.

If you agree with me that making the world a safer financial place requires not just a quasi international lender of last resort for countries that succeed in strengthening their banking systems but also ongoing efforts to upgrade auditing and accounting practices, securities market regulation, bankruptcy and insolvency law, and corporate governance, then the agenda for reform is long and complex. The mechanism for completing it will be the promulgation of international standards in the above-mentioned areas, and peer pressure for countries to comply. The Bank for International Settlements, not the IMF, according to the commission, should take the lead in coordinating this standard-setting process.

I will admit to be troubled by this. Despite its recent expansion into Asia, vesting the BIS with responsibility for setting global standards would delegate this task to a small number of high-income countries, which would hardly enhance the legitimacy of the process. Legitimate global standards can only be set by a global institution; the IMF would seem to be the most eligible available candidate. The Fund has universal membership. It conducts annual Article IV consultations with its members. It already attempts to publish the results of those consultations. It already rates each of its members' compliance with other membership requirements such as currency convertibility. The argument that the IMF, if it is to become less of a fireman, must become more of a policeman, policing countries practices in these other areas related to financial stability, is too compelling to ignore.

To conclude, the commission has made some positive contributions to the literature on how to strengthen the international financial institutions. It has directed attention toward weak banking systems and soft currency pegs as the principal threats to international financial stability. It has highlighted the need for the IMF to refocus on the crisis problem, while leaving poverty alleviation and development to the other IFIs. But its specific recommendations for reforming the operating procedures of the international financial institutions, and the IMF in particular, are unlikely to prove operational. They remind us why attempting to make the world a safer financial place by reforming the IFIs without at the same time reforming the broader economic and financial environment in which they operate is unlikely to succeed.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

Thank you very much for the thoughtful comments. We, indeed, do live in a world when the IMF often gets the last word. And we have a panel like that, as well. We're very pleased to have Mr. Yusuke Horiguchi, who is now the director of the Asia and Pacific Department. No sooner did he arrive in Asia than the Asian economy started to grow at 9% a year. So I congratulate you and look forward to your remarks.

Yusuke Horiguchi
Director, Asia and Pacific Department
International Monetary Fund

The Asian crisis was a currency crisis, and a very violent one. At the same time, it was an external debt crisis, and also it was a banking crisis. I do not think we can come readily to a clear conclusion about which one was a cause and which one the effect. The three crises basically occurred simultaneously—at least so they appeared—making the situation extremely difficult to deal with.

Although we cannot be categorical about which crisis was the cause and which the effect, many, if not all, of us agree that, if the Asian emerging market economies are to avoid the recurrence of a similar catastrophic event, they have to deal squarely with the underlying weaknesses of their economies which manifested themselves in these three aspects of the Asian crisis. But in concrete terms, what should they do?

Let me begin with a broad perspective. In my view, all these three aspects of the Asian crisis were related, at least indirectly, to the growth strategy that was pursued by the crisis-hit countries. The strategy was to spur growth by massive investment year after year in priority sectors—typically export oriented industries—which were considered by the authorities as strategic sectors for rapid economic development. This strategy involved such features as directed lending under tight government guidance; close relationships between major corporations and large banks which showed up most conspicuously in rampant connected lending; and formal or informal exchange rate pegs, intended to facilitate investment and growth in export sectors. This investment-based growth strategy — while successful in engendering rapid growth for some time — led eventually to major balance sheet weaknesses in the banking sector and corporate sector, putting macroeconomic stability at great risk.

Thus, the first point I would like to make today is that, as the Asian emerging market countries seek to regain their position as one of the world's fastest growing regions, they will need to adopt a different growth strategy in order to avoid the re-emergence of financial vulnerability down the road. The new growth strategy should be based on faster total factor productivity growth instead of massive investment. Spurring faster productivity growth, in turn, will require relying much more on market forces and much less on government intervention than in the past. Reforms in the direction of freer and more open financial, goods, and labor markets are therefore essential.

This is a preamble, but an important one for setting an appropriate context for our discussion today of a strategy to reduce vulnerability and avoid crises.

Let me now discuss more specifically what could be the main elements of a strategy that the Asian emerging market economies should follow to deal decisively with the points of vulnerability in their economies that manifested themselves in the three aspects of the Asian crisis.

Efforts to restore the health of balance sheets in the financial sector, in particular the banking sector, are a top priority. Non-performing loans in their books need to be reduced much further and their capital adequacy ratios, measured appropriately, need to be raised. In terms of specific policies, a key is the continued improvement in prudential regulation and supervisory system in the context of which banks should continue to strive at sound risk management. Also important is the strengthening of the legal and judicial systems to deal appropriately with recalcitrant debtors.

The strengthening of the balance sheets of the non-financial corporate sector cannot be achieved on a sustained basis without market discipline—shareholder discipline, bank credit discipline, and bond market discipline. To strengthen market discipline in turn requires improving the regulatory, legal, and institutional infrastructure — e.g., internationally accepted accounting standards, an effective system of audits, rigorous disclosure rules, and enhanced minority shareholders' rights, just to cite a few.

At the same time, the authorities must take care to avoid macroeconomic imbalances, including the entrenchment of unsound fiscal positions, a build up of excessive external debt (particularly of short maturities), and unsustainable exchange rate policies.
One of the key issues in this context concerns the choice of exchange rate regime for the Asian emerging market economies. This issue cannot be divorced from the profound changes that have taken place in world financial markets over the past dozen years or so.

First, as a result of the revolution in telecommunications and information technology that has dramatically lowered transaction costs in financial markets, as well as substantial liberalization and deregulation of domestic and international financial transactions, financial markets have become globalized in the sense that the balance sheets of major financial and corporate entities around the world are closely interconnected through currency and capital markets. In the globalized financial markets of today, capital movements are not only very large but also highly sensitive to changes in yield differentials and to shifts in perception of risks. This means that a reversal of capital flows can be abrupt, swift, and massive.

In the meantime, developing countries have become increasingly integrated into the world economy, with a deepening involvement of Asian emerging markets in international capital markets being a notable example. No doubt, in this process these economies have been able to reap many of the benefits of globalization, but they have also been increasingly exposed to some of its risks.

In many Asian emerging market countries, those risks were exacerbated by the currency pegs they adopted, either *de jure* or *de facto*. Increasing complacency about foreign exchange risk engendered by such exchange rate regimes led, in time, to a significant buildup of external debt, with a large part of it short-term. The risks that this entailed were exacerbated in 1996-97 as a result of a sharp rise in real effective exchange rates of those dollar-pegged currencies of the Asian emerging economies. Thus, the stage was set for potential crisis—which unfortunately became a reality.

One of the key lessons drawn from the recent history thus far is that, for the emerging countries in Asia as well as countries elsewhere with heavy involvement in global financial markets, the policy requirements for maintaining a currency peg have become daunting. Also, as Professor Eichengreen notes in his recent writings, there are a very few precedents for achieving a smooth exit from a fixed exchange rate regime. Often the exit is forced, after a period of resistance against mounting pressures, with very damaging consequences. Against this background, it is clear that floating exchange rate regimes should be the predominant choice for emerging market economies which, by definition, have substantial involvement in modern global financial markets.

Of course, this is not to deny that, for certain emerging economies, pegged exchange rate regimes, buttressed by requisite supporting policies and institutions, can be workable. For such economies, in general, the harder and more rigid the peg, the better. In the case of Hong Kong, for example, a currency board type arrangement stood the test of a violent crisis with remarkable resilience. I should hasten to add, however, that I have doubts about the viability at present of this system for other Asian emerging market countries, because those countries — I have the five crisis countries in mind in particular — are still in the process of establishing a solid financial system, without which a currency board is simply not a real option.

The next issue is the appropriate *modus operandi* of floating rate regimes. Two observations are in order.

First, for floating rate regimes to function effectively, it is important that exchange rates are allowed to actually move — in both directions — in response to market forces, sometimes by significant amounts in short periods. Only such movements can persuade private economic agents to recognize, and to manage prudently, the foreign exchange risks that are inescapable for countries open to global financial markets.

However, and this is the second point, what I just said does not imply a policy of benign neglect toward the exchange rate. For emerging market countries, with their high degree of involvement with global trade and finance, movements in exchange rates have important economic consequences, and it is often appropriate for economic policies, including monetary policy and exchange market intervention, to take account of and react to exchange rate developments. But this should not be done to such an extent as to become a tight management of the rate, which can create complacency about foreign exchange risks with the dangerous ramifications that I noted earlier.

Let me now turn to the monetary policy implications of floating exchange rate regimes. As the exchange rate no longer fulfills the role of nominal anchor with the switch to floating exchange rates, a key issue is how to establish an alternative anchor that will serve to maintain low inflation.

One option, which is receiving increasing attention among Asian developing countries, is an inflation targeting framework, such as that adopted in several industrial and emerging market countries over the past ten years or so. The experience under inflation targeting is encouraging — it has been associated with good inflation and growth outcomes in virtually all countries that have gone this route. It is timely for Asian emerging market countries, which now record low inflation and would be best served with floating exchange rate regimes, to consider seriously the option of an inflation target as a nominal anchor.

Before concluding, let me touch on the question of what role — if any — capital controls might play in a strategy to prevent crises. I would like to offer several observations on this question.

There may be valid arguments for price-based capital controls as a means to address market failures. In particular, financial markets are subject to information asymmetries that can result, among other things, in herd behavior and instability, leading to panic and financial crisis with significant macroeconomic costs. For this reason, a case can be made for price-based restrictions on short-term capital inflows and, in exceptional circumstances, even measures to directly limit capital outflows.

Even in these circumstances, however, capital controls should be viewed as a temporary mechanism because ultimately capital controls lose their effectiveness. Market participants are adept at evading controls on specific transactions such as short-term capital flows. As a result, countries are often forced to broaden controls progressively to longer-term transactions, a process which tends to increase sharply the costs associated with capital controls.

Since the effectiveness of capital controls erodes over time, they should ideally be used in the context of a well-defined timetable for establishing appropriate prudential regulations and strong supervisory systems in the context of which market-based risk management systems can operate effectively.

Capital controls should not be used to delay needed macroeconomic policy and exchange rate adjustments. While recognizing that there may be a case for capital controls when capital flows are clearly inconsistent with longer-term fundamentals, it needs to be emphasized that capital controls should not be viewed as substitutes for appropriate macro and exchange rate policies.

My remarks today have addressed the issue of what each individual Asian emerging market country can and should do to minimize the risk of another crisis. The discussion on the topic of this panel is not really complete, however, without addressing the question of how to strengthen the international financial system, the so called "new financial architecture." Unfortunately, time does not permit me to cover that issue except to emphasize the particular importance of making major progress in devising ways to "bail in" private creditors in a crisis situation, which should work to discourage reckless behavior on the part of private creditors.

Jeffrey Sachs
Galen L. Stone Professor of International Trade
Harvard University

We have more than run out of time. But fortunately, we're really at half way of the story since we have another important session on the financial architecture coming up after a short break. And, I'm sure that from my experience, Andrew Crockett will be able to manage the time so effectively to guarantee the participation of the audience, as well.

We heard some wonderful presentation. No definitive answers, I might say – mainly, take care of your economies, not yet necessarily the question of the broad global structure. And I think we'll hear more about that in discussions of the capital flows in the next session.

Please join me in thanking this distinguished panel.

2. New International Financial Architecture : Focusing on Hedge Funds and Short-term Capital Flows

Andrew Crockett
General Manager
Bank for International Settlements

Thank you very much. I would like to join other speakers in saying what a pleasure it is to be here in Seoul for this important forum, to thank our Korean hosts for their excellent arrangement for this conference and to congratulate President Kim and his administration on their initiative in fostering this dialogue which I'm sure will play a very important part in the on-going debate on the financial architecture.

We meet here at a time when economic prospects in Korea, particularly, but also in the rest of Asia are looking distinctly brighter and with this take great satisfaction in that development. But it should not, I think, blind us to the fact that there is much more to do if we are to create domestically and internationally the conditions that will permit sound economic growth in the future and minimize the risks and the severity of future economic crisis. Within the domestic economies, the task which we all recognize as strengthening financial systems is not one that can be fully achieved within 1 or 2 years.

Korea and the other countries in the Asian region have made very important strides in identifying the sources of difficulties and in mapping out a strategy for strengthening economic sectors. And I join others in commanding the authorities for the vigor with which they have begun this program. But let us speak, let us remember that it will be a longer task. It is not possible to create strong banking systems to change a financial culture within a short span of time. And that's why I think it's so important for us to meet in a gathering like this and to remind ourselves of the steps that were made to be taken and to discuss how best to approach that. And that applies to the subject of this and the previous session, the international financial architecture.

As Barry Eichengreen remarked, many of us have participated in very many sessions and conferences devoted to the international financial architecture. And some important developments have taken place. If there is time later on, I would like to brief you on some of the measures and discussions taking place in the Financial Stability

Forum. But, you will recollect that following the crisis internationally and following the turbulence in financial markets in the second half of 1998, the G-7 countries decided that it would be desirable to set up a forum for financial stability that would bring together senior officials at the deputy level, deputy ministers of finance, deputy governors of central banks, heads of financial supervision, together with the principal international organizations that fund the bank, the NACD, and the standard setting bodies, the banking supervisors, the securities regulators, and the insurance supervisors better to coordinate efforts to build a stronger international financial system. Because one thing that we realize, is that in an international financial system, where private capital markets play such an important role. A key thing is to make sure that forces of market failure can be identified and dealt with and that can only be achieved through collaborative and cooperative effort amongst a wide range of authorities responsible for financial stability. Whereas I say I will talk a little more about the Financial Stability Forum and the work that we have been doing particularly on capital flows and hedge funds if time permits later on in the discussion. But I don' t want to take too long in introducing the subject because we are running out of time and although I have awarded myself a green light before the beginning of my remarks, I will stop now and turn the session over. We will first hear from Stephen Roach, the chief economist of Morgan Stanley Dean Witter.

Stephen Roach
Chief Economist
Morgan Stanley Dean Witter

Thank you Mr. Chairman and forgive me as I attempt to see if this technology works.

Miracle of Miracles, the new economy is alive in the new economy. It has been said that the global It has been said that global currency crisis of the late 1990s was the first true crisis of globalization. I agree. It has also been said that it was the world's worst financial debacle since the 1930s. I agree on this count, as well. This was the crisis that was supposed to have taught us all some lasting and painful lessons. It was billed as the wake-up call that would gather us around the world to develop tools and policies that would lead to sounder management of increasingly integrated and fast-moving world financial markets. Unfortunately, it hasn't.

And the risk is that it won' t. With world financial markets in a new state of exuberance and global economic recovery more vigorous than it has at any point in the past 13 years and many respects, the urgency for post-crisis reforms has subsided. And in my view, that mean we could be in danger of squandering an extraordinary opportunity for reform. Of all the lessons of the Asian crisis, that could be the most tragic.

I do feel that there is a dangerous complacency setting in. And it is out of such complacency that the next crisis is invariably born, usually hitting where and when it is least expected. That' s one of the very painful lessons of recent history. Japan appeared triumphant to the world in the late 1980s. Mexico was thought to be in outstanding shape in 1994. And the East Asian miracle was the stuff of history books in the first half of the 1990s. Yet, in all cases, the end was at close at hand. This record is enough, in and of itself, to sound a warning to that one economy that remains triumphant today. And that' s the U.S. economy and, on that accont, I do agree with Professor Sachs about the presumed permanence of American hegemony.

And yet the world is ill prepared for the next crisis. There is no global policy agenda. Policymakers remain largely dominated by domestic concerns. Coordinated action comes only at points of extreme crisis – and then grudgingly. The best international policy is presumed to be a collection of the best national policies. Trade liberalization efforts – currently exemplified by China' s bid for WTO accession – get bogged down in national politics. Talk of reforming the architecture of the international financial system has lost momentum. The selection of a new managing director of the IMF was dominated by timeworn geopolitical bickering. All this is most discouraging. There is, in my opinion, no natural political constituency in favor of global reforms.

What can be done? There' s a lot that can be done. During most of 1999 I had the pleasure of serving on an independent task force sponsored by the New York-based Council on Foreign Relations that was charged with making recommendations for the reform of the international financial architecture. You' ve already heard from one member of the task force, Barry Eichengreen, and the director of the taskforce was Goldstein, has been seen roaming the halls here in Seoul.

In my remarks to you this afternoon, I would like to simply go through the thrust of this report, especially, in so far as it pertained to capital flow volatility, the subject of this session. So with a help of little magic, I' m going to take you through a few quick slides.

First of all, as we embarked in our quest for a new financial architecture, we thought it was critical to identify those principles that would guide our deliberation.

- First, and foremost, we believe it is important to intensify our efforts in the realm of crisis warning and prevention.

- Second, we believe it is critical that savings should flow to those countries and uses that offer the best return.

- Burden-sharing is indeed a key in our view.

- Fourth, we believe in the role of market-based incentives to deal with crisis prevention and resolution.

- Architectural reform must be a two-way street, involving not just the developing world, but the industrial world, as well.

- And, like everyone, we believe that the mandates of both the IMF and the World Bank must be refocused.

With that in mind, went about our work of trying to frame what we thought was some realistic recommendations for reform and they are as follows:

- First, we believe that there should be greater rewards for those countries which take effective and transparent steps to reduce their crisis vulnerability; these rewards should take the form of more favorable IMF lending terms.

- Second, and the point I will address in detail, we think short-term capital inflows should be discouraged

- Third, burden-sharing is important and we endorse very strongly the point made by Barry Eichengreen on “collection action” clauses in sovereign bond contracts.

- Fourth, we believe that the IMF and the G-7 should not only advise emerging economies against adopting pegged exchange rates but that they cease providing funds for those that maintain unsustainable pegs.

- Fifth, we think that there should be a return to normal IMF lending limits during country crises. For "systemic crisis," it is appropriate to consider what we called a "contagion fund."

- Sixth, we recommend that the IMF and the World Bank return to basics and narrow their focus. And, in particular, the IMF should stay out of mandating longer-term structural reforms. The World Bank should stay out of crisis lending and management.

- Seventh, we believe that there should be really a global conference of finance ministers convened on matters of architectural reform. Only then can a real political consensus be reached on the imperatives of this task.

While there is no doubt that capital lubricants, capital flows of lubricant of international commerce, played a dramatical role for most of our modern day economic and financial history. As these go offshores actually capital flow is a sure of a proxy and global GDP or below where they were last century and early part of this century. So as globalization progresses, you can expect even more capital flows in the years and decades to come.

The key question is "Is there or not systemic risk associated with these capital flows?" And the risk is that there is because in my view, very small asset allocation shifts out of large G7 countries can have large impacts on emerging markets leading to periodic asset bubbles and systemic boom-bust cycles. We've seen all too many of them in recent years and decades. And that asks a very important question "Is volatility of asset prices intrinsic to globalization?" It's what I call the David and Goliath syndrome with the industrial world being Goliath and the developing world being the Davids of our modern times. This gives you an example of what David is up against. If you'll just look at the world equity market capitalization and the large Goliaths of the world, the three red lines at the bottom, and compare them with the market capitalization in very tiny emerging market equity markets. And what happens is it only takes a tiny asset allocation shift from the G7 to have major impacts on small emerging market capital markets leading to the risk of boom-bust cycles, as I just diluted to.

Now of course, over the long sweep of history, we have encouraged capital market liberalization and we have fostered a climate that makes the possibility of these boom-bust cycles more and more likely. Let's just take a look at recent trends in capital flows to emerging markets to give you some indication of how volatile they are. This is a total emerging market picture, back to 1980, and you can see that the decade of 1990 has been a real roller coaster ride. I don't have to tell you about what it's been in Asia especially in the last couple of years, and you'll also note, similar, but less damped, actually more damped volatility in Latin America. Take a look at capital flows by type of investment. The long-term flows of course are the most stable. Foreign direct investment ends a secure stable and admirable form of financing for economic development. Portfolio investment obviously much more volatile, especially in recent years into Asia. And the real winner for volatility in terms of short-term capital flows comes with banks and/or related flows.

What about these Highly Leveraged Institutions that gets such a publicity today? I would have to say that "Don't just believe in your hedge funds." Banks are involved in this and yes, the company that I work for is too. I think the record of history shows that HLIs as we like to call them, seems like UFOs, did play a role in the ERM crisis in the early 90s but did not play materially well in the peso crisis nor the Asian crisis of 97 and 98, contrary to opinion. Hedge funds have grown dramatically in recent years and this slide speaks for itself, but note that assets under management in the global hedge fund industry are less than 2% of total assets under management in the world today. And you can take another free billing off of that in light of the desire of one-one on hedge fund to close at sharp this week.

The U.S. is not without its own problems in terms of capital flow vulnerability. So far it's to say that our massive current account deficit is now acquiring financing to the tune of over a billion dollars a day. We'll get it, the question is at what price? What do we recommend doing? We have a 5-point plan that I'll just put up here and take you through it.

The first point is that we do recommend holding-period taxes on short-term capital inflows. They worked for Chile. I think they can work elsewhere in the developing world. We think there should be several important features of these holding-period taxes. They should be transparent enough and non-discriminatory; they should be price oriented rather than quantity-oriented; they are not in anyway whatsoever a substitute for sound policy fundamentals; and they should not be put in place to discourage the entry of foreign financial firms.

The third recommendation is to intensify IMF surveillance over debt management practice.

Fourth is that the capital adequacy weighting schemes should avoid incentives for short-maturity, cross-border flows and avoid incentives for inter-bank lending.

And fifth and finally, yes, we do endorse strengthened regulation of these Highly Leveraged Institutions, especially transparency of positions and exposure by the commercial banking system to these institutions.

The important point to note that I want to leave you with is that the next crisis happens, is going to happen, and is inevitable. The record speaks for itself on this regard. Based on IMF data between 1975~1997, there were 158 different instances of currency crises, 54 banking crises, 32 instances of combined currency and banking crisis, and in more than a dozen of these cases, the cost of the bailout exceeded 10% of the victim's GDP. The next crisis is inevitable. We cannot assume that just because we are in a period of recovery, prosperity, and frothy financial markets, that there is nothing to do. The time to act in a global financial architecture is now capital flow volatility is an important issue that should be urgently addressed.

Thank you very much.

Andrew Crockett
General Manager
Bank for International Settlements

Thank you very much Stephen. Our next speaker is Paul Chiu. Paul has been Minister of Finance in Taiwan for the last 3 or 4 years. Before that, he has a distinguished academic career and has been the deputy governor of the central bank. Paul.

Paul Chiu
Minister of Finance
Chinese Taipei

Thank you, Mr. Chairman.

Excellencies, Distinguished Guests, Ladies and Gentlemen:

On behalf of the Chinese Taipei delegation, I would like to express our sincere thanks to the government and the people of the Republic of Korea for cordially inviting Chinese Taipei to this beautiful city of Seoul to take part in this very important Forum. I do indeed feel very honored to have this opportunity to exchange views with the many representatives of APEC economies and also the very distinguished scholars present here. Today, I would like to speak on the topic of "Short-term Capital Flows and the Related Financial Architecture in Emerging Market Economies." This paper contains 5 sections. Section 1 is a brief introduction. In section 2, I will first discuss two different economies, one with a high saving rate and the other with a low saving rate. For each scenario in turn, I will look at the impact of short-term capital flows on the money supply, the quantity of bank credit and the efficient allocation of resources. In Section 3, I will discuss the impact that these short-term capital flows have on both financial stability and financial modernization, while at the same time drawing upon the experiences of Chinese Taipei. In Section 4, which precedes my conclusion, I will highlight some of Chinese Taipei's experiences in handling the financial crisis, and also venture to share some views regarding international financial structural reform.

Modern financial architecture is built upon money multiplier or leverage effects. The effect of money multiplier can be observed from macroeconomic and monetary policy. The high-powered money can generate between five and ten times the broadly-defined money supply or bank credit within this system, which in turn, through the influence of the velocity of money, both the level of real GDP and prices are affected. The second kind of multiplier or leverage effect is that which appears at the microeconomic level. For instance, the Bank for International Settlements requires that banks maintain a minimum capital adequacy ratio of 8 percent. This means that banks are allowed to undertake risky assets to some eight to ten times their capital. Therefore, if banks have rising sizable non-performing loans or bad assets, a credit crunch will inevitably occur. I firmly believe that these two multiplier or leverage effects are two major building blocks of any modern financial system. Rapid flows of international short-term capital can affect high-powered money and the efficiency of resource allocation, which in turn exert influence on the competitiveness of an economy' s financial environment as well as both the quantity and quality of its broadly defined money supply and bank credit.

In the pat years, the international community had been advocating free capital mobility. The reasoning behind this was that, by freeing up such movements of capital, funds would be allocated in the most efficient manner. This would not only promote technology transfer, but would also bring more employment opportunities to the recipient countries. In addition, the gap between rich and poor countries would be reduced, and ultimately global economic development could be enhanced. Nevertheless, from the past experiences of such liberalized capital movements over little more than a decade, it has been observed that volatility of short-term capital in newly-industrializing economies has markedly affected the operations of banks as the volume of bank credit has also rapidly expanded and contracted. Furthermore, the experiences of the financial crisis have given us an opportunity to reevaluate our stance with regard to the impacts of these liberalization measures.

Following the financial liberalization and globalization, a significant characteristic of the recent financial crisis is that inflows of short-term capital into emerging market economies have given rise to increases in both new high-powered money and bank credit. This has also resulted in low interest rates and increased investment and consumption. However, if there has been a major financial reversal, domestic financial markets have also experienced excessive contraction, soaring interest rates, and both real estate and stock prices have tumbled. As a result, both financial institutions and private enterprises have collapsed, and this has seriously affected the economic system as a whole. The problem of asymmetric information in the financial markets both at home and abroad causes market participants to engage in highly risky activities. Once there are signs of impending trouble, a financial reversal will take place. The huge amount of international short-term capital, which had previously flowed into the recipient country, suddenly makes its way out again, for reasons having little to do with economic fundamentals. In terms of economic terminology, multiple equilibria exist and there is no unique and stable equilibrium point.

Large movements of short-term foreign capital not only affect a country's financial stability, but also result in regional or even global financial crisis through contagious effect. In the aftermath of the Asian financial crisis, the international community gradually accepts the view that an orderly and gradual approach should be adopted to liberalize their capital accounts. And the liberalization can proceed further as the ability to absorb the impacts from such liberalization was strengthened. This is a more correct and realistic viewpoint, and it is also the strategy that Chinese Taipei has adopted for many years. (A brief history of Chinese Taipei's liberalization of foreign capital movements is given in Appendix A.) An ideal policy for liberalizing movements of foreign capital would require that financial liberalization be implemented first internally and that the domestic financial system would first be proved sound. The liberalization of foreign capital movements would first proceed with the deregulation of the current account, and then with the liberalization of the capital account. With regard to capital transactions, those of a long-term nature would be liberalized first, and only after that would capital transactions of a short-term nature be relaxed. Finally, we should still maintain the policy of not allowing non-residents abroad having deposit accounts in domestic currency should be regarded as the last line of defense to maintain exchange rate stability.

On the other hand, McKinnon and Pill (1996) observe that as emerging market economies begin to implement economic and financial liberalization, they will frequently engage in excessive borrowing. For this reason, McKinnon and Pill not only propose that short-term capital movements be moderated, but that attention should also be paid to the rising domestic credit, particularly in relation to consumer loans and real estate lending.

Chinese Taipei has adopted various sterilization policies to maintain the stability of financial markets. During the late-1980s, Chinese Taipei was faced with huge short-term capital inflows. The monetary authorities, in addition to allowing the NT dollar to appreciate in an orderly manner, resorted to issuing Treasury bills, savings bonds and certificates of deposit and using postal savings re-deposits placed with the Central Bank at a time when the money supply was quickly expanding. Not only did we mop up the excess liquidity, but also lessened the impact of the money multiplier as well as curbing the excessive expansion in bank credit. In addition, the monetary authorities adopted measures of selective credit controls, thus preventing the excess funds from being channeled into the stock and real estate markets.

Foreign funds constitute an important channel through which emerging market economies may obtain resources from abroad. However, we should bear in mind that conditions differ from one economy to another, and the importance and effectiveness in terms of obtaining funds from abroad is also not the same.

In terms of those emerging market economies that have a lower saving rate, while inflows of short-term capital can provide more funds to import machinery and equipment and raw materials from abroad, thus be beneficial to capital formation. However, from a financial perspective, inflows of foreign funds give rise to the expansion of high-powered money, and in turn have a five- to ten-fold multiplier effect in terms of expanding both bank credit and the broadly-defined money supply. It is worth noting that, among this five- to ten-fold multiplier effect, the four- to nine-fold increase in bank credit is generated by the monetary authorities in addition to the amount of original increase in foreign exchange reserves. Although this additional liquidity may be partially absorbed by the increased demand for money through low interest rates, in the short run, this will give rise to an excess supply of money. In short, if capital inflow is not sterilized in an appropriate manner, it will certainly give rise to excess liquidity. But in an economy with a low saving rate, as its foreign exchange is recycled, it will flow out of the country and exhibit a kind of sterilization effect. Its impact on the domestic money supply and bank credit will thus be relatively small. However, inflows and outflows of short-term foreign capital for purely speculative purposes will still give rise to fluctuations in financial markets, and result in an overall negative impact. Chile had adopted a correct policy to impose a reserve requirement on short-term capital inflows. This policy lengthened the holding period of portfolio investment while not limiting the amount of foreign capitals. Of course, economy such as this should also encourage domestic saving to gradually lessen its reliance on foreign funds.

As regards to economies with a high saving rate, they do not really need to excessively rely on short-term capital inflows to finance their direct investment. And therefore the effect of capital movements to domestic capital formation is relatively limited. In those economies that are characterized by excess saving, if their monetary policies are not properly managed, excessive short-term capital inflows will tend to cause local funds to be channeled into financial activities of a purely speculative nature, thereby giving rise to a "bubble economy".

Chinese Taipei is an economy with a high saving rate. As a result, there have been less short-term capital inflows when compared with several other economies. However, we have been firmly working toward more openness of the financial markets, with a view that this not only help promote efficient asset allocation, but also will give rise to important channels through which international standards of banking and securities operations could be effectively introduced to our economy. After having access to the WTO, we will fully open our capital market by January 2001.

In order to lessen the negative impact of short-term capital movements, it is important for the emerging market economies to moderate short-term capital movements based on their own economic and financial conditions. Generally speaking, it is relatively more costly to impose direct controls over short-term capital movements as such controls will result in significant distortion in the capital market. A more ideal approach is to adopt indirect "market-based" management. Of these, the one that is most frequently mentioned is that of Chile which imposed reserve requirements on short-term capital inflows. While this measure may not be able to limit the total amount of capital inflows, but as Dr. Eichengreen pointed out, it can effectively lengthen the holding period of portfolio investment by foreigners, and will therefore lessen the negative impacts from such capital inflows.

In addition, a dual exchange rate system, a Tobin tax, and the imposition of asymmetric long and short open foreign exchange position limits on banks are effective market-based measures to manage capital inflows indirectly.

With regard to the sequence of capital movements that should be liberalized, as well as the pace at which financial liberalization should take place, both Turner (1991) and Reisen (1996) observe that short-term inter-bank capital flows are the most unstable and temporary in nature, followed by portfolio investment, and then foreign direct investment. The most stable one is long-term bank lending. This observation deserves our attention. Reisen proposes that the focus should be on both inflows and outflows of foreign capital, *i.e.*, the gross amount of capital flows, not just the net flows.

Eichengreen (1999) recommends an orderly approach to capital account liberalization and a policy package to accommodate such process. In his point of view, foreign direct investment should first be liberalized and secondly should the local stock and bond markets be open to the non-residents, *i.e.,* the liberalization of portfolio investment, and finally bank borrowing from abroad be liberalized.

The experience of Chinese Taipei dealing with the liberalization of short-term capital movements is similar to what those scholars have suggested. At present, the short-term foreign funds borrowed by banks are mainly to facilitate international trade activities. Furthermore, while the regulations regarding short-term inflows of foreign capital to invest in the securities and stock markets are lessened to a greater extent, to prevent excessive amounts of funds from flowing into banks, restrictions are also placed on institutional investors that may inwardly remit such funds. Specifically, at least 70 percent of the inwardly remitted capital must be invested in equities, and no more than 30 percent may be deposited with banks.

In addition, to effectively manage bank liquidity, Chinese Taipei imposed ceilings on banks' foreign liabilities, but these restrictions were subsequently lifted. In 1999, a law was passed to allow for the imposition of a reserve requirement on banks' foreign liabilities to prevent large inflows of short-term foreign capital. We also require that banks determine their own appropriate foreign exchange position limits, and require that they report to the Central Bank. The main purpose of this measure is to strengthen banks' risk management and to serve as a way to monitor short-term capital movement. By requiring banks to immediately report large foreign exchange transactions to the Central Bank, Chinese Taipei was able to effectively manage short-term capital flows in a timely manner.

Stated simply, the liberalization of capital movements is a means to an end, not an end itself. The ultimate objective of any economic policy is to promote financial market efficiency and to foster the stable growth of the economy. Any liberalization of capital movements should always serve those objectives.

The existence of offshore banking units (OBUs) greatly increases the difficulties in managing hedge funds. If we impose more restrictions on domestic financial markets to prevent huge capital inflows, these hedge funds will move to these OBUs, rendering the restrictive measures ineffective. For this reason, the approach being adopted by the advanced economies is to further strengthen the disclosure requirements, and to require banks to enhance their risk management in order to curb excessive lending to hedge funds and other highly leveraged institutions. In this regard, hedge funds are being controlled indirectly.

Nevertheless, such approach is not sufficient to protect the emerging market economies to a full extent. For this reason, those economies should also design and implement their own policy package to regulate hedge funds. In Chinese Taipei, we require foreign investors to validate themselves as the qualified investors, and to disclose other pertinent information including the names of the beneficiaries. At the same time, we have regulated hedge fund in a manner similar to that regulating securities investment trust funds (SITEs) by prohibiting their transactions supported by margin financing scheme. Such regulations have been effective to prevent hedge funds in Chinese Taipei from excessive expansion.

It is generally believed that the exchange rate should be determined by the market mechanism. In order to avoid excessive exchange rate fluctuations, the central bank should maintain its independence to implement coherent monetary policy and to sustain macroeconomic stability.

In regard to foreign exchange reserves, theoretically speaking, its optimum level should be determined by the import demand. However, given Chinese Taipei's special situation that it is not a member of IMF, we should therefore take emergency situations into account. For this reason, we have maintained high foreign exchange reserves, which have not only served to increase public confidence in our economy, but also to help maintain stability during the recent financial crisis. Although there has been cost involved in accumulating these foreign exchange reserves, based on our own experiences, the benefit outweighs the cost.

Proper management of short-term capital flows is an important means to mitigate the negative effects of volatility of capital flows. However, it can by no means replace structural economic reform. It is also very important for those emerging market economies to maintain sound economic fundamentals.

Based on our experiences from the recent financial crisis, an economy should pay attention to the following issues if it is to avoid the recurrence of such crisis. An economy with insufficient domestic saving should look for direct foreign investment or long-term foreign borrowing. And every effort should be made to lengthen the duration of short-term capital inflows. An economy with a higher saving rate should pay attention to the expansion effect of short-term capital inflows to the broadly-defined money supply, bank credits, as well as on the efficient allocation of resources, to avoid the build-up of a bubble economy. Sustained current account deficits are undesirable. If such situation does occur, appropriate policies should be implemented to quickly remedy this problem. The nominal exchange rate should be flexible and the level of the real exchange rate should be kept in line with economic fundamentals. Modernization of bank operation and improvement of transparency of their financial conditions are the basis of good corporate governance. Financial market should also be modernized so that banks and enterprises can strengthen their ability to hedge risks. The liberalization of international capital flows needs to proceed in a gradual and orderly manner.

The result of banking deregulation in recent years has been that regulation over bank's required reserve ratios has been completely abolished. Only adherence to the BIS's minimum capital adequacy ratio of 8 percent has been implemented. However, the BIS ratio only applies in the case of the risk management of individual financial institutions. It is incapable of exercising control over total supply of bank credit. To lessen the impact of short-term capital movements on the financial sector as a whole, Chinese Taipei is currently maintaining an average reserve ratio of around 6.35 percent on banks' NT dollar deposits. From the perspective of microeconomic financial policy point of view, the BIS's 8 percent minimum capital adequacy requirement allows individual banks to undertake risky assets amounting to from eight to ten times their capital. If their individual net worth deteriorates as a result of bad debts, then for every bad debt that is written off, the amount that they can extend in the form of loans will be reduced by from eight to ten times the amount of that bad debt. This will in turn mean that even soundly operating enterprises will face a credit crunch. It is precisely for this reason that special care needs to be taken to supervise banks' operations. Large inflows of short-term capital may create excessive expansion of liquidity and therefore generate keen competition among banks in their lending, and this causes the quality of loans to deteriorate. Therefore, it is essential that banks' ability to manage their credit risk be strengthened in order to improve their asset quality.

Furthermore, there is a need to ensure banks to have sufficient capital to absorb the losses and to avoid the problem of moral hazard. In 1991 when Chinese Taipei allowed new banks to be established, the minimum capital requirement for setting up a new bank was raised to a relatively high level of NT$10 billion (or US$330 million). The *Banking Act* also stipulated that all banks should adhere to the BIS minimum capital adequacy requirement of 8 percent. In addition, banks have already been allowed to issue preferred shares in order to strengthen their capital structure and deepen the capital market in Chinese Taipei. The purpose behind the high minimum capital requirements was that the financial authorities could easily handle the problems in a timely manner when troubled financial institutions still have positive net equity value. Apart from this, in February 1999 Chinese Taipei announced that the business tax was reduced from 5 percent to 2 percent. It is estimated that banks could use the approximately US$4.4 billion saved from the reduction of tax rate to write off their bad debts, and the average non-performing loans ratio for banks would be cut from 5 percent to 2.5 percent in four years time from July 1999 through June 2003. The soundness of the banking system would therefore be enhanced.

In order to enhance the transparency of financial markets, credit rating agency that conforms to international standards has been established. It has been effectively providing the public with more reliable financial information especially when mergers and acquisitions are considered. Chinese Taipei has also established a Joint Credit Information Center to have a file on the credit information of all financial institutions and major insurance companies in relation to their business with private enterprises. Financial institutions can readily have access to this credit information before undertaking loan businesses with the potential customers. This is an effective way to improve loan quality and reduce problem loans in advance.

It is important to promote both the stock and bond markets as alternative funding channels to the banking system. They are very helpful for enterprises to raise medium and long-term funds. When there is an outflow of short-term funds leading to higher short-term interest rates and a depressed stock market, those enterprises can resort to this important bond market channel for raising medium and long-term funds, thus mitigating the negative effect from sharp short-term capital movements. In this regard, we will allow banks to issue debentures so that banks can use funds raised in the capital market for on-lending to their customers.

At the time of the Asian financial crisis, the impact on Chinese Taipei was relatively small compared to some neighboring economies. Chinese Taipei's exports to Indonesia, Korea, Malaysia, Philippines and Thailand declined by 29.7 percent in US dollar in 1998. However, thanks to the strong growth of the US economy, and a domestic economy marked by low inflation, economic stability was maintained. Our exports to the US and to Europe increased, and total exports for the year as a whole declined by only 9.4 percent in 1998 as compared with that of the previous year. Our weighted stock market index (i.e. the TAIEX) fell from 8,996 points on July 2, 1997 to 5,400 points on February 5, 1999, leading to a decline in the wealth held by the private sector. However, between 1990 and 1998, we greatly benefited from our hi-tech industry including the IT industry. An average growth rate in excess of 10 percent was recorded for this industry in each year during this period, and this contributed significantly to the average GDP growth rate of 6.2 percent over the same period. The resulting income effect was able to make up for the reduction in private wealth. Private consumption increased by 6.77 percent and 4.83 percent in 1997 and 1998, respectively. In November 1998 when our firms faced a liquidity shortage and serious problem of credit crunch, the government stepped in and organized an *ad hoc* working group to help enterprises obtain short-term funds for their operations. This was particularly helpful to those enterprises that were operating normally but were suffered from shortages of working capital. This in turn proved effective in avoiding a reduction in total supply of bank credit. During the second half of 1998, two bills finance companies and one local bank encountered difficulties of huge losses. However, the government quickly took action even before the problems occurred. It made an arrangement that the troubled institutions to be taken over by banking consortia or the Central Deposit Insurance Corporation. The stability of our financial markets was thus maintained.

Although the current foreign exchange regime is not based on a dollar-gold exchange standard. However the US dollar is still an important reserve asset, which serves in part as a base for the creation of monetary aggregates in many economies. For this reason, the increases or decreases in foreign exchange brought about by short-term capital movements significantly impact the changes in the monetary aggregates of the emerging market economies through the money multiplier. Under such circumstances, some economies will inevitably face a liquidity crisis when there are balance of payment deficits and sudden capital outflows, and will need to have their liquidity requirements met by other regional and global international organizations. Therefore, as financial globalization becomes a reality, economies will now need to cooperate closer in order to resolve some common financial challenges that are currently facing us.

Chinese Taipei sees the merits of promoting the idea of establishing a regional financial fund to cope with likely financial crises in the future. For such a fund to be established, it should be supported and assisted by the IMF, without duplicating the work of the IMF. The proposed fund should comprise all the APEC member economies. Chinese Taipei has both the willingness and the ability to provide necessary support for such a fund, and indeed look forward to its establishment.

To conclude, in the case of emerging market economies, the liberalization of capital movements should take place step-by-step. Medium and long-term international capital flows should first be fully liberalized, then followed by gradual deregulation of short-term capital movements. Only when a financial safety net has been established, should short-term capital movements be fully liberalized.

Looking into the future, global economy and financial markets will continue to become increasingly closely integrated, and this will particularly be the case among APEC economies. The increased interaction and cooperation among individual economies and international financial markets will further strengthen regional cooperation through a regional fund. In sum, each economy should make every effort to enhance the prudential regulation of its domestic financial markets, while continuing to attract foreign capital. In addition, it should also maintain macroeconomic stability, if the recurrence of a financial crisis caused by short-term capital movements is to be avoided.

Yoshimasa Hayashi
State Secretary for Finance
Japan

It is a great honor for me to have been invited here today to speak at this APEC Forum on "Shared Prosperity and Harmony" hosted by the Government of the Republic of Korea.

Korea has achieved a dramatic recovery from the currency crisis. I would like to express my sincere respect for the Korean government led by President Kim Dae-jung and the Korean people for their great effort toward this recovery. I believe it is most significant that this forum offers an opportunity for a frank exchange of views among top government officials from APEC economies, including those who suffered from the currency crisis, high-level representatives of international institutions, and renowned private-sector experts.

First, I would like to say a few words about the global economy since the Asian crisis in 1997 and the international crises that followed the Asian crisis. The steady cooperative efforts of the international community to strengthen the international financial system have begun to bear fruit, and the world economy has been regaining stability recently. However, with the advancement of information technology and the liberalization and globalization of international financial and capital markets, it is not possible to completely eliminate the risk of crises caused by large-scale and abrupt capital movements, which were fundamental causes of the Asian currency crisis. Thus, it is still extremely important to consider not only ways to prevent such crises before they occur, but also measures to resolve them expeditiously and appropriately when they do occur.

Against these challenges, valuable progress has been made in several areas. In particular, the themes of this sub-session, that is, highly leveraged institutions including hedge funds and short-term capital flows, have been discussed at various international fora as extremely important issues. Extensive deliberations have been made at the three working groups of the Financial Stability Forum(FSF), which is chaired by our moderator, Mr. Andrew Crockett. Recently, the Forum has released executive summaries of their reports, and I should now like to express my views on t 재 of the three issues, while reviewing the discussion to date.

In the past, it was believed that HLIs could function as "stabilization speculation," because they had flexibility to cope with changes in the market, but a thorough deliberation on the dire impact of HLIs activities with high leverages was not made.

The international community as a whole began to tackle the problems caused by hedge funds after the Russian currency crisis in the summer of 1998 and the failure of Long Term Capital Management(LTCM). The problems have been discussed not only at the Summit of Asia Pacific Economic Cooperation(APEC), but also at various other fora that address global economic and financial issues, such as the IMA, the G7 meetings, the Manila Framework, and specialized international organizations such as the Basle Committee on Banking Supervision and the International Organization of Securities Commissions(IOSCO).

Among these, at the working group of the FSF, which was mostly established by G7 countries in cooperation with international institutions, intensive examinations have been made, especially on (1) the potential systemic risks arising from bankruptcies of HLIs, as demonstrated by the failure of LTCM, and (2) the so-called "market dynamics" issues, that is, the destabilization of markets and the loss of market integrity in medium-sized open economies by the aggressive trading practices of HLIs, as demonstrated in the Asian currency crisis.

First, concerning systemic risks, the failure of LTCM implies that there would be problems with risk management both at HLIs and at their counterparties. It also suggests that HLIs would have been allowed to employ excessive leverage. Also, it is said that even if the disclosure by individual HLIs is sufficient, if information about the overall market liquidity is insufficient, excessive leverage compared to market size may accumulate and result in risk expansion.

Second, regarding the influence of HLIs on market stability and integrity, it seems that under the unstable and fragile market conditions of 1998, the large and concentrated positions of HLIs resulted in amplifying market volatilities and potential pressures in several medium-sized open economies.

While possible responses may be classified into direct and indirect regulations, the report of the FSF argues that at the present time indirect regulations based on the principles of enhancing market discipline and promoting and sustaining adjustments in firm behavior are deemed appropriate. Additionally, it argues, if the above-mentioned recommendations are not appropriately implemented, direct regulation of HLIs such as capital requirements could be examined further.

I agree with this conclusion, and I expect this direction to be pursued, I also think that, in case market manipulation is suspected, further study on the following measures by emerging economies to defend their markets, will be needed; (1) the requirement on HLIs to report their activities in the interest of maintaining market integrity; and (2) "non-standard" policy intervention measures like those effectively taken by Hong Kong and Malaysia, which differ from traditional approaches like foreign exchange markets interventions and interest rates adjustments.

Next, I should like to address capital flows. Capital account liberalization and capital controls are issues that have been discussed very frequently since the outbreak of the currency crisis. In these discussion, it has been noted that those economies with wide-ranging capital controls that were not integrated into the international financial system did not suffer much during the crisis. This suggests that capital account liberalization, it is important to equip financial sectors with appropriate prudential regulations as well as to adopt sound and consistent macroeconomic policies. Additionally, the liberalization of direct investment, which is of a long-term and stable nature, should precede the liberalization of short-term capital flows. Economies with excessive dependence on short-term capital would become vulnerable to the shifts in investors' confidence.

In general, capital controls are no substitute for sound macroeconomic and structural policies. They entail costs due to the inefficiencies and misallocations of resources. Nevertheless, as in the successful case of Chile, where the reserve requirement was applied for a certain ratio of capital inflows, controls on capital inflows, appropriately combined with policies to increase the flexibility of exchange rates and other measures, can restrain short-term speculative capital inflows. Japan's such long-standing position has gained support these days.

Regarding regulation of capital outflows, the case of Malaysia as I mentioned before, where the government successfully defended its currency against speculative attack without the assistance from the IMF can be considered a success. In Malaysia 긩 case, the capital controls contributed to the stability of the exchange rate as well as to the achievement of the economic recovery. Of course, such measures cannot always be justified, and the possibility of loopholes must be considered. They cannot be applied in exactly the same form to other economies. They should, however, be evaluated positively as one possible response to the danger of sudden capital flight.

Some have argued that capital controls can serve as a second-best measure until financial sectors and prudential regulations are strengthened. However, prudential regulations cannot cover all unstable capital flows, because they primarily cover transactions by financial institutions.

Therefore, capital controls, especially those on inflows, are worth considering as measures to supplement prudential regulations and appropriate macroeconomic policies.

The working group of the FSF has studies the responses to economic vulnerability to capital movements. The group aims to establish risk management strategies for each economy as a whole, considering the overall balance sheet of each economy, in terms of risk management of public debt, risk management by the banking sector, and data requirement for effective debt management. In its report, the FSF has expressed its intention to encourage work on the risk management of public debt by the IMF and World Bank. As for risk management by banking sectors, the report pays attention to the mutual relations among liquidity risk, foreign exchange risk, and credit risk, and expresses general support for the work of the Bale Committee on Banking Supervision.

In conclusion, we, in cooperation with IMF, should continue to learn from the valuable experience we have gained form international financial crises and should consider practical responses appropriate to each situation.

Based on the experience of the Asian currency crisis, Japan has been advocating measures to strengthen the international financial system, reflecting the new world economy in which rapid and large-scale capital transfers may occur.

While some progress has been made in the study of appropriate policies since the K ln Summit, we cannot afford to be complacent in preventing future crises and making appropriate preparations for such eventualities. Specifically, the international community as a whole must address the reform of the international financial system, focusing on implementation of the FSF's recommendations, private sector involvement, and use of international standards. It will also be necessary to cooperate to reform the functions of the IMF.

Among these items, I should like to conclude my remarks by discussing the IMF reforms. The reforms are expected to be one of the main topics at a series of meetings this spring. The IMF is the organization at the center of the world financial system, and its reform is absolutely necessary if it is to exercise the great authority needed to prevent and resolve the types of crisis that will mark the 21st century.

Japan has already offered a number of suggestions, including paying greater attention to large-scale and abrupt capital movements when conducting IMF surveillance and formulating its programs, limiting the IMF's involvement in structural policies to those policies that are directly linked to solving crises, enhancing the IMF's transparency and improving its decision-making procedures, and reviewing the distribution of quotas to better reflect changes in the global economy. I would like to express my appreciation for the progress, which has been made in many of these areas so far.

The role private capital markets in funding the developing and emerging economies has increased its importance. Hence, I basically support reviewing the functions of the IMF tin the direction of promoting or catalyzing access to private financial markets. However, we still need an international safety net to respond effectively when a currency crisis occurs. From this standpoint, it is clear that the IMF will have to maintain or even strengthen its functions as a kind of international "lender of last resort" in certain cases, such as a crisis caused by temporary liquidity shortage. For example, regarding the Supplemental Reserve Facility, it plays an important role to resolve the types of crisis that will mark will the 21st century as demonstrated in the case of Korean crisis. The Contingent Credit Line, a facility to prevent crises, should be improved to become a more attractive tool It is also our responsibility to secure the financial resources necessary for those purposes.

Moreover, we should keep in our mind that the IMF was originally founded to perform the functions of a “credit cooperative.” It was intended to support the efforts of members, which fell into balance of payments problems but not necessarily a currency crisis, to strengthen fiscal and financial policies and implement necessary structural reforms. Certainly, we need to avoid the moral hazard of chronic dependence on IMF resources. However, the function of supporting members conditional on appropriate policies should continue to be important. This function provides an environment for the IMF to carry out its role as lender of last resort effectively during financial crises. Therefore, IMF medium to long-term facilities, which support structural adjustments, like the Extended Fund Facility, will still play a certain role.

In this connection, streamlining the IMF's facilities, including possible abolition of facilities, which have not been used, may be necessary o improve the functions of the

IMF so that they better fit its present role. The Currency Stabilization Fund and Debt and Debt Service Reduction, which have not been used, were decided to be abolished by the IMF Board this March. While streamlining IMF's facilities, actual application of IMF's facilities should remain a critical issue as well. Discussions on a wide range of areas are under way at the IMF's Board, including a review of the IMF's facilities, the strengthening of safeguards of Fund resources, the improvement of programs and surveillance, and increased transparency of procedures. We hope that these interrelated issues will be examined carefully and addressed in a coherent manner.

Finally, as I have mentioned, the reform of international financial institutions including the IMF, is crucial and should be promoted earnestly. Japan is resolved to contribute to them. In addition, I believe the regional framework based on the candid exchange of views on the economic situation of each economy will play an increasingly important role in strengthening the international financial systems in this context. In this sense, I sincerely hope that the discussions at this forum will prove most fruitful.

Thank you very much.

Shafie Mohd. Salleh
Deputy Minister of Finance
Malaysia

First and foremost, I would like to thank the organisers for inviting me to share a few words in this forum. I am indeed honoured to be here today in the presence of such distinguished guests.

Two years have passed since the start of the East Asian crisis, and recovery has emerged in crisis-hit countries at a much faster pace than earlier expected. GDP growth has surpassed expectations, balance of payments has strengthened and unemployment is on the downtrend. Capital flows are beginning to return to the region, in line with the renewed confidence and interest among international investors. Asset markets have improved significantly from the lows recorded and yield spreads of Asian sovereign bonds over the US Treasuries have narrowed tremendously, reducing cost of raising capital in the market. This faster-than-expected recovery poses another risk; risk of complacency and not pushing forward with the necessary reforms that is crucial to mitigate the recurrence of another crisis and to ensure a sustainable growth.

The resurgence of economic growth and capital flows in particular portfolio flows seem to mark a reversal of trend from the days of the crisis. The time is ripe now for governments and policymakers alike to reflect and to take stock of measures taken to address the issues and efforts to overcome inherent weaknesses in the international financial system so as to avert another crisis.

We agree that capital flows played a crucial role in the efficient allocation of resources across borders and have brought impressive growth to East Asia in the 1980s and the early 1990s. In line with this, Malaysia welcomes foreign direct investments but the ramifications by the recent crisis would continue to remind us to be ever more vigilant of capital flows which are volatile and short term in nature.

Ladies and Gentlemen,

The new Millennium herald the time when the forces of globalization, liberalization in trade and advent in technology are moving in such a quick pace. Technology and improvements in telecommunications coupled with market innovations and financial liberalizations allow faster pace of financial integration. The forces of globalization could bring with it risks and destabilising consequences that can result in costs that far outweigh the benefits. These advancement in technology enable flows to move across border more freely and rapidly.

In today's world, explosion of e-commerce, 24-hour cyber trading, the euphoria to have a share of any dot coms companies seem to be the fashion of the day. The financial markets too have become more sophisticated. On line information had minimised cost of information on asset price to investors, which enable them to calculate correlation among asset prices enabling them to monitor efficiently and closely developments market movements. At the same time, these advancements in technologies have enhanced player's decision-making in the markets and facilitate cross-border flows.

We also note that increased cross border flows reflects the increased institutionalisation of savings and the now relative importance of institutional investors in financial markets. The participation of these institutional investors into foreign markets have brought depth and liquidity in markets and helped promote development in capital markets. It is more difficult to distinguish the activities of the different class of institutional players now. Pension funds and insurance companies used to be traditional and conservative in their investments. Globalization allows them to invest outside their domestic confines for higher returns. Propriety traders in commercial banks and the investment houses also undertake take big position and sometimes track the trading styles of hedge funds. We also note of the trend that more and more banks and investment houses are setting in-house hedge funds spurred by lucrative business as investors are still attracted by the higher returns offered. We continue to monitor all these developments and agree to some extent the difficulty of regulators to track the activities of each class of players in the market.

Ladies and Gentlemen,

When the Malaysian Prime Minister first highlighted that the hedge funds need to be regulated, the international community staunchly opposed and condemned Malaysia's view. We are pleased to note that the view has changed, particularly following the LTCM debacle in August 1998. The international community has now widely accepted the dangers associated with unfettered liberalisation of financial markets and destructive role played by hedge funds and currency speculators. Despite the recovery in crisis-affected countries, we still stand firm on the need to reform the international financial architecture.

The new international financial architecture should aim for achievement of a global agenda for the benefits of all and address the fundamental weaknesses of the free market system. More specifically, the new IFA should achieve a number of objectives. Firstly, the IFA should be able to avoid disruptive destabilising capital flows to maximise benefits from globalised capital markets and minimising risks. Secondly, it should contain the adverse impact of currency trading especially on small economies. Thirdly, it should mitigate occurrence of future crisis and limit the contagion effect of any crisis. Lastly, it should aim to achieve symmetry in good behaviour in government and private sector. Current discussion on IFA is inclined to focus more on ideological rather than practical issues. The value of free-market as reflected in free floating exchange rate regimes and free capital flows are constantly being reiterated. There is nothing wrong with this approach and we do not dispute the merits of free market principles, but we need to ensure that markets function efficiently.

In reforming the new IFA, authorities should take into account the regulatory gaps and supervisory structure of some countries that is lagging behind in financial innovations and internationalisation. The global community was quick to point out that this factor has greatly exacerbated the contagion effect when the crisis struck. Malaysia like the other crisis- hit countries are aware of the importance of new banking and corporate reforms to be put in place. However, the call for change should not only be confined to strengthening of individual countries financial systems but should also be matched by efforts to strengthen the international financial system.

A major problem with the international financial system is the lack of transparency of the market players. While increased demands are made for governments to be more transparent, it is puzzling that the private sector is not subject to greater transparency requirements, especially since the Asian crisis was caused by private sector excesses. The transparency of the Government needs to be complemented by a mechanism to strengthen surveillance and transparency of private sector market participants. In particular, greater transparency in relation to dealing in offshore financial centres and other large market players is important to ensure that large market players, notably, highly leveraged institutions, do not "corner the market" in small emerging market economies and create destabilising consequences.

In addition to extending disclosure requirements to the private sector, we need a global mechanism to supervise the international financial markets as mere disclosure of information cannot guarantee that the destructive volatility of international capital flows would not happen again. Such a global regulator would act in a similar capacity as that of domestic regulatory bodies. Its function should be directed at ensuring an orderly functioning of the international financial markets and at monitoring movements of short-term capital flows. Recent experience of several economies suggests that highly leveraged funds, were easily able to manipulate and corner financial markets in Asian countries. Thus, measures to inhibit cross-border manipulative activities in financial markets, rules against the cornering of financial markets and appropriate international standards for financial institutions with respect to exposure to hedge funds and other leveraged financial institutions need to be considered and formulated.

There should be a more comprehensive framework for the orderly liberalisation of the capital account, with appropriate criteria to serve as guideposts for countries, particularly, emerging market countries. In particular, due consideration should be given to the state of development of the domestic economic and financial sector in relation to the openness and size of the economy before embarking on such liberalisation. The IMF's technical expertise could be directed at helping countries to develop and deepen their own domestic financial markets, as well as criteria and safeguards for capital account liberalisation. The approach should focus on creating incentives for countries to liberalise the domestic financial market rather than using legal powers to promote financial liberalisation.

In the past, changes in the financial environment have been met with corresponding changes in the international financial system. Since the Plaza Accord in 1985, however, changes in the financial environment have not been matched by a parallel change in the management of the global financial system, particularly in the 1990s. The international financial system has continued to operate within a framework designed for a global environment of the 1970s and 1980s.

Ladies and Gentlemen,

Given the present environment and the potential effects of sharp reversals of flows, we believe that safeguards and protective policies be put in place until there is assurance from the international community that vulnerabilities in the system could be overcomed and a framework safeguarding individual economies from the adverse consequences of capital movements be set up. Taking this into account, Malaysia will continue implementing safeguard to prevent destabilising effects of the short-term flows. This provides us with the opportunity to concentrate on restoring stability and sustaining economic growth of the country. Malaysia has always advocated that there is no standard prescription to crisis management and that the path we chose was the best option given the environment of highly destabilising and unrestrained capital flows. Malaysia's approach is a viable option and has produced results. It is also interesting to note that other countries in the region have also adopted prudential regulations on capital flows and internationalisation of national currencies to mitigate some of the risk of volatile flows. Supervision on the use the use of derivatives products for example the Non-Delivery Forward (NDF) to speculate against currencies is tightened.

While the bank restructuring and corporate reforms are work in progress at this stage, surveillance activities at the regional basis have been also been strengthened to complement efforts by the IMF, the World Bank, IOSCO and other authorities to monitor capital flows. At the recent ASEAN finance ministers meeting in Brunei, there was a broad consensus to set up a mechanism to monitor capital flows with a view to establishing a monitoring system of capital flows in ASEAN and to improve system of data collection and dissemination. An ASEAN working committee was also formed to facilitate financial sector liberalisation under the ASEAN Framework Agreement of Financial Services. Efforts are also being mobilised to develop and deepen the capital market in the region.

We also like to reiterate our view that the concerns and issues of the crisis-hit economies be heard of in international fora so that the new IFA reforms can be adopted by both developing and developed countries. Our representation at the Working Group is a step in the right direction and we would certainly welcome wider participation of ASEAN countries in the G-20 meeting and other international forums.

Taking into picture all these developments, it is evident that risk remains in the market place and we should not allow complacency to set in despite the recovery and efforts of crisis resolution. Various recommendations on the reform of the IFA, particularly those relating to destabilisng short-term flows and HLIs, should be translated into concrete actions.

On that note, thank you for your time.

PART III: Regional Cohesion for the Alleviation of Social and Economic Disparities

1. The Search for a New Social Walfare Paradigm

Meghnad Desai
Professor
London School of Economics

Thank you, ladies and gentlemen.

We shall now begin session III on regional cohesion for the alleviation of social and economic disparities. We have a distinguished panel of speakers, who will report on their experiences both with the Korean economy and with other western economies.

Let me just start by saying that while, yesterday, we had a lot of discussions about money and finance, today, we will discuss people and real social problems that are caused by the crisis. So, it's not just that money goes in and out, but as money goes in and out, people's lives are affected by crises. And across the world, due to globalization, countries are experimenting with the welfare state, trying to find new solutions to new problems, finding that the old tried method do not work. As well, countries who just suffered a crisis have had to invent some new remedies. And we will have four economies reporting on that.

Our first speaker would be Professor Richard Freeman of Harvard University. Dr. Freeman is a prolific and innovative economist. He has worked on a variety of topics such as labor markets, crime, higher education, trade unionism, transitional economies. He is active in many areas of labor economics and other things at Harvard. He also is very active in my own institution, the London School of Economics, where he is the Director of the Centre for Economic Performance and he's also recently given a very visionary sort of lectures at LSE with his new model of capitalism. So, I wait to hear what Professor Richard Freeman has to say.

Richard Freeman
Herbert Ascherman Chair in Economics

Harvard University

Thank you for inviting me. It’s a pleasure to be in Korea.

What I want to talk about is a change in the nature of the social welfare system that is going on. I think that the U.S. is a lead country in this, so I’ll use many U.S. examples. But I think that this new model, which I’ve left out the word “harmony,” but I used the word “shared capitalist model” because Americans, we’re not particularly harmonious people. But then again, neither are the Koreans when it comes to labor disputes and thing like that.

This new model I want to talk about has some good features, it has some bad features. And I think the policy issue is how to combine the aspects of this new model, so that it benefits normal people more. This discussion will tie with what we had yesterday in terms of the financial things because one of the main themes I want to bring across is that the new model of work and welfare, as it’s developing in the U.S., ties the well-being of workers to their firms and, therefore, to the financial success of their firms and of the economy more broadly, as opposed to tying their economic well-being to government deficits.

So, I will basically use these slides and I’ll try to be as fast as I can in my 17 minutes, but not too fast for the translator.

The first slide lays out the difference between the new and, what I call, the old work and welfare managements. Right now, we have the labor market there. And the key thing in the wages front – and it’s really extraordinary in the U.S. how this is developed – is the movement from fixed hourly or monthly pay to variable compensation related either to the profits of the firm or stock ownership. And I’ve estimated about 50% of the American workforce is currently paid by this “new” method. Now, we’ve had bonuses in Asian countries that served a similar purpose. I don’t think, however, that the bonuses, certainly in Japan – and someone can tell me about how variable the Korean bonuses have been – have been any near as variable as the bonuses in some of the American workplaces. This year, the Ford Motor Company workers, the ordinary blue collar workers, received $8,000 in profit share. Next year, they fully understand they may receive 0. It is a completely variable form of pay. This year, workers in Starbucks, who sell you the coffee, receive stock options. They fully understand, though they may be very unhappy, that next year, their stock options could be worthless. So, there's a shift, so where 50% roughly people receiving some form wages in this new system.

In the area of regulations, we've often thought of regulating the labor market. There's some government agency that does regulations. Some people think of the U.S. as a deregulated labor market. That is false. The U.S. has incredible array of regulations. What we have done, however, is we don't have too many regulators. And so, the new system really relies upon companies or companies and unions to do a good deal of the actual carrying out of labor laws. The particular system I've put up here, the alternative dispute resolution system, is grown to be a method where, if I feel my legal rights at the workplace have been violated by my employer, rather than going to the government or going to court, I can use a privately set-up system. I have some doubts about how virtuous a private system is when it is set up by the employers. And I think this requires probably some super government regulation to make sure it works fairly and properly. But it is going on and it's growing.

Then, in terms of the decision-making in the old labor market, we always thought there's the boss and he tells us what to do – the hierarchial method. Today, in the U.S., almost every firm that you can think of that has succeeded has employee involvement committees, teams, and is devolving all sorts of decisions to workers. So, this is a very different labor market than the labor market of, let's say, the 1950s, 1960s, when we previously had full employment. We're again at full employment but with a very different devolution of decision-making and sharing of participation.

And what about the welfare state? The U.S. old welfare state – and the word often used was a safety net. Ronald Reagan used the word safety net and Ronal Reagan may be the last of the old welfare state people the country has had. Because now we have largely changed our welfare system incredibly, today in the U.S., most of its welfare benefits are tied to work. And that's critical. People will get lots of benefits if they are working. And if they are not, the benefits are much lower and they've been reduced.

This occurs also in the retirement area. In the old system, we have social security, which is a publicly defined benefit mode of pay, and private-defined plans – your employer said you would get a thousand dollars a month when you retire, if you work 20 years with the employer and have some wage of some kind. Today, growing by leaps and bounds in the U.S. is defined contribution plans. That means the workers' money is in some stock market entity. It could be in cash but people have them in mutual funds and things like this. And whether they do well or poorly when they retire depends on how well the system is, indeed, going to be working. And that is growing so rapidly in the country.

Education, which I won't talk about because that, I think, is the subject that will be covered in the next panel.

So, I'd now like to go to the next slide and just give you some idea of the compensation side to this from some new estimates that I've made. Stock ownership programs is a share of the private workforce. The public workers are not part of this. And the many people in the non-profit sector will not be a part of this because there are no shares. I would love to have shares of Harvard University. The endowment fund is worth lots of money and I would be much better paid if I had some stock options on the endowment fund. But that's not the way universities pay professors. So, I estimate that roughly 25% of people in the U.S. have a substantial part of their pay determined by ownership. 8% of the people are covered in ESOPs, which I understand exists in Japan, in Korea. I don't know about the other Asian countries. That's been steady over the last 10 years. I think we've about reached the level that we will see in our country.

What's been growing rapidly is all employee stock option plans. That has risen from about 0% in 1990 to about 8% of the workforce today. That in all employee stock option plan means workers – an example I gave was Starbucks' clerks – are paid with options the same way that the CEO and other executives are being paid. And that has reached 8% of the U.S. workforce, truly remarkable. I mean, no one would have predicted this 10 years ago. And then, many companies gave you opportunities to buy stock at a discount. So, if I'm working for Coca Cola, I can buy Coca Cola stock at a significant discount from the company. You'll notice that I've made 25%. These numbers actually add to 26%. That just means that all of these numbers are fuzzy and 25%, a quarter, is a good estimate. Profit in gains sharing estimate of about a quarter, as well.

Then we come to these defined contribution plans, where people are putting their retirement money in something there called, 401k plans. But there are other forms of these plans. And I just distinguished here, those with a sizeable amount in company stock, as opposed to those that own mutual fund in the market. And my estimate was 11%. If anybody else said to me it was 15 or 20%, I wouldn't be upset. We don't have a very good estimate of this, but a large fraction of American workers have their retirement funds tied up in plans that buy company stock. There's a risk in that. And so, at the end of this, I came up with a number that is somewhere in the order of 45%. That is not the 25 plus 25 plus 11. It's not that I can't add, but that I made an estimate for how much overlap there is. And then, from another survey, I got another estimate 54%. So, my conclusion of this is about half the workforce is being paid through these new methods of pay. And that means about half the American workforce, if the financial situation does poorly, we have a crisis in our country. Their retirement income pay is going to go way down there. There is going to be a real problem in our country.

The third slide shows that this is very closely related to giving workers more decisions at workplaces. And as I say here, as economic theory would predict – well, an economist should say whenever economic theory gives you something that's correct, you ought to brag about it because, so often, we are either wrong or irrelevant to the situation. What we would expect would be that companies that have these programs, where they devolve decision to workers, will also be companies that give to the workers some share of compensation because you want to give them both decision-making and the incentive. And that's, of course, what we've done with executives. And what you see is the 66% of companies that have these involvement schemes are paying people with some form of sharing of financial rewards. And 34% are those without these formal schemes.

Now, I'm going to jump to the welfare system. So the labor market is much more sharing of financial rewards and decision-making. Again, the U.S. market is not a welfare state. While we're not a welfare state in the way that most European countries are, but in fact, you look here and you see huge increase in U.S. expenditures over the 90s of what you might have said, "looks like welfare to me." The key thing is the earned income tax credit. It is our major welfare program in our country. It is a supplement to the wages of low-paid workers. It says to low-paid workers, "Gee, work hard. We know the market isn't valuing your services enough and we will supplement your pay with thousands and thousands of dollars of extra money," a work-related benefit.

The medicaid is a way for us to say to low income people the same kind of thing – we don't have national health insurance, which many people believe would be a more efficient way of dealing with this – that we're not leaving these people out in the cold. The EITC, though, is the key component of American welfare system support for work.

This shows you what I've already discussed – the large growth of defined contribution plans. So, we currently have 55 million people are participating in these plans. That means your retirement money tied up in some fashion with the stock market in the financial community. And then 401k plans are the ones that are growing. Working people will have $40,000 on average in these plans. And, of course, that includes the young and the old and so on.

Turn to the next slide. I'll just direct your attention to one number here. It's the total disposable income situation. What this table shows you is the difference today between working and non-working for low income people versus the difference under our previous welfare system. And what you notice is, in 1997, we have a $7,129 difference than the previous period. What has happened in the U.S. has been a rather large increase. By putting the earned income tax credit, a person who sits there and says, "Should I take a job or should I stay on welfare?" we have shifted the balance incredibly in favor of working.

The last slide. In this, I want to summarize what this new model the U.S. has developed looks like – linking pay to company performance, linking social benefits to work. We've individualized and privatized rights and benefits. So we have a law that protects us, but we're expected, in some sense, or our companies are expected to make sure that that law in fact does what it does. We don't have government regulators doing as much as was done in the past.

Then I go through strengths and weaknesses because I don't think this is a perfect system by any means. Certainly, no one planned this system. Much of it developed from the competitive market. The great strength, I think, is that this is a very much of an improve efficiency system. And, I'm sure it is one of the reasons why the U.S. is having such a great productivity boom. People are looking around saying, "Why is the U.S. suddenly having this boom?" Well, we have strength in the incentives for people to produce over what it was in the past. And you don't have to be a supply-side maniac to believe that that's going to work. And all of the evidence is that it does work. So we have greater efficiency and people do this.

It is also done and it does, I guess, address the harmony issue. It has aligned employee and employer financial interests. And that's very interesting problem for some trade unions and for some other people because, suddenly, I'm being paid the same way the CEO is being paid. My concern that he is being paid much more than me might diminish decentralizes the labor laws we just discussed. And I think the key thing is that it has helped extend our full employment because it has made us a more efficient society with more variable pay, which then means workers can get money that is not really inflationary. A share of profits – the $8,000 that went into the Ford Motor Company workers this year – is not showing up in some sense as extra labor costs in Ford Motor Company. That is a shared capitalist system. They are being treated the way a shareholder is being treated – getting more money when the company does well.

Then there are the weaknesses. The big one is this system really reduces our insurance against risk. Lot of workers are suddenly financially in potential trouble. If our stock market collapses, if people refuse to invest in the U.S. anymore, then that will be a great problem. It increases the dispersion of pay. Two people in exactly the same situation – one of them happens to start working at AOL.com, the other one happens to start working at General Motors – one of them may become a millionaire and the other one, doing exactly the same work, is just a normal salary person. We are going to have a terrible problem. I think if we run into a big recession, it's a big risk the country is taking by going down this system, tying our social welfare system to work and to the performance of the productive sector. Some people may believe that it's too great a risk. But then, an interesting question is how you can devise a system that would have the efficiency benefits of this and then be able to almost shift to another system if we go into a big recession, given the governments are not that quick to shift policies. And that, I think, is the great trouble that this particular system will have. We're probably less suited for a period of unemployment than we were in the past, but we are much better suited for a period of full employment. And so, some sense there's great pressure in our country to keep the full employment going.

Thank you.

Meghnad Desai
Professor

London School of Economics

Thank you very much Richard Freeman. Irma Adelman will be back. We've rescheduled the program so she will be the last speaker on the panel. So, the next speaker is Professor Glen Cain.

Professor Glen Cain is a well-known specialist in labor economics and poverty studies. He has been a professor and researcher, director of Institute for Research on Poverty at the University of Wisconsin. And he is now Professor Emeritus at Wisconsin, Madison.

Glen Cain
Professor Emeritus
University of Wisconsin, Madison

Thank you.

My topic is “The New Welfare Reform Law in the United States.” I have a long paper, long footnotes, long appendix... I will try to compensate by giving a short summary.

I begin with the contrast between two economic events in the U.S. One is the current economic boom: 8 consecutive years of economic expansion, achieving the highest level of economic prosperity in US history, and record budgetary surpluses. The second event in this period is the enactment of a law that ends the federal program, Aid to Families with Dependent Children (AFDC), which since 1935 guaranteed a small monthly cash income to poor, single-parent families, headed by mothers with young children. The catch phrase to describe the new law is “work, not welfare.” The law virtually requires that these, nearly all, mother-head families become self-supporting, which in turn essentially requires that they find jobs that pay enough to maintain their families.

The new law has the awkward name of the Personal Responsibility and Wjork Opportunity Reconciliation Act, so I will refer to it simply as the NEW WELFARE REFORM LAW, or as the NEW LAW. It is a complicated law, but the primary provisions are that it shifts most of the responsibility for designing and administering welfare programs for poor mother-head families to the 50 states, requiring that the welfare mothers must be limited to a maximum of 5 years of cash assistance support, although states may allow fewer than 5 years of support. There is also a provision that says, after a maximum of 2 years of support, the mother is required to in a private-market or public job in order to receive the cash assistance. The catch phrase here is "workfare, not welfare." States may even require immediate employment to receive assistance.

Other provisions of the law give the states incentives to place mothers in jobs, to reduce non-marital childbearing, to increase payments to these families from the absent fathers, and to impose various restrictions on welfare assistance to immigrants to the United States.

Consider the Wisconsin state law, which is the most well-known of the state welfare programs, because it is fully in place and the most successful in reducing the AFDC rolls. It virtually requires immediate work for all mothers on the rolls and for new applicants. If the mother cannot be placed in a private-market job (the first priority), paying at least the minimum wage, then she will be required to take a Community Service Job (for 40 hours per week) to receive her monthly payment of $760. This is a high payment relative to other states, but it is less than the earnings from a minimum wage job, which would pay $890 a month; which, itself, is less than the poverty level for a family of 3. Mothers often find that they are better off struggling with jobs on their own, or they are moved off the rolls if they are placed in private-market jobs. The case load of welfare families in Wisconsin has been reduced from 81,000 families in 1993 to 8,000 in 1999. In the United States as a whole, the AFDC cases are down by 50%, and the decline in continuing.

I pose the Following 5 Questions:

1. Does the new welfare reform law reflect and foreshadow a reversal in the long-run trend of increases in Transfer Payment Programs in the United States; the cutting back of the welfare state?

2.. Has the new law contributed to the growth in the economy?

3. What explains the advent of the new law?

4. How will it affect the extent and distribution of poverty?

5. Are there lesson in it for other nations?

Question 1. No, the new law does not mark the end , or even the beginning of the end, of the welfare state, defined as a comprehensive system of Transfer Payments to a variety of groups. See Table 1. This will be the first of several abbreviated tables from my paper for my oral remarks. GDP in column 1 is in trillions of 1996 dollars. Column 2 shows Total Transfer Payments as a % of these growing GDPs. Column 3 shows the main Tps to the aged, who are the primary recipients; accounting for about 60% of the Total Tps. Column 4 shows the very small share of Transfer Payments for welfare mothers.

Question 2. No, the new welfare reform law has had nothing to do with the economic boom. The boom was 5 years underway by 1997, when the law began to be implemented across the nation. Also, in a labor force of 140 million, the welfare mothers are 2-to-3 million of very low earners, and their increased market work owes a lot to the tight labor markets and prosperity, in addition to the new law.

Question 3. Why were the poor mother-head families singled out for the welfare reductions? I discuss 6 reasons in my paper, 5 of which I will mention here. The long tradition and degree of success in the US of relying on employment and wage earnings as the means by which families rise above poverty. Transfer payment programs came relatively late to the US compared to other industrialized countries. Before 1960, Tps, even the social insurance programs like Old Age assistance, played a minor role in raising family incomes above the poverty line. Employment of mothers has become so widespread in the US that law-makers and the public at large found it easy to demand employment and self-support among welfare mothers. See Table 2. I make three points. A) The rise in LFPRs of wives, husband present (even) with pre-school age children from 1960 to 1998; B) the similar high employment rates among the category of Divorced, Separated, and Widows (with pre-school children); and C) I want to bring to your attention the sharp increase that shows up in the employment rates of the group most at risk of being on welfare, Neve-Married Mothers; an increase of 12 percent points from 1996 before the welfare law was implemented to 1998. I am sure that this increase reflects the effect of the new law.

Reason 3. A hard to measure but widespread belief that economic growth was no longer effective in reducing poverty, perhaps because poverty came to be dominated by the female-head families. Also, many economic research papers concluded that economic growth was no longer effective. I claim otherwise. Let us look at Figures 2 and 3. Here, and in more rigorous econometric tests, I suggest that this reason is not correct.

In Figure 2, I use median family income as a summary measure of the overall state of the economy. The figure shows for the 1959 to 1973 period the sharp rise in median family incomes coinciding with the sharp decline in two poverty rates, all families and for female-head families. I view 1973 as a turning-point year, when annual earnings for male full-time workers stopped growing and unemployment began reaching high levels. After 1973 we see the much slower increase, sometimes a decrease, in median family incomes, and a levelling, sometimes a rise in the poverty rate. Note that the female-head poverty rate is more responsive to the state of the economy.

Figure 3 shows a sharper test of the relation between median family income and the poverty rate. There are 39 year-to-year changes in the income and poverty rates, and the inverse relation is very strong. Only 4 of the 3i9 changes have an unexpected same sign.

A fourth reason for the new law: Public hostility toward welfare support as a result of the increase in female headship, itself a product of 2 factors: marital breakups and non-marital childbearing. These problems may not have existed if there were support to these families from the absent fathers, but this support is so low that it has become a national scandal. Some relevant statistics on these issues are shown in Table 3. Column 1 shows the increase in mother-head families as a proportion of all families with children, from 9% in 1960 to 24% in 1998. Col. 2 shows what has come to be called the feminization of poverty. Column 3 shows the trend of the two poverty rates for All Families and for Mother-Head Families.

The last question: Are there lesson in the new law for other nations? I doubt that there are, at least at this point. Three reasons. The experience is too new and there is too much variation in the new programs in the 50 states. Also, we are now in a boom economy; the crucial test will come with the next recession; and three, I return to the peculiar institutional setting of the new welfare reform law in the US; the huge role of female-headship and non-marital families in the poverty problem. Also the issues of immigration and the ethnic heterogeneity in the US , as these two factors affect poverty and the setting of the new law.

The full paper has a more extensive discussion of the power of wage growth and full employment in the long-run decline in poverty and how it is relevant for female-head families , especially in the wake of the new welfare law.

Meghnad Desai
Professor
London School of Economics

Thank you very much Professor Cain. You can see the very interesting thing, if I would just sum up for a minute, that people used to say about the Asian miracle that one advantage that the Asian countries had was that it did not have a welfare state. All they had were the kinship network to fall back on. And developed countries had a welfare state.

The developed countries no longer have the same welfare state. And one very important transformation, both in the U.S. and in U.K. is that, now, for prime age men and women, work is almost only choice to any welfare benefits, any benefits at all from the state, unless you are severely disabled or something like that. If you can, you have to work. You only get welfare if you can’ t.

Workers are more integrated into the profit and loss mechanism of the firm for which they work than it used to be. So, the number of stakeholders is rising and the number of people who are dependent on the state is falling. In a sense, I think this will have an interesting consequence for Korea and other countries, which were thinking of embarking on a proper western-style welfare state of the old variety. And, now that the old variety has disappeared, you don’ t need to bother. Stay where we are and improve what there is, rather than go all the way around the beverage circle and back.

So I think there are some profound lessons to be learned and I’ m sure that Kim YooBae, who is Senior Secretary to the President on Welfare and Labor, will give us some of his views on that. He’ s been active in the field of industrial relations and labor economics. And he’s previously served as an economic advisor to the ILO.

Kim YooBae
Senior Secretary to the President for Welfare and Labor
Republic of Korea

Thank you Mr. Chairman.

It is my pleasure to have the opportunity to speak to the global experts and APEC member representatives gathered here today to participate in “The Search for a New Welfare Paradigm.” I am here, in my capacity as Senior Secretary to the President for Welfare and Labor, for the Republic of Korea, to introduce Korea's productive welfare policy and to exchange views with the experts gathered here on how to develop that policy in step with current and future dynamics and the search for a global welfare paradigm.

I would first like to start with the relationships between the market and welfare before discussing a new welfare paradigm. Though there exist a broad range of socio-economic and political systems, the common and highest goal of all nations is the well-being of the people. From this point of view, it can be seen that two significant historic developments were achieved in the 20th century. One was the maximization of productivity through the socially efficient distribution of resources and the other was the concept of national welfare, which assumes social responsibility for the basic livelihood of human beings. There were, of course, government planned economic experiments, such as those seen in many socialist nations, and the contrasting conservative view which stressed the marketization of welfare with no government intervention. However, these systems could not achieve permanence nor justify themselves as being viable.

The market economy maximizes social value added with the creation of goods and services following the principle of efficiency, which is necessary to create a larger pie for individuals to share. On the other hand, national welfare responds to the needs of society's members for their basic livelihood, requiring that emphasis first be put on equitable distribution.

I believe that an important issue to be considered here, from the developmental perspective, is the linking of the market and welfare, which have an interdependent yet, in principle, strained relationship. The market and welfare issues should not be approached by merely imitating social democracy and neo-liberalism, which stressed either the demand side or supply side, but should be approached from a more practical aspect guided by the search for a generative welfare model which links the merits of both the market and welfare.

The blind pursuit of growth and efficiency in an unjust market economy, with its inherent cycle of corruption, distorts the market economy and may threaten all aspects of people's lives. A distorted market, in turn, creates the conditions that bring on government intervention, in the form of redistribution policies, as it addresses the social outcome of market failures. If the government attempts to solve its national welfare issues only through comprehensive redistribution policies, this will, in itself, distort the motives for participating in the market and bring about rigid and massive budget expenditures, which may result in further economic crisis caused by governmental failure.

This vicious cycle, which causes the continued failure of both the market and the welfare system, can be changed into a positive cycle by creating a welfare system and by implementing a national role for social intervention which functions positively in the context of economic development. Korea learned the lesson, in the successful process of overcoming the economic crisis in late 1997, that joint prosperity must be pursued through the developmental linking of the market economy and national welfare.

The “Government of the People,” has successfully overcome the economic crisis during the last 2 years. Korea has not escaped the crisis by returning to the way it was before the financial crisis, but is instead actively and successfully promoting the innovative systematization of the market economy and national welfare. New jobs are now expanding in small and medium enterprises and venture businesses, rather than in the conglomerate sector, and for the first time, all people under the minimum-cost-of-living will be guaranteed a basic livelihood this year through the implementation of the public assistance system.

As President Kim Dae-jung expressed yesterday in his APEC Seoul Forum opening address, productive welfare emphasizes basic livelihood security consisting of harmony of distribution and redistribution policies. Equitable distribution regards all members of society who participate in productive activities within the framework of democracy and the market economy and redistribution regards those without labor ability or who are not achieving basic livelihood, education and medical care.

In addition, the government policies of primary distribution within the market and secondary redistribution outside the market not only emphasize general relief but aim at productive effects that act in both directions. In other words, market distribution emphasizes human resources development focusing on lifetime education and training to increase the flexible market participation opportunities of the people in step with the development of the knowledge-based society. Redistributional public welfare focuses on providing aggressive rehabilitation opportunities for recipients.

Furthermore, productive welfare does not only pursue distribution. It is also aimed at improving the quality of life of the people through social investment efforts. This includes guaranteeing an enjoyable and sustained life through the fostering of cultural and tourist industries, the expansion of sports and leisure opportunities to all people, and improvement of the environment.

While creating this productive welfare paradigm we ultimately aim at pursuing the mutually facilitating and complementary development of the market and economy. While living standards will be improved, efforts will also be made for balanced social development which will socially expand human rights and dignity.

President Kim Dae-jung's direction for productive welfare was clearly stated in last year's Independence Day of Korea congratulatory address and the basic framework for productive welfare was prepared through legislation of the National Basic Livelihood Security Act in September 1999. A historic transition has taken place in Korea where all people under the minimum-cost-of-living will now be guaranteed a basic livelihood by the government.

The reform and introduction of related systems are actively being pursued in order to enhance the quality of life and to increase the size of the middle classes through livelihood stability and asset formation. The 'Government of the People' is pursuing policies to create 2 million jobs in new industries, including small and medium enterprises, venture businesses, and cultural and tourist industries.

The government, therefore, prepared and began implementation this year of a 3-year plan for structural improvement of income distribution. In particular, it is expected that, along with improvement of the knowledge-based economy, there will be stable extension of the people's welfare because the plan includes the strengthened income redistribution function of taxes and the financial stability of welfare revenue.

Ladies and gentlemen,

As you know, the recent and pre-existing socio-economic disparities are not just the concern of any one country, they are, in fact, issues of grave significance to all the member economies of the Asia-Pacific region. With this in mind, President Kim Dae-jung addressed the problem of disparities between countries and classes in last year's Auckland APEC summit and proposed that Korea host the APEC Seoul Forum to aid in the search for an integrated and cooperative plan.

With this respect, Korea proposes a ‘welfare policy cooperation channel’ through which the outcome of this APEC Seoul Forum will be organized and used in cooperative discussions. These talks will focus on social safety nets, social insurance, services for the disadvantaged and a preventative plan to address the worsening income distribution within APEC in the developmental process of APEC.

In order to achieve this, the APEC Social Safety Net Task Force, which was operated in a virtual method up till now, should be actualized. Economic Committee (EC) programs should focus on the alleviation of socioeconomic disparities, and we hope that the promotion of cooperation through these channels, including the present HRD Working Group, results in high-level policy talks after holding appropriate symposia. Finally, the funds for cooperative programs in the social and welfare areas within APEC must also be reviewed to enable them to be formed and utilized more efficiently.

We are aware of the fact that we have not yet achieved the golden age that existed in the Western welfare states in the 1960's. This is deeply connected to the development pattern and pace of the global economy.

I sincerely hope that the outcome from this many-sided and multi-layered search for a new welfare paradigm with the global experts and APEC members gathered here today becomes a turning point in the development of APEC.

Thank you very much.

Meghnad Desai
Professor
London School of Economics

Thank you very much.

Our last speaker is Professor Irma Adelman. She's very well-known as an expert on the Korean economy. 40 years ago, I was working on some work she had done on econometrics. She's done work on labor economics, development economics and she has been awarded the Bronze Tower Award by the President of Korea in 1971. So, she is allowed to tell us about the Korean economy.

Irma Adelman
Professor in Graduate School
University of California, Berkeley

Economists love impossibility theorems and, I guess, I'm not an exception. The impossibility theorem, I would like to state, applies to the firm's behavior. And it says that a firm facing cyclically varying demand can not have all of the three following characteristics. It can not have a non-decreasing employment at non-decreasing wage rates and hard budget constraints. The reason is very simple. When there is a prolonged downturn, it must be able to meet its payroll out of shrinking revenue over time. It can do that either by firing workers or decreasing their wages or by borrowing.

When societies are faced with choices, it is their value which dictate what choices will be made. In this respect, Western societies have individualistic values, while Confucian societies have communitarian values. So, you might expect that the choices would be quite different. And indeed, they have been.

Out of the three constraints which can not exist simultaneously, the Korean social contract involved maintaining commitment to workers by non-decreasing employment at non-decreasing wages, while violating the hard budget constraint. And the whole institutional structure of corporations and financial institutions was aimed to support and validate that commitment.

Western societies, with their individualistic values, chose to violate the non-decreasing employment constraint, while maintaining, sometimes reluctantly, non-decreasing wages and hard budget constraints. The result was that two very different kinds of institutional structures developed in Western individualistic societies from East Asian Confucian societies.

The consequence of the Confucian societies were, however, laid to an over-leveraged institutional structure in which corporations accumulated more and more debt. The accumulation of the debt was validated by an implicit commitment from the banking system to support their operations and expansion by lending. And that, in turn, was supported by an implicit commitment from the finance ministry to support the banks, if they ran into liquidity problems.

From a point of view of my personal values, I much prefer the Confucian approach to the Western approach. Unfortunately, the Confucian approach, after a while, becomes infeasible with the rates of economic growth that have been experienced by corporations on the one hand and globalization on the other.

The first chink in the Confucian armor came when banks were privatized. Up to the point at which banks were privatized, the quality of their banking portfolio and assets was essentially irrelevant. It merely amounted to a transfer between the treasury and the banks, which occurred more or less, automatically as growth proceeded. In 1980, this automaticity link was cut by privatizing banks. And when banks were privatized, their assets were not purged of non-performing loans. They were privatized as they stood. And part of the bad assets, since these loans were long-term, have continued into the present. In addition, the government continued to pressure banks, though privatized, to continue their policy of supporting the commitments of the corporate sector. And whenever the corporate sector got into trouble, banks stepped up their loans. That was, in effect, how the system got out of the recession of 1991~92 and 1980~81.

The reason privatizing banks worked was because firms were eager to acquire banks because that ensured them of a continued supply of loans, contractually almost, rather than just implicitly. Banks were losing proposition from 1980 on, when they were privatized. If you look at the national account statistics, which I did, you will find they have negative net operating surplus, consistently, since they were privatized. So, there were no retained earnings and no flexibility for banks to continue their policy beyond a certain point.

The second chink in the armor occurred when capital markets were opened up and some foreign investment started pouring into the country. That started in the 1990s. Why was that a chink in the armor? Well, because the implicit rules of Korean firms were not terribly well-understood by the Western firms, who assumed the firm is a firm. And they were, then, negatively surprised when, under pressure, Korean firms reacted differently from Western firms.

The third chink in the armor was the tremendous growth of asset sales and production of the *chaebols*. That, in fact, meant that Korean firms grew, on the one hand, “too big to rescue” and, on the other hand, “too big to let fail.” So, this imposed the last blow upon the old social contract. The way this became evident is, first, the failure of Hanbo Steel in 1996, which the government pressured banks to try and rescue and which ate up liquidity of both the banking system and the foreign exchange reserves of the country.

The second manifestation was that about 8 of the 30 largest *chaebols* failed. That is, they went into bankruptcy and restructuring at the beginning of 1997. Still, it was not really understood that this was a death toll of the old social contract until the financial crisis started. In an effort to improve their operating surplus, since Korean banks were limited both by ceiling rates on loans and lower limits on their demand deposits, and spread was extremely small – it was of the order of 1% which we know from western banks is really not sufficient to continue their operating in a solvent manner – banks turned to foreign borrowing because world interest rates were below domestic interest rates. And for reasons of their own, foreign banks were very eager to lend to Korean banks. Then, they took short-term loans from foreign sources, converted them into long-term loans to Korean corporations and, thereby, increase their illiquidity of the banking system.

The whole package came down as a result of Thailand’ s problem. They had to borrow as foreign borrowing and foreign capital started being worried about the Korean financial and corporate structure and started fleeing the country. And, I will not repeat the rest of the story, but the moral is that restructuring of the social contract of the banking system is required by the imperatives of the impossibility theorem. This is the point at which Korea finds itself, now. And in the interest of making its operations, that is, its institutional structure more consistent with the global institutional structure, it is clearly opting for the Western solution of the impossibility theorem. But, in order to make it consistent with Confucian values, the President has embarked upon a concerted effort to mitigate the harsh effects of the Western solution upon its victims, who are the unemployed, the unemployable and the otherwise ill-equipped to be participants in the current kind of economy.

I should express my admiration for the choices and approaches, which the President is urging upon the Korean society and people. It is based not only on good values, but it is also based on good economics. Perhaps, a surprise since communitarian values and good economics usually conflict. The approach is based on the realization that there are two kinds of poor at any point in time. On the one hand, you have, what I would call, the demographically poor – people who are too young, too old, people who are chronically disabled, people who are disabled because of industrial and other accidents, and single heads of households who have too little labor power in order to earn a adequate living. That’ s one class. The other class of poor are the unemployed and those who possess very low levels of marketable skills or who’ s levels of marketable skills have been rendered obsolete by the changes in patterns of demand.

The President is proposing to address those people by heavy investment in education and retraining, which is the proper response. The reason I say it’ s a proper response is because transfers have to be continued, forever, if they are mere transfers, while the fruits of investment in the development of the human capital of those who would like to work, but can not earn sufficiently high level of income continue into the future, if the investment is made once.

We are now coming to the realization of this in some of the industrial economies, in particular, the United States and, to a lesser extent, although my chairman may contradict me, Great Britain, in which there are movements to convert welfare into workfare. In the U.S., I was shocked in 1980 to read in the 1980 census that 26% of high school kids were the children of third generation welfare recipients. What this meant was that an underclass of seriously disadvantaged poor had developed without work habits, without appropriate role models, without any hope of acquiring marketable skill and working their way out of their status.

The reason this is relevant to the Korean approach is because the Korean choice will avoid the formation of that permanent underclass by investing in, what in the West we call workfare, and here it's called productive welfare, from the very beginning. So, you don't form this culture of poverty, alienation, desperation and inter-generational transmission of a disadvantaged status.

Meghnad Desai
Professor
London School of Economics

I would like to thank all my speakers, in particular, Dr. Adelman because she's brought together the financial and corporate and labor market issues, which Korea faces. But I think, as we have emphasized throughout this session, these problems are common to all countries of APEC. While the solutions will be slightly different, eventually, as Professor Adelman said, there are impossibilities here and some there. And you can not wish them away by just writing a check. Those checks bounce.

2. Reducing the Knowledge Gap through Regional Cooperation : Cyber Education, Human Resource Development and the Transfer of Technology

Peter Sullivan
Vice President
Asian Development Bank

Thank you very much.

Distinguished guests, ladies and gentlemen.

I am very delighted to have the opportunity to represent the Asian Development Bank and to participate in this very important and timely forum. I' m also delighted to be back here in Seoul where Korea is an active and important member of the Asian Development Bank. I recall a visit to Korea about a little over two years ago and the meeting held in this very hotel in early December 1997, when ADB participated with the World Bank and the IMF in the IMF-led rescue package. At that time, the ADB made our largest loan ever, 4 billion dollars, to Korea for financial sector reform. I' m ver delighted that little over two years later, I can come back to Korea where the economy has recovered so rapid and so successfully to a point where the substantial portion of that loan was no longer required, was not drawn down by Korea and, in fact, was cancelled at Korea' s request. We, at the ADB, are again finding ourselves looking to Korea as a strong supporter of the ADB' s work.

Today' s session, this morning, is "Reducing the Knowledge Gap through Regional Cooperation: Cyber Education, Human Resource Development and the Transfer of Technology.

President Kim Dae-jung noted in his opening address to us yesterday that the new millennium heralds in age of globalization, digitalization and knowledge-based economies. But he also noted that knowledge and information gaps between the industrialized and developing economies can spur conflicts and disputes by widening the existing wealth disparities among nations. And he noted that the communications demands of some 90% of the world' s population are not being met.

How can we ensure the developing countries participate in and benefit from the information age? This is a matter that can and should be addressed through strengthened cooperation among the APEC economies.

The themes which are identified for this session's discussion – human resource development, the transfer of technology and cyber education – can all play important roles in addressing the widening knowledge gap and ensuring the mutual prosperity of the APEC economies. Development of human resources can contribute to the achievement of such fundamental objectives as the reduction of poverty, the expansion of employment opportunities and the widening of access to education. The transfer of technology offers vast potential for strengthening mutual prosperity across the region. And cyber education, through the internet and other networks, offers an enormously effective way of sharing information and knowledge.

To address these issues and others, we are very fortunate to have a very distinguished panel of international experts across a wide range of disciplines, nationalities and approaches. And this diversity, I think, is clearly reflected in the presentations which we will hear this morning.

So, without further due, let me introduce our first speaker, though in fact, he hardly needs an introduction. Alvin Toffler has been giving advanced information and sharing powerful new ideas for many years. As early as the 1960s, he was predicting quite correctly the explosive rise of the computer, cable TV and the internet. He's been an advisor to CEOs, heads of states and senior financial leaders. His books, where he collaborates with his wife Heidi who is a contributor to all of these efforts, include *Future Shock*, *The Third Wave*, *Powershift* and, most recently, *Creating a New Civilization*. They're widely read and well-known. Among honors, he has received the McKinsey Foundation Book Award for contributions to management literature. I think we're all looking forward to hearing his thoughts on where we are heading in the 21st century.

Alvin Toffler
Futurist
Toffler Associates

Good Morning. I want to thank APEC for inviting me, giving me the opportunity to meet with you today. I'm not going to speak about the entire picture of panorama of change, technological and economic, but focus a little more closely this morning on education, as the organizers have asked me to do.

Today, there is a widespread recognition that education and knowledge are fundamental to economic advance, that human resources are the most important resources that we have. This was not true 30 or 40 years ago. In conventions and meeting like this, education received much less attention. But, today, there is a greater appreciation of its importance. Even the most backward analysts, today, are coming to understand that the most resource of the economy of the future is not oil or steel or rubber, but knowledge – the knowledge that permits us to transform these other resources into forms that we, as human beings desire – and that the most important form of labor is not, any longer, repetitive muscle work, but innovative mental activity.

Every politician in every country, now, claims to be an education reformer. But what kind of education? And for whom? And, is reform what we need? I would argue that what we need is not reform, but, in fact, revolution in education, that the fundamental concepts on which most of our education systems are based are now increasingly inappropriate for the world that we're about to enter.

Let me start by saying that all education, whether we stop to think about it or not, is based on an image of the future. When our children ask us "why do I have to study Algebra?" or "why do I have to study this or that?", parents usually answer "because it will help you in the future." And the assumption is that we know what that future requires. I would argue that most of our education activity today, and in the case of the rich countries involving hundreds of billions, perhaps, trillions of dollars, is education pointed at the past, instead of the future.

I often think of a hypothetical village, a village that has existed on the edge of a river for thousands of years. And, in that village, the young people are educated by their parents and their families. The village is completely dependent on the river. From the river, they get fish. From the dampness of the soil, they grow certain kinds of crops. Everything in their life revolves around the river. And for thousands of years, generation after generation, the parents have taught their children how to survive and to funtion in this environment.

Now imagine that five hundred miles away, upstream, unbeknownst to the people in the village, somebody is building a dam. And the dam is going to change and close off that river. What happens to the education that those children are receiving from their parents? If the education they're receiving from their parents is the same, which is how to live on the river, then they're going to be preparing their children for a future that does not exist. The river isn't going to be there.

I believe that that expresses exactly the situation that many of our countries are now in. One way to think about education is to ask ourselves how has it differed in different kinds of economies and societies.

Many of you may be familiar with the terminology that my wife and I use. We talk about the first great wave of change being the agricultural revolution. That changed the human race from nomadic tribal populations into essentially peasant-based agricultural economies. And it doesn't matter whether in Asia or Europe or anywhere in the world. Labor was backbreaking and very hard. Productivity was very low. The family usually worked together in the fields as a team, a production unit, so to speak. The children worked from a very early age, right along with the parents. A very low value was placed on formal education. Later on, we began to develop schools, but the family placed a relatively low value on education, especially for girls. Where there were schools, the teachers tended to be poorly trained and lacking the most essential tools – pencils and papers, even.

The dream of ministers of education and of governments was to transform that into "modern" education. I put the word modern in quotation marks because modern does not mean advanced. It means industrial, industrialized. The dream was to create a "modern" school that looked like the schools in industrialized countries when the second wave of change arrived with the industrial revolution 300 years ago or so and began to transform Europe, North America and parts of Asia, and industrialize. We changed from a peasant-based culture, civilization and economy to an urban industrial way of life. With tat came fundamental change in the nature of education.

If you look at the education that now exists in most of the industrialized countries – what I would call "countries of the second wave" as distinct from advanced economies – what we find are schools that essentially operate like the economy itself. An economy in industrial societies – what we used to call "modern" – was essentially based on mass production, mass distribution, mass consumption, mass media, mass recreation, mass sports, mass weapons of mass destruction and mass education. We developed schools that operated very much like factories. The children were tested going in, they did routine and repetitive work all day long, and at the end of a certain period of time, they were ejected from the system. They had now been completed, their education was complete. They were produced like toothpaste or sausages through a system that was designed to prepare them for the future. And, in fact, that system did prepare them for the future because, if you look beneath the formal curriculum – the curriculum could be mathematics or it could be history or it could be language or whatever – if you look underneath that overt curriculum, there is a hidden covert curriculum. And that's true in every education system. The covert curriculum in the industrial world was show up on time. Punctuality was very important. So children march when the bell rings. They go from class to class as the bell rings. Why is that? Because in the factory, punctuality is extremely important. In the agricultural world, if somebody shows up late to the field 10 minutes late, the family can still be working. But, on an assembly line, if you're 10 minutes late, you disrupt everybody else's work. So, punctuality became very important and all the schools began to emphasize punctuality. What kind of work were you going to do if you grew up to be a factory worker? You're going to do rote and repetitive work, the same job over and over and over again. So, for many students, work consisted of ten or fifteen or more years of doing rote and repetitive work, preparing them accurately for the kind of world that they would inhabit later on.

As far as authority and obedience is concerned, what kind of workforce do you want in a factory? I worked in a factory for many years with my hands. My bosses did not want me to think. They just wanted my muscles. That's all they wanted. They didn't like it that I had a book in my back pocket. The fact of the matter is what we wanted were large, uniform, disciplined industrial workforces that did rote and repetitive work and did not ask too many questions. And that is the kind of education that we produce.

In schools, children learn not to ask certain questions. And the smartest children are the first to learn which questions not to ask. In fact, what we were doing was assimilating the future for these children. We were creating a little world in the school that represented the larger world that they were going to go into. And in that larger world, children were segregated by age. They marched in walk step. The schools emphasized the basic industrial principles of standardization, synchronization, specialization, maximization. Big schools were thought to be very efficient – economies of scale. Large bureaucratic ministries developed to guide all this. And the hope was to get rid of the little school house and to create large scale mass education systems.

I'm critical of this. But at the same time, it was, in many countries, a very powerful, advanced and good system. It did prepare kids for the appropriate future and it also democratized kids because kids from different classes might mingle in the same classroom and so on. So, I don't want to leave the impression that the mass education system was somehow evil. The question is, is it still appropriate? Is this the model for education for tomorrow's world?

Well, we know. We started by saying, and other speakers have talked about the emerging of a knowledge-based economy, an advanced economy of the future in which knowledge becomes the most important factor of production. All of us who studied economics have been told that the factors of production are land, labor and capital. If that's what your book still says, throw it out. That book is obsolete because, if it doesn't mention knowledge, it is ignoring the most important factor of production. If you have the right knowledge and the right hedge at the right time in the right place, you need less land, less labor, less capital, less time, less energy and less of all the other resources that are required to produce a unit of production. Knowledge, therefore, is the primary factor of production in the economy that we're moving into.

What does that mean in terms of work and the kinds of work we're going to expect today's children to do in that third wave, knowledge-based economy of the future? The requirement are quite different from those of an industrial, second wave economy. We don't want children who don't ask questions. We don't want children who go to grow up to do rote and repetitive work. Machines can do rote and repetitive work. We don't want just blind obedience and stupidity. What we want is questioning people, thinking people.

Work changes. The work system of a new economy has ten characteristics that are fundamentally different from the characteristics of industrial, second wave, so-called "modern" society. To modernize is to go backwards today. We're going beyond the modern. And, in the new economy, the third wave economy, there are these ten differences in how people work.

First of all, the work shifts from muscle to mental. We use our brains more and our mouths and our ideas and our relationships and our language and our culture much more importantly than we use our muscles.

Second, in a second wave factory system, work is basically interchangeable. When I worked on the automobile assembly line making automobiles, if I died, I could be replaced by somebody in two minutes because it required very little skill. And it required very little participation with anybody else. I just participated with a machine. And, if I died, somebody else could do that. So, work was basically interchangeable in large factories with thousands of workers doing that kind of work

What is happening now, as we move to the more advanced economy, is work becomes less interchangeable. It is more diversified and more specialized. There's a greater division of labor. There's more team processes. And the consequence of that is we're moving from interchangeable labor to non-interchangeable labor. We're more difficult to interchange.

Third, in an industrial society, work takes place in the factory or in the office. In our emergent advanced economy, our third wave economy, work takes place anyplace, anytime. It's moving out of the factory, out of the office. When we wrote 20 years ago in the book *Third Wave* that people would be working at home, all of main stream media laughed at us. New York Times had an article on page one, making fun of that suggestion. They said that Toffler's just a visionary. And the *Economist*, even a few years ago, was still making fun of this idea. But, in fact, more and more people are working at home. In the U.S., probably somewhere between 20 and 30 million people – that's almost a third of the workforce – does some or all of its work at home. And 13% or 15% at households have businesses in them. That's a fundamental change. We also work, as we're doing right now – in hotels, in restaurants, on airplanes, in taxi cabs. We're working anyplace, anytime. Work moves out of the factory and the office.

Fourth, what do we want from those workers? Do we want workers who just follow orders or do we want workers who innovate? Because of hyper-competition, even at the global level, the pressure is on for companies to constantly innovate, not only new products and new services, but new ways of delivering them, new kinds of relationships, new organizational structures, new everything. And innovation becomes a central requirement for the success of the enterprise. And therefore, increasingly, we want innovative workers – workers who can think, who can make suggestions for better ways to do things. That's the opposite of what we wanted when I worked in a factory.

In the old system, wage work was the dominant model. Everybody had a job. They had certain hours. They were paid by the hour or by the output. We're moving increasingly toward a different system in which many workers are essentially entrepreneurs – contractors, selling their labor individually to the enterprise and operating, as we say, as free agents – sometimes because they have to, many times because they want to. That is a different way of life. And many workers, now, in the emergent economy depend not just on an income. The income from their job may be less but there may be multiple revenue streams – money from a sideline business, money from an investment, money from a pension fund or what have you – so that the dependency on the particular job for the entire income changes.

What about careers? In the second wave economy, if you got a job, the assumption was you would continue in that career for your entire working life. And pretty much, you would stay with the same company. But even if you didn't stay with the same company, you would do the same work. So, if you were a lawyer, you didn't go to the Asian Development Bank and do something else. If you were an accountant, you stayed with the firm, year after year, decade after decade, and then you got your gold watch and you retired. In fact, we now know that in the new society, people continually change their jobs and their careers. Even if they stay in the same company, they are doing different kinds of work because the work, itself, is changing as the economy changes.

What about organizations? When we went to work for a giant insurance company in the 1920s or 1950s, you found an organizational structure. And that organizational structure was, more or less, permanent. So, you knew who the boss was, you knew who was the assistant boss, you knew which department did what. Everything was fixed, stable and more or less permanent, organizationally. Now, what is the situation? The organization is in continual change. Everyday, there's a re-organization. Everyday, there are new relationships required, not just between organizational units, but between the people in those organizational units. So the firm is now a dynamic, continually changing organism. It's changing its shape, its form all the time. That's a different environment for the worker.

And, of course, the products are changing and the services are changing. You learn to produce product A and, just as soon as you're finished producing product A, in fact, before you were finished producing product A, you're already preparing to produce product B, C, D, E. And, as a result, there is constant change in the skills that are required. What are the skills that will be required by your economy in 10 years or in 20 years? They will not be the same skill set that are now required.

And, finally, there is the idea in this old, more or less, static or stable second wave economy that you learned at the beginning of your life and what you learned would last you. You can just continue to reuse that information as long as you lived, as long as you worked. And, now, we know you need life-long learning. You've got to continue to relearn, So, the requirement of the labor force of the emergent economy are dramatically different from the requirements in an industrial, second wave economy. We need, of course, people who can read, people who can do some math. But we also need people who are literate – computer literate and media literate, who can understand when they're seeing something on television, how that has been manipulated, who is sending what message to whom, and what effect the different media have. Media literacy is extremely important.

And the education has to be targeted towards each student. Each student is different. They're not just standardized units in a mass production education system. We have to focus the education on the individual student. Now, strangely enough, what are we doing in manufacturing? We're moving toward customization, customized production. What are we doing in the marketplace? We're moving toward customized markets, what we call de-massified markets. What's happening in the media? Turn on your internet. You get personalized streams of information. So, at every level, the system is moving away from mass toward de-massified, from mass to individual. And the same thing is true in the workplace.

And what about thinking? Do we want just the skill to memorize? This is a major problem for some languages that's very complex and require enormous amount of memorization. But, what we want goes far beyond memorizing our mathematics or our history or whatever. We now need people who don't just memorize and repeat. Databases can do that. We can use databases to store a lot of the repetitive information.

What we need are people who can solve problems. We need to teach about models. how to think in terms of models. We need, as I said, innovation. We need to break down the disciplines because we new discovered, inside the individual company, it used to be "here was the marketing department, here was the financial department, they were the engineers and they were the manufacturing department." And they didn't have to talk to each other very much. We're now spending billions of dollars to put information technology systems in that permit them to talk to each other, to talk up and down the hierarchy without going through all the steps, and to cross information from department to department, because for the marketing people to do their job, they need to know what the engineers are doing. The engineers need to know what the marketing people are doing. And they all need to know what's happening in finance. And what's happening is that, inside the company, there is a breakdown of what used to be the corporate equivalent of academic disciplines – the discipline of marketing, the discipline of engineering and so on. And we're going to see in academia and in education, the need to break down the walls between the disciplines. People have been talking about this for many years. On the other hand, universities and schools don't change very easily. And one of the thing they hate to change is the disciplinary barriers inside.

But, if we want an education system that parallels the requirements of an economy, you have to break down the disciplines, as well. And, in fact, we may be moving toward a world in which there are problems, not disciplines, in which all disciplines are merged to solve a particular problem.

The system is becoming life-long, fast, globalized that we need new ways to measure learning and, above all, new ways to learn. And, as I have often said on other occasions, the real illiterate of the 21st century won't be he or she who can not read or write, but he or she who can not learn, unlearn and relearn. So, this is a completely different set of requirements for education. That means we need to change the system.

By the way, I am not suggesting here that all education is just for economic purposes. There's a lot of education necessary to help make people human. And I, myself, am a product not of economics or science or technology, but of the humanities and literature and so on. So, I am not suggesting that the only thing an education system has to do is provide a workforce. It does other things. But, it also has to provide a workforce.

So, we need to change the system. And what do we find? We find enormous resistance to change. In the first wave agrarian society, typically, the family was an obstacle to change. They needed the kids to do the work. They still do in many poor parts of the world. They need the kids to do the work. They can't spare them to go to a school. They're afraid. And especially, the girls are deprived of education.

But, in the second wave, so-called "modern" society, there is equally or even greater oppositions to change – teacher's unions. Do teachers need unions? Maybe the do, maybe they don't. But, the fact is that in country after country after country, form the United States to Bolivia, from Bolivia to Japan, teacher's unions are filled with bureaucracies and that the ministries of education have been powerful obstacles to change. And I'll talk about my own country because that's the one I know best. In the U.S., politicians, again, talk about the need to reform. But, they, particularly the Democratic party, also need the votes of 2 million teachers, who are civil servants. And those teachers want change, but only those changes that guarantee that their position remains unchanged. Now, that's not possible.

Today, we are in an era of ferment and we're seeing the beginnings of a great may experiments. Not all of the experiments are going to succeed. We do not have a perfect model for the third wave education system. But, we see change. Singapore, as you know, is experimenting with "how do you teach or create or encourage innovation?" In Costa Rica, a little country in the middle of Central America, at the Universidad Latina, each classroom has a 42 inch Fujitsu plasma screen and 2,000 students have access to the internet though an ISDN line. And the school's goal is to have interactive video conferencing for all its students at anytime.

In the U.S., there are experiments with school vouchers. Some of you may or may not know what a voucher is. Instead of money to the school, you give money to the parents in the form of a voucher. And the parents can spend that. They can buy education with that voucher at whatever school they think is the best one in their vicinity. The public schools do not like that. But that is intended to promote innovation and competition in the public school themselves. Some American school districts are outsourcing education. They're actually calling in a business. There are businesses that do education. And they're saying, "We can't teach these kids well. We'll hire you. Teach them." There are may experiment with this in different parts of the country. In addition, the New York Times reports that approximately one million U.S. kids are, now, formally being educated at home by their parents. Bear in mind there now is probably a computer in every one or, at least, half of those homes.

In addition to all of these, we have many ventures in cyber education. Recently, just a week ago, a software billionaire in the United States announced that he would contribute a hundred million dollars to start a free university on the net, open to anyone in the world. Jonesknowledge.com, which is a company in Colorado, on whose board I happen to serve, was the first entirely on-line international university to become fully accredited by education authorities. It focuses primarily on business education. Also targeted at business education is the University of Phoenix. The University of Phoenix only accepts students over the age of 23, who have work experience. It has 13 campuses, – this is a profit making enterprise – 55,000 students who attend face-to-face classes and 10,000 who take courses on-line. Other internet-based schools are proliferating very rapidly.

Another report describes Knowledge Universe, a company assembled by three leading billionaires – Michael Milken; Larry Ellison, the founder of Oracle software; and Rupent Murdock. Together, they' ve created a company which makes toys that help children learn. It has a daycare company. It also helps teach and use technology more effectively and so on and so forth.

There are many experiments now just beginning on how do we use these new capabilities. Around the world, we hear rising concern about the digital divide. Se don' t have time to discuss that right this moment, but I used to be much more pessimistic about the digital divide than I am today. I believe there are several things happening that are going to narrow the digital divide significantly.

And so, what I would leave you with is that we are at the edge of a fundamental revolution in models of education, in the types of education, and that what we need in order to redefine and reconceptualize our schools is, just like those people in the village, an image of the future. We need to ask ourselves, "what does the future require of kids we' re now moving through the system?" And we need to be conscious of these changes that the new economy requires. And until we do that, until we can decide what we think the future – nobody knows the future for sure, of course not – but unless we have some coherent image of the future that we think makes sense or, at least temporarily makes sense, our efforts to reform education will, I believe, fail.

Peter Sullivan

Vice President
Asian Development Bank

Thank you very much Dr. Toffler for a very stimulating view of the education needs for tomorrow's workplace, tomorrow's labor requirements in a knowledge-based future. It's very difficult to cut you off and I apologize. I think we could have listened for another half hour to your thoughts and ideas or more. We only have about 35 minutes left, so I'll have to ask other speakers, if they can, to try to keep their speeches relatively short.

Our next speaker is the Vice Minister of Finance of Vietnam, Dr. Le Thi Bang Tam. Dr. Tam has previously served as Director and Deputy Director of the State Treasury and as an expert in the State Budget Department among other government positions. She has also taught at the Hanoi Finance and Account University. I believe she will try to address some of the questions of equality and bridging of the information gap, as well as timing of economic liberalization.

Le Thi Bang Tam
Vice Minister of Finance
Vietnam

Distinguished speaker.
Ladies and gentlemen,

First of all, I would like to thank the Government of the Republic of Korea for hosting this meaningful event and giving me a chance to speak today. I do believe that with its underlying practical perspectives, the Forum "Shared prosperity and harmony' will play a significant role in furthering both bilateral and multilateral cooperation among economies in APEC, in particular, and all over the world at large.

We have been observing a brighter and brighter global economic picture as the US economy adheres to a record high growth rate, the EU economy sustains its stable development, and particularly, the Asian economies steadily recover and regain their momentum for growth. Taking this opportunity, I would also like to convey my admiration to the Government of the Republic of Korea for its efforts in leading the country out of the crisis and into a period of remarkable high growth rate. However, there are still concerns on how to sustain growth and stability in the world economy and thus the global economic development on the basis of “Shared prosperity and harmony” is somewhat of great interest.

Ladies and gentlemen,

In 1999, Vietnam was significantly affected by the financial crisis. The actual GDP growth rate was down to about 5% comparing with 8-10% in the period of 1990 - 1997. The CPI was at the lowest level due to the deflation. The state administration expenditures had to reduce by 10% in order to spend more for hunger elimination and poverty reduction. The banking sector was in a difficult situation.

To overcome these difficulties, in year 2000, our government is determined in continuing the economic reform with the following targets:

- The GDP growth rate about 5.5% - 6%
- Export growth rate about 11.5% - 12%
- Reducing the ratio of poor households to about 10 – 11%
- Job creation for about 1 million labors.

In order to reach these targets, Vietnam plans to implement the five following measures:

Firstly, creating favorable conditions and more effectively support production and business sectors, completing the comprehensive legal framework and taking appropriate policy measures to support economic sectors.

Secondly, liberalizing markets and actively participating in international integration process by continuing to issue regulations for opening securities market, operating the real estate market, developing further the labor market, etc. Continuing Vietnam’s participation in AFTA, APEC, and negotiating new bilateral trade agreements and Vietnam’s accession to the WTO.

Thirdly, improving the investment efficiency by effective implementation of the institutional and policy reform, restructuring capital investment by the State and implementing reforms in credit policies …

Fourthly, continuing reform and realignment of banking and financial system and state own enterprises to improve the efficiency. Implementing debt restructuring by setting up debt trading companies.

Finally, addressing imperative social issues such as hunger elimination and poverty reduction, job creation.

Ladies and gentlemen,

Reducing the knowledge and economic gap in the liberalization through regional cooperation is an important component to sustain the global economic development in the future. Within the framework of my address today, I would be very pleased to share with you some thoughts over the two following issues:

Firstly, further liberalization should come along with paying more attention to the equality issue and putting more efforts to bridge the gap among economies at different development levels.

In practice, there have been various approaches to this issue on the international arenas, say, the discussions, which have been carried out within the frameworks of the WTO and APEC.

The WTO and its predecessor, GATT, has been considered as a proactive tool in moving forward the global trade liberalization. The equality among economies at different development levels has been touched on, and best reflected in its "Special and different treatment" provision. However, these provision has become seemingly blurred when applied for the past few years. Happenings and results of the Seattle Meeting and different viewpoints of economies on discussed topics have mirrored an unsatisfactory solution for this issue.

In comparison with the WTO, APEC approaches the issue in a different way as it offers more flexibility to member economies in undertaking commitments commensurate with the economic development level of each member. This approach is reflected in principle *voluntary*, ensuring every member economy feasible and affordable liberalization. Besides, CAP and ECOTECH models focusing on cooperation in science and technology, economic research, human resource development and etc. have contributed to bridging the knowledge gap among member economies and extended technical assistance toward relatively underdeveloped economies.

In the context of increasingly polarized development levels in the world economy, I believe that APEC has chosen an appropriate and flexible approach. We, APEC economies, should focus more efforts on this equity aspect to ensure that the liberalization be carried out while taking into consideration of different development levels of member economies and not go against the interests of poor economies.

Keeping that in mind, APEC should continue its efforts in establishing forums to seek solutions for the interests of developing economies, particularly poor ones, in order to help those economies take their advantages, keep pace with the global economic development and liberalization as well as prevent increasing poverty and hunger. Developing economies need assistance from developed economies to participate fully and equally in international economic relations.

I wish that APEC economies encourage bilateral and multilateral assistance programs to help developing economies carry out their national programs on poverty alleviation and hunger reduction in order to bridge the knowledge and development differences among economies to create a foundation for peace, stability and sustained development.

I also welcome the intention of enlarging membership of G20 to include more developing country members so that the developing world will be better represented and their interests will be better looked after.

Secondly, liberalization should be used as a vehicle to obtain economic recovery after crisis as well as to prevent recurrence of the crisis in the future.

Trade and investment liberalization is an important instrument to achieve higher production and distribution efficiency through more rational labor division and resource allocation. Based on the increased efficiency, global as well as individual economy shall strengthen its economic fundamentals.

At the same time, trade and investment liberalization will also foster regional and global links, establish mutual assistance and help the quicker recovery after crisis.

However, too hasty trade and investment liberalization with underdeveloped domestic institutional and legal frameworks can eventually cause a crisis itself. Several APEC economies have learned lessons from the recent crisis and I hope that this sad history will never happen again.

Mindful of those findings, I would like to call for more APEC's efforts in moving forwards programs of exchange of practical and technical experience concerning institutional and legal framework development in the liberalization, particularly the prudential regulations necessary for effective and well-secured liberalization.

Ladies and Gentlemen,

I hope that the compendium of opinions over the issues discussed under this Forum will serve as initial points for possible formation of certain cooperation programs under APEC in the future.

Once more, I would like to commend the initiative of forming Forum "Shared prosperity and harmony" and with a great success for the Forum.

Thank you very much for your attention.

Peter Sullivan
Vice President
Asian Development Bank

Thank you very much Dr. Tam. Dr. Tam has raised fundamental issues of equality inherent in the knowledge gap and the need to link investment to liberalization with appropriate levels of domestic institutional and legal frameworks. She's also encouraged APEC to take efforts to provide programs for the exchange of experiences to help develop these appropriate institutional and legal frameworks.

Our next speaker, the distinguished Minister of Education of the Republic of Korea, Dr. Yong Lin Moon, will perhaps be able to respond to Dr. Tam's suggestions by offering strategies to reduce the knowledge gap in the APEC region. Dr. Moon is a distinguished author and educator, who has played a major role in developing Korea's education policy. He has served as Professor of Seoul National University and been a member of the Presidential commissions for the New Education Community on Education Reform and on Policy Planning, among others.

Yong Lin Moon
Minister of Education
Republic of Korea

Thank you, Mr. Peter Sullivan.

Honorable Ministers, Distinguished guests, ladies and gentlemen:

The new millennium, characterized by revolutionary changes in information technology and its impact on our knowledge-based economy, demands a paradigm shift in ways of managing government, industry, and other sectors of our society. We have entered a new era where the resources we value most differ radically from those of the industrial era. Previously, land, labor and capital were the main factors that created economic wealth. Now, most valued resources in the digital age are knowledge and information. These new factors will affect the way we do things in the workplace and at home.

At the dawn of the new millennium, we have great hope and also concern for change. With the advancement of science and technology, mankind will enjoy a higher standard of living and an improved quality of life as cutting-edge information and communications technology brings about great changes in every sector of society. For example, in Korea, the number of mobile phone subscribers now outnumber the users of wire-line service. Also, access to Internet information in schools, offices and at home is increasing at a fast rate.

In view of these developments, the leading economies are placing the highest priority on educating their people to be better equipped to work in the knowledge-based economy. There is a consensus that knowledge is the most important factor in a nation's economic development. The capacity to acquire, to create and, and to utilize new knowledge and information is a key element in developing economies in this new century.

We need to devote a great deal of resources and planning to develop and maximize the potential of human capital. We also need to address a number of key issues and make changes in the education sector to meet the challenges of the 21st century. As all of us work together, we can meet and exceed the demands and challenges that are before us now.

In understanding these challenges, the concern we face is the widening knowledge gap between rich, industrialized countries and poorer, developing countries. Developed countries possess the capacity to create and utilize knowledge and information, while the developing countries have limited access to this knowledge and information and an even more limited capacity to create their own knowledge base. Without the implementation of effective global policies, the knowledge gap between advanced and developing countries will continue to broaden. This knowledge gap may threaten the well-being of many countries, affecting the security of the global community as a whole.

During the fall of September of 1999, APEC leaders met in Auckland, New Zealand. Along with other concerns, the APEC leaders met to address the widening knowledge gap between the rich, developed countries and poorer developing countries brought about by the IT revolution.

Ladies and gentlemen,

The time has come for us, as members of APEC, to address the knowledge gap seriously and make a concrete plan to narrow the knowledge gap. The topic of this forum "APEC Shared Prosperity and Harmony" refers to the role that all the economies across this region should play in encouraging economic growth and improving the quality of living for all people in the Asia-Pacific region. We should cooperate together to expand educational opportunities by using advanced technology which will bring success for a more prosperous future of our global community.

Therefore, I challenge you to initiate action plans through the APEC process that will reduce the knowledge gap by mobilizing all possible resources to reduce technological imbalance and any other problematic areas of concern. This is the very reason why we are here together.

Since its inception in 1989, APEC has built up positive cooperation between member economies. In the 1991 Seoul APEC Declaration, member economies agreed upon "enhancing the positive gains that will be experienced, both for the region and the world economy, by increasing economic interdependence, that encourages the flow of goods, services, capital, and technology."

Based on this agreement, the APEC member economies have initiated many projects for creating, sharing, and utilizing new knowledge, information and skills through ministerial meetings, working group meetings, education forums, and the APEC Study Center, to name a few.

Collaborative efforts were mainly centered around solving common problems that most members experienced in the areas of education, training and labor market management. From the inception of APEC, Korea has played an active role in these types of programs. For example, during the last Senior Officials Meeting in Brunei last February, Korea initiated a task force on the knowledge-based economy in the ECOTECH sub committee.

Through these efforts, APEC made some progress in closing the knowledge gap. However, we must take further steps in this regard. We must be very specific and more practical when devising strategies to close the knowledge gap. Due to the rapid development of information and communication technology, there has been many changes in the education sector. Cyber learning is a new mode of education that will help to enhance the learning process with formidable speed and convenience. Much of this can be seen in the increasing use of the Internet in the classrooms of the advanced economies. Naturally, developing countries will also aspire to participate in such advances.

E-education is one of the most urgent areas demanding attention. By educating and empowering their people with e-education, the member economies will be able to disseminate a higher level of skills to all sectors of society. The result will, then be a synergy between people and knowledge that will spur on economic development and the strengthening of national competitiveness.

From this point of view, President Kim, Dae-jung addressed this issue at the Auckland Leaders' meeting last year. He said that it is high time that the APEC launch an 'e-Education Project' to reduce the knowledge gap among member economies. The ultimate goal of the project is to alleviate social and economic disparities by developing human resources among member economies through educational cooperation. With this in mind, I would like to propose the launching of two e-education initiatives that will mobilize human resources, and financial and technical support from member countries. The basic principle of these initiatives is based on voluntary cooperation and participation by all economies involved. Active participation of all member economies will be essential for the successful implementation of the project. Also equally important is the openness and willingness to collaborate and to provide support by all the participating economies.

As a follow-up to the Leader’s initiatives, Korea would like to be an active participant in this effort. First, a volunteer service program, named 'APEC Internet Volunteers Program, will be organized to give technical assistance to the economies in need. This initiative aims to strengthen the capacity of recipient countries to utilize the Internet in order to have better access to the global stock of knowledge and information.

The new era has been characterized by the increasing participation by civic groups, NGO’s and universities in assisting developing countries. In Korea, a number of universities have very successfully engaged in assisting sister institutions in developing countries in the last several years in the area of computer and Internet skills. With this in mind, we will encourage universities to adopt sister educational institutions in the recipient countries for the purpose of transferring Internet and computer skills.

Specifically, universities from member countries will provide student volunteers who will be placed in the countries of their interest where they will serve as “IT experts.” The volunteers will teach the people in the recipient countries how to utilize the Internet to access global knowledge stock. Each of the volunteers will have attained a certain level of competency in computer and Internet skills, and English. It is advisable for the organizer of the program to give flexibility and freedom on the part of the volunteers and the participating institutions in the selection of service areas, countries, and duration of their service. It will be necessary to create mechanism for efficient coordination of these efforts. A related component of this project includes the provision of computer equipment. In principle, the cost needed to implement the Internet volunteer program will be borne by the countries where the volunteers originate. Finally, the range of the program involves a multi-year commitment by the participating institutions to ensure the continuous enhancement of the competence of recipient countries in the use of computers and the Internet.

Secondly, Korea proposes to launch an education initiative that will foster growth in the number of qualified IT experts. It is agreed that teachers are the critical success factors in education across the region. There is growing awareness of the need to revitalize the teachers' pre-service and in-service training programs. As the advancement of information and communication technology accelerates, teachers will have to take on new roles and acquire new skills to meet the challenges of the digital age. This program aims at empowering teachers capable of managing e-Education in member economies, and to improve teaching and learning methods through integrating information and communication technology in education.

This initiative will also include the networking of centers of excellence related to Information and Communications Technology and teacher training institutions to improve mutual understanding and cooperation among the member economies. These institutions will contribute training experts and teachers to acquire the necessary tools required for e-Education.

As a preliminary phase of the program, a survey may be needed to assess teachers' needs concerning the integration of information and communication technology in the training programs. As a result of the needs assessment, unique courseware may be developed to facilitate the teaching-learning process.

These two education initiatives, if systematically designed and implemented as intended, can contribute to the facilitation and sharing of knowledge to meet the needs of developing countries, and also create new knowledge and consolidating of the knowledge base. It is without a doubt that these actions will improve the quality of life and contribute substantially to the development of our global community. Ultimately, these actions will serve as a tool for closing the knowledge gap among the APEC economies.

Korea, together with the support and cooperation of other member economies, would like to develop specific action plans based on these two proposals on the 'e-Education Project.' We welcome your insightful advice and full cooperation. The Korean government will fully support and actively participate in other efforts to reduce the knowledge gap across the region. With all our joint efforts, we will create a future that forebodes an improved quality of life with peace and prosperity for all.

Thank you very much.

Peter Sullivan
Vice President
Asian Development Bank

Thank you very much, Mr. Minister. Like Alvin Toffler, Dr. Moon has pointed out the shift in resource values from land, labor and cpital to knowledge and information. He has challenged us to try to develop plans to reduce the knowledge gap that Dr. Tam has described. And he has discussed two specific initiatives, a volunteer service program and teacher train & networking of centers of excellence, picking up on themes which were presented by President Kim Dae-jung in his opening address yesterday. These proposals, I think, are quite exciting and, Mr. Minister, ADB would very much like to work with you on these proposals to see if we can find ways that ADB could assist in helping to realize them.

Our next panelist, according to the program, is World Bank President, James Wolfensohn. Before we hear from Mr. Wolfensohn, however, we are very fortunate to have the World Bank’s country director for Korea, Dr. Sri Ram Aiyer, with us this morning. Mr. Aiyer will give, very briefly, his views on Korea’s approach to the issues we are addressing this morning. And then, following his presentation, I will briefly introduce a video presentation by President Wolfensohn.

Sri Ram Aiyer
Country Director for Korea
World Bank

Thank you very much, Mr. Chairman.

Mr. Toffler, honorable ministers, distinguished participants in the APEC Forum on Shared Prosperity and Harmony, on behalf of the World Bank, I am pleased to introduce to this distinguished audience, a video presentation by our President, Jim Wolfensohn, about the opportunities and challenges of knowledge-based development. Mr. Wolfensohn decided to keep his presentation at the global level and focus on the digital divide. And, he asked me to share with this audience a complementary note to his speech, sharing with you the central message of a study on *Korea's Transition to a Knowledge-Based Economy* that the World Bank is preparing jointly with the OECD, because the message would be of interest to other APEC countries. The Bank is collaborating with the Korean Government on knowledge issues and this study is an input into the Government's strategy on knowledge development that is expected to be announced in the near future.

The Bank-OECD study emphasizes four elements of the challenge to develop a knowledge-based economy:

- Economic incentives and institutions that promote flexibility and entrepreneurship to create and make effective use of knowledge
- Educated, skilled and creative people
- A dynamic information infrastructure
- An effective national innovation system.

On the strategy and policy framework for meeting this challenge, the Bank-OECD study offers five main messages which we would like to share with you:

This first is that the role of government is different in a knowledge-based economy. It changes from an emphasis on direct government interventions to the provision of an enabling environment for private sector initiative and activity. The government's new role emphasizes:

- Unleashing the creative power of markets
- Providing the rule of law, transparency, information disclosure and accountability
- Providing other public goods to build the modern infrastructure of a knowledge-based economy such as intellectual property rights, valuation of intangible assets, cyber laws, etc.
- Addressing access and equity issues; and mitigating the risks of the digital divide.

The second message is that Korea needs to extend and deepen its international integration by:

- Tapping into global knowledge systems
- Further opening up to foreign trade and investment
- Linking with and drawing on global educational systems
- Achieving harmonization in information communication technologies
- Participating more actively in international fora and institutions such as WTO, WIPO, etc.

The third message is that the transition to a knowledge-based economy calls for a systemic approach to reform because of increased interactions among policies and actors across traditionally disparate areas of policymaking, and sectors. Enhancement of knowledge by spurring innovations and their dissemination throughout the economy requires a conducive overarching economic policy and institutional regime. These include, for example, policies promoting competition, a financial system that is sound and has the depth to respond to the financing needs of a dynamic economy generating viable new activities, and a flexible labor market.

The fourth message is human resource development is a fundamental enabler of a knowledge-based economy, in which Mr. Toffler spoke elequently about. The Korean educational system served the country well during the “catch-up” phase of industrialization, or modernization as he called it, but now needs radical reforms to:

- Emphasize skills and creativity that foster innovation
- Develop a system of life-long learning geared to the information age.

The fifth message is that implementation of these major, interlinked reforms to promote a knowledge economy requires a strategy with the following essential elements. And countries such as Canada, Finland, Ireland and Sweden have done very well in this area. These are:

- Buy-in from stakeholders and the population at large
- Coordination and setting of monitorable goals
- Evaluation and constant adjustment of public policy and institutional regimes
- Institutionalization of the process so that it spans successive elected governments.

Before closing, I would like to mention a recent experience in Korea. Training in internet use was offered under the Government's 'Cyber 21' program to mothers beginning on March 2, 2000. The goal was to train 1 million housewives in 18 months. The 20 hour, week long course was offered, at private computer schools, for 30,000 Won, while the normal fee would have been 100,000 Won. Enrollment in the first ten days exceeded all expectations, topping 70,000, and all computer schools taking part in and around Seoul are fully booked throughout July. The Government now expects to exceed the target within the first year.

Ladies and gentlemen.

The thirst for learning and for knowledge has been a hallmark of Korean society. It was a key ingredient in Korea's impressive economic achievements over the last forty years. It also promises to ease the transition of Korea to a knowledge-based economy.

Thank you very much.

Peter Sullivan
Vice President
Asian Development Bank

Thank you very much Dr. Aiyer and thank you for conveying so much information in such a relatively short time. We appreciate that as we are behind schedule.

Our next speaker is James Wolfensohn, the World Bank's 9th president. Before assuming his role as President of the World Bank, Mr. Wolfensohn had a very distinguished career, ranging from Australia fencing team to active interests in the arts, from legal practice in Australia to senior positions with major investment firms, including running his own international investment firm. As the World Bank president, he has been responsible for a wide range of programs from the first comprehensive debt reduction program to address the needs of the world's poorest countries to his recent Comprehensive Development Framework.

Ladies and gentlemen, in discussing cyber education, information technology and e-education as we are this morning, what better way to demonstrate the possible role electronic exchange of information than to do so with a speaker who's located half way around the world. So, with that, let me please introduce the video of President Wolfensohn.

James Wolfensohn
President
World Bank

I am very happy to be with you today and to participate in this meeting. I also remember with great enthusiasm, the speech that was made last November by President of Republic of Korea, Dae-jung Kim when he talked about productive welfare, when he addressed the recent challenges that had faced Korea and spoke particularly of the recovery and of the future. And in that, address of such enormous proportions that he pointed to the technological challenges that face not only his country but the region and the world. It's, therefore, very exciting for me to be able to participate in this third segment of your meetings, although I must tell you that I look with some hope and some nostalgia about the meetings that were held in the afternoon, I believe yesterday, on the new financial architecture for preventing the recurrence of economic crisis. There was a time when I used to get asked to participate in these discussions and so I feel rather modern now being invited to participate in a segment which addresses issues of technology.

But it is not surprising that one should move from issues of finance to issues of technology, when you are involved in an institution like the World Bank which is concerned with development. It is not just finance alone which brings about development, allows us together with the governments we serve to address the questions of poverty, it is in fact the whole mix of issues which come together to lead to effective programs that can affect the issues of the poor and nothing is more important as we think of the future, as thinking in terms of the impact of this remarkable revolution.

We look at it, of course, in a background of global population of six billion people, growing in the next 25 years to eight billion, with three billion today living under two dollars a day and 1.2 billion living under one dollar a day. But those statistics are known to you. But the more significant statistics for today, let me just mention to you, it is that half world's population has never made a phone call. But 90% of the internet hosts reside in high income countries with only 16%of the world's population. New York has more internet hosts than the whole of Africa. Finland has more hosts that the whole of Latin America and the Caribbean and perhaps most challenging of all that the OECD countries are estimated to invest a hundred and fifteen dollars per capita in modern information infrastructure when the rest of the world invests only $19.28 cents.

Now this presents a very significant challenge because we believe at our institution and I am sure all of you do that the key to the future in terms of peace and prosperity in our planet is the way in which poor people are able to be exposed to opportunities which they will grasp. It has been very clear to us for many years that poverty is an issue which is not faced by charity. This is an issue which President Kim very well understood in his address. Charity is not the issue. It is opportunity. It is the chance for people wherever they are to have access to knowledge and resources to allow them to make better lives for themselves and for their children. Our recent studies of 'Voices of the Poor' make it clear what people want is that opportunity and the key to that opportunity is, in fact, knowledge – knowledge that can allow people to grasp opportunities of which they learn through communication and information.

Now we have today the technology that can pass knowledge to everybody on this planet and what we have to do, of course, is to bring about partnerships between government, private sector, non-governmental organizations and institutions such as our own. To bring about systematic changes that can allow for the hardware and the framework in which knowledge can be transferred. It is not just a technical problem. The technology, of course, is changing but the technology already exists for the transfers of knowledge. What we have to understand as we approach this revolutionary age is that solutions will be found in a mix of public and private policies, a mix of institutional reaction, of regulation, of reform, of education, of setting an environment in which this enormously powerful technological development can be connected into a social movement that can affect the lives of people everywhere. It requires a comprehensive approach in the most real sense and it is to that focus that I believe this conference will be addressing much attention.

Certainly, we at our institution are not just knowledgeable in the areas of technology but we are reaching out to try and build ways in which we can extend our knowledge of technology to make it applicable to the issues of poverty and, may I say, to the issue of peace on our planet. ‘InfoDev,’ one of our creations is an institution which is not only originated in the market but which draws its strength from private sector and even some government participants who put together both knowledge and funding to allows to have innovative program throughout the developing world to support and sponsor those innovation who have ideas and commitments and to bring about new way in which knowledge can be transferred and used.

We also have a program that gets into schools, our so-called ’World Links’ program which is getting to more than 30 thousand teachers and students in more than 15 countries in the developing world linked to an ever greater member in the developed world when we living together students from one side of the world with the other teachers to try and have them learn together utilizing this technology. We have a program of the African virtual university in Africa. We have established a system which is a growing of global distance learning networks in which all established facilities where, whenever it is in the world, classrooms of thirty or forty people adjacent to another classroom where we have thirty or so computers. We link both with schools and with computers. People in those countries, with participants, partners, teachers, students, and other parts of the world, so that we can give effect to this exchange of knowledge.

And finally, we are working now on what we call a global gateway, which bring together public and private sectors to try and see how we can establish a mechanism in which we can all share in the knowledge and experience that each one of us has. With no dominating, but having a basis on which there can be a ready exchange information, views, best practices and knowledge in a way no one previously dreamed of. I was told just this week an example of India where a technology company put on the wall between its operations and the slums, a screen and a touch pad for people to use. They put up the camera to record what happened. There was no training, there was no one there to explain to anybody what this could be used. This was put on one of poorest streets in India. By the end of first day, children came to that facility and already had made contact with the Disney network. By the second day, they had broad range of access which the kids themselves had worked out what to do and, within a month, they were downloading material and preparing websites and you see from the films taken, it was not just adult but few adults. It was kids, fourteen, fifteen and sixteen coming along and they were bringing youngsters, five, six, seven and eight years old, putting them on the box and teaching them what is going on. The impact of this was quiet remarkable and they also set up in rural area and city area showing equal access of boys and girls. Children were teaching themselves. The power of this technology is quite remarkable.

Another colleague recently in Ethiopia who is addressing a group of Ethiopians about internet trading about the possibility of using a computer for e-business. Expecting that he would then have to explain basics. He asked the group, “Is there anyone who has known website?” and gentleman put up his hand. “I have website.” and he said, “What did you do with it?” and the man replied, “Well, there aren’t many hosts in my country. But, there are a lot of Ethiopian taxi drivers in New York, in Chicago and in Washington and they like to send goats and presents home to their families here in Ethiopia. So I opened up a website and I do business everyday with this group in United States and I sell goats on the web.

We don’t need to dot every i and cross every t in terms of use of information technology. What we need to do is to create environment in which knowledge experience and enthusiasm of younger people and of communities can take advantage of the new technology. This requires changes in policy, it requires openness, it requires trust in the people that we think to serve.

It is not a question in development of which should adapt to this new age. It’s only a question of when countries who do not cross this challenge will clearly pull back. Have they in their hands, a unprecedented opportunity to effect their lives of hundreds and millions people and franchise those people to help themselves. This is a part of dream of President Kim ‘s a part of dream which should encourage all of us and give us enthusiasms and all of us and give us enthusiasms confidence for the next century

I want to thank Peter Sullivan for moderating this session and I wish you very good discussion during after noon.

ANNEX

INVESTMENT: EFFECTIVE WAYS FOR SUBSTANTIAL LIBERALIZATION

Dr. Felipe M. Medalla

Secretary of Socio-Economic Planning

of the Republic of the Philippines

Session 1: Surmounting the Economic Crisis Through Liberalization and Reform

APEC Forum on Shared Prosperity and Harmony

Seoul, Korea

March 31-April 1, 2000

Studies and experience have shown that liberalization is positively correlated to economic growth particularly in the long run. Based on studies undertaken by various international economists, economies with low tariff barriers were found to grow faster than those with high protection. Results also suggest that economies have grown faster on the average after liberalization both in the long-run and short-run. Those who liberalize the most also gain the most. Trade facilitation, however, was found to have a greater impact than tariff reduction. Studies also suggest higher investment shares.

Trade reforms were found to have positive output effects. The exportable sector, particularly manufactures gained substantially from the trade reforms. The impact on income distribution is generally progressive except for the lowest income group.

Despite the benefits derived from trade liberalization, there remains hesitancy on further undertaking the reforms. Among the issues raised against trade liberalization were the possible loss of tax revenue arising from the cut in tariffs and other taxes, short-run dislocation; deterioration in the trade balance and the balance of payments position, timing, pacing and sequencing of the trade reforms, beneficiaries; political aspects of the reforms; and redistribution effects.

Two conditions may have to be considered to further trade liberalization: sustained growth and good governance. Sustained growth eases the social adjustments caused by trade liberalization. Reforms supportive of sustained growth i.e., acceleration of social development through a comprehensive modernization program; delivery of basic social services, sustained infrastructure development especially in the rural areas; continued deregulation and strengthening of regulatory and supervisory institutions; and fiscal, monetary and financial policies that promote growth and stability are necessary to achieve growth with equity.

There is a need to strengthen international cooperation efforts to improve the existing financial system with a view to preventing the recurrence of the crisis by providing better mechanisms for crisis management and making it more conducive to trade and development.

In mobilizing external resources for development, the challenges ahead include the following mobilizing enhanced and more stable sources of international investment flows towards a larger number of recipient developing economies reversing the decline in official development assistance (ODA) and ensuring effective targeting and use of ODA as a catalyst for sustained economic growth and sustainable development and funding lasting solutions to the debt problem of developing economies. The Challenge ahead also lies in sustaining and, where needed, elaborating the sustainable economic framework to attract foreign investments. In the area of mobilization of internal resources, it requires increased domestic savings and ensuring the efficiency of national financial markets.

Trade policies and trade liberalization should be made more consistent with overall development objectives. In developing economies, ways and means need to be sought to ensure that trade a more decisive contribution to alleviating poverty. The role of trade for stimulating economic growth, the distribution of growth effects, and sectoral policies, and in the longer term the diversification into industry and advanced services require further attention, including the monitoring of the development impact of multilateral trade agreement.

Architectural Reform:

Managing Financial Market Volatility in the New Millennium

Speech by

Stephen S. Roach

Chief Economist and Director of Global Economics

Morgan Stanley Dean Witter

before the

APEC Forum on

Shared Prosperity and Harmony

Seoul, Korea

March 31, 2000

It has been said that global currency crisis of the late 1990s was the first true crisis of globalization. I agree. It has also been said that it was the world's worst financial debacle since the 1930s. I agree on this count, as well. Yet it was supposed to have taught us all some lasting and painful lessons. It was billed as the wake-up call that would finally make a difference in leading to sounder management of increasingly integrated and fast-moving world financial markets. Unfortunately, it hasn't.

Sadly, this outcome is not all that surprising. With world financial markets in a new state of exuberance and global economic recovery more vigorous than at any point in the past 13 years, the urgency for post-crisis reforms has subsided. The world seems fine, and, as the saying goes, "...if it isn't broken, don't fix it." Moreover, there is no natural political constituency in favor of acting on reforms. This deeply disturbs me. Like it or not, we are in danger of squandering an extraordinary opportunity for reform. Of all the lessons of the Asian crisis, that could be the most tragic.

Amidst the celebration of post-crisis healing, a disturbing and potentially dangerous complacency is setting in. A quick scan of the global landscape indicates why. On the surface, Asia certainly appears to have learned its lesson. Proud Asian Tigers are determined never again to seek the IMF's aid. Current-account adjustments have been dramatic – leading to a seemingly record buildup of foreign-exchange reserves; moreover, most of East Asia's potentially destabilizing currency pegs have been dismantled. But beneath the surface, Asia's record on structural reforms – especially corporate and financial-sector restructuring – remains disappointing. Indeed, on arriving in Korea, I was struck by two headlines in the 29 March business section of the *Korea Herald* -- "Government revving up efforts to reform chaebols" and "More Koreans oppose foreign M&As." In other words, the heavy lifting of structural reform is yet to begin. Recovery without reform is the rap on Asia these days. But this foot-dragging is continuing to be masked by the region's powerful cyclical recovery.

Latin America has taken much longer to get back on its feet from its lost decade of the 1980s, but the region now appears to be in reasonably sound shape. The pace of Brazilian reform exceeded most expectations, and the recent upgrade of Mexican debt to investment-grade status attests to a new culture of reform and sound policy management in that country. Central Europe is also on the mend, and there is even renewed hope for Russian reform – both political and economic. On balance, barring a destabilizing turn of events in Greater China, the developing world seems as crisis-free as it has been in a long time.

That leaves the industrial world, where complacency is also running high. America, of course, is now presumed to be perfect – its economy, its policies (monetary, fiscal, and regulatory), its companies, its entrepreneurial spirit, its technologies, and its financial markets. While Europe suffers by comparison, it is also on the upswing. Amid an extraordinary wave of cross-border M&A activity, most Europeans are brimming with newfound confidence. Post-EMU structural reforms finally seem to be falling into place, although political harmonization has not kept pace with economic and financial-market integration. Japan remains the odd man out, especially in the face of its lagging restructuring efforts. Ironically, with perceptions growing that the Japanese economy is finally doing better, companies are increasingly confident they can get away with less cost cutting.

Out of such complacency the next crisis is invariably born, usually hitting where and when it is least expected. That's one of the very painful lessons of recent history. Japan appeared triumphant to the world in the late 1980s. Mexico was thought to be in outstanding shape in the early 1990s. And the East Asian miracle was the stuff of history books in the first half of the 1990s. Yet, in all cases, the end was at close at hand. This record is enough, in and of itself, to sound a warning about the presumed permanence of American hegemony.

And yet the world is ill prepared for that possibility. Despite the heightened incidence of crises and the increased integration of ever-faster-moving world financial markets, there is no global policy agenda. Policymakers remain largely dominated by domestic concerns. Coordinated action comes only at points of extreme crisis – and then grudgingly. The best international policy is presumed to be a collection of the best national policies. Trade liberalization efforts – currently exemplified by China's bid for WTO accession – get bogged down in national politics. Talk of reforming the architecture of the international financial system has lost momentum. The selection of a new managing director of the IMF was dominated by timeworn geopolitical bickering. All this is most discouraging. As I said earlier, there is no natural political constituency in favor of reforms.

What can be done? During most of 1999 I had the pleasure of serving on an independent task force sponsored by the New York-based Council on Foreign Relations that was charged with making recommendations for the reform of the international financial architecture. Chaired by Carla Hills and Pete Peterson, 29 of us met frequently over the course of last year -- engaging in active debate over what needed to be done in the aftermath of the global financial crisis of the late 1990s. The membership of the task force was carefully drawn from a variety of key constituencies -- former senior U.S. government officials, academics, business leaders, sitting politicians, labor leaders, and finance. In September of 1999, we published our findings in the form of a 148-page book, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture.* It's not on any best seller lists, but it is well worth the read.

I believe that our findings represent the most prescient agenda for action that has been put forth on the international scene. And I say that mindful of other noble efforts that been recently put forth in this area, including that just published by the so-called Meltzer commission as empowered by the U.S, Congress (formally known as The International Financial Institution Advisory Commission). Our recommendations are balanced, far-reaching, and in some cases, controversial. They offer promise at a time of complacency. They offer vision at a moment of myopic gratification. They offer hope that we will be better able to control the inevitable next crisis. And they are apolitical. They must be heard.

In my remarks to you this afternoon, I would like to summarize the findings of the CFR task force and then draw your detailed attention to one of our most important, and controversial recommendations -- that pertaining to capital flow volatility. Capital flow volatility is one of the intrinsic characteristics of increasingly integrated world financial markets. In my opinion, we are left with no choice: Capital flow volatility must be better understood and managed if we are to learn to live with globalization.

Before we embarked on our mission, we on the CFR task force identified what we called our guiding principles -- the beliefs that would shape our search for architectural reform. Six considerations were judged to be of critical importance in that regard (Slide 1):

- First, and foremost, we believe it is important to intensify our efforts in the realm of crisis warning and prevention.

- Second, we believe it is critical that savings should flow to those countries and uses that offer the best return.

- Third, we believe in fair burden-sharing among private creditors, official debtors, and official creditors in the resolution of future crises.

- Fourth, we believe that the role of market-based incentives should be increased insofar as crisis prevention and resolution are concerned.

- Fifth, we believe architectural reform must be a two-way street. Not only must the developing world embrace reforms, but the industrial countries need to do their part.

- Sixth, we believe that the mandates of both the IMF and the World Bank must be refocused on areas that they are best equipped to handle.

These were the principles that shaped and guided our often-intense deliberations amongst ourselves, as well our consultations with world leaders. With this value system in place, our task force than went about its work. Based importantly on these operating principles, we came up with seven key recommendations that we believe are central for the urgent reform of the world financial architecture (Slide 2):

- First, we recommend that there be greater rewards for those countries which take effective and transparent steps to reduce their crisis vulnerability; these rewards should take the form of more favorable IMF lending terms.

- Second, we recommend discouraging short-term capital inflows to emerging economies with fragile financial systems. I will speak at greater length about this admittedly controversial recommendation shortly.

- Third, we recommend a more formalized burden-sharing structure for crisis resolution, In particular, we endorse the introduction of “collection action” clauses in sovereign bond contracts.

- Fourth, we recommend that the IMF and the G-7 not only advise emerging economies against adopting pegged exchange rates but that they cease providing funds for those that maintain unsustainable pegs.

- Fifth, we recommend that the IMF return to normal lending limits during country crises. For crises judged to be “systemic,” existing credit lines should be deployed for victims and a new “contagion find” should be set up to provide assistance to innocent victims. We believe these measures are essential to confront the perils of moral hazard.

- Sixth, we recommend that the IMF and the World Bank return to basics and narrow their focus. The IMF should stay out of mandating longer-term structural reforms. The World Bank should stay out of crisis lending and management.

- Seventh, we recommend that a global summit of finance ministers be convened to reach a consensus on architectural reform. Only this can provide the political empowerment needed to galvanize support for such long overdue and urgent actions.

While these recommendations will not prevent the next financial crisis, in my opinion, they could do much to temper the perils associated with such inevitable occurrences. Over the broad sweep of economic history, financial crises have occurred with great and alarming regularity. In today’s era of globalization and high-speed interconnectedness, that tendency may even be exaggerated. The reason -- the rapid and powerful swings of financial capital flows. In my view, understanding and managing capital-flow volatility poses one of the greatest challenges to policy makers, investors, financial intermediaries, and world citizens in the years ahead. It is this subject to which I now turn in greater detail.

There can be no mistaking the critical role that the flows of financial capital have played over the long sweep of economic history. In an increasingly open and interconnected global economy, capital flows are the true lubricants of international commerce(Slide 3). And yet, interestingly enough, the role of capital flows today is nowhere near as important as it was in the early part of the 20th century and the latter part of the 19th century (Slide 4). As globalization progresses, the role of capital flows can only grow. For that reason alone, we must develop policies and safeguards that take this new and inevitable reality into greater consideration.

There are some important characteristics of global capital flows that could prove especially vexing when designing architectural reforms. In particular, there is a distinct possibility that there may well be a systemic risk of heightened volatility to the globalization of capital flows (Slide 5). The industrial world possesses enormous pools of saving and financial capital. By contrast, the developing world has tiny capital markets. Consequently, relatively small asset allocation shifts out of G-7 capital markets into emerging markets can have large impacts on asset prices in the developing world. The result could lead to periodic asset bubbles and systemic boom-bust cycles. That raises the all-important question as to whether extreme bouts of financial market volatility are intrinsic to the very process of globalization. It is what I have called a classic David and Goliath syndrome -- with the small economies of the developing world constantly engaged in battle with the giants of the industrial world. We studied this problem carefully on the Task Force and came to the conclusion that just like the biblical David, the emerging-market Davids of today need a slingshot. I will come back to that shortly.

The numbers bear this mismatch out (Slide 6). The combined equity market capitalization of the United States, Europe, and Japan is currently close to $30 trillion. By contrast, the combined market cap of the leading equity markets in the developing world. is less than $1.5 trillion. This mismatch of 20 to 1 is what systemic risk may be all about. A 1% asset allocation shift out of the United States is, in and of itself, worth $150 billion; that would overwhelm any of the emerging equity markets shown in this slide -- leading to the types of asset bubbles that have been all too evident in emerging markets in recent years. Consequently, the potential for systemic risk of capital flow and asset price volatility is a very real possibility, in my view (Slide 7). As we encourage capital account liberalization and the globalization of investment strategies, we must take this important characteristic into consideration (Slide 8).

This volatility shows up loud and clear if you examine recent trends in capital flows to the emerging markets, as we do in the next several slides. As can be seen in the first of these slides, there was an extraordinary round trip of net capital inflows into emerging markets in the 1990s (Slide 9). They surged in the first half of the decade and then tapered way off toward the end. Two key crisis points obviously had a significant impact on that trend -- the peso crisis of 1994-95 and the Asian crisis of 1997-98. Slide 10 isolates capital flows into Asia. It underscores the truly extraordinary about-face that occurred in the crisis; it highlights the role played by official inflows -- in the form of IMF-led bailouts -- that attempted to compensate for the flight of private capital. Slide 11 examines the same trends for Latin America. Note, of course, that the peso crisis of the mid-1990s had a far less disruptive impact on capital flows to the region than was the case with the Asian crisis sat the end of the decade.

The next three slides decompose net capital inflows into the developing world by type of investment. Slide 12 shows the steady and growing role played by foreign direct investment -- clearly the most stable source of financing to emerging markets. Most believe, as do I, that reliance on such a stable source of long-term financing should be given emphasis in framing proposals on architectural reform. I will come back to that point shortly. Note, however, even for fixed investment flows, there was a marked downturn in both 1997 and 1998, especially in Asia.

Not surprisingly, portfolio investment -- flows into emerging market stocks and bonds -- has been far more volatile (Slide 13). This could well be traceable to the David and Goliath syndrome I just described. But clearly the biggest source of volatility for capital flows into emerging markets can be traced to bank lending (Slide 14). That was true of the Latin debt crisis of the 1980s, the peso crisis of the mid-1990s, and the Asian crisis of the late 1990s. Banks have long been the first to cut and run in a crisis. And that has only become more and more evident over time. The results of this analysis and decomposition of capital flows were central to some of the recommendations we on the CFR task forced framed on architectural reform.

There are, of course, always those who wish to find scapegoats at moments of crisis. The hedge funds and other so-called highly-leveraged institutions -- banks and investment banks -- have long been the favored target in this regard (Slide 15). In my opinion, their culpability is vastly overblown. While hedge funds did play a significant role in the ERM crisis of 1992-93, academic and IMF research indicates that was not the case in the peso crisis, nor in the Asian crisis. Yes, there has been explosive growth in the number of hedge funds in recent years (Slide 16). There were more than ten times as many of them in existence at the end of the 1990s than was the case at the beginning of the decade. But the funds under management by these investment partnerships are but a tiny slice -- less than 2% -- of the total funds under management around the world by all other institutional investors (Slide 17). It takes a rogue trader or a highly levered speculative bet to make an impact at the margin. Yes, there have been some notorious examples of just such excesses in recent years. But I continue to believe that they are the exceptions and not the rules. Indeed, it is clear to me that the degree of leverage in the world financial system remains sharply below that which prevailed prior to the Russian debt default and near-failure of Long Term Capital Management in late 1998. Nevertheless, I also concede that some regulatory oversight of hedge funds and other HLIs should be included in any proposals for architectural reform. I will also return to that point shortly.

At the outset I stated that we on the CFR task force thought architectural reform and crisis management should be a two-way street. The industrial world has important problems of its own to face in this regard. No where is that more apparent than in the United States (Slide 18). Faced with a record and rising current-account deficit, capital inflows have taken on great new importance in shaping U.S. financial markets and, ultimately, the health of the

U.S. economy. By our estimates at Morgan Stanley Dean Witter, America's current account gap as a share of GDP could well rise into the 4.5% to 5% range by the end of 2001; that means that the U.S, will have to attract more than $1 billion of foreign capital per day for the foreseeable future. I have no doubt that the flows will occur. The question is -- at what price? Should foreign investors lose confidence in dollar-denominated assets -- for whatever reason -- the reverberations could be profound. The dollar could weaken sharply, as could stock and/or bond prices. And the financial-market euphoria that reigns supreme at the moment around the world could quickly be turned inside out. Capital flows cut both ways. And just we are recommending that the developing world be mindful of the risks inherent to such flows, the same message should not be lost on the industrial world.

And so I conclude that capital-flow volatility is inherent to globalization. If we accept that basic premise, and are mindful of the characteristics of these flows as I just laid them out, then a plan for action emerges. To repeat our key conclusion: We on the CFR task force felt that architectural reform must be premised on measures that would shift the mix of capital flows into the developing world from short-term flows to more stable longer-term alternatives. At the margin, we believe that short-term capital inflows should be discouraged. And here's now the five-point plan that we suggest should be implemented to accomplish that objective (Slide 19):

- First, we urge implementation of Chilean style holding-period taxes on short-term capital inflows for all emerging market economies with fragile domestic financial sectors. As Slide 20 indicates, these capital controls were quite effective in altering the maturity mix of Chile's external debt -- away from short-duration and toward long-duration liabilities. Given the extraordinary volatility in portfolio inflows and bank lending that was evident in the 1990s -- and underscored in my previous remarks -- we think such a measure is appropriate on a broader scale. As such, we think such holding-period taxes would not only skew external liabilities toward more stable long-term financing, but they work out to be an effective tax on the excesses of volatility and hot money.

- Second, we believe that these taxes on short-term inflows should be transparent and non-discriminatory; we also feel they should be price oriented rather than quantity-oriented. At the same time, we do not believe that such capital controls should be viewed as a substitute for correcting poor policies; nor should they be used to impede the entry of foreign firms into developing world financial services industries (Slide 21).

- Third, we urge the IMF to intensify its surveillance over debt management practices in the developing world. In particular, the Fund should seek to discourage excessive reliance on short-term, foreign-currency denominated debt (Slide 22); it should also discourage the use of put options in medium and long-term debt instruments. Had these pitfalls been avoided, there is good reason to believe that the Asian crisis would have been a good deal less severe.

- Fourth, we believe that any revisions in the Basle Capital Adequacy Framework should not be famed around weighting schemes that encourage short-maturity, cross-border flows. By contrast, we urge that short-term liabilities be given a fairly high-risk weight in calculating regulatory capital requirements. This recommendation also applies to the excesses of interbank lending. As Slide 23 indicates, while some post-crisis progress has been made on this count, there is still a long way to go.

- Fifth, while hedge funds have generally gotten a “bum rap” as culprits for recent crises, we do endorse the need for more effective regulation on these investment partnerships and other segments of the HLI universe. In particular, transparency and full disclosure of HLI positions on a timely basis seems appropriate; the same seems desirable for bank lending exposure to HLIs (Slide 24).

As I stated at the outset, I believe that frothy financial markets are ripe once again for next crisis. Times are good and, as a result, the urgency of reform has faded. The seemingly systemic potential for capital-flow volatility is at the root of my concerns. Ironically, the globalization of sector investing in world equity markets could well be the last straw. Gone are the days when investors could count on the inherent offsets of country investing. In the old days, if one country were to tumble, outperformance elsewhere in the world would pay handsomely for diversified global investors. Now, technology moves in lockstep around the world – from America's Nasdaq to Euroland's Euro-tech index, Japan's Jasdaq, and Korea's Kosdaq. Similar patterns have shown up in the cyclicals, financials, healthcare, consumer nondurables, and so on.

This raises a warning flag for the over-extended technology play: Technology, media, and telecom now account for 41% of total capitalization in global equity markets. Thus, a sustained drop in the Nasdaq could wreak havoc on the sectorized daisy chain that now links world financial markets and the global economy. America is central to this risk. A sustained decline in the Nasdaq could trigger an asymmetrical wealth effect for an equity-dependent U.S. economy, and this could spark fears of the first wealth-induced recession since the 1930s.

And so the world comes full circle – from crisis to healing and now back to vulnerability. The good news is that the next crisis is not imminent. But the bad news is that the classic preconditions of investor complacency and rich valuations are now in place. As always, the next crisis will be triggered by a shock. A technology "event" looms most worrisome in this regard, especially one centered on a Nasdaq-induced implosion. But there are other possibilities – a China accident, a Japan relapse, and a Euro meltdown are all high on my watch-list. But rest assured, whatever the shock, it is not in the price of a market that has gone to excess.

Yet there's little talk that crisis could ever recur. That flies in the face of a painful reality check (Slide 26). In the 1990s alone, there were three episodes of wrenching crises – the ERM (exchange-rate-mechanism) crisis of 1992–93, the peso crisis of 1994–95, and the Asian crisis of 1997–98. According to International Monetary Fund research, during 1975–97 there were 158 country-specific currency crises, 54 banking crises, and 32 instances when a country experienced a combined currency/banking crisis. Moreover, there were a dozen instances when the ensuing cost of fixing the crisis exceeded 10% of a nation's GDP (in contrast, the late-1980s S&L bailout in the U.S. amounted to 2–3% of GDP). Unfortunately, financial crises have become the rule, not the exception. As surely as night follows day, the next crisis is inevitable.

The Asian crisis was supposed to be different. "Never again," was the cry of its victims. Just like its predecessors, this last crisis sparked promises of reform. Task forces were formed and commissions have come and gone. But the policy follow-through has been woefully disappointing. That must change. The time to act is now -- before it is too late.

Thank you very much.

THE SHARED CAPITALIST MODEL OF WORK AND WELFARE

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In the traditional model of the labor market and welfare state firms pay workers a fixed wage/benefit in return for doing what management wants while the state provides a safety net and social insurance for persons out of the market or with limited earnings capacity. Under this system, unions negotiate for fixed pay/benefits and use their political strength to gain state benefits and protection for all workers. Non-union firms pay workers what the market demands and provide benefits to reduce their labor costs (through savings in wages, turnover, etc)

This system changed dramatically in the 1990s in the bellweather US. Workers well-being has become more tied to that of their firms, while social benefits have become more tied to work (Exhibit 1). The incentive system for production and work has been strengthened at the expense of the social safety net.

In the job market, compensation packages increasingly give workers varying shares of company returns through stock options, ESOPs, gain/profit-sharing (Exhibit 2). Variable compensation systems related to company or group performance cover over half of the private sector work force. These systems of pay are, moreover, closely linked to employment involvement committees and teams that give workers greater decision-making power on the job (Exhibit 3). Because the US has relatively few regulators to enforce labor laws and a declining proportion of workers in trade unions, employees often sue employers in courts when they believe that the employer has violated their rights. In response, many employers have privatized the governance of workplace rights through alternative dispute resolution systems that gives company appointed arbitrators the authority to resolve workplace disputes.

In theory, the combination of variable pay associated with company performance and greater worker decision-making give workers the incentives to do more at their work place. Most studies find that that in fact these various systems are associated with higher productivity and worker satisfaction. They seem to work best in union settings, where employees have an independent source of power to help design and monitor their functioning. Variable pay systems should also reduce the variability of employment, and potentially lower the rate of unemployment at which inflation begins rising. The Federal Reserve has estimated that a single form of variable pay, stock options, may have reduced the rate of wage inflation by 0.3% in the current boom. But shared compensation systems are no panacea to economic shocks, vide the recession in Japan, whose bonuses also vary with company conditions.

The welfare state has shifted from a social safety net for the jobless to a system of augmenting the pay of low wage workers through the earned income tax credit and other payments (exhibit 4). By raising the minimum wage, the US has also improved the rewards to work in the bottom rungs of the income distribution. Private firms have moved the pension system from one dominated by defined benefit to one dominated by defined contributions, with considerable funds invested in the employing firms' stock (exhibit 5). And medical insurance remains an employee benefit with employees bearing greater share of costs. Various conservative analysts propose that the state individualize other social welfare benefits: unemployment insurance, government provided health insurance for the elderly, social security.

By tying benefits to work and, the new US welfare system has greatly strengthened the work incentive for low paid workers (exhibit 6). Coinciding with an economic boom, this has enabled the US to reduce its welfare rolls by unprecedented numbers. Between 1993 and 1999 the proportion of the US population receiving welfare has fallen from 5.5% to 2.5%, while the rate of poverty has dropped as single parents obtain jobs that pay more than welfare. In some ways the US welfare state has come to resemble the Swedish welfare state, which also tied most benefits to work.

In the full employment 1990s the US shared capitalist mode tying workers' pay to firm performance, individualizing the welfare system, and linking benefits to work has succeeded. But this system also has some problems. Tying workers= pay and pensions to company performance shifts risk from capital, which can diversify assets, to labor, which cannot do so. It makes workers' financial well-being more dependent on the firm and less on overall market conditions, adding to dispersion of pay unrelated to productivity. A welfare system that rewards work will increase labor supply in a boom but leaves workers without much support in a recession.

All told, the emerging shared capitalist system of work and welfare in the US resolves much of the incentive problems associated with traditional work and welfare arrangements at the cost of reducing social insurance and income security in bad times. In the full employment 1990s, the system has worked successfully. But it is not well-suited for dealing with severe or lengthy economic recession. Relying on full employment rather than a safety net to maintain the well-being of low income citizens is a risky bet to take. If work and welfare can keep the good times rolling, it may be a bet worth making. If not, the widespread view that the US has achieved a superior form of capitalism for the 21st century will bite the dust.

The New Welfare Reform Law in the United States: Its Background and a Preliminary Appraisal

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The New Welfare Reform Law in the United States:
Its Background and a Preliminary Appraisal

I. Introduction and Summary

During a period of the greatest economic prosperity in the history of the United States, when the economy has grown for the last eight consecutive years, a law was enacted in 1996 to end the federal program, Aid to Families with Dependent Children (AFDC), a welfare system[1] that had since 1935 entitled poor single-parent families with children 18 years of age and younger to a small monthly income. The catch phrase to describe the new law is Awork, not welfare, which refers to the law=s virtual requirement that these (nearly all) mother-headed families become self-supporting, which, in turn, implies that most of these mothers find jobs in the labor market that pay above-poverty wages. Monthly cash transfer payments are still available from the new law=s program, Temporary Aid to Needy Children (TANF), and the amounts may be higher than those of the old (AFDC) program, but the amount will be less than what could be earned from a minimum wage job and yet require that the mother work full-time at a public job arranged by the welfare agency. If the mother finds full-time employment paying the minimum wage or more, her earnings are likely to exceed the ceiling limit for eligibility for TANF.

There were 5 million families (14 million recipients) in the AFDC program in 1993, a year when the national economy was sluggish. Median family income was relatively low and both unemployment and poverty were at relatively high levels.[2] By the beginning of 1997 the economy improved and AFDC rolls declined by 17 percent (to 4.1 million families). But between January 1997 and

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1) The term "welfare system" refers to a system of national and state programs designed to provide economic assistance to poor households. These programs are generally "means tested" (restricted to households with low incomes). See Appendix A for a glossary of terms and a brief definition of the major programs providing economic assistance. The title of the new welfare law, which is not self-explanatory, is The Personal Responsibility and Work Opportunity Reconciliation Act, abbreviated as PRWORA

2) Median family income, $41,700 in 1998 dollars, was lower than any year between 1984 and 1998; unemployment, at 6.9 percent was at its second highest level between 1986 and 1999; and the poverty rate was at its highest level between 1983 and 1999(*Economic Report of the President*, 2000, pp. 344-7).

June 1999, under the jurisdiction of PRWORA, the AFDC (now TANF) rolls had declined to 2.5 million families (and 6.9 million recipients), a decline in family cases from 1993 of 49 percent and a decline during the 30 months of PRWORA of 38 percent.[3] A report by the President=s Council of Economic Advisors called this Afall in welfare caseloads ... unprecedented, wide-spread, and continuous@ and stated that Aemployment of welfare recipients has increased.@ The report attributed most of the decline to the new welfare law, PRWORA, with some, but less, credit to the continued improvement in the economy (Council of Economic Advisors, 1999). Simply stated, the new welfare program has the goal of moving mothers off the welfare rolls and into the alternative of employment for their sustenance. In 1996 60 percent of these mothers had one or more children under six years of age in 1996 (*Green Book, 1998*, p. 447), so finding jobs for the mothers had to be accompanied by finding day care for their children.

The new law, PRWORA, shifts almost all of the federal government=s responsibility for designing and administering welfare programs for the population of poor mother-headed families to the 51 states (including Washington, D. C.), which already (under AFDC) allowed widely varying benefit levels. Federal revenue now contributes to the new state systems in the form of lump sum (Ablock@) grants, based on the state=s pre-1996 payment amounts, which means that the federal contribution will no longer, as it had under AFDC, increase automatically if the state=s welfare rolls increase. Instead, the new law contains a complicated set of federal incentives that will reward states for lowering their welfare rolls and increasing the employment of the welfare mothers. Although the state governments have an incentive to keep benefit levels low to avoid higher state taxes and to discourage in-migration of Awelfare mothers”[4] from low-benefit states, the general prosperity and the decline in the TANF rolls from their AFDC levels have enabled states to maintain or even raise the benefits provided to the smaller welfare population. but the requirements these mothers face for eligibility to receive these benefits are more restrictive.

3) Website of Department of Health and Human Services: dhhs.gov/new/stats/case.fam.htm, March, 1999.
4) I will use the term “welfare mothers” to include former AFDC mothers and those who would have entered the AFDC system had the system continued.

The law is part of a broader devolution of governance from the federal level to the local level that has been occurring during the past 20 years. However, this devolution is a matter of form, not of substance, and the substance is that of a sharp reduction in support to a substantial proportion of the nation=s poorest families. It is this reduction that seems incongruous with the overall prosperity of the general population and with large surpluses in the federal budget in recent years.

The state of Wisconsin is conducting one of the most closely watched of the 51 new programs, because it was one of the first programs to be fully implemented and has imposed a virtual requirement that the welfare mothers engage in market work in order to receive aid and has had amazing success in reducing its number of TANF cases: from 81 thousand in 1993 to 46 thousand in 1997 to 8 thousand by June 1999[5] One journalist, Michael Massing, reports that A...politicians, policy analysts and journalists [are] today arriving in Wisconsin to see the welfare state being dismantled. The BBC, the *London Observer*, and leading Japanese papers have all sent correspondents. So have most major American news organizations...@ (Massing, 1999). The claim of Athe welfare state being dismantled@ is, as shown below, greatly overstated, even for the small fraction of U.S. families that received welfare assistance under the terminated AFDC program. In 1996 they constituted only 5 percent of all families, but 13 percent of families with dependent children (*Green Book, 1998*, p. 402). Nevertheless, the reduced economic protection for these families is both threatening and real.

What explains the advent of this new welfare reform? Does it reflect and foreshadow a reversal in the long-run trend of increases in transfer payment programs that have categorized the U.S., along with many European nations, as a Awelfare state@? Has the new law contributed to the economy=s increased employment and economic growth? How will it affect the extent and distribution of poverty? Are there lessons in it for other nations? Before describing the details of the new law and my analysis of it, a summary of answers to these questions can be given that will put the new changes in perspective.

The New Law (PRWORA) Is Not the End (or the Beginning of the End) of the Welfare State

5) Same website as above. A qualification to these statistics is that some of the earlier cases reported under AFDC involved so-called “child-only” cases, wherein cash transfers for the children were provided to their non-parental guardians, and these “child-only” cases are now separately classified under another program.

The new welfare reform law, PRWORA, does not indicate a reversal in the trend of increasing transfer payments in the U.S. As shown in Table 1, total transfer payments have generally increased as a percentage of a rapidly growing Gross Domestic Product (GDP) up through 1998. Even if the new program, TANF, were to end all cash assistance to these families (which will not occur, for reasons discussed below), the total amount of expenditures on transfer payment programs in the U.S. would decline by no more than three percent, which occurred in 1994, the peak year for AFDC expenditures. In 1998, expenditures on TANF were less than two percent of all transfer payments. Even if PRWORA succeeding in placing all welfare mothers in jobs that lifted their families above the poverty line (defined in Appendix A) so that they would no longer receive economic assistance from other transfer payment programs, such as food subsidies (the Food Stamp program) and subsidized health care (the Medicaid program), the total amount of expenditures on transfer payment programs would decline by no more than nine percent[6] But no one expects that all welfare mothers will be so successfully employed as a result of PRWORA, and other assistance programs (most importantly, Food Stamps, Medicaid, and a wage subsidy program called the Earned Income Tax Credit) have not been terminated. In addition, government programs to subsidize child care for the welfare mothers are being expanded, and expenditures for these programs will offset some of the savings in other transfer payment programs.

Transfer payment programs in the U.S. are dominated by a variety of Asocial insurance@ programs, which are essentially universal in their coverage.[7] Within this category, the largest expenditures are for Old Age, Survivors and Disability Insurance (OASDI), which provides cash payments and subsidized health insurance mainly to the population of retired persons over age 62. In 1996, before PRWORA was implemented, the Awelfare@ (or Ameans-tested@) transfer payment programs for the poor were a modest 28 percent of the social insurance programs, and the terminated AFDC program, was, itself, only 9 percent of the Ameans tested@ programs in 1996.[8] Again, PRWORA has indisputably brought about a substantial reduction in the governmental assistance previously available to these mother-head families B assistance, it should be said, that seldom lifted these families above the officially designated poverty line. Indeed, a point that I wish to stress is that while the overall system of transfer payments that

6) The nine percent figure is based on the author ' s estimate of the expenditures for were the Food Stamp and Medicaid programs that are received by welfare mothers who part of AFDC.
7) The term "social insurance" and other terms and programs in this paragraph are difined more fully in the glossary in Appendix A.
8) These figures of 28 and 9 percent are the author ' s estimates based on statistics from *Green Book, 1998,* which reports the expenditures on all major transfer payment programs.

define a Awelfare state@ is substantial and growing, one sizeable segment of the poor population in the U.S. has been targeted for reduced assistance. The explanation for this targeting is discussed below.

The New Law (PRWORA) Has Had No Effect on the Recent Economic Growth of the U.S.

The upturn in the U.S. economy began in 1992, well before the new welfare reform law was implemented in 1997. As noted above, only five percent of U.S. families were directly affected. In 1998 140 million Americans worked during the year, and 7 million of these workers were the single-parent mothers in families with dependent children. Between 1996 and 1998 the number of mother-head families with dependent children who were officially classified as poor declined by 0.3 million (*Census P60 -207, 1999,* pp. 17, B-10), so even if we assumed that this increase were entirely attributable to the welfare reform law, the contribution to total employment would be minuscule. The contribution to total output would be even less because the earnings capacities of women eligible for AFDC are low. Finally, the decrease in poverty in these families and their increase in employment are to some extent attributable to the economy=s growth and tighter labor markets, not to PRWORA.

Why the AFDC Program for Mother-Headed Families Was Singled Out for Termination

It is always risky for anyone, including (and maybe especially) economists, to explain political events such as the PRWORA legislation. I suggest several economic factors, which are discussed and supported in the body of this paper. Here, several social, political, and ideological are mentioned in passing, although some may believe that these are the most important.

1. A reliance on employment and wage earnings has been the basic and largely successful source by which families rise above poverty in the U. S. throughout its 250-year history. Both social insurance and welfare (means-tested) programs came rather late to the U. S. compared to other comparably industrialized nations.

2. The employment of mothers, even mothers with young children, has become widespread across all economic classes and is apparently socially approved. Thus, the expectation and effective requirement that poor single-parent mothers obtain jobs has this rationale.

3. Beginning in the 1980s, a prevailing view existed that economic growth in the form of rising wages and incomes was no longer effective in reducing poverty and welfare rolls, especially among mother-headed families. It is difficult to document this public opinion, but it appeared in recent economic research. I will argue below that this view is not supported by the economic evidence that I present.

4. There was increasing public concern and disapproval of the combination of a rising proportion of single-parent families with dependent children, where the absent fathers were not supporting their children, and the consequent increase in the number of families receiving AFDC and other associated welfare assistance. The fact that a large and increasing proportion of welfare mothers had never married, and the belief by many that the AFDC welfare program (in particular) provided incentives to create these father-absent families, added to the public disapproval and political momentum for welfare reform. In 1995 57 percent of the AFDC families were headed by a mothers with no marriage tie, which is double the 27 percent of mothers who had divorced or separated from their husbands (*Green Book, 1998, p. 440*). In fact, PRWORA includes provisions to attempt to reduce the number of children born out of wedlock and to increase child support payments by absent fathers.

5. Two ethnic groups have been disproportionately represented in AFDC: blacks and Hispanics, with the latter group having mainly national origins in Mexico, other parts of Central America, and the Caribbean nations. Discrimination against these groups by the white majority in the U.S. has declined over time, but it still exists. Compounding the problem of color discrimination is a growing resentment against the Hispanic immigration, both legal and illegal, into the U. S. This group=s income status is on average considerably lower than that of the white majority, placing them at greater risk of going on welfare. In fact, PRWORA included provisions to reduce the availability of transfer payments to immigrants, even for immigrants who had become U.S. citizens.

6. My most speculative hypothesis to explain the new welfare reform law is the paradox that appears in the following argument. A powerful idea underlying the conservative (right-wing) advocacy for reducing the role of government in the economy and implementing free-market policies such as deregulation, reduced government spending, lower taxes, and less welfare assistance is that individual consumers and workers can better determine what is best for their well-being than government agencies. Yet many of these same advocates claim that poor mothers who choose to receive welfare assistance

(specifically, to choose to participate in AFDC) are not acting in their or their children=s best interests; instead, that their best interest will be served by ending the program and taking away that choice. It is as if Agoing on welfare@ had consequences similar to becoming a drug addict. I am not necessarily arguing that eliminating the AFDC option is not in the best interests of welfare mothers, only that it seems to conflict with a basic political and ideological view of the political forces that have brought about the end of AFDC. Nor am I saying that this is the only reason implied or cited by these political forces. They have certainly espoused the first five reasons listed in this section.

Are There Lessons from the U. S. Experience with the New Welfare Reform?

My speculations on this question are brief and disappointingly non-committal. As noted above, there are 51 separate programs, and most have been in effect for about two years and none of them thoroughly studied. Even so, if success in these programs is measured by reductions in the number of families enrolled in the new TANF program compared to the old AFDC program, then the new program has already shown resounding success. If success is measured by whether a majority of the Aleavers@ of the old and new programs have obtained jobs, then a variety of disparate sources and reports indicate that most have, but whether these jobs have earned annual incomes for these mothers and their families is not yet known Even the whereabouts of many of the leavers (perhaps one-third) is not know to the authorities or the researchers. In any case, all agree that success has to be measured by current and future economic and social conditions of the lives of the families who were in AFDC or who would have enrolled in AFDC if it were still in existence. Will their standard of living increase or decrease over the next five to 10 years compared to what it would have been without the new changes? Will their children be better off with working mothers but with less home care by their mothers? Will non-marital child-bearing decrease and will marriages increase and be more stable?

Based on my suggested answers to several questions posed above, the lessons for other countries from the U.S.=s experiment with a new welfare policy seem unlikely to be very informative. Again, the new welfare law in the U.S. affects a small fraction of the population and of the nation=s transfer payment programs. Even more parochial are several of the institutional features of the particular Awelfare problem@ that has been under the spotlight. I have referred to three features above. One is the

Afeminization of poverty@ in the U.S. as a result, mainly, of single-parent, mother-headed families; mother headship itself being mainly a result of out-of-wedlock births and marital dissolutions. Another is the ethnic heterogeneity in the U.S. and its degree of discord, and how both contribute to the poverty problem. Another is the relatively sizeable amount of immigration to the U. S. and in the perception (if not the fact) of how this aggravates the problems of poverty, single-parent families, and welfare dependency.

In the rest of this paper, I will discuss these issues in more detail, but I will give most of my attention to the state of the economy and the labor market as major determinants of the fate of those affected by the new welfare reforms. These macroeconomic forces are beyond the control of the individual families that, on or off welfare, continue to struggle with poverty or the threat of poverty.

II. The New Welfare Reform Law, Its Goal of Self-Sufficiency for Welfare Mothers, and Its Implications for the Role of the Labor Market

The new federal law, PRWORA, has produced 51 distinct state welfare systems with several common features that are required by the national law. Each state will receive federal money for the new TANF program that will be limited to supporting welfare mothers for a maximum of five years. The law has provisions that encourage the states to impose shorter time limits. Each state must impose a work requirement on the mothers after two years, and most states are imposing shorter time limits. In the state of Wisconsin, for example, the requirement that the welfare mother take a job (or engage in full-time training for a job) to be eligible for TANF benefits begins immediately for both those already on the welfare rolls and the new applicants.

Wisconsin=s program has the following four tiers of job placement, listed in order of their self-designated success: (1) unsubsidized jobs in the private sector; (2) jobs in the regular economy that are eligible for a wage subsidy, paid to their employers. These jobs must pay at least the legal minimum wage ($5.15 an hour, or $10,300 for a full year, which is about 21 percent of the national median earnings of a full-time worker and is 77 percent of the poverty line for a family of one adult and two children).

(3)Welfare mothers with even less preparation for employment are required to work at Acommunity service jobs@ that pay them only what their monthly cash transfer payment amounts to, which is currently $763 a month (amounting to $4.58 per hour). If they miss time at work their transfer payment is reduced in proportion to the time missed. (4) Those least able to work and who do not enter the other three tiers are assigned some type of training or work preparation for 40 hours a week, for which they are paid $712 a month. The wage subsidy, tier (2), is not much used. Most client-mothers are in tiers (1) and (3).

The monthly cash payments are not scaled to family size, as were the AFDC payments, so the mother of 10 children receives the same monthly payment as to the mother of 1 child. Wisconsin=s welfare program is intended to instill in their clients the rules (and the culture) of the labor market, in which one=s wage rate is not dependent on one=s size of family and where monthly payments depend on the hours spent at work. A mother=s failure to follow her work assignment results in lesser payments and can lead to dismissal from the program and its monetary support. Those who comply with the program can receive subsidies for the following benefits: day care for their pre-school children, health insurance, food stamps, and the wage subsidy that comes through the federal income tax systemCthe Earned Income Tax Credit.

No one knows precisely why the numbers in Wisconsin=s program have plummeted so sharply and so rapidly. Some mothers leave the program because they are sufficiently successful in tier (1), some because they find the other options onerous and unsatisfactory, and some because of certain life events such as having to move to another state or moving into a different family situation for idiosyncratic personal reasons. Some of the leavers return to the program. A major source of the declining numbers in TANF relative to the numbers in AFDC is believed to be mothers who decide not to enroll in TANF to begin with. The eight years of tight labor markets in Wisconsin and the fact that earlier, pre-PRWORA, experimental state programs had taken a hard line in imposing work requirements are other important reasons why the welfare option lost favor. Wisconsin=s experience appears to be shared, more or less, by the other 50 state jurisdictions.

In Wisconsin and in the nation at large our knowledge that welfare rolls have fallen is not matched by knowing the income status and other measures of the standard of living of the mothers who were on welfare or who would have gone on welfare if the old program were still in existence. The determinants of income and poverty status need to be examined in their own terms.

Figure 1 is a simple guide to this examination. It emphasizes the role of labor earnings and family living arrangements because these are critical for welfare families currently and for explaining the historical decline in poverty in the U. S. Item B in Chart 3 of the figure refers to the relation between poverty and such macroeconomic indicators as gross domestic product (GDP), per capita GDP, median family income, median wages, unemployment rates, and the distribution of incomes and wages.

Of course, many forces other than the state of the economy will determine the course of the poverty problem under the new regime of welfare reform. Attitudes of the poor toward employment and toward their family arrangements may change. Marriages may occur or families may move in together to form non-poor households. Private philanthropy may play a larger role. Ways may be found to improve the system of child support from absent fathers. New institutions at the local level, such as public employment projects, may arise to change the old relationships between macroeconomic performance and the poverty rate. States may offer permanent programs of subsidized health insurance and child care for the working poorCwith emphasis on the term Apermanent,@ given that many states may offer such subsidies only during a transition period from welfare to self-support. Federal expenditures for food stamps might be expected to expand if the incomes of the welfare (or ex-welfare) families decline.[9] But even with these types of adaptations, few will doubt that the success or failure of the new welfare reforms depends in large part on the labor market.

9) Surprisingly, this has not happened and, as reported in the *New York Times*(1999), “the experts are puzzled.... The biggest problem[for the former welfare families who have suffered income losses], opposing camps agree, is that many families who have left welfare are not getting food stamps even though they remain eligible for the benefit. In 1995, 88 percent of poor children benefitted from food stamps. [In 1998] the number had dropped to 70 percent.”

III. Wages and Employment in the Long-run Reduction of Poverty in the United States

Wage Growth

Rising wages and full employment, particularly the former, have been the dominant historical forces that have reduced poverty in the U. S. The current retrenchment of government assistance, mainly aimed at families that are headed by non-aged, non-disabled mothers, may be viewed as a return to relying on these traditional labor-market sources of income. For both economic and political analysis, it is important to recognize that these sources have been highly successful over the long run of 100 (or more) years; successful, that is, in comparison with most other nations and previous human history (Kuznets, 1971; Rosenberg and Birdzell, 1986). A brief argument for the centrality of wage growth in the historical setting is given in this section. See Appendix B for source citations and a more complete presentation of the evidence.

Consider the period in U. S. history from 1900 to 1960, when government transfer payment programs played almost no role in raising family incomes above the poverty line. In 1960 median family income (in 1996 dollars) was approximately \$27,600, median wage earnings of full-time, year-round workers was \$23,000, and the official poverty rate for families was 18 percent, with the poverty line in that year being \$16,000 (adjusted for inflation) for a family of four. Using the long-run annual rate of growth in per capita income between 1900 and 1960, 1.9 percent, as an estimate of the growth in family incomes, the median family income in 1900 is estimated to be \$8,900. Reasonable assumptions about the distribution of income and family sizes in 1900 assure us that at least 75 percent of the families in that year would have been classified as poor if the current definition of poverty is used. (Note that the current definition uses an absolute income figure for different family sizes, adjusted each year only by the change in the inflation.)

Two conclusions follow from this example of a comparison of the modern 1960 poverty rate with those of long-past decades before 1960. One is that the comparisons between modern levels and the shockingly high poverty levels of the past can look bizarre, because the concept of poverty is inevitably viewed relative to the level of income and the standard of living that prevailed in those distant periods. The second conclusion is that a moment=s reflection tells us that the nation=s historic rise in family incomes up through 1960 for the vast majority of American families is almost entirely attributable to the rise in wage rates earned by the adult members of the families. I estimate that the annual rate of growth in the wage of full-time workers was 2.3 percent a year between 1900 and 1960. This rate of growth allowed the large long-run increase in family incomes despite the sizeable reduction in the average hours worked per year for full-time workers over this 60-year period. Clearly, labor earnings, rather than other sources of personal income, such as rents, dividends, interest receipts, capital gains, or transfer payments, were responsible for the growth in the average family=s income. This proposition also generally holds for the 40 years since 1960, although a sizeable minority of persons, especially those over 65 years of age, have benefitted from the expansion of transfer payment programs that have been established or grown since 1960.

The Rise in Women=s Employment

Marketwide increases in wages like those discussed in the previous section increase family incomes not only directly but indirectly by increasing women=s labor force participation rate (LFPR).[10] The positive effect on family income of the increase in employment by women is unambiguous in two-parent families, where two adult earners are now the norm. For families with dependent children in which the mother is family head, the combination of higher wages and improved employment opportunities for women is, at a minimum, important in reducing poverty, and it is essential in the common case where these families receive little or no alimony, child support, or other income from non-labor sources. Women=s earnings in the labor market are critical in the new welfare regime. One uncertainty about the effect on poverty of the increased employment of women is how this increase affects the rise in the proportion of single-parent families. This will be discussed below.

In 1935, when federal legislation established the AFDC program (then called Aid to Dependent Children), less than 10 percent of mothers in husband-wife families were employed; perhaps 8 percent were employed if a child in these families was under six years of age.[11] Mothers who received AFDC

10) Econometric evidence for the powerful role of rising wage rates as a cause of the increase in women's employment has been abundant since the publication of Jacob Mincer's classic article(1962). See Heckman and Killingsworth(1986) for a survey of research that supports Mincer's basic points. See Appendix C for a brief discussion of why the market wage explanation for the rise in women's LFPR is more persuasive than the decline-in-fertility explanation.

11) This estimate is based on a 14 percent LFPR of all wives(husband present) in 1940(Census, *Historical Statistics*, 1975, p. 133), along with an estimated lower LFPR in the depression year of 1935 and the fact that the LFPR of mothers is less than for all wives.

transfer payments were not required to seek or hold jobs. One reason was the scarcity of jobs during that depression period. Another reason that was longer lasting was the traditional and approving view of a mother=s stay-at-home work in child care. We may, therefore, better understand (without necessarily approving) the 180-degree change in current welfare policy, by recognizing that, today, almost two-thirds of mothers in married-couple families *with children under six years of age* are either employed or actively looking for employment.

The LFPR of wives, husband present, with a youngest child under six years of age, has steadily risen from 12 percent in 1950 to 64 percent in 1998 (see Table 2). This occurred despite the fact that average earnings of husbands nearly doubled from 1950 to 1998, which implies that mothers in 1950 were less able to Aafford@ to stay at home than mothers in the 1990s.[12] An important reason for the low LFPR of wives in the earlier period, despite the lower incomes of their husbands, is that market wages for women were so much lower then than now and that the positive Awage effect@ on the labor supply decision of wives dominates the negative Aincome effect@.

A mother in a single-parent family has, generally speaking, more difficulty holding a full-time job than a mother in a married-couple family, assuming the numbers and ages of their children are the same, because the married couple can share in the tasks of housework, child care, and market work. A single mother is further constrained in attaining earnings above the poverty level because women=s wages are, on average, about 70 percent of men=s wages, reflecting less employment experience, less employment training or other market skills, and gender discrimination in the labor market.[13] On top of all this, AFDC mothers faced severe disincentives to work for pay, because their AFDC benefits were drastically reduced as their earnings rose, perhaps leaving them worse off if they held a job, particularly if

12) The median incomes of husbands were approximately $17,000 in 1950 and $32,000 in 1990(in 1996 dollars). U.S. Bureau of the Census, *1950 Census of the Population, Population Report P-E No. 2A*, "General Characteristics of Families," pp. 490, and Census, P60-174, 1991, p. 124.

13) In 1997 the median earnings of women were 74 percent of men's earnings among full-time, year-round workers. However, 72 percent of male workers worked full-time, year-round, compared to 56 percent of female workers. The median earnings of all female workers were 62 percent of the median for all male workers. Census, P60-200, 1998, p. 380.

the Medicaid benefits accompanying AFDC receipt are factored in[14] Supporters of the work requirement of the new welfare system, however, could point to the LFPR of mothers in single-parent families, which tend to be higher than that of mothers in families with a husband present (see Table 2), despite the fact that mothers in single-parent families receiving AFDC assistance have a very low LFPRCaonly 6 percent in 1992, according to a report by the General Accounting Office.[15]

Three inferences from these statistics are warranted. First, in 1996, when PRWORA became law, the *levels* of the mothers= LFPRs for all three marital classifications reinforce the apparent public approval of the law=s requirement that welfare mothers be employed in order to receive benefits within their five-year maximum period of eligibility and to be self-supporting after that five-year period. Second, the *slower increase* in LFPRs of the two father-absent groups from 1960 to 1996, the year before PRWORA was implemented, is often interpreted as an effect of the rapid expansion of the old welfare system from the mid-1960s to 1980. These two groups of mothers are, of course, most likely to have participated in the old AFDC program, with its strong disincentives to work in the paid labor market. Third, the large jump in the LFPRs of these same two father-absent groups from 1996 to 1998, when the PRWORA reforms were underway, is evidence that these mothers have been impelled (or pushed) into the labor market. The group of mothers most likely to have been in the pre-reform AFDC program are those

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14) The *Green Book*(1998, p. 408) gives the following illustration, using Pennsylvania as an example. The annual dollar benefits in 1997 for an AFDC mother of two children with no other income is shown to be $7,798, which is the sum of the cash payments($5,052) and food stamps($2,746). If she were to earn $12,000 during the year, her disposable family income would be $13,231, after allowing for earned income tax credits($3,641), reductions in benefits, and payments of Social Security taxes($912) and work expenses($3,600) rimarily day care expenses. Thus, her disposable income rises by only $5,433, implying an implicit “tax” on her $12,000 of earnings of 55 percent. Because the family loses eligibility for Medicaid health insurance beyond a transitional one-year’s coverage after the family income exceeds $9,000 a year, the family may be worse off with the mother’s earnings of $12,000 that with no earnings. The zero-earnings benefit level of $7,798 paid by Pennsylvania is similar to the median maximum benefit amount of $8,304 among all 50 states and the District of Columbia(p. 418).

15) U.S. General Accounting Office(1995). This report also cited other studies which found that 38 percent of mothers on AFDC worked *at some time* during the year, but pointed out that these mothers may not have been enrolled in AFDC all year.

with a youngest child under six years of age, and their LFPRs of 53.0 in 1995 and 55.1 in 1996 rose sharply to 67.3 in 1998, a larger increase (of 12.2 percent points) than that for any other group.

Summary. Long-run trends in the employment of women and the gradual increase in women=s wages relative to men=s wages (discussed below) are trends that are favorable to achieving the goal of substituting Awork for welfare@ in the new welfare system. Unfortunately, there are several shorter-run trends that are unfavorable to the ultimate goal of reducing poverty among families with dependent children. For men, particularly unskilled male workers, wages have been stagnant or declining for over 20 years, and the better record of wages of women workers has amounted to a very small increase over this period. Also, the upward trend in the employment of mothers should be tempered by the finding from economic research that employed mothers tend to be those who can earn relatively high wages. Most welfare mothers appear to have low earnings capacities, based on their education, training, and experience (Burtless, 1995 and 1998). In 1996, only 21 percent of poor families with dependent children had a worker with a full-time, year-round job, and only 12 percent among poor families with a female head (Census, website, 1997, Table 17). Whether the labor market can overcome these various barriers to reducing the poverty rate among the predominantly feminine poverty families is the major question facing the new welfare regime. The high level of LFPR reached in 1998 by the never-married mothers with young children, youngest between 6 and 17 and youngest under 6, is a positive sign of their employability, but whether their jobs are full-time and paying above-poverty wages remains to be shown.

IV. The Decline in Poverty from 1959 to 1974 and Its rise and Persistence since 1974

One reason the new welfare reform law was enacted was the public dissatisfaction with the rise and persistence of poverty for the 20 years after 1974. The decline in poverty in the 15 years preceding 1974 set a standard that was expected to continue. It is worth looking at the two periods before and after 1974 to examine their striking differences in poverty trends and to try to understand why the political climate turned against the welfare program for poor single-parent mothers in 1996.

The Roles of Government Expenditures and of the State of the Labor Market in Reducing Poverty from 1959 to 1974

In 1965 the Office of Economic Opportunity was established by legislation to begin what was widely called a Awar on poverty.@ Between 1965 and 1975 public means-tested transfer payments, including in-kind assistance, increased threefold, from $42 billion (1997 dollars) to $133 billion. Including the social insurance programs, dominated by OASDI (for the aged) the increase is from $145 billion to $424 billion (Burtless, 1994, p. 57). Family poverty rates declined from 13.9 percent in 1965 to 8.8 percent in 1973 and 1974 (see Table 3)Can annual rate of decline of 5.6 percent. Was this decline attributable to the large increase in social and welfare expenditures?

Before reaching this conclusion, consider the fact that the family poverty rate declined by 4.6 percentage points (or 4.7 percent per year), from 18.5 in 1959 to 13.9 in 1965Ca six-year period before the Office of Economic Opportunity and the officially proclaimed war on poverty began. The annual rate of poverty decline is higher in 1965B1973, but it is also true that the economy was more prosperous and the labor market tighter in this period. The average annual unemployment rate from 1965 to 1973 was 4.1 percent, substantially lower than the average of 5.5 percent from 1959 to 1965 (*Economic Report of the President*, 1996, p. 316). Also, the annual growth rate in the median earnings of male full-time year-round workers was 2.0 percent from 1960 to 1965 and 3.0 percent from 1965 to 1973. For women, the corresponding growth rates were 2.0 percent from 1960 to 1965 and 2.3 percent from 1965 to 1973, and, as noted above, the proportions of employed women and multiple-earner families were higher in 1965B1973 (Census, P60-180, 1992, pp. B-32 to B-33; *Economic Report of the President*, 1996, p. 321). Finally, median family income, the macroeconomic indicator that is most closely linked to the poverty rate, grew at annual rates of 2.9 percent from 1959 to 1965 and 3.2 percent from 1965 to 1973 (Census, P60-180, 1992, p. B-22). An important methodological point here is that changes in family incomes, earnings, and unemployment rates of the poor have little effect on the nationwide median values of these variables, because poor families constituted the lowest 9B19 percent of the income distribution during 1959 to 1974.

Thus, both (1) government expenditures that provide cash payments, in-kind income, and services to the poor, and (2) a prosperous economy that provides better earnings opportunities to all families are logical explanations for the reductions in the poverty rate from the mid-1960s to the mid-1970s. The relative importance of the economy is supported by the fact, noted earlier, that wages rose and poverty fell over many decades before 1960, when government transfer programs to aid the poor were meager. In fact, the disincentive to work inherent in transfer payment programs suggest that the poor would work less in response to these programs.

The Rise and Persistence of Poverty from 1973B1974 to 1997

During the period from 1973B1974 to 1997 the family poverty rate rose from 8.8 percent in 1973B1974 to a high of 12.3 percent, reached in 1983 and 1993, and was 10.0 percent in 1998. Thus, the new regime of welfare reform began at a time when the steady decline in poverty rates of the earlier postwar years were reversed over the 24-year period following 1974. The increase in poverty was greater for families with dependent children, rising from 11.4 percent in 1973 to 16.5 percent in 1996 and 15.0 percent in 1998. Associated with this was an increase in the proportion of children under 18 in poor families (not shown). (See Table 3.)

To explain the overall increase in poverty, especially among families with dependent children, let us examine three major interrelated developments during the post-1973 period: (1) a decline in some of the government expenditures aimed at reducing poverty, (2) the slowdown in the economy, and (3) the continued increase in the proportion of single-parent families. Keep in mind that these and other reasons for the increase in poverty had to offset two other ongoing trends, the rise in educational attainment and the decline in fertility, which operated to decrease family poverty rates.

<u>*Government Expenditures to Reduce Poverty*</u>. Danziger and Weinberg (1994, p. 48) state that ABetween 1973 and 1979 social spending [government expenditures on low-income households] continued to grow, but the economy slowed dramatically.@ The economic slowdown could be emphasized as a reason for the rise in poverty, and the rise in poverty as a reason for the increase in transfer payment expenditures. However, the authors also state, AThat the official poverty rate was virtually constant while spending was rising, however, led to a major shift in public opinion [in opposition to these programs]."[16] Here, the message is that anti-poverty programs, especially AFDC, were losing their political support, which anticipates the soon-to-come welfare reform law of 1996. In fact, skepticism about the effectiveness of AFDC in reducing poverty was always present because of the program=s undeniable disincentives to work and its alleged incentives to form and maintain a single-parent family.

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16) For those who opposed the 1996 welfare reform law and the end of entitlement to income support, it must seem a bitter irony that, although the stagnation in wages and earnings can explain much of the reason that poverty stopped declining in recent years, the very persistence of poverty and the accompanying rise in welfare rolls led to the political support for the legislative shift from welfare to workfare.

Between 1972 and 1997 the real value of AFDC cash benefits declined by 52 percent. The nationwide median of the maximum state benefits received by a mother with two children and no earnings fell from $9,442 in 1972 to $4,524 in 1997 (in 1997 dollars). If we add the cash value of food stamps, the decline was 30 percent, from $11,821 to $8,304 (*1993 Green Book*, p. 1240, and *1998 Green Book*, p. 418), but noncash benefits are not counted in the income figures that determine the official poverty line.[17] In 1997 the median maximum state benefit for a family of three was only 34 percent of the poverty line. Adding food stamps increased the state median to 62 percent of the poverty line. Also, legislative changes in the AFDC program in the early 1980s effectively cut some AFDC recipients from the program by tightening eligibility standards.

A comparison with the experience of the elderly is informative. The poverty rate of the elderly declined despite a decline in employment that was also in response to the disincentives of income maintenance programs for the elderly. The LFPR of men over the age of 65 declined from 23 percent in 1973 to 17 percent in 1997; of women from 9.0 percent to 8.6 percent (USDL, *Handbook*, 1989, pp. 26B27; USDL *Employment and Earnings* Jan. 1998, p. 164). Over the same period the inflation-adjusted value of their government transfer payments from Old Age, Survivors, and Disability Insurance and (to a lesser extent) Supplemental Security Income rose sharply and lifted a substantial proportion of the elderly above poverty. (See Danziger and Weinberg, 1994, for figures up to 1990.) The decline in their poverty rates, rates which are based on money income, does not reflect the largest increases in government expenditures on their behalf, which came in the in-kind forms of Medicare and Medicaid.

The poverty rates of single-parent, mother-headed families with dependent children, many of whom were in AFDC, rose from 1975 to 1998, but the reductions in the cash value of AFDC benefits could not have had much affect for the simple reason that by 1975 most families on AFDC were already

17) The cost of Medicaid is not added to the cash payments and the cash-equivalent value of food stamps because it is difficult to know what cash-equivalent value recipients give to Meficaid. Moreover, the cost of a given service from Medicaid rose more rapidly than did the Consumer Price Index. For example, the CPI of health care rose by 194 percent from 1980 to 1995, while the overall CPI rose by 85 percent(*Statistical Abstract,* 1996, p. 483).

below the poverty line. For example, the poverty line in 1975 for a family of three was $4,293 (1975 dollars), while the AFDC maximum annual cash benefit for a three-person family ranged across states (excluding Alaska and Hawaii) from $576 a year in Mississippi to $4,152 in Connecticut. The median state amount for a family of this size was $2,280, only 66 percent of the poverty line (*Green Book*, 1989, pp. 546B547). In summary, cuts in government expenditures on income maintenance programs, which mainly were cuts in the cash payments to AFDC families, do not explain the rise in poverty rates in the post-1973 period.[18] The next two explanations are more persuasive.

The Labor Market and the General Economy. After 1973, the indicators of family economic well-being stopped improving, and poverty stopped declining. That much can be said without controversy. Unemployment rates, after averaging 4.5 percent per year in the 1950s, 4.8 percent in 1960s, and 5.4 percent from 1970 to 1974, rose to 7.0 percent in the period 1975B1979, 7.3 percent in 1980B1989, and 6.3 percent in 1990B1996 (USDL, *Handbook*, 1989, p. 129; *Economic Report of the President, 2000*). (Note: 1996 is used as the terminal year because this was the year the PRWORA was enacted.) Average earnings declined for full-time, year-round male workers from $37,902 (1997 dollars) in 1973 to $32,882 in 1996. Women=s full-time earnings increased from $21,466 in 1973 to $24,254 in 1996. Because men are a larger fraction of full-time, year-round workers, the overall (weighted) average of this measure of earnings declined from $32,922 in 1973 to $29,398 in 1996 (Census, P60-184, 1992, p. B-35 and P60-200, 1998, pp. 38B40).

Median family income is a broader measure of the state of the economy than earnings and, like poverty, is based on the family as the unit of analysis. Median family income, in 1997 dollars, was the

18) A qualification to this judgment is the following point. Some AFDC families were in the porgram for less than one year, so these families could have fallen below the poverty line because the AFDC cuts reduced their combined income from AFDC and the income they received when they were not in AFDC for that year. It is noteworthy that the ratio of poor female-headed families to AFDC families rose from an average of .71 in 1970-1981 to .85 from 1982-1992 he latter period coming after or during the Reagan-Bush administrations ’ cuts in AFDC(*Green Book*, 1993, p. 685). Perhaps the lower proportion of poor female-headed families in the pre-Reagan years reflected some of the part-year AFDC families whose higher AFDC payments raised their full-year ’s income above the poverty line.

same in 1973 ($40,979) as in the recession year of 1993 ($41,051), despite more multiple-earner families in 1993 (Census, P60-200, 1998, p. B-8). The family poverty rate increased from 8.8 percent to 12.3 percent over that period. When median family income rose from the 1993 level to $43,271 in 1996 (an 5.4 percent increase), the family poverty rate declined to 11.0 percent, still above the 8.8 percent rate in 1973B1974. Clearly, the increases in poverty after 1974, when median family income slightly increased, tells us that other factors beyond the stagnation of family incomes were affecting poverty. High unemployment throughout much of the period between 1973 and 1996 is one factor that would have a particularly harmful effect on the working poor. Before discussing unemployment and other factors, let us view the graphs on the 1959B1998 time-series of median family income and poverty rates.

Figures 2 and 3 show a strong year-to-year inverse relation between changes in median income and the poverty rate for all families and for female-headed families.[19] The interpretation of this relation requires a brief comment on methodology. Three key measures of macroeconomic performance that affect povertyCmedian family income, median wages, and the unemployment rateCmay all be viewed as exogenous to the poverty rate. Because median income and median earnings measure the 50th percentiles, they are barely affected by the values of income and earnings for the poverty population, which makes up the lowest 8B12 percent of families (or the lowest 11B15 percent of persons) in the income and earnings distributions of families and person. We can view these three income, earnings, and unemployment variables as causal to the poverty rate in the sense that exogenous forces, some of which are policy variables, that affect these three variables will also affect the poverty variable. Of course, to say that median earnings of full-time, year-round workers are exogenous to poverty still leaves open the question of what caused, say, median earnings to changeCwhether, for example, faulty monetary and fiscal policies caused median earnings to fall. But it is also useful to be able to say that poverty rose because average

19) For the all-family group, the 39 year-to-year changes in median family incomes from 1959 to 1998 include 32 changes that “agreed” with the theoretically expected opposite-sign change in the poverty rate, four changes that did not agree, and three changes that were neutral. There were only two changes in median family income of more than 1 percent(1978-1979, 1.3 percent, and 1995-1996, 1.2 percent) when the change in the poverty rate had the “wrong” sign.

wages fell, even if we do not know what caused wages to fall. Think of how often debates about the role of family breakups or about the disincentive effects of this or that government program arise when there is a jump in poverty rates.

Between 1980 and 1994, median family incomes were roughly stationary, but family incomes became more unequal, suggesting that rising inequality was a cause of the increase in the poverty rate. Causality in this relationship is, however, ambiguous without more information. To illustrate, assume poverty increased because more marriages broke up, depriving families with children of a full-time earner. Assume further that the reason for the marital breakups was a societal changeCmost would say a societal declineCin Atraditional values.@ Then, assuming the decline in values was not itself caused by the widening of the income distribution, the proposition that increased inequality of family incomes Aexplained@ the rise in the poverty rate is not very useful. An alternative and equally valid hypothesis is that the rise in poverty (because of family breakups) caused the rise in income inequality.

The rise in the proportion of single-parent families (discussed below) is one reason family incomes have become less equal. However, most economic research on the rise in income inequality points to the increase in wage inequality, which was mainly a result of changes in the technology of production that increased the demand for skilled workers relative to the demand for unskilled workers. (See the discussion of this issue in Johnson, 1997, and the *Economic Report of the President,* 1997, pp. 163B188.) Evidence of increased inequality in wages is shown in Figure 4, which uses years of schooling completed as a measure of skill in the labor market. Among full-time, year-round workers the average earnings of workers with less than 12 years of schooling declined, and declined more than the average of all workers from 1979 to 1996. During the same period the average earnings of workers with 12 years of schooling declined, and declined relative to the average earnings of workers with 13 or more years of schooling.[20] The most serious economic failing affecting poverty in the post-1973 period was the decline

20) Baldwin and Cain(1997) use a definition of full-time, year-round worker that was borrowed from Katz and Murphy(1992) and is slightly different from the official definition used by the Department of Labor(see Fig. 4). The general pattern of the time series of wages for the different education groups shown in Figure 4 has

and stagnation of wages. The relative decline in the wages of low-skill workers, who are overrepresented in low-income families, was a contributing, but secondary, factor.

The Increase in Single-Parent Families with Dependent Children. In 1996 the median income of single-parent families with dependent children was 33 percent of the median income of two-parent families (Census, website, 1997, Table 17), a slight decline from 35 percent in 1974 (Census, P60-180, 1992, p. B-23). The reasons for the low incomes of single-parent families are well known: low earnings, low child support and alimony payments from the absent father,[21] and low levels of income support from government programs. As shown in Table 3, column 4, their family poverty rate was 39 percent in 1998, slightly less than the low of previous low of 40 percent in 1979 and far below the high of 60 percent in 1959, the first year in the modern time series of poverty rates. Despite this long-term decline, we see in columns 5 and 6 the basis for the much-discussed Afeminization of poverty.@ The percentage of poor families with a woman as family head rose from 23.0 in 1959 to 45.4 in 1973 and to 54.5 in 1997. In families with dependent children the percentages are 28.0 in 1959, 56.4 in 1973, and 61.4 in 1997.

As single-parent families become a larger proportion of the population of families, the overall risk and incidence of family poverty increases, other things equal. Column 7 in Table 3 shows the increased percentage of mother-headed families with dependent children among all families with dependent children: 9.4 in 1959, 14.8 in 1973, 23.6 in 1997, and 24.0 in 1998. The increase in the percentage of all families headed by women (not shown) is similar (Census, P60-207, 1999, pp. B10BB11).

The following question can be answered by the familiar technique of composition analysis: What would the family poverty rate have been in year *t* if the three family typesCmarried-couple, female-

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appeared in many research articles and books.

21) Two authorities on the subject of child support report that "Only six of ten mothers potentially eligible for child support actually have such an award. Of those who have an award, only half receive the full amount to which they are entitled, and over a quarter receive nothing.... Divorced mothers are those most likely to have an award right of the hereas never-married mothers are those least likely three in ten" (Garfinkel and McLanahan, 1994, p. 208).

headed (no father present), and male-headed (no mother present)Chad the same proportions in year *t* as in year *t-k*, assuming the same poverty rate in year *t* of each family type and assuming that no other changes occurred? The method is here applied to families with dependent children, because this group is most affected by the new welfare reforms and because it is not affected by the government programs that reduced poverty rates among the elderly. The calculations show that the 1997 poverty rate of 15.7 percent for families with dependent children would be 12.6 percent if the three family types constituted the same fractions of all families in 1997 as they did in 1974, when the poverty rate for all families with dependent children was 12.1 percent.[22] Taking the method at face value, the calculation implies that 86 percent (= {15.7-12.6}/{15.7-12.1}) of the 1974B1997 increase from 12.1 to 15.7 percent is owing to the change in the composition of family types.

Now consider the earlier period when poverty declined. Between 1959 and 1974, the proportion of families with dependent children that were single-parent families rose from 10.7 percent to 17.4 percent. If the proportion of single-parent families in 1959 was as high as in 1974, but poverty rates for each family type remained the same, then the 1959 poverty rate for all families would have been 22.9 percent instead of the actual rate of 20.3 percent. The actual 1959B1974 decline from 20.3 percent to 12.1 percent occurred despite the change in composition of family types over this period. This indicates how a growing economy and the various positive effects of government antipoverty programs can offset the poverty-increasing effects of higher proportions of single-parent families. This statement holds even if a growing economy and the government programs in aid of the poor contributed to the increase in female-headed families.

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22) The all-family poverty rate reached its low point of 8.8 percent in 1973 and 1974, although the poverty rate for families with dependent children was slightly higher in 1974(12.1 percent) than in 1973(11.4 percent). The lowest poverty rate for famillies with dependent children was 10.8 percent in 1969(this figure is not shown in Table 2). The year 1974 is used in the composition analysis because it is near the “turning point” year, 1973, and it is the first year for which poverty rates for families headed by a male(with no wife present) are reported by the U.S. Bureau of the Census in its P60 series (P60-200, 1998, pp. C-9 to C-14). All calculations for this composition analysis are availabel from the author, including the calculations when the “Other year” is used as the base year for fixing the demographic composition; for example, predicting the 1974 poverty rate if the 1997 headship composition were used.

This type of composition analysis is only suggestive of the underlying causal factors, and there are potential flaws in its use. Selecting just one type of change, here a particular demographic change, can be arbitrary. (See Gottschalk and Danziger, 1993, on this point.) Also, the assumption that the selected demographic change would not have changed other forces affecting poverty is questionable. For my purposes, however, the crucial methodological assumption is that the rise in female headship is exogenous to the family poverty rate and to other variables that caused the post-1974 rise in the poverty rate.

A contrary example, in which the formation of single-parent families is an endogenous response to other causes of poverty, is the hypothesis of Wilson (1987) that the loss of jobs to black males of marriageable ages leads to poverty and, in turn, to marital breakups and out-of-wedlock births. Although plausible, this hypothesis has been challenged (see Cherlin, 1992, pp. 102B111, and Jencks, 1992, pp. 120B142), and it has been applied only to blacks, who have faced the combined handicaps of living in neighborhoods where job opportunities have declined and living in a segregated housing market that inhibits their moving to sites where jobs are more abundant. Black families were 12 percent of all families and 28 percent of poor families in 1999 (Census P60-207, 1999, pp. B-10, B-14).

For the population as a whole, however, the case that the long-run increase in female-headed families is causal to increases in the poverty rate is strong. The rates of marital breakups (divorces and separations) and out-of-wedlock births (as a proportion of all births) have risen among all ethnic groups and economic classes in society; they rose in the prosperous period from 1959 to 1973 and in the period of economic stagnation from 1973 on; and they have risen in all industrialized nations.[23] The cultural forces that have led to a decline in stable, traditional families are associated with changes in the status of women in modern industrialized societies. Interestingly, two causes of these changes, the technological

23) For the increase in divorces across social classes and in other industrialized nations, see Goode(1992, pp. 119). For the increase in children born out of wedlock across social classes and in other industrialized nations, and the consequent increase in families with a never-married mother as the family head, see DHHS, *Out-of-Wedlock Childbearing*, 1995, pp. viii and 670. On the comparison between the periods of prosperity and stagnation: Table 2 shows that the annual rate of the increase in female-headed families with dependent children as a proportion of all families with dependent children was higher between 1959 and 1973, 3.3 percent, than between 1973 and 1996, 2.1 percent. The average increase in the percent of these female-head families was 3.8 percent points between 1959 and 1973 and 3.7 percent points between 1973 and 1998.

advances in birth control and the technological changes in market production that have diminished the importance of physical strength in the labor market, have each, by themselves, diminished poverty.

A controversial question among economists and demographers is the extent to which the rise in female headship is attributable to the incentives to establish single-parent families embedded in the old AFDC welfare program. Suffice it to say that even if AFDC had this effect, it need not invalidate the proposition that the increase in female-headed families in AFDC is separate from (exogenous to) the determination of median incomes, median wages, and national unemployment rates, which are macroeconomic indicators of poverty-causing forces of central interest to this paper. AFDC mothers were never a large part of the unemployed population, because most were classified as Anot in the labor force@ rather than as employed or unemployed.

Consider, as a final point, the connections between the post-1973 increases in female headship, family poverty rates, and income inequality. The lowest 20 percent of the family income distribution has become increasingly made up of female-headed families. Because the upper income boundary of this quintile has been above the poverty line for a family of five since 1960, almost all poor families are contained in this quintile, even though many families in this quintile are not poor. (In 1997, 87 percent of poor families with dependent children had a family size of five or fewer [P60-201, 1998, p. 1].) The decennial censuses show that in 1959, 25 percent of families with dependent children in the lowest quintile were mother-headed families, 41 percent in 1969, 50 percent in 1979, and 63 percent (estimated) in 1989.[24] The increase in income inequality occurred mainly in the 1980s, when the poverty rate for families with dependent children rose from 14.7 percent in 1980 to 16.4 percent in 1990. But we have seen that the increase in female headship as an explanation for increasing family poverty rates holds for

24) All citations are from the decennial censuses of the U.S. Bureau of the Census: *Census of the Population, 1960, Families, PC(2)-4A*, Table 14, p. 162; *Census of the Population, 1980, Detailed Population Characteristics, Part 1, U.S. Summary, PC80-1-D1-A*, Table 297, p. 475; *Census of the Population, 1990, Detailed Population Characteristics, Part 1, U.S. Summary, CP-2-1*, Table 37, p. 37. I found no statistics for the income distribution of families with dependent children in 1990. The figure in the text was estimated by using the 1980 ratio of the proportion of all female-headed families in the bottom quintile of the all-family income distribution to the proportion of female-headed families with dependent children in the bottom quintile of this income distribution, an then assumed that this ratio was the same in 1990.

all decade changes, including the decade of the 1980s.[25] Female-headed families with dependent children constituted 48.1 percent of poor families with dependent children in 1980; 56.0 percent in 1990 (column 6 in Table 3). These percentages are similar to the proportion of female-headed families with dependent children in the bottom quintiles in the distribution of family incomes in 1980 and 1990 (50 percent and 63 percent, respectively).

In summary, if we combine the sluggish performance of the economy after 1973 with the continued increase in female-headship among families, there need be no mystery about the overall rise and persistence of poverty since 1973. The cuts in AFDC cash payments and the widening wage gap among skill groups of workers also exacerbated the poverty problem, but these were minor factors.

V. Does the Strong Negative Relation between Economic Growth and Poverty Rates Shown from 1959 to 1973 Still Exist?

Since 1993 a number of econometric studies have examined the relation between aggregative economic growth and poverty, covering various periods between 1959 and 1993 (Blank and Blinder, 1986; Cutler and Katz, 1991; Blank, 1993; Blank and Card, 1993; Tobin, 1994; Powers, 1995; Blank, 1997). One finding that is common to these studies is that the effectiveness of macroeconomic growth in reducing poverty has diminished in recent years. Blank (1997, p. 29) states: A...the historical relationship between macroeconomic growth and changes in poverty has fundamentally deteriorated...@, and expressed the implications of this finding as follows: AThe final conclusion ... is not a promising one for policy makers: The impact of economic growth on poverty has substantially declined in the US during the past decade [i.e., the 1980s]. Even seven years of sustained economic expansion did little to significantly lower the poverty rate or increase incomes of low-income families@ (1993, p. 51). Given that the new welfare regime calls for work, not welfare, as the source of income for families with dependent children, the prospect for improving the well-being of these families would appear to be pessimistic.

25) Further evidence that the increase in female-headed families is a better explanation for the rise in family poverty rates from 1980 to 1990 than the increase in income inequality during that decade is the following finding: Female-headed families with dependent children constituted 48.1 percent of poor families with dependent children in 1980; 56.0 percent in 1990(column 6 in Table 3). These percentages are similar to the proportion of female-headed families with dependent children in the bottom quintiles in the distribution of family incomes in 1980 and 1990(50 percent and 63 percent, respectively).

My investigation and evidence in this section reaches the opposite conclusion: that economic growth remains effective as the principal, and a practical, means to reduce poverty for families with able-bodied adults of working age. We have already seen in Section IV that the 1959B1973 period of secular growth and the post-1973 period of secular stagnation were consistent with the historic negative relation between wage growth and family poverty that has prevailed for over a century.

Before presenting the econometric evidence on this issue, let me suggest, and then discount, three plausible a priori arguments why the historic relation between growth and poverty might have weakened in recent years.

1. Increases in female-headed families have led to a larger proportion of families without an employed adult, and without an earner the family would not be able to gain directly from tighter labor markets and higher wages. Yet in Figure 2 the cyclical falls and rises in the time series of median family income and the poverty rate for female-headed families from 1974 on are not only clearly inverse but more strongly inverse than the relation between income and the poverty rate for all families. One explanation is that most married-couple families have incomes well above the poverty line, so their poverty rate will not be much affected by a tighter and more prosperous labor market. Female-headed families, in contrast, tend to be clustered around the poverty line, which means that the increases in earnings that do occur for these families are more likely to raise their incomes above the poverty line. Also, keep in mind that although the long-run trends of both median family income and the proportion of families headed by a female are both positive, Figure 2 (and the statistical tests shown below) deal with year-to-year changes.

2. Immigration of low-wage workers, mainly Hispanic, (a) has grown in the last 25 years, increasing somewhat the poverty population, and (b) will increase in *response* to tighter labor markets and wage growth. Both (a) and (b) will slightly attenuate the natural negative relation between economic growth and poverty. Nevertheless, studies of the economic impact of immigration have not shown it to be

an important cause of the sluggish U.S. economy after 1973 or, except among Hispanics, the rise and persistence of poverty (see National Research Council, 1997, especially pp. 141, 164, 190, 220B230).

3. Wage and income inequality could have increased to the extent that poverty would increase even in a period of sustained and substantial economic growth. This has not been the record in the past, and the widening inequality in the 1980s occurred when wages were stagnant and unemployment was high. Also, as noted above, the time-series relation between poverty and income inequality is made complicated by the fact that both variables are mutually affected by such exogenous forces as unemployment and the rise in the female headship of families.

Table 4 presents a sharper test of the relation between standard macroeconomic indicators of the state of the economy and poverty and shows a comparison of this relation for the two periods under question B the growth period of 1959 to 1973 and the period of stagnation and limited growth after 1973. Because macroeconomic time series are often difficult to interpret to discern causal (or here proximate causal) relations, and because the post-1973 levels of income and earnings in the U. S. were flat, showing little variation, the data are transformed into year-to-year changes to use what little variation there is. In the table regression results are shown for a dependent variable, the year-to-year change in the family poverty percent, determined by changes in several indicators of the macroeconomic economy: the unemployment rate and, alternatively, median family income or median earnings of male full-time year-round workers or per capita GDP.

In rows 1, 6, and 11 the coefficient of median family income is negative, "large,"[26] and, importantly, similar for the periods when economic growth was strong, 1959B1973 (row 6), and when

26) The term "strong" is justified on the following grounds. First, in rows 1, 4, and 7 the coefficient of the percentage change in median family income from year to t+1 shows that for a 1 percent increase in median family income the poverty rate decreases by about 2 percent. To illustrate: a 5 percent increase in median family income, from $40,000 to $42,000, would predict a 10 percent decline in the family poverty rate from, say, 15 percent to 13.5 percent. Second, the coefficient of the median family income variable is statistically significant. Third, the coefficient of median family income was about the same in both the prosperous period of 1959-1973 and the stagnant period from 1973 to 1997, which indicates a robustness and stability in the relation over this 39-year period. In regressions not shown, the *level* of median family income was also strongly negatively related to the *level* of the poverty rate for 1959-1997 and 1959-1973, but there was no relation between the two

economic growth was weak, 1973B1997 (row 11). In the simple regressions (rows 3, 5, 8, 10, 13, and 15) with the change in male earnings or per capita GDP as the measure of economic growth, the results are similar and almost as strong as they are with median family income.[27]

The other rows in Table 4 show the relations between the change in the poverty rate and two right-hand-side variables: the change in income (or earnings) and the change in the unemployment rate. The income (or earnings) variables again have the expected sign, are statistically significant for income but usually not for earnings and, although reduced in absolute value, have practical significance. The change in the unemployment rate has the expected positive sign and is statistically significant for 1959B1997 and 1973B1997, but in one case not for 1959B1973 (where there are only 11 degrees of freedom and where the variation in the unemployment rate during this 14-year period is relatively small). The quantitative Aeffect@ of the change in unemployment on the change in poverty is small. For example, using the 1959B1997 regressions, an increase in the unemployment rate from 6.0 to 7.2 percent, a 20 percent increase, would predict only a 1.6 percent increase in the poverty rateCfrom, say, 15.0 percent to 15.2 percent. Two points are worth noting, however: The positive effect of unemployment is somewhat larger and is statistically significant in the period from 1973 to 1997, when growth was slow. Also, the unemployment rate is a proxy for labor market conditions that may be improved by monetary and fiscal policies; thus, changes in the unemployment rate can also be interpreted as a cause of changes in median incomes.

The constant term in the regressions in Table 3 is noteworthy because it represents an underlying, although unexplained, trend in the poverty rate after conditioning on the included variables. For example, taken at face value, the simple regression with median family income shows a similar

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variables for 1973-1997. From 1973 to 1997 there was no secular trend(upward or downward) in either median family income or the poverty rate, so only the changes in these variables, brought about mainly by business cycle, could show a relation.

27) The male earnings variables has the advantage of representing the market wage avilable to quality-constant workers and is, therefore, more closely related to the labor market than the other two income variables. However, the earnings variable does not reflect job losses or involuntary part-time work that occur during economic downturns. Per capita GDP is a more complete measure of the economic performance of the economy, but it is less closely linked to the economic status of families in the bottom half of the income distribution.

positive trend in the poverty rate of somewhat more than 1 percent per year for each of the three time periods (rows 1, 6, and 11). Including both median income and unemployment produces no trend (i.e., a zero constant) for the prosperous period of 1959B1973, and a small positive trend for the 1959B1997 and 1973B1997 periods. It is, however, the similarity across all three periods in the response of the poverty rate to the macroeconomic forces of median family income and the unemployment rate that I wish to emphasize.

The effect of unemployment on poverty is of special interest, because unemployment is more amenable to change by government policies than are incomes and wage rates. Those in the low-income population who are in the labor force are, it is evident, sensitive to the unemployment rate. The research that concludes that economic growth has lost much of its force in reducing poverty needs another look.

Conclusion and Summary. This paper began by describing the new welfare reforms as a change from the entitlement of cash payments for AFDC families to an end to those entitlements and a requirement that welfare mothers become self-supporting. The new reforms essentially require that most welfare mothers obtain market employment to support their families. One measure of the success of the new reforms is the amount and speed of the decline in welfare rolls. By this measure the new reforms have demonstrated considerable success. A more complete measure is the extent to which the families of welfare mothers rise above the poverty level or improve their standard of living. Information on this issue will be difficult to obtain, and any satisfactory answer will not be available for several years.

This paper has emphasized the importance of rising wages in reducing poverty. If full-time, year-round earnings had increased by 1 percent per year from 1973 to 1996Cabout half the historic rate of increase in wagesCthen median full-time, year-round earnings for men would have increased to $41,200 in 1997, which is 22 percent higher than the actual median, $33,674, of that year. Women=s median earnings did increase over this period, but only by 0.5 percent annually. Another policy goal for the labor market is maintaining full employment, and while it is difficult to specify full employment with a number that economists can agree upon, the 6.8 percent average annual unemployment rate from 1973 to 1997 is surely well above the full employment level.

Still another way to lower the poverty rate is to return to the proportions of two-parent families that existed in 1960 and earlier, but this strategy raises two questions that social scientists are unable to answer. One is whether the broad social and cultural forces that have made marriages less stable (or less likely to occur) can be reversed. A second is whether higher wages for womenCso important in reducing poverty among female-headed familiesCwould deter marriage and encourage divorce by increasing the economic independence women achieve from higher wages and expanded employment opportunities. Higher wages for men might have the opposite effects on marriage, but productivity and wage growth in modern times stem from brain power, not physical strength, so wage growth would surely apply to both sexes. Indeed, most economic studies have shown that the male-female wage gap has narrowed in the last two decades.

My conclusions are the following. Wage growth is essential to reduce poverty among families with dependent children, particularly among welfare mothers. The traditional source of achieving wage growth and reducing poverty remains macroeconomic growth. Economic growth has not lost its power to reduce poverty, as some economists have recently claimed. In the near future most welfare mothers will remain poor under the new welfare system, but wage growth will, at least, raise their living standards.

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Note: The following short forms of references are used in the text for convenience:

Example of the P60 citations:
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APPENDIX A
GLOSSARY OF TERMS AND KEY FACTS FOR U.S. TRANSFER PAYMENT PROGRAMS

TERMS

means tested programs B eligibility for benefits from the program depends on the household=s income and assets, generally restricted to low-income households.

universal programs, also referred to as **social insurance** programs, are the opposite of means tested programs in the sense that the household=s income and assets are not criteria for eligibility for the receipt of benefits, although for some programs the amount of the benefits received may depend on the income or earnings of the recipient.

in-kind transfer payments, such as free or subsidized food stamps, housing allowances, or medical insurance may be differentiated from money (or cash) transfers. In this paper tax advantages to certain groups are not considered as transfer payments.

poverty level of income, also called the **poverty threshold** or **poverty line**, is an annual income amount, varying by the size of the household unit, below which the household is classified as poor. The thresholds were officially set in the early 1960s and are adjusted annually by the inflation rate. In-kind transfer payments are not included. In 1996, for example, the poverty threshold for a family of size three was a money income of $12,300; for a family of four, $16,200. These amounts were 29 and 38 percent of the median family income in 1996. The average size of families in the U.S. is around 3.2.

PROGRAMS (Source: *1998 Green Book*, U. S. Congress, May 1998. Page numbers below refer to this document.) This is a limited listing, restricted to the major programs.

Social Insurance Programs

1. **Old-Age Survivors, and Disability Insurance (OASDI**) provides monthly payments to retired (usually age 65 and over) and disabled workers, their dependents and survivors. It is nearly universal in its coverage, although those with a limited employment history may not be eligible for these benefits. A benefit program accompanying OASDI is the government subsidized health insurance program, Medicare, which is listed next. If the relatively small proportion of the aged and disabled who are not eligible are poor, they are likely to be eligible for the means-tested program, Supplemental Security Income, listed below. Maximum monthly benefits for a retiree at age 65 in 1997 were $1,326, which would be 1.6 times the poverty level for a family of two. Expenditures for OASDI in 1996 were $350 billion, when the number of recipients was 43.7 million (pp. 3-4).

2. **Medicare** is a nationwide health insurance program for those over age 65 and certain disabled persons, available to all OASDI recipients. Expenditures in 1996 were $174 billion, after deducting the enrollment payments made by the recipients (p. 103).

3. **Unemployment Compensation** B A federal and state program that provides temporary (usually 26 weeks) and partial wage replacement to involuntarily unemployed workers who were recently employed. In 1996, a year of moderate unemployment (5.4 percent), expenditures were $22 billion for the 8.1 million recipients.

Means Tested Programs (for poor and near-poor households)

1. **Supplemental Security Income** (SSI) is a federal income assistance program, providing nationally standardized monthly payments to Aneedy aged, blind, and disabled persons@ (p. 262). In 1996 the maximum amount provided to an aged couple was $705, which was 89 percent of the poverty level of income. Benefits are reduced if the household receives other income. Expenditures in 1996 were $28 billion for 6.6 million recipients (pp. 264-5).

2. **Temporary Assistance to Needy Families** (TANF) in 1997 replaced the previous program, **Aid to Families with Dependent Children** (AFDC), which was established in 1935. The new welfare reform mainly consists of this replacement. Recipients of both programs are (TANF) or were (AFDC) almost entirely single-parent families (over 90 percent of which are headed by the mother) with children under 18 years of age (or children still in school). Average monthly payments for AFDC families were $374 in 1996 (sharply down from their top level of $734 in 1970), with large variation across the 50 states. The average payment is less than the maximum received if the family has no other income. Generally, for each dollar of a family=s own income, the family=s benefit is reduced by a dollar. For a family of size three (the average) the median state=s payment was 34 percent of the poverty line in 1996, but these amounts are supplemented by other programs listed below. In 1996 the average number of AFDC families in a given month was 4.6 million, which was 4.8 percent of all families with children, and total expenditures were $20 billion (p. 402). The TANF program is discussed in the text.

3. **Food Stamps,** like SSI, has a single national standard benefit amount that varies inversely with the recipient=s income. Its monthly in-kind transfer payment supplement the income of eligible (low-income, low assets) households. Recipients of SSI and AFDC (or TANF) are automatically eligible for food stamps. Generally, for each dollar of own household income, the food stamp benefit is reduced by one-third of a dollar. In 1996 the number of recipients was 27 million and the expenditures were $23 billion (pp. 927 and 945).

4. **Medicaid** provides medical assistance to SSI and AFDC (or TANF) recipients and a relatively small number of other households with low incomes and low assets. It is state administered and partially state financed, so the state by state variation in coverage and benefit levels is large. AIn 1996, Medicaid covered 12 percent of the total U.S. population (excluding institutionalized persons) and 44.6 percent of those with incomes below the Federal poverty level@ (p. 956). Expenditures in 1996 were $162 (p. 969).

5. **Earned Income Tax Credit** (EITC) is effectively a subsidy for low-earners in the form of Aa specified percentage of wages up to a maximum dollar amount. The maximum [percentage] amount [34 percent for a family with one child] applies over a certain income range [0 to $6,330] and then diminishes to zero over a specified phaseout range [$11,610 to $25,078]@ (p. 866). In this example the maximum subsidy for the year is $2,152, attained at the earnings amount of $11,610, which then declines by 16 percent until the income limit of $25,078 is reached. I estimate that those below the poverty level receive about $18 billion from the EITC; with about $11 billion going to families with a single parent. All the above figures are for 1996.

Other Programs

Other social insurance and means-tested benefit programs could be listed, but the above programs are the major ones that permit a relatively straightforward classification and calculation of expenditures. For example, veterans of U. S. wars receive a mix of means tested and social insurance components that provide cash and in-kind benefits. Some programs for child care and education are means tested, but most of the subsidies for these purposes are universal in their coverage.

APPENDIX B
WAGE GROWTH IN THE LONG-RUN REDUCTION OF POVERTY

Let us focus on long-run trends in order to abstract from periods of cyclical downturns, when unemployment is important in determining labor earnings. Consider the period from 1860 to 1960, when a family=s income was mainly determined by labor earnings. Exceptions were the rich, who constituted a small proportion of the population occupying one end of the income spectrum, and another small proportion of persons at the other end of the spectrum who were wards of orphanages, insane asylums, and old folks= homes. The income support from government or private charity received by these wards never did and was never intended to lift them above poverty. The incomes of the vast majority of families, therefore, were determined by wages or, in the case of self-employed farmers, returns to their labor and land. Self-employed farmers became an increasingly small proportion of the labor forceConly 9.7 percent by 1940 and 4.6 percent by 1960 (Lebergott, 1964, p. 511). (Farm workers who work for wages are not included in these percentages.)

The increase in wages from 1900 to 1960, estimated by dividing average annual earnings in year-round jobs by the estimated average annual hours of work, was 2.3 percent per year.[28] In 1996 dollars, full-time, year-round median earnings were approximately $23,000 in 1960 (Census, P60-180, 1992, p. B-32; see references for a full citation), and $6,000 in 1900, estimating the latter by a back-projection of the 2.3 percent growth factor.[29] The latter figure would not be considered a Aliving wage@ today. Poverty, however, is a

28) Lebergott(1964, pp. 523) implies a 2.6 percent annual rate of growth in wage rates of “full-year” workers from 1900 to 1960. I calculate the average wage by dividing the 1900 average earnings by 3,000 hours and the 1960 earnings by 2,000 hours. The hours figures are based on the approximations of 60-hour and 40-hour work weeks in 1900 and 1960, respectively, along with a constant 50-week year. The wage measure for full-time, year-round workers avoids the distortion that results when the proportion of part-time and/or part-year workers in the labor force increases, as it has in recent decades. The 1960 median earnings of full-time, year-round workers(Census, P60-180, 1992, p. B-32) is .84 of Lebergott’s 1960 figure for average earnings. Conservatively, I use the smaller Census figure for 1960(divided by 2,000) and Lebergott’s 1900 annual earnings figure(divided by 3,000) to calcuate a 2.3 percent annual growth rate in wages over this 60-year period.

29) 1992, p. B-32) is .84 of Lebergott’s 1960 figure for average earnings. Conservatively, I use the smaller Census figure for 1960(divided by 2,000) and Lebergott’s 1900 annual earnings figure(divided by 3,000) to calcuate a 2.3 percent annual growth rate in wages over this 60-year period.29) The 1900 figure is a back-projection based on the trend line of wages(strictly speaking, a log-linear trend), and it will differ from the actual earnings in 1900 depending on whether earnings in that year were above or below the trend line.

concept that applies to the family unit rather than to an individual person or worker.[30] The huge increase in the average annual earnings of a family=s full-time, year-round worker in 1960 compared to 1900 implies a large decrease in family poverty, but quantifying this decrease is difficult.

Measuring family poverty rates requires information on family size and the income of all family members. Unfortunately, the first national survey to obtain family income statistics was the 1940 decennial census. The following facts about families in 1900 compared to 1960 are, however, revealing. In 1900 a larger proportion of families were two-parent families, but a far smaller proportion of mothers worked in the market and fertility rates and family sizes were larger. Child labor was much more extensive, but this made only modest contributions to family income, except on farms.[31] Indeed, the use of child labor, especially in urban settings, was an indicator of family poverty.

Per capita income, which requires only population and national income statistics, has been estimated for as far back as 1840, and I will assume that its growth rate approximates the growth rate of family income. Per capita income grew at an annual rate of 1.6 percent from 1840 to 1960 (Kuznets, 1971, p. 18), 1.9 percent from 1900 to 1960 (U.S. Department of Commerce, 1966, pp. 166B167), and 1.8 percent from 1920 to 1990 (*Economic Report of the President*, 1993, p. 74). The 1900B1960 figures illustrate the lower growth rate for per capita income (1.9 percent) than for wages (2.3 percent). This reflects mainly the long-run decline in a worker=s average hours worked per year, from roughly 3,000 hours (a 60-hour work week for 50 weeks) in 1900 to 2,000 hours in 1990 (Census, *Historical Statistics*, 1975, p. 168). Wages per hour had to rise at a faster rate than family income to achieve a specified growth rate in income, given that almost all family income consists of labor earnings and that the total hours of market work by the family declined (Cain, 1984). The growth in leisure implied by the decline in time spent at work is itself important in measuring the

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30) Poverty statistics also apply to the household unit, which could consist of one person living alone or two or more persons living together who are unrelated by blood, marriage, or adoption. This paper concentrates of the family unit, especially families with dependent children present.

31) See Census, *Historical Statistics*, 1975, p. 133 for labor force participation rates of married women; pp. 49 and 53 for fertility statistics; pp. 15 and 134 for statistics on child labor.

improvement in the overall standard of living, even though leisure consumption does not directly affect the current measure of poverty.

By assuming that the growth rate for family income is the same as that for per capita income, we can estimate the family poverty rate for the earlier years mentioned above. For example, to compare 1920 with 1990, we can use the median family income of $42,440 in 1990 and calculate that $12,000 was the back-projected median family income in 1920, based on the 1.8 percent growth rate. (All figures will be expressed in 1996 dollars.) Since the poverty line in 1996 was roughly $16,000 for a family of four (and $18,200 and $12,500 for families with five and three persons), well over 50 percent of families in 1920 would be classified as poor, using the current criterion.

Similar calculations (and estimation of the relation between the 50th, 75th, and 90th percentiles) indicate that over 90 percent of American families would be classified as poor in 1840 and over 75 percent in 1900Cperhaps bizarre statistics that show how the concept and measure of poverty have changed over time to reflect some degree of relativity to prevailing income levels. When the current definition of poverty was first applied in 1959, a rule of thumb was that the poverty level of income for a family of four persons was equal to about half the median family income. Although this ratio declined to .36 (= $16,600/$46,340) in 1998 dollars, these relative definitions of poverty would not produce the shockingly large percentages of poor families just calculated for 1840, 1900, and 1920.

Comparisons of the poverty rate between 1960 and earlier years are especially interesting, because only after 1960 did government transfer programs become an important factor in bolstering the incomes of low-income families with dependent children. The family poverty rate in 1960 was 18 percent overall and 20 percent for families with children under 18. In that year families with dependent children were 60 percent of all families (Census, P60-189, 1995, p. B-22). Clearly, the decline in family poverty to 18 percent in 1960 from those high levels in 1840, 1900, and 1920 is almost entirely attributable to the rise in wage rates and reasonably steady employment, rather than to the increases in such other sources of income as rents, dividends, interest, capital gains, and even income transfers. The reference to Asteady employment@ calls attention to pervasive poverty in the depression between 1930 and 1940, when much of the extent of poverty was attributable to high levels of unemployment rather than to l ow wages of those who worked.[32]

Since 1960, government transfer payments, both cash and in kind, have become an important policy instrument in antipoverty programs. (Their role in reducing poverty among families with dependent children is discussed in Section III.) These programs, in particular Social Security retirement benefits, have been especially successful in reducing poverty among the aged and (to a lesser extent) the disabled (*Green Book*, 1993, p. 71).[33]

A strong case can be made that growth in wages is the fundamental cause[34]for the generosity of the Social Security program, which is financed by payroll taxes and operates as a pay-as-you-go system. Without wage growth and, at least as important, the expectation of wage growth for succeeding generations, I doubt if recent generations of workers would have been willing to transfer as much of their earnings to the cohort of older retired and disabled persons. These intergenerational transfers permitted the Social Security payments to far exceed the value of the original contributions of the recipient older group.[35] Wage growth and various tax

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32) Tobin (1994, p. 148) suggests that two-thirds of Americans were poor by the current definition in the 1930s. Lebergott (1964, p. 189) estimates that the average annual unemployment rate between 1930 and 1939 was 18 percent, and it was 15 percent in 1940. His estimates for the average annual unemployment rates for the three decades from 1900 to 1929 are 4, 5, and 5 percent, respectively. In the four years after World War II, from 1946 through 1949, the average annual unemployment rate was 4 percent, and it was 5 percent from 1950 to 1959 (USDL, *Handbook*, 1989, p. 129)

33) From 1959 to 1997 the poverty rate for persons 65 and older decreased from 35.2 percent to 10.5 percent (Census, P60-201, 1998, p. C6). Government transfer payments, primarily Old Age, Survivors, and Disability Insurance and secondarily the means-tested Supplemental Security Income pprogram, contributed mightily to this achievement (Danziger and Weinberg, 1994). This record is all the more notable because life expectancy among the aged increased. A 65-year-old in 1960 could expect to live 14 more years; in 1991, 17 more years (Census, P23-190, p. 3-1, 1996).

34) The use of the term fundamental cause is always sensitive to the problem at hand and subject to dispute. In this paper I refer to the rise in wages as “causal” in the following sense. The combination of capital accumulation and improvements in technology, health, and education are the predominant antecedent causes of the growth in wages and they are mainly exogenous with respect to increasing both the demand for labor and the quality of labor supply. Education is probably the most endogenous of these forces with respect to the long-run rise in wages, but aggregative expenditures on education have increased in part as an effect of rising family incomes and of the technologically driven increased demand for higher labor skills. These arguments do not imply that wages at the aggregative level cannot be directly affected by explicit policies such as minimum wage laws, subsidies to education causality depends on the problem at hand.

35) Indeed, the apprehension of the current generation of younger workers regarding their expected low returns from Social Security retirement and health benefits stems from the stagnation of wages during the past 24 years, along with the fact that when they reach retirement age this cohort will become a larger proportion in the population, relative to the working-age population.

subsidies have also been fundamental causes of the increases in private pensions, payments from private insurance, and personal savings, which are other sources of the rise in incomes of the aged and the disabled.

APPENDIX C
Wage Increases or Fertility Declines as the Major Cause of the Rise in Women′S LFPR?

Attributing the long-run rise in women=s employment mainly to the increase in wages can be contested by the hypothesis that the decline in women=s fertility was the principal cause. Although peripheral to this paper, these competing hypotheses were informally tested during the baby-boom period after World War II. Women=s wages rose and so did their LFPR, even though birth rates increased sharply. A related point is that although poverty is defined by family size as well as family income (as shown in Figure 1), fertility declines have not been a major source of poverty reduction since the 1920s, because low birth rates have prevailed during the last 70 years, excepting only the baby-boom period after World War II from, say, 1947 to 1962.[36] Indeed, this baby-boom experience serves to downgrade the role of fertility in its effect on poverty, because the 45 percent rise in median family income between 1947 and 1962 (Census, P60-180, 1992, p. B-22), which was mainly due to higher wages, brought about lower poverty rates despite the increase in average family size. Furthermore, the increase in family poverty rates after 1974 occurred when birth rates among American women were at historic lows, dropping below the replacement rate of 2.1 children ever born per woman from 1972 on (*Statistical Abstract*, 1999, p. 78).

The decades-long *increase* in market work by women is, in fact, mainly by mothers in married-couple families, which is why two-earner families have become the norm among husband-wife families. (See Table 2.) In 1998, 70 percent of all families with dependent children were married-couple families. Their poverty rate was 6.9 percent. In families with dependent children in which both husband and wife were employed during the year, not necessarily in full-time, year-round jobs, the poverty rate was 2.8 percent. The contrast with female-headed families with dependent children (24 percent of all families with dependent

36) The cohort of women born in 1895 to 1899, who reached the age of 30 between 1925 and 1929, on average had 2.7 children during their lifetime. This was substantially less than that for women born between 1855-1859, 1860 864, and 1865 869, who reached age 30 between 1885 and who had completed cohort fertility rates of 5.0, 4.7, and 3.9, respectively. Women born between 1900 and 1919, who became 30 between 1930 and 1949 had on average from 2.4, 59 2.7 children during their lifetimes. Women who reached age 30 between 1955 and 1969 period that reflected the post-war baby boom ad completed cohort fertility rates of just 1975, p. 53; and recent issues of the annual *Statisical Abstract*.)

children) is striking: 38.7 percent were poor. However, in families in which the mother worked the poverty rate was about 11 percent (Estimated, based on Tables 2.3 and B-10 in Census P60-207, 1999.)

Figure 1. Guide to the Main Points of the Paper

Chart 1. Proximate determinants of poverty in families with dependent children

All determinants may be viewed as primarily definitional. Emphasized linkages are solid lines and unemphasized linkages are dotted lines. Other possible linkages among the variables below, including many mutually causal linkages, were omitted for simplicity.

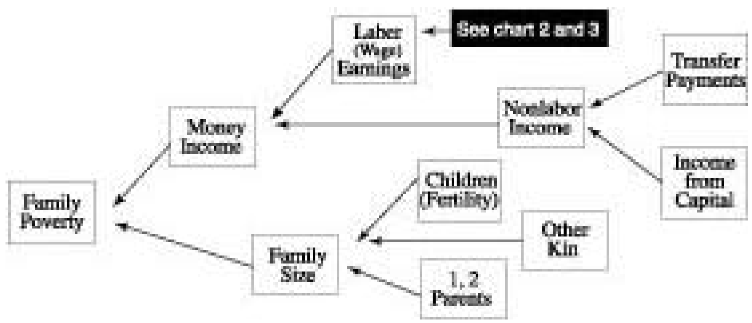


Chart 2. Selected earlier-stage determinants of key variables: wage rates and labor earnings

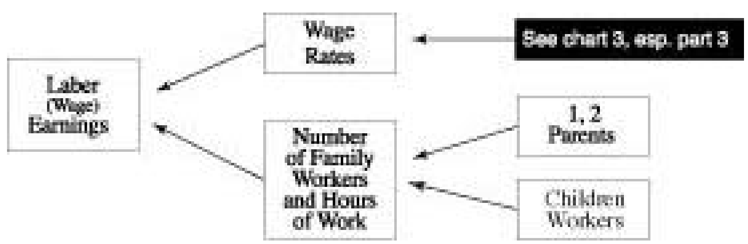


Chart 3. Selected auxiliary relations

A. Microeconomic

1. Demographic: marriage and fertility _ wage rates, especially women=s

2. Employment rates of women _ women=s market (exogenous) wage rates

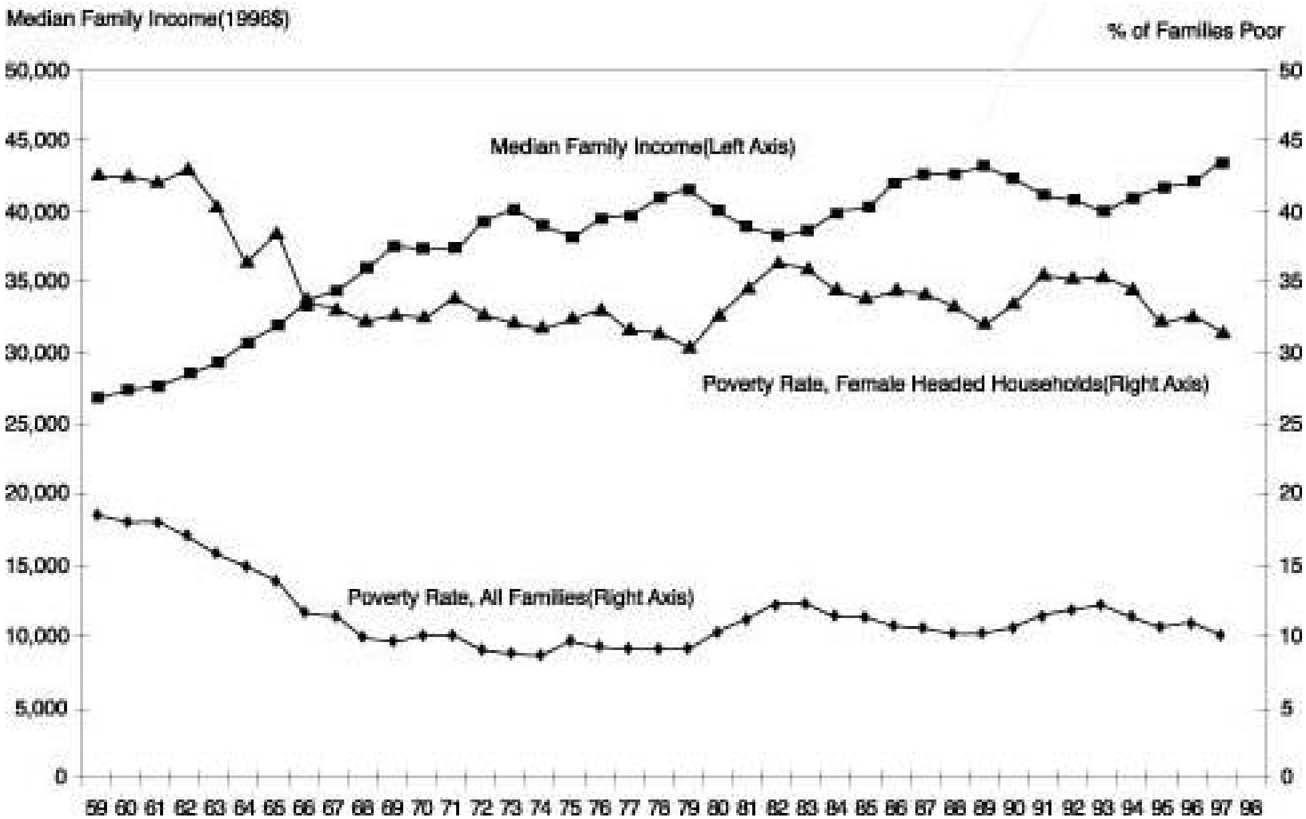
3. Transfer payments _ government policy, plus intrafamily transfer payments (e.g., child support)

B. Macroeconomic

1. Aggregate (average) levels of wages and unemployment rates _ structural causes of productivity and macroeconomic fiscal and monetary policies

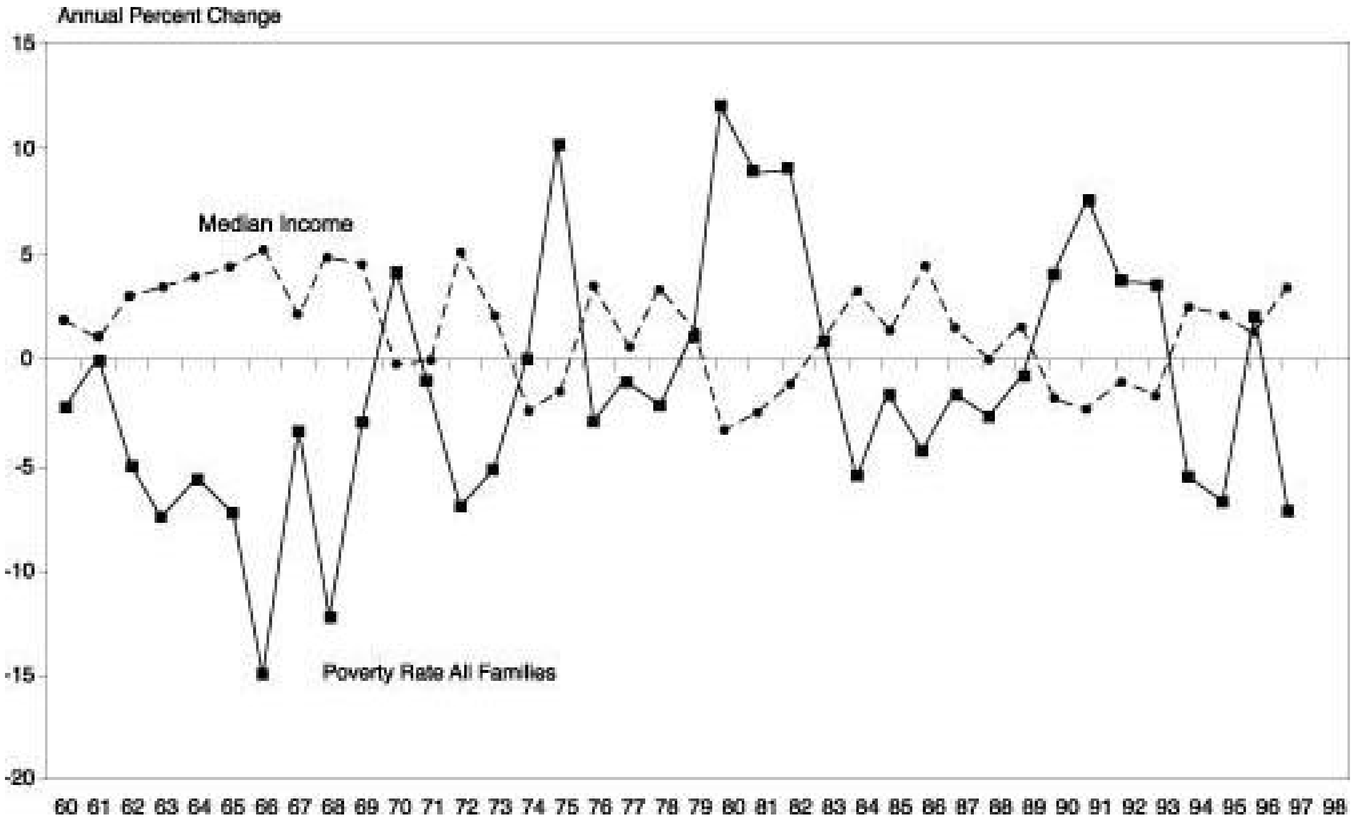
2. Distribution of family incomes and personal wages _ all of the above

Figure 2. Median Family Income and the Poverty Rate for All Families and for Female-Headed Families, 1959-1997



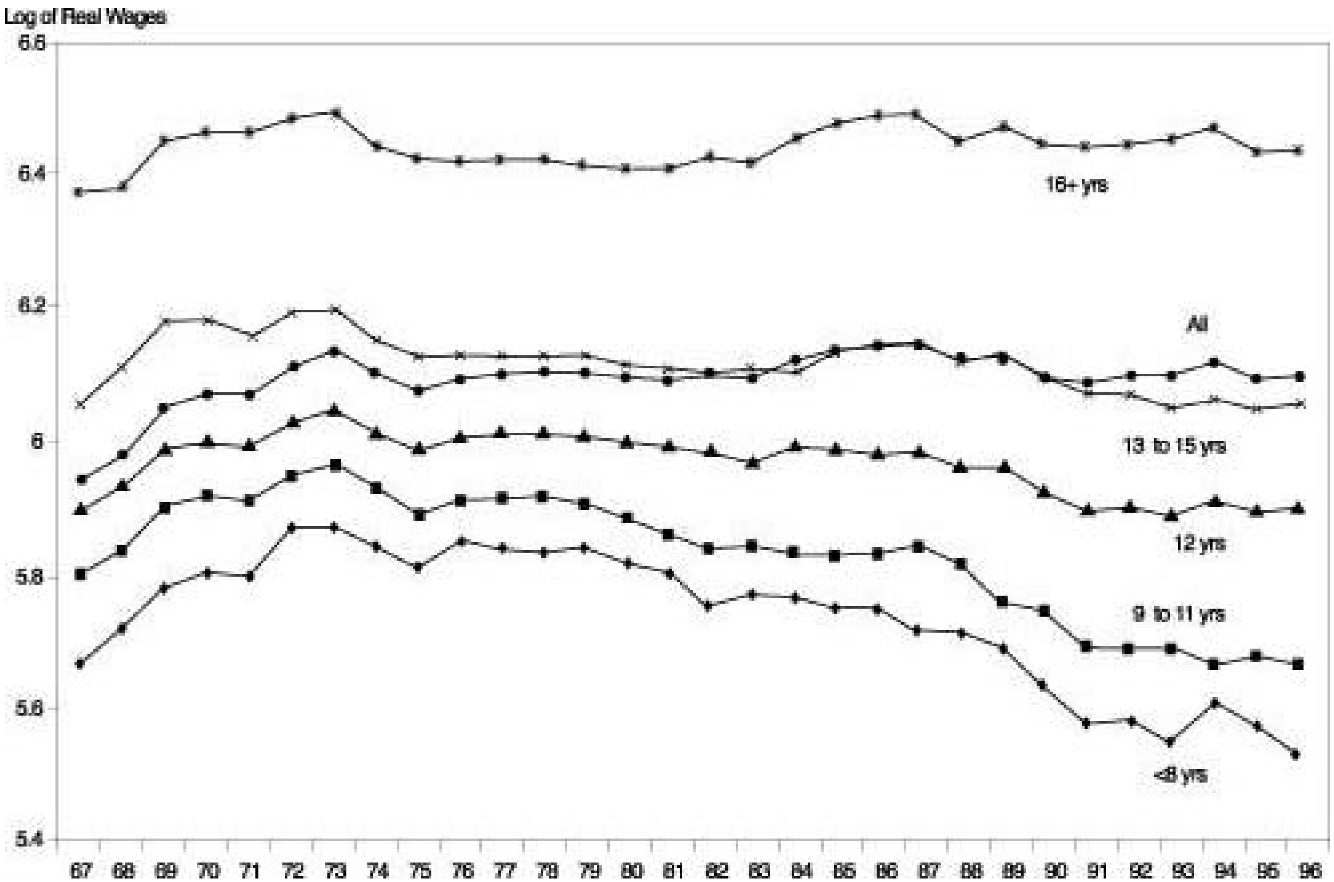
Source: U.S. Census Bureau, Current Population Reports P60-206 and P60-207, 1999.
Note: The poverty rate for female-headed families is less than the poverty rate for female-headed families with dependent children that is shown in Table 2.

FIGURE 3. Annual Percentage Change in Median Income and in the Poverty Rate for All Families, 1960B1997



Source: U.S. Census Bureau, Current Population Reports P60-206 and P60-207, 1999.

FIGURE 4. Log of U.S. Real Wages by Years of Education, 1967B1996



Source: Robert E. Baldwin and Glen G. Cain, AShifts in U.S. Relative Wages: The Role of Trade, Technology, and Factor Endowments,@ Discussion Paper 1132-97, Institute for Research on Poverty, University of WisconsinBMadison, 1997. Based on data from U.S. Census Bureau, March Current Population Surveys, 1967B1996.

TABLE 1
U.S. Gross Domestic Product (1996 Dollars) and Expenditures on Major Government Social Insurance and Welfare Programs as a Percent of GDP, Selected Years, 1959B1998

		Government Transfer Payments as Percent of GDP				
			Social Insurances[b]			
Year	GDP (billions)	Total[a]	OASDI[e]	Unemployment Insurance[f]	AFDC/TANF[c]	Other[d]
1960	$2,357.2	4.6%	2.1%	0.6%	0.2%	1.2%
1970	3,549.4	6.9	3.7	0.4	0.5	1.9
1980	4,872.3	9.7	5.5	0.6	0.4	2.9
1990	6,683.5	9.9	6.1	0.3	0.3	3.2
1994	7,337.8	11.5	6.9	0.3	0.3	4.2
1996	7,813.2	11.5	6.9	0.3	0.3	4.2
1998	8,516.3	10.9	6.6	0.2	0.2	3.9

Source: *Economic Report of the President, 2000*, pp. 306, 308, 335, 339.

[a]Does not include business transfers to persons.
[b]See Appendix A for definition of social insurance. Not all social insurance programs are separately listed in this tables.
[c]AFDC is Aid to Families with Dependent Children, the welfare program (see Appendix A) for mostly poor single-parent mothers with children. In 1997 this program was replaced by TANF (Temporary Assistance to Needy Children) by the 1996 welfare reform law.
[d]AOther@ is a mixture of some social insurance programs, such as government pension programs, and some welfare programs such as Food Stamps, Medicaid (a health care program for low-income families), and Supplementary Security Income (an income maintenance program for poor persons who are aged, blind, and disabled and who are not eligible for OASDI).
[e]OASDI is the Old Age, Survivors, and Disability Insurance program, including the Medicare program for health insurance for recipients of OASDI.
[f]Unemployment Insurance allows compensation payments for (usually) 26 weeks to workers who have lost their jobs through no fault of their own and who have been employed for a sufficient length of time before their job loss, and who are willing and able to take a job while unemployed. About 90 percent of all experienced wage and salary

TABLE 2
Labor Force Participation Rates[a] of Women in Families
with and without Children under Age 18, by Marital Status (Selected Years)

								Women with Children	
			All Women[b]						Youngest, 6B17
		Youngest, under Age 6							
Year	Married, Husband Present	Divorced, Separated, Widowed	Never Married	Married, Husband Present	Divorced, Separated, Widowed	Never Married[c]	Married, Husband Present	Divorced, Separated, Widowed	Never Married[c]
1960[d]	30.5	40.0	44.1	39.0	65.9	NA	18.6	40.5	NA
1970	40.8	39.1	53.0	49.2	66.9	NA	30.3	52.2	NA
1980	50.1	44.0	61.5	61.7	74.6	67.6	45.0	60.3	44.1
1990	58.2	46.8	66.4	73.6	79.7	69.7	58.9	63.6	48.7
1995	61.1	47.3	65.5	76.2	79.5	67.0	63.5	66.3	53.0
1996	61.1	48.2	65.2	76.7	80.6	71.8	62.7	69.2	55.1
1997	62.1	48.7	68.8	77.6	81.1	74.0	63.6	74.2	65.1
1998	61.8	49.4	68.1	76.8	82.7	81.2[e]	63.7	72.5	67.3[e]

Source: 1960, 1970, 1980, USDL, *Handbook*, pp. 235B237; 1990B1998, *Statistical Abstract*, 1999, pp. 416B7.

[a]Employed + unemployed (actively seeking work) as a proportion of all women in the demographic category eligible to be in the labor force. The eligible population is the noninstitutionalized civilian population 16 years of age and over.

[b]Note that Aall women@ includes women over the age of 55, whose labor force participation rates are relatively low. The fact that women=s labor force participation rates are often higher for those with young children present than those for Aall women@ is mainly attributable to the larger proportion of older women in the latter group. Widows also have relatively low labor force participation rates because they tend to be older.

[c]Until 1997 never married women with children were over represented in AFDC, which is a program that had severe disincentives to employment.

[d]The labor force statistics for 1960 include 14- to 15-year-old women, whereas in the other years the official definition of the labor force is restricted to persons 16 years of age and older. The LFPR of 44.1 for never married-women in 1960 is especially biased down in comparison with the figures for later years, because 14- to 15-year-olds are almost exclusively in this demographic category, and the labor force participation rates of this age group were much lower than the average for all ages.

[e]The labor force participation rates for never-married (a single@) women with children show sharp increases from 1996 to 1998.

TABLE 3. Poverty Status of Families, Selected Statistics for Selected Years, 1959B1998

Year	All Families (1)	All Families with Dependent Children (2)	Married Couples with Dependent Children (3)		Female Head with Dependent Children (4)	All (5)	With Dependent Children (6)	% of all Families with Dependent Children that Have a Female Head (7)
	Poverty Rates (Percent)					% of Poor Families with Female Head		
1959	18.5	20.3		(16.0)[a]	59.9	23.0	28.0	9.4
1965	13.9	15.6		(11.4)[a]	52.2	28.5	34.2	10.2
1970	10.1	11.6		(6.9)[a]	43.8	37.1	48.1	12.8
1973	8.8	11.4		(5.8)[a]	43.2	45.4	56.4	14.8
1974	8.8	12.1	6.0	(6.2)[a]	43.7	47.2	56.7	15.7
1980	10.3	14.7	7.7		42.9	47.8	56.0	19.2
1983	12.3	17.9	10.3		47.1	46.6	53.2	20.2
1990	10.7	16.4	7.8		44.5	53.1	60.4	22.3
1993	12.3	18.5	9.0		46.1	52.7	60.0	24.0
1996	11.0	16.5	7.5		41.9	54.1	61.2	24.1
1998	10.0	15.1	6.9		38.7	53.3	61.4	24.0

Source: U.S. Bureau of the Census, P60-207, 1999, pp. B10BB11.

[a]Poverty rate for married couples plus families with a male head (and no wife present). Male-head families were 1.4 percent of married-couple families in 1959, 1.7 percent in 1970, 1.5 percent in 1973, and 2.1 percent in 1974.

TABLE 4

Regression Estimates: Annual Change in the Family Poverty Rate (Dependent Variable[a]) in Response to Changes in Aggregative Economic Variables, 1959B1998, 1959B1973, 1973B1998[b]

			Coefficients of Independent Variables (standard errors in parentheses)	
			Annual Percent Changes in	
Years	R^2	Constant	Median Family Income	Median Male Earnings[c]

1)	1959B1998	.75	.013	(.006)*	-2.15	(.20)*		
2)		.79	.008	(.005)	-1.75	(.25)*		
3)		.30	-.006	(.009)			-1.45	(.37)*
4)		.65	-.007	(.006)			-1.06	(.27)*
5)		.58	.035	(.009)*				
6)	1959B1973	.67	.015	(.016)	-2.39	(.48)*		
7)		.70	.001	(.022)	-1.82	(.74)*		
8)		.13	-.021	(.030)			-1.28	(.99)
9)		.56	-.042	(.024)*			-.44	(.79)
10)		.65	.010	(.016)				
11)	1973B1998	.70	.013	(.006)*	-1.98	(.27)*		
12)		.80	.011	(.005)*	-1.15	(.32)*		
13)		.16	.000	(.010)			-1.10	(.51)*
14)		.71	.004	(.006)			-0.39	(.32)
15)		.59	.043	(.010)*				

[a]Dependent variable: percent change in poverty rate (mean = -.016, 1959B1998).

[b]Durbin-Watson tests in these regressions allow acceptance of null hypothesis of no serial correlation in all regressions.

[c]Percent-change Means for Independent Variables, 1959B1998:

Median family income .013.

Median male earnings (full-time year-round workers) .007

Unemployment rate -.010

Per capita GDP .023.

Opening Address of the APEC Forum on Shared Prosperity and Harmony

by
Dae-jung Kim
President, Republic of Korea

His Excellency Pehin Abdul Rahman, Chair of the APEC Ministerial Meeting, and distinguished guests!

It gives me great pleasure to host the APEC Forum on Shared Prosperity and Harmony at the onset of the new millennium.

We are joined here today by ministers and senior government officials of the APEC member economies, world-renowned scholars and prominent experts.

We have gathered in the wake of the new millennium to devise a brighter future for APEC.

The new millennium heralds an era of globalization, digitalization and knowledge-based economies. It is an era in which competitiveness is determined by knowledge and information, rather than natural resources. This digital era moves at the speed of light.

Furthermore, the new millennium is an era in which cooperation between government, the market and civil society and cooperation among economies, alike, must be strengthened for all mankind to co-exist and prosper altogether.

Since its establishment in 1989, APEC has come a long way, positioning itself to look forward to further progress.

The dynamic economic relations and cooperation to date have firmly established APEC as the largest body for economic cooperation in the world. In particular, since the adoption of the Bogor Declaration in 1994, sustained regional trade and investment liberalization efforts have greatly contributed to the common prosperity of the member economies.

Furthermore, APEC has played a pivotal role in the international efforts to overcome the financial crisis that has challenged the Asian economies since the latter half of 1997.

In the onset of this new millennium, I believe there are three common tasks that the APEC member economies should collectively address for a brighter future in the Asia-Pacific region.

First, we must further our efforts in structural reforms and trade and investment liberalization in order to achieve sustained prosperity in the region.

Second, we must devise a diverse range of cooperation measures for preventing the recurrence of financial crises.

Third, we must explore specific action plans for regional cooperation in order to alleviate the social and economic disparities among member economies and, further, to achieve shared prosperity in the Asia-Pacific region.

Ladies and gentlemen!

I would, firstly, like to emphasize the importance of structural reforms and trade and investment liberalization.

Today, the world is transitioning and advancing from the era of the industrial economy to an era of a knowledge and information economy. We have just entered into an era where competition is determined by speed, going beyond the conventional competition by price and quality. The only way for an economy to remain competitive under such ‘mega-competition’ is through reform and liberalization.

Accordingly, in order to achieve sustained development in the Asia-Pacific region, each member economy must boldly pursue structural reforms and trade and investment liberalization.

The Asian economies have been able to successfully overcome the financial crisis in a relatively short period of time as they resolved the structural problems that have accumulated in the overall economy.

Korea is not an exception.

Korea has taken advantage of the financial crisis as an opportunity to completely overhaul its economy. Accordingly, Korea has boldly pursued reforms and liberalization based on the national policy of a parallel development of democracy and the market economy.

Korea has implemented reforms in the four key areas of the economy; the financial, corporate, labor, and public sectors. These reform measures focused on fundamentally resolving the weaknesses in the economy caused by cronyism, government intervention and corruption.

As a result, Korea was able to achieve a real growth of approximately 10% last year. Prices have stabilized at an all time low of 0.8% inflation. Foreign exchange reserves exceed US$ 80 billion, compared to only US$ 3.9 billion in 1997, when the crisis hit. Furthermore, Korea has fully paid back its emergency loans from the IMF.

Ladies and gentlemen!

I believe that investment liberalization will benefit both the investing and host economies, greatly contributing to shared prosperity.

In Korea alone, foreign investment last year amounted to US$ 15.5 billion.

There is an old Korean saying – “catch two birds with one stone.” I believe that foreign investment brings with it an injection of foreign capital, enhanced transparency of business management, the transfer of advanced management techniques, an expansion of markets and job creation, thereby allowing us to catch five birds with a single stone.

I would like to emphasize that, in an era of a truly borderless economy, foreign companies in Korea are Korean companies, while Korean companies abroad are foreign companies. This is to underscore that foreign companies in Korea deserve to be treated as one of our own companies.

Today, the negative views that Korean people had towards foreign investments in the past have completely changed.

At the APEC Economic Leaders' Meeting held in Kuala Lumpur in 1998, I proposed to host the APEC Investment Mart in order to promote investments in the region. In the first APEC Investment Mart, held in Seoul last year, over two thousand potential investors took part, making it a great success for all concerned.

I hope that the next APEC Investment Mart will reap even greater success in promoting investment in the APEC region.

To this end, Korea will facilitate the expansion of its overseas investment, in addition to actively attracting foreign investments.

Ladies and gentlemen!

Secondly, we must promptly explore, among the APEC member economies, ways to prevent the recurrence of financial crises.

At present, over US$ 1 trillion of foreign currencies is being traded daily. Economies that are unable to adapt to such large-scale international financial markets are apt to be vulnerable to potential future financial crises at any time.

In addition, large-scale inflows and outflows of speculative capital pose dangers to the financial stability of economies.

Financial crisis in a single economy can spill over to its neighbors and this contagion can develop into a global crisis. Such problems clearly surfaced in the midst of the Asian financial crisis.

It is, without doubt, important for each economy to exclusively establish a sound financial system and devise prudent foreign exchange policies in order to deter potential risks arising from international financial markets.

However, I believe that efforts to prevent financial crises in advance, through mutual cooperation, are also crucial to the stability of international financial markets.

There have been intense discussions on the establishment of a new international financial architecture. In particular, discussions on ways to minimize the adverse effects of highly leveraged financial institutions such as hedge funds are currently under way.

In this context, I would like to propose a 'hedge fund monitoring channel' to be promptly established at an appropriate international financial institution. I believe that such a channel will contribute to the stability of international financial markets by enabling a readily exchange of information regarding investment activities of highly leveraged financial institutions.

I hope that the APEC Senior Finance Officials will actively discuss these issues at this Forum and report their recommendations at the next APEC Economic Leaders' Meeting.

Furthermore, I believe that sharing the experiences of APEC member economies in overcoming the economic crisis will help prevent the recurrence of future crises. I also believe that if we jointly develop a 'Foreign Exchange Crisis Forecast Model' by collectively incorporating our past experiences, it will prove to be useful.
Such a model will provide a means by which to provide advance warning of the risk of economic crisis, based upon the assessment of the economic conditions of individual economies.

Ladies and gentlemen!

Finally, the most important task is to explore detailed action plans with an end to achieving shared prosperity and social harmony in the region by alleviating social and economic disparities through cooperation among the APEC economies.

At the APEC Economic Leaders' Meeting held in Auckland, New Zealand last year, I proposed to hold a forum to discuss ways to achieve such shared prosperity and harmony. It is to this end that today's forum is being held in Seoul.

Income distribution has worsened as several APEC economies have undergone financial crises.

I would also like to stress that knowledge and information gaps between industrialized and developing economies, in this age of knowledge and information, can spur conflicts and disputes by widening the already existing wealth disparities among APEC member economies.

The information age is rapidly contributing to the wealth of mankind. Currently, however, such wealth has only been enjoyed by a minority of industrialized economies and the reality is that the basic communication demands of 90% of the world's population are not being met.

The information age must be advanced in such a way that developing economies can also participate in and benefit from it. By doing so, it will greatly contribute to global peace and shared prosperity.

I have underscored this point at a World Bank symposium titled the "Network Economy," held late last year. Many, including the President of the World Bank, have already expressed their strong interest and support.

The Korean government has embraced the parallel development of democracy and the market economy, along with productive welfare, as the three pillars that guide its national policies.

Productive welfare, based on human development, aims at reducing the disparities between the rich and the poor.

First of all, it guarantees, by law, basic necessities such as minimum living conditions, education and medical care for the displaced and poor.

Moreover, it places emphasis on human resources developments that allow for all able citizens to provide high value-added to society and increase their levels of income.

Furthermore, it focuses on raising the quality of life by enabling people to enjoy cultural activities, leisure, sports and a cleaner environment.

I hope that such a concept of productive welfare can be expanded to be employed across the entire APEC region.

First of all, I would like to propose the establishment of an 'APEC Cyber Education Network.'

The Network will enable the poor and vulnerable members of the population, especially in developing economies, to easily access high quality education. It will also facilitate Internet usage and vocational training.

Furthermore, I hope that information infrastructure, such as computers and high-speed information networks, will be established in all corners of the Asia-Pacific region through such a network.
Also, I would like to see practical support activities materialized through the formation of 'Youth Internet Volunteers.'

It is my belief, that in times of unforeseen difficulties, the member economies should provide assistance, so that the burden may be shared. To this end, I would like to propose the establishment of an 'APEC Social Safety Net,' participated in by both governments and the private sector.

In this context, I hope that support for, both, APEC member and non-member economies will be strengthened.

The APEC region has recently experienced a number of traumatic natural disasters in a series of floods, earthquakes and fires. Even as we speak, many people in Mongolia are suffering from the severe cold.

A social safety net in APEC could have alleviated such difficulties.

The Bill Gates Foundation has granted US$ 40 million to the International Vaccine Institute for disease eradication in the least developed countries, while a private association of venture enterprises contributed approximately US$ 100 million for the good of the public. I hope to see such voluntary participation from the private sector in the APEC Social Safety Net Project.

Ladies and gentlemen!

North Korea is also an economy facing difficulties in the Asia-Pacific region.

I have previously stated, through the Berlin Declaration announced on March 9th during my visit to Germany, that the Republic of Korea is ready to provide North Korea with a wide range of assistance to help them overcome their economic hardships.

I believe that taking interest in the economic difficulties of North Korea is very important for the peace and common prosperity of the Asia-Pacific region.

I hope that North Korea will be able to participate in APEC activities, as an economy with guest status, upon consultation with the APEC members, if it so wishes. Furthermore, I look forward to a day when North Korea will become a member of APEC.

In addition, I believe that it is time for businesses in the APEC member economies to fully consider entering into the North Korean market.

During my visit to Europe earlier this month, European businessmen showed a great deal of interest in the North Korean market. I believe that joint ventures with Korean businesses, which have a considerable amount of experience with respect to North Korea, would be desirable if there are any concerns about the risks involved in entering the North Korean market.

The Republic of Korea has received loans for structural reform from the International Bank for Reconstruction and Development in times of difficulty in the past. Korea has also received support from the IMF and APEC member economies in the recent financial crisis.

I hope that North Korea, too, will be able to receive assistance from international organizations such as the IBRD, IMF and ADB, in times of need. As a further step, I would also like to see the establishment of a formal channel for active support by APEC member economies, in the event of a request for assistance by North Korea.

As a member economy of APEC, the Republic of Korea is, of course, willing to actively participate in such efforts.

His Excellency Pehin Abdul Rahman, Chair of the APEC Ministerial Meeting, and distinguished guests!

As the global economy is being integrated into a single market, economic problems of a single economy or region rapidly spill over and become a worldwide problem.

The knowledge and information revolution is opening new opportunities for all of mankind. However, in order to realize well-being and prosperity for all from such change and opportunity, I believe that, more than ever before, we need to foster fair competition, along with a spirit of sharing and cooperation.

I am certain that this APEC Forum will stimulate shared prosperity and harmony in APEC and, further, provide the opportunity to realize the universal values of mankind.

I wish you all good health and success.

Thank you.

Congratuatory Remarks

H.E. Pehin Dato Abdul Rahman Taib
The Minister of Industry and
Primary Resources of Brunei Darussalam

Mr. President, Excellencies, distinguished guests, ladies and gentlemen

At the outset, allow me to convey His Majesty the Sultan and Yang DiPertuan of Brunei Darussalam's best wishes to you and for the success of this Conference.

When you introduced this initiative last September in Auckland, Mr. President, we acknowledged that it arose from your personal conviction to care for the people that are risked being left behind in the globalised world. Sometimes, these people are seen merely as necessary casualties of the unkind world; but for you, they should be brought in, and ways must be found to enhance prosperity and harmony for all in the region.

As APEC Chair this year, Brunei Darussalam very much welcomes your noble effort not least because we want to say that you are not alone in your belief. We thus want to congratulate you, Mr. President, for your timely initiative in bringing together such a distinguished group of people to discuss some of the most important issues that our region is facing in the wake of the financial crisis and the on-going process of recovery.

This initiative undoubtedly is an excellent example of the valuable contribution APEC has been able to make to the region's efforts to restructure and reform. Time and time again APEC has shown that it has the ability to bring together the most influential thinkers of our region and put them side by side with leaders, ministers and senior business representatives to discuss the important issues of our common future.

All because of your foresightedness and compassion that we are here and now looking forward to a rich debate on the policy challenge and much needed ideas on how these challenges can be overcome.

Mr. President, ladies and gentlemen,

This forum is being held during a time of guarded optimism. Most of our crisis-stricken economies are now experiencing recovery that has generally come more quickly and strongly than was previously expected.

Notably, Korea, under your leadership, Mr. President, and with the sacrifice and determination of the Korean people, has become the pacesetter in the Asian recovery. Koreas effort has shown how economies which have a strong enough national commitment can overcome the challenge of restructuring and reform.

The healthy debate in APEC that leads to a better understanding of the crisis and its causes will also continue to encourage the region’s economies to move in the right direction. More importantly, peer review and persuasion within the group did in some respect help policy markers to undertake difficult but necessary domestic measures.

As we emerge out of the crisis, it is also evident that APEC has played an important role as a catalyst for reform and recovery. During the height of the crisis, APECs commitment to liberalisation within the context of the multilateral trading system was a source of strength in putting economies on the path to recovery. APEC in a way was instrumental in preventing potential backsliding and retreat into protectionism that was initially feared by many.

Mr. President,

The crisis also caused some to question the consequences of deeper international economic integration and intensified globalisation, especially that of capital markets and of the international financial system as it exist. In this regard, APEC was able to make a significant contribution to the debate on a new financial architecture-in particular it added to the diversity of voices which otherwise might have been totally dominated by the privileged few.

One of the key lessons to emerge from the discussions was just how important strong and effective economic and corporate governance practices are in globalised world. Those economies well equipped with strong foundations in these areas have been the most resilient to the crisis.

APEC-in particular APEC Finance Ministers-has devoted much effort in the area of strengthening economic and corporate governance. In this regard, the on-going work in promoting international standards, principles and practices in the key areas of banking and financial market supervision has been particularly noteworthy. APEC has also been able to complement-and sometimes provide impetus-to the work of other international and regional organisations.

In other words, APEC has become an important cog in the wheel of reform.

But there remains much to be done. We have come to Seoul to take stock and look further into the reform agenda.

Mr. President

The theme for APEC 2000-*Delivering to the Community*- is focused on what more APEC needs to do to ensure that the momentum for recovery is maintained and which ultimately will secure a future for the region that indeed is prosperous.

The first two sub-themes for APEC 2000 : *Building Stronger Foundations and Creating New Opportunities* are designed to prioritise APECs work in area of reform and growth. The third, *Making APEC Matter More,* is aimed at ensuring that APECs work is made more relevant to the community it serves.

From Brunei’s perspective, one specific thing that APEC must work harder at is to develop its agents of reform : its people. The crisis revealed that haphazard restructuring and liberalisation can often have disastrous consequences. By developing its human resource potential to the fullest APEC economies will be prepared to make those difficult- but ultimately essential policy choices that will lead to prosperity. After all, if economies need strong institutions to provide the foundations for strong and robust economic growth, it surely needs trained people to man them.

With economic and technical assistance as one of its three pillars, APEC has a good framework for cooperation in the area of human resources development. Brunei as Chair this year will ensure that the human factor will form an integral part of a more comprehensive and coherent approach to developing human resources in APEC. Much valuable work has already been done in this area and Brunei intends to continue this as a priority.

Addressing the human factor also involves tackling social policy concerns in our communities, including the employment aspects of reform. Without this as part and parcel of the reform agenda, Asia risks inflicting long-term costs upon itself. The presence of experts in the field of poverty here gives us an opportune moment to reflect on what policies we should consider.

Mr. President,

In Auckland last year, His Majesty the Sultan and Yang DiPertuan of Brunei Darussalam expressed concern over disparities among and within economies and urged APEC to play its part in narrowing this gap. Such gaps exist not only in traditional areas of development but also in the area of knowledge.

This is becoming more apparent as globalisation intensifies and economies and societies aspire to become more knowledge-based. As such, we readily recognised the need to reorient our education and training towards incorporating a new-knowledge bias.

APEC is active in promoting research in this field, and our host-Korea-must be applauded for its political leadership on this issue. We hope that by November in Brunei Darusslam, we will be able to see the fruits of APECs work in the form of possible practical policy options.

Mr. President,

One key question for APEC and which will also be deliberated here will be how well can we contribute to developing policy coherence in the international economic system.

The crisis has shown that developments in the financial markets can severely affect the workings of the real economy and that such contagion recognises no turf lines. As the global economy recovers from yet another crisis, we should ensure that we continue to work towards achieving a more integrated approach to dealing with issues such as liberalisation, restructuring and reform.

APEC for its part should consolidate the linkages within itself and where appropriate continue to intensify the engagement of outside expertise. Furthermore, APEC must remain strident in espousing the concept of open regionalism, especially in such testing times for trade talks.

APEC can contribute to showing the world that a regional arrangement exists where economies can help each other in a common agenda for development, and where partner economies through assistance can help all members to turn threats from globalisation into opportunities.
Mr. President,

By way of conclusion, I would like to congratulate and thank you once again for initiating this forum. We in Brunei Darussalam look forward to the presentation of the outcomes of this forum at this year's Economic Leaders meeting in Bandar Seri Begawan. I am positive that our deliberations will present us with interesting and provoking thoughts as to the future course of APEC policymaking.

Thank you.

Closing Statement

Tae Joon Park
Prime Minister, Republic of Korea

His Excellency Pehin Abdul Rahman, Chair of the APEC Ministerial Meeting, and distinguished guests to the APEC Forum on Shared Prosperity and Harmony.

It gives me great pleasure to announce the successful completion of the APEC Forum in Korea, as we begin to meet the new challenges of this New Millennium.

I want to thank all the guests who have participated in the fruitful discussions, and proposals.

The new world of the 21^{st} century will feature an international economic order unlike any in the past.

As the world unites into a single market, goods, services and capital are moving more freely across national borders.

In addition, the digital economy, the knowledge based industries and information based industries are providing a new basis for wealth in the 21^{st} century.

However, with this change in the economic environment, there is a danger that the income disparities between countries and between classes will worsen.

In this new economic order of the 21^{st} century, all countries in the world should cooperate, for mutual benefit. This spirit of cooperation is the most important task of the new century.

As we saw in the Asian Financial Crisis of 1997, the difficulties of a single county can quickly become a worldwide problem in an instant. Such new facts of life emphasizes the importance of international cooperation.

For myself, I fell that the most important result of this APEC Forum was that the APEC member economies which had undergone the financial crisis, had the opportunity to share their experiences, and hasten the establishment of a new and prudent international economic system.

Also, at this Forum, the APEC members had the opportunity to discuss how we can realise the goals of the "Bogor Declaration" by advancing trade and investment liberalization and also by discussing in depth, how APEC can contribute to the WTO.

Another noteworthy result of this forum was that a productive discussion took place on the topics of international financial sector cooperation, social inequality and the alleviation of the knowledge gap, topics which are growing in importance every day.

As a result, I believe that in order to reduce the instabilities due to international capital flows, the APEC members need to actively participate in the "Hedge Fund Monitoring Channel" and the "Foreign Exchange Crisis Prediction Model."

Furthermore, it is important for APEC economic to establish a new "productive welfare" paradigm, which the member economies can pursue together.

These topics are crucial to the enhancement of mutual cooperation between APEC member economies, and setting for a path for APEC in the 21st century.

President Kim Dae-jung, in his opening address, emphasized that it is time for North Korea to participate in APEC, and for the private sectors of the APEC members to actively participate in North Koran economy.

The Korean government will pursue diverse policies in order to realize the goals of tis APEC forum, and will also do its best to develop new ideas to facilitate and carry them out.

With regard to APEC region cooperation, in order to carry our the many suggestions made this Forum, each national government, individually, and with other APEC members, needs to put in a maximum effort.

I hope all of us will double our efforts to pursue the common goals of APEC. Finally, I hope that, based upon the suggestions made in the APEC Forum, cooperation between the APEC members is accelerated, and furthermore, will contribute to the fraternity of all countries in the world. With this hope, I end the APEC Forum.

I wish all the participants' health and happiness.

Thank you.

PROGARAM

<u>March 31, 2000 (Friday)</u>

Opening Ceremony

Opening Address: Kim Dae-jung, President the Republic of Korea

Congratulatory Remarks: P. A. Rahman, Minister of Industry and Primary Resources, Brunei Darussalam

Session I: Surmounting the Economic Crisis through Liberalization and Reform

Sub-session 1: The Importance of Structural Reform and Trade & Investment Liberalization in Overcoming the Economic Crisis

Moderator: Robert Barro, Professor, Harvard University, USA

Speakers: Supachai Panitchpakdi, Deputy Prime Minister, Thailand

Noor Fuad, Deputy Minister of Finance, Indonesia
Lim Swee Say, Minister of State for Trade and Industry, Singapore
Hun-Jai Lee, Minister of Finance and Economy, Republic of Korea

Sub-session 2: APEC Trade and Investment: Finding Effective Ways for Substantial Liberalization

Moderator: Ippei Yamazawa, President, Institute of Developing Economies, Japan

Speakers: James Sutton, Minister for Trade Negotiations, New Zealand
Felipe Medalla, Secretary of Socio-Economic Planning, Republic of the Philippines
Rosario Almenara, Vice Minister of Economy and Finance, Peru
Peter Drysdale, Professor, Australian National University, Australia

Session II: A New Financial Architecture for Preventing the Recurrence of Economic Crisis

Sub-session 1: Financial and Foreign Exchange Policies for Preventing the Recurrence of Economic Crisis

Moderator: Jeffrey Sachs, Professor, Harvard University, USA

Speakers: Tarrin Nimmanahaeminda, Minister of Finance, Thailand
William McDonough, President, Federal Reserve Bank of New York, USA
Ian Bennett, Associate Deputy Minister of Finance, Canada
Barry Eichengreen, Professor, University of California-Berkeley, USA
Yusuke Horiguchi, Director of Asia and Pacific Department, International Monetary Fund

Sub-session 2: New International Financial Architecture: Focusing on Hedge Funds and Short-term Capital Flows

Moderator: Andrew Crockett, General Manager, Bank for International Settlements

Speakers: Paul Chiu, Minister of Finance, Chinese Taipei
Hayashi Yoshimasa, State Secretary for Finance, Japan
Shafie Mohd. Salleh, Deputy Minister of Finance, Malaysia
Stephen Roach, Chief Economist, Morgan Stanley Dean Witter, USA

April 1, 2000 (Saturday)

Session III: Regional Cohesion for the Alleviation of Social and Economic Disparities

Sub-session 1: The Search for A New Social Welfare Paradigm

Moderator: Meghnad Desai, Professor, London School of Economics, UK

Speakers: Richard Freeman, Professor, Harvard University, USA

Irma Adelman, Professor, University of California-Berkeley, USA

Glen Cain, Professor Emeritus, University of Wisconsin-Madison, USA

Kim YooBae, Senior Secretary to the President for Welfare and Labor, Republic of Korea

Sub-session 2: Reducing the Knowledge Gap through Regional Cooperation: Cyber Education, Human Resource Development, and the Transfer of Technology

Moderator: Peter Sullivan, Vice President, Asian Development Bank

Speakers: Alvin Toffler, Futurist, USA

Le Thi Bang Tam, Vice Minister of Finance, Vietnam

Michael Moore, Professor, Pennsylvania State University, USA

Moon Yong Lin, Minister of Education, Korea

James D. Wolfensohn, President Of The World Bank

Sri Ram Aiyer, Ountry Director For Korea, World Bank

Closing

Summary Report: Kyung Tae Lee, President, Korea Institute for International Economic Policy, Korea

Closing Statement: Tae Joon Park, Prime Minister, Korea

1) The term “welfare system” refers to a system of national and state programs designed to provide economic assistance to poor households. These programs are generally “means tested”(restricted to households with low incomes). See Appendix A for a glossary of terms and a brief definition of the major programs providing economic assistance. The title of the new welfare law, which is not self-explanatory, is The Personal Responsibility and Work Opportunity Reconciliation Act, abbreviated as PRWORA

2) Median family income, $41,700 in 1998 dollars, was lower than any year between 1984 and 1998; unemployment, at 6.9 percent was at its second highest level between 1986 and 1999; and the poverty rate was at its highest level between 1983 and 1999(*Economic Report of the President*, 2000, pp. 344-7).

3) Website of Department of Health and Human Services: dhhs.gov/new/stats/case.fam.htm, March, 1999.

4) I will use the term “welfare mothers” to include former AFDC mothers and those who would have entered the AFDC system had the system continued.

5) Same website as above. A qualification to these statistics is that some of the earlier cases reported under AFDC involved so-called “child-only” cases, wherein cash transfers for the children were provided to their non-parental guardians, and these “child-only” cases are now separately classified under another program.

6) The nine percent figure is based on the author’s estimate of the expenditures for were the Food Stamp and Medicaid programs that are received by welfare mothers who part of AFDC.

7) The term “social insurance” and other terms and programs in this paragraph are difined more fully in the glossary in Appendix A.

8) These figures of 28 and 9 percent are the author’s estimates based on statistics from *Green Book, 1998,* which reports the expenditures on all major transfer payment programs.

9) Surprisingly, this has not happened and, as reported in the *New York Times*(1999), “the experts are puzzled.... The biggest problem[for the former welfare families who have suffered income losses], opposing camps agree, is that many families who have left welfare are not getting food stamps even though they remain eligible for the benefit. In 1995, 88 percent of poor children benefitted from food stamps. [In 1998] the number had dropped to 70 percent.”

10) Econometric evidence for the powerful role of rising wage rates as a cause of the increase in women’s employment has been abundant since the publication of Jacob Mincer’s classic article(1962). See Heckman and Killingsworth(1986) for a survey of research that supports Mincer’s basic points. See Appendix C for a brief discussion of why the market wage explanation for the rise in women’s LFPR is more persuasive than the decline-in-fertility explanation.

11) This estimate is based on a 14 percent LFPR of all wives(husband present) in 1940(Census, *Historical Statistics*, 1975, p. 133), along with an estimated lower LFPR in the depression year of 1935 and the fact that the LFPR of mothers is less than for all wives.

12) The median incomes of husbands were approximately $17,000 in 1950 and $32,000 in 1990(in 1996 dollars). U.S. Bureau of the Census, *1950 Census of the Population, Population Report P-E No. 2A*, “ General Characteristics of Families, ” pp. 490, and Census, P60-174, 1991, p. 124.

13) In 1997 the median earnings of women were 74 percent of men ’ s earnings among full-time, year-round workers. However, 72 percent of male workers worked full-time, year-round, compared to 56 percent of female workers. The median earnings of all female workers were 62 percent of the median for all male workers. Census, P60-200, 1998, p. 380.

14) The *Green Book*(1998, p. 408) gives the following illustration, using Pennsylvania as an example. The annual dollar benefits in 1997 for an AFDC mother of two children with no other income is shown to be $7,798, which is the sum of the cash payments($5,052) and food stamps($2,746). If she were to earn $12,000 during the year, her disposable family income would be $13,231, after allowing for earned income tax credits($3,641), reductions in benefits, and payments of Social Security taxes($912) and work expenses($3,600) rimarily day care expenses. Thus, her disposable income rises by only $5,433, implying an implicit “ tax ” on her $12,000 of earnings of 55 percent. Because the family loses eligibility for Medicaid health insurance beyond a transitional one-year ’ s coverage after the family income exceeds $9,000 a year, the family may be worse off with the mother ’ s earnings of $12,000 that with no earnings. The zero-earnings benefit level of $7,798 paid by Pennsylvania is similar to the median maximum benefit amount of $8,304 among all 50 states and the District of Columbia(p. 418).

15) U.S. General Accounting Office(1995). This report also cited other studies which found that 38 percent of mothers on AFDC worked *at some time* during the year, but pointed out that these mothers may not have been enrolled in AFDC all year.

16) For those who opposed the 1996 welfare reform law and the end of entitlement to income support, it must seem a bitter irony that, although the stagnation in wages and earnings can explain much of the reason that poverty stopped declining in recent years, the very persistence of poverty and the accompanying rise in welfare rolls led to the political support for the legislative shift from welfare to workfare.

17) The cost of Medicaid is not added to the cash payments and the cash-equivalent value of food stamps because it is difficult to know what cash-equivalent value recipients give to Meficaid. Moreover, the cost of a given service from Medicaid rose more rapidly than did the Consumer Price Index. For example, the CPI of health care rose by 194 percent from 1980 to 1995, while the overall CPI rose by 85 percent(*Statistical Abstract*, 1996, p. 483).

18) A qualification to this judgment is the following point. Some AFDC families were in the porgram for less than one year, so these families could have fallen below the poverty line because the AFDC cuts

reduced their combined income from AFDC and the income they received when they were not in AFDC for that year. It is noteworthy that the ratio of poor female-headed families to AFDC families rose from an average of .71 in 1970-1981 to .85 from 1982-1992 he latter period coming after or during the Reagan-Bush administrations ’ cuts in AFDC(*Green Book*, 1993, p. 685). Perhaps the lower proportion of poor female-headed families in the pre-Reagan years reflected some of the part-year AFDC families whose higher AFDC payments raised their full-year ’ s income above the poverty line.

19) For the all-family group, the 39 year-to-year changes in median family incomes from 1959 to 1998 include 32 changes that “ agreed ” with the theoretically expected opposite-sign change in the poverty rate, four changes that did not agree, and three changes that were neutral. There were only two changes in median family income of more than 1 percent(1978-1979, 1.3 percent, and 1995-1996, 1.2 percent) when the change in the poverty rate had the “ wrong ” sign.

20) Baldwin and Cain(1997) use a definition of full-time, year-round worker that was borrowed from Katz and Murphy(1992) and is slightly different from the official definition used by the Department of Labor(see Fig. 4). The general pattern of the time series of wages for the different education groups shown in Figure 4 has appeared in many research articles and books.

21) Two authorities on the subject of child support report that “ Only six of ten mothers potentially eligible for child support actually have such an award. Of those who have an award, only half receive the full amount to which they are entitled, and over a quarter receive nothing.... Divorced mothers are those most likely to have an award right of the hereas never-married mothers are those least likely three in ten ” (Garfinkel and McLanahan, 1994, p. 208).

22) The all-family poverty rate reached its low point of 8.8 percent in 1973 and 1974, although the poverty rate for families with dependent children was slightly higher in 1974(12.1 percent) than in 1973(11.4 percent). The lowest poverty rate for famillies with dependent children was 10.8 percent in 1969(this figure is not shown in Table 2). The year 1974 is used in the composition analysis because it is near the “ turning point ” year, 1973, and it is the first year for which poverty rates for families headed by a male(with no wife present) are reported by the U.S. Bureau of the Census in its P60 series (P60-200, 1998, pp. C-9 to C-14). All calculations for this composition analysis are availabel from the author, including the calculations when the “ Other year ” is used as the base year for fixing the demographic composition; for example, predicting the 1974 poverty rate if the 1997 headship composition were used.

23) For the increase in divorces across social classes and in other industrialized nations, see Goode(1992, pp. 119). For the increase in children born out of wedlock across social classes and in other industrialized nations, and the consequent increase in families with a never-married mother as the family head, see DHHS, *Out-of-Wedlock Childbearing*, 1995, pp. viii and 670. On the comparison between the periods of prosperity and stagnation: Table 2 shows that the annual rate of the increase in female-headed families with dependent children as a proportion of all families with dependent children was higher

between 1959 and 1973, 3.3 percent, than between 1973 and 1996, 2.1 percent. The average increase in the percent of these female-head families was 3.8 percent points between 1959 and 1973 and 3.7 percent points between 1973 and 1998.

24) All citations are from the decennial censuses of the U.S. Bureau of the Census: *Census of the Population, 1960, Families, PC(2)-4A*, Table 14, p. 162; *Census of the Population, 1980, Detailed Population Characteristics, Part 1, U.S. Summary, PC80-1-D1-A*, Table 297, p. 475; *Census of the Population, 1990, Detailed Population Characteristics, Part 1, U.S. Summary, CP-2-1*, Table 37, p. 37. I found no statistics for the income distribution of families with dependent children in 1990. The figure in the text was estimated by using the 1980 ratio of the proportion of all female-headed families in the bottom quintile of the all-family income distribution to the proportion of female-headed families with dependent children in the bottom quintile of this income distribution, an then assumed that this ratio was the same in 1990.

25) Further evidence that the increase in female-headed families is a better explanation for the rise in family poverty rates from 1980 to 1990 than the increase in income inequality during that decade is the following finding: Female-headed families with dependent children constituted 48.1 percent of poor families with dependent children in 1980; 56.0 percent in 1990(column 6 in Table 3). These percentages are similar to the proportion of female-headed families with dependent children in the bottom quintiles in the distribution of family incomes in 1980 and 1990(50 percent and 63 percent, respectively).

26) The term “strong” is justified on the following grounds. First, in rows 1, 4, and 7 the coefficient of the percentage change in median family income from year to t+1 shows that for a 1 percent increase in median family income the poverty rate decreases by about 2 percent. To illustrate: a 5 percent increase in median family income, from $40,000 to $42,000, would predict a 10 percent decline in the family poverty rate from, say, 15 percent to 13.5 percent. Second, the coefficient of the median family income variable is statistically significant. Third, the coefficient of median family income was about the same in both the prosperous period of 1959-1973 and the stagnant period from 1973 to 1997, which indicates a robustness and stability in the relation over this 39-year period. In regressions not shown, the *level* of median family income was also strongly negatively related to the *level* of the poverty rate for 1959-1997 and 1959-1973, but there was no relation between the two variables for 1973-1997. From 1973 to 1997 there was no secular trend(upward or downward) in either median family income or the poverty rate, so only the changes in these variables, brought about mainly by business cycle, could show a relation.

27) The male earnings variables has the advantage of representing the market wage avilable to quality-constant workers and is, therefore, more closely related to the labor market than the other two income variables. However, the earnings variable does not reflect job losses or involuntary part-time work that occur during economic downturns. Per capita GDP is a more complete measure of the economic performance of the economy, but it is less closely linked to the economic status of families in the bottom

half of the income distribution.

28) Lebergott(1964, pp. 523) implies a 2.6 percent annual rate of growth in wage rates of "full-year" workers from 1900 to 1960. I calculate the average wage by dividing the 1900 average earnings by 3,000 hours and the 1960 earnings by 2,000 hours. The hours figures are based on the approximations of 60-hour and 40-hour work weeks in 1900 and 1960, respectively, along with a constant 50-week year. The wage measure for full-time, year-round workers avoids the distortion that results when the proportion of part-time and/or part-year workers in the labor force increases, as it has in recent decades. The 1960 median earnings of full-time, year-round workers(Census, P60-180, 1992, p. B-32) is .84 of Lebergott's 1960 figure for average earnings. Conservatively, I use the smaller Census figure for 1960(divided by 2,000) and Lebergott's 1900 annual earnings figure(divided by 3,000) to calcuate a 2.3 percent annual growth rate in wages over this 60-year period.29) The 1900 figure is a back-projection based on the trend line of wages(strictly speaking, a log-linear trend), and it will differ from the actual earnings in 1900 depending on whether earnings in that year were above or below the trend line.

30) Poverty statistics also apply to the household unit, which could consist of one person living alone or two or more persons living together who are unrelated by blood, marriage, or adoption. This paper concentrates of the family unit, especially families with dependent children present.

31) See Census, *Historical Statistics*, 1975, p. 133 for labor force participation rates of married women; pp. 49 and 53 for fertility statistics; pp. 15 and 134 for statistics on child labor.

32) Tobin (1994, p. 148) suggests that two-thirds of Americans were poor by the current definition in the 1930s. Lebergott (1964, p. 189) estimates that the average annual unemployment rate between 1930 and 1939 was 18 percent, and it was 15 percent in 1940. His estimates for the average annual unemployment rates for the three decades from 1900 to 1929 are 4, 5, and 5 percent, respectively. In the four years after World War II, from 1946 through 1949, the average annual unemployment rate was 4 percent, and it was 5 percent from 1950 to 1959 (USDL, *Handbook*, 1989, p. 129)

33) From 1959 to 1997 the poverty rate for persons 65 and older decreased from 35.2 percent to 10.5 percent (Census, P60-201, 1998, p. C6). Government transfer payments, primarily Old Age, Survivors, and Disability Insurance and secondarily the means-tested Supplemental Security Income pprogram, contributed mightily to this achievement (Danziger and Weinberg, 1994). This record is all the more notable because life expectancy among the aged increased. A 65-year-old in 1960 could expect to live 14 more years; in 1991, 17 more years (Census, P23-190, p. 3-1, 1996).

34) The use of the term fundamental cause is always sensitive to the problem at hand and subject to dispute. In this paper I refer to the rise in wages as "causal" in the following sense. The combination of capital accumulation and improvements in technology, health, and education are the predominant antecedent causes of the growth in wages and they are mainly exogenous with respect to increasing both the demand for labor and the quality of labor supply. Education is probably the most endogenous of

these forces with respect to the long-run rise in wages, but aggregative expenditures on education have increased in part as an effect of rising family incomes and of the technologically driven increased demand for higher labor skills. These arguments do not imply that wages at the aggregative level cannot be directly affected by explicit policies such as minimum wage laws, subsidies to education causality depends on the problem at hand.

35) Indeed, the apprehension of the current generation of younger workers regarding their expected low returns from Social Security retirement and health benefits stems from the stagnation of wages during the past 24 years, along with the fact that when they reach retirement age this cohort will become a larger proportion in the population, relative to the working-age population.

36) The cohort of women born in 1895 to 1899, who reached the age of 30 between 1925 and 1929, on average had 2.7 children during their lifetime. This was substantially less than that for women born between 1855-1859, 1860 864, and 1865 869, who reached age 30 between 1885 and who had completed cohort fertility rates of 5.0, 4.7, and 3.9, respectively. Women born between 1900 and 1919, who became 30 between 1930 and 1949 had on average from 2.4, 59 2.7 children during their lifetimes. Women who reached age 30 between 1955 and 1969 period that reflected the post-war baby boom ad completed cohort fertility rates of just 1975, p. 53; and recent issues of the annual *Statisical Abstract*.)

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