

WINNING ECONOMIC STRATEGIES

FOR THE 21st CENTURY

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Mr. Chairperson, distinguished speakers and panelists, and honored guests. I am honored to be able to be here today, to address this group on a topic of broad interest to both our countries and indeed the entire world.

Our chairperson has given me the challenge of addressing a truly daunting topic: What are to be the high-profit high-growth industries of the next century and where Korea's comparative advantage might lie within that constellation of "winners." What will be the 21st century's version of the microelectronics revolution? Much as I would like to accommodate him, there are others, many in this room today, whose guesses would be much better than mine. Of course, that's all anyone can do: guess. Those of us who guess right, and have the courage of our convictions, will be tomorrow's leaders. Those of us who don't will be consigned to Marx's "dustbin of history." What I propose to do for you today is at once more modest and I believe more useful: attempt to identify the conditions, within a country or within a firm, that are necessary for that country or firm to take advantage of these future opportunities, to be poised to recognize the next great wave and prepared to ride it to national or corporate greatness. What can Korea, and your corporation, do today to prepare itself for the 21st century's *carpe diem*?

To address this issue, let us first look at what has worked for various countries in the past. While the Industrial Revolution started in Britain, it was the US in which it reached its fullest flowering in the century from 1865-1965. The US had the world's largest domestic market, it was the country most open to entrepreneurial energy, and a "frontier" culture of opportunity. In this fertile soil grew a disciplined workforce and the world's largest corporations which were able to take advantage of economies of

scale so essential to successful manufacturing. Europe's role? It's early lead was brought to a halt by the First World War and the substantial shrinkage of world trade and international capital flows that followed this conflict. The Second World War and its aftermath saw the peaking of US industrial power. During the early 1950's, the US produced half the world's output. During the 1960's, US firms reached beyond their domestic market to become global, helped by rising incomes in Europe and later Asia and by the postwar commitment to rebuilding free trade under the aegis of GATT.

But the rising tide of international trade raised all boats, including those of a recovered, even resurgent Europe in the 1970's. The burgeoning Common Market firms could challenge US economic dominance in certain selected markets, but it was Japan that presented the most serious challenge to America. The pre-war kin-based *zaibatsu* evolved into the more modern more robust *keiretsu*, but even the new Japanese model depended upon strong relations among a grouping of firms and with the government, which itself was highly stable and could deliver both macroeconomic stability as well as cheap capital. The combination of a highly disciplined workforce, highly regulated domestic markets, management focused on efficiency and quality, and the drive for success in export markets made Japan, Inc. the world's powerhouse economy. In the 1980's, Americans feared that the Japanese would do what the Soviets had not been able to do in 50 years of the Cold War: "catch up and surpass" the industrial might of the US.

How did this happen? It must first be recognized that the postwar economic dominance of the US is unparalleled in world history, and certainly not sustainable. Second, what made the US unique in its century of industrial dominance was now available to all with the power to take advantage of it: access to huge markets (guaranteed via GATT), plenty of capital (guaranteed through expanded international capital markets), and mobile technology. What was needed to take advantage of it? A disciplined and inexpensive workforce, educated professionals, political stability, and incentives to compete in world markets.

Japan was the first economy to capitalize on these advantages, but certainly not the last. Barely decades behind, the so-called Asian dragons used the same factors to "catch up

and surpass” *Japan* in precisely those industries in which Japan had caught up with the US: steel, shipbuilding, semiconductors, consumer electronics, and display technologies (TV, computer monitors). These countries followed the Japanese model: oligopolistic industries, large firms, tight relationships with government, and highly controlled domestic markets. The emigration of industrial power from the US to Japan was not a fluke, but merely the first indication that manufacturing muscle could, under the right circumstances, emigrate anywhere.

How has the US faced the challenge of Japan and the five dragons? For the last 15 years, the American economy has been reinventing itself, accelerating the trend away from a mass production economy to a knowledge economy. Financial services, technology (chips, software, aircraft, biotechnology), and creativity (Hollywood) are the hallmarks of the new Americans. The US has used its expertise in research and development to create this knowledge economy, based on an educated and creative workforce and capital markets that support risk-taking and entrepreneurship. This transformation has not been without cost. The recession of the early ‘90’s taught US firms to get lean and mean; firms got smaller, workers were redeployed, and resources have moved from the large bureaucratic firms of the past, such as IBM and General Motors, to the small, entrepreneurial firms of today, such as Microsoft and Intel. This redeployment has been rather costly, as the blue-chip stocks of yesteryear lose value and workers are forced to look for new, lower-paying jobs. Further, this painful though necessary transformation is far from over; I look for it to continue into the foreseeable future. But what is the bottom line? In the broadest sense, US markets are moving both capital and labor out of low-valued-added segments in all industries and into to higher-value-added segments in those industries.

How has Japan faced the challenge of the Asian NICs? With modest success; it has attempted to follow the US lead into higher-value-added segments: autos, computers (LCD screens rather than DRAMs), financial services. To support this, it has attempted to become more R&D-intensive. The jury is still out on how well they are doing this. In flat-panel display technology, they are doing just fine. In other areas, such as biotechnology, software, microprocessors, aircraft design, they are not doing so well. During its years of industrial expansion, Japan was well-served by focusing its efforts

on manufacturing and away from R&D, preferring to purchase technology, primarily from the US. In the knowledge economy, high-wage Japan is finding that it cannot compete on the basis of high-volume high-quality manufacturing, which is moving offshore as it did in the US 1975-85.

What are the lessons for Korea and the other NICs in all this? As their national incomes rise, the next wave of NICs will attempt to do to Korea what Korea did to Japan, and what Japan did to the US: catch up and surpass with lower-cost manufactured goods of equivalent quality. It is tempting to speculate upon who will be in that next wave of NICs? Of course, everyone favors China as the coming economic giant of Asia and indeed the world. My candidate for the area of the world which may surprise us all is Latin America. Several important countries, such as Mexico and Brazil, are beginning to get their economic houses in order. If and when they do, the energy and inventiveness of their people will amaze the world, I believe.

However, let me emphasize that *who* the next NICs will be is not nearly as important to Korea as the certainty *that there will be* the next NICs. When this occurs, Korea will have to follow the Japanese and the Americans in moving toward higher-value-added segments of their industries if they wish to enjoy the fruits of the knowledge economy.

Is Korea prepared for this? Let's first examine what the emerging knowledge economy looks like in its country of origin: the US.

- Smaller, flatter, more entrepreneurial firms, prepared to move into new opportunities without bureaucratic drag;
- R&D-intensive firms;
- educated, risk-taking labor force;
- minimally dependent upon government, either as a customer or as a protector/promoter.
- ability to manage close cross-border alliances.

This is not to say that all the US has transformed to this wonderful new knowledge economy. In fact, this transformation has exacerbated some of our country's social problems: violence, poor primary and secondary education, drugs, and racial ghettos. The American Dream seems even further away for the disadvantaged, as the economic rewards of today and tomorrow are directed to the educated, creative, and talented. Yes, this constitutes the core problem of our country, but does not change the basic fact that the American Way into the next century lies in the knowledge economy.

We have heard much recently of the "Asian Way," a way of life based on the Confucian values of hard work, respect for authority, and the importance of family. It is tempting to conclude that it is this model that has permitted the East Asian countries to take advantage of the diffusion of manufacturing technology in the last twenty years. The question is, does the "Asian way" lend itself to moving Korea to the forefront of the worldwide knowledge economy? Such deep cultural issues are certainly beyond my competence as an economist. I was certainly pleasantly surprised by the ability of the US to reinvent itself during the last 15 years. I will be watching Japan very closely over the next decade to see if it is able to accomplish the same thing. Can it open up its *keiretsu* industrial structure to accommodate more entrepreneurship? More innovation? More open domestic markets, not only to foreign but domestic competitors? Less dependence upon political influence? The Korean *chaebol* model is likely to feel exactly the same pressures that are beginning to appear in Japan today, sometime in the next decade. How well will Korea adapt to these pressures?

Let me now turn my attention to the global economic and political environment in which the knowledge economy will evolve. We may think of this environment as the soil in which the firms and economies of the future will or will not grow. Having a rich soil is no guarantee that the knowledge economy will flower; but having a poor, thin soil is a guarantee that it will not. What are these pre-conditions in a society that would permit the growth of the knowledge economy? I list them here in what I view as their order of precedence; e.g., the last three do not matter if the first is not present, etc.

- relative freedom from violence and warfare;

- the rule of law: contracts must be enforceable;
- macroeconomic stability;
- asset mobility: workers, firms, and capital.

Let me discuss each in turn. It should be no surprise that nations and regions immersed in armed conflict have no resources to devote to productive enterprise, and conflict can reduce even the richest regions to penury; witness the tragedy of Lebanon, a bustling, entrepreneurial country until ravaged by war. At the local level, portions of the US exposed to drug violence are shunned by investors and consumers alike.

Without safety, no one will risk productive assets. Unfortunately, the East Asian region does not appear to be a model of political stability. The scars of the Second World War run deeper here than in Europe, and as recent events in Korea have forcibly reminded us, the Cold War is still going on here. With the strengthening of Japan and China, the ability and willingness for America to continue its role as peacekeeper is waning.

Tianenmen Square, the Yongbon reactor, closed military dictatorships, and the assimilation of Hong Kong into the PRC are all unpleasant reminders that for all its tempting promise, East Asia can be a dangerous place to do business. The outbreak of hostilities in any part of the region would certainly have a chilling effect on investment, both foreign and domestic, and likely lead to a flight of resources, both financial and human. I view the continued inward investment in Hong Kong as the triumph of business fantasy over political reality; I do not expect it to last into the next century.

Once peace is assured, business can only flourish under a rule of law, where property rights are defended by the government and contracts are honored. In some countries of East Asia, the rule of law is weak, especially under dictatorial regimes. The experience of McDonald's in Beijing, where a 20 year lease was torn up as a matter of convenience for a favorite of the government, will give pause to future investors.

The knowledge economy also depends upon laws recognizing intellectual property, a concept foreign to much of the world. In truth, some form of ownership of ideas is necessary if the creation and dissemination of knowledge is to be the basis of the new economy. As the US has been pushed into the knowledge economy, it is the first nation

to confront the problem of market valuation of ideas, so intellectual property has been interpreted by many as merely an American ploy. The refusal of some nations to recognize ownership of ideas will ensure that creators of ideas, the true heroes of the knowledge economy, will find a new home more compatible with their talents. Throughout its history, the US has been the beneficiary of the policies of other nations who treat their creative and talented citizens shabbily; we will continue to be so as long as such nations, such as some in East Asia, exist.

Another, less obvious, threat to the rule of law comes, paradoxically, via a perversion of the laudable Confucian value of respect for family, and that is nepotism in government and business. We see much evidence of family connections in East Asia, which negatively influences both the political and the economic spheres, making competition tilted strongly to the favored few: outsiders need not apply. Of course, this is a world-wide problem, as the politics of the Middle East and the Caribbean demonstrate. Nevertheless, East Asia seems to have an ample supply of leaders' relatives in positions of power. Japan's evolution away from family-based *zaibatsu* to relationship-based *keiretsu* was an important step away from a feudal-based toward a market-based economy.

The painful lessons of Latin America and the emerging economies of Eastern Europe and Central Asia make crystal clear the necessity of stable macroeconomic policies for the creation of wealth by the private sector. High and uncertain inflation, wasteful government spending, and corrupt officials have amply demonstrated their ability to throttle economic development and discourage investment. This is an area in which many countries of East Asia have done remarkably well, indeed better than the US and certainly better than Europe. Unfortunately, the PRC seems to have little idea how macroeconomic policies are supposed to work. I see China as being the macroeconomic loose cannon on the ship, rolling uncontrollably from boom to bust, and likely affecting the rest of the region.

Closer to your interests, I also see a very large macroeconomic risk for Korea when, as must eventually occur, North and South come together. Our only experience with such a national reuniting is with East and West Germany, which has nearly wrecked what

was once the most stable macroeconomy in the world. There are some obvious lessons from that experience, but the bottom line is that reunification will be an enormous shock to your economy, even if you avoid the most obvious of Germany's mistakes.

Lastly, the most vibrant, opportunistic, and successful knowledge economies of the next century will be those in which the mobility of assets is maximized. Workers will move from dying old industries to dynamic new ones, managers and professionals will ply their trade in any state, prefecture, or country, stale rigid firms will go out of business and new entrepreneurs will find capital willing to bet on their success. Success in the marketplace will be determined not by who you know in government, nor by who your father is, nor by how big your firm has grown in the past, but rather by how well you satisfy customers' needs today and in the future, relative to the world's best competitors.

Does this sound good? Isn't freedom wonderful? Well, it isn't, at least for many. Truly dynamic economies impose costs, sometimes large costs, on individual economic agents, be they workers, customers, professionals, or firms. Valuable skills become outdated, previously useful physical capital becomes worthless, customers are confronted with new and confusing choices, and firms that cannot bend with the wind are broken. Yes, there are many winners in economic change, but there are many losers as well. The temptation of all governments always has been, and will continue to be, to impose restrictions, regulations, and laws that attempt to hold back this dynamism in order to protect some politically effective lobby of losers. Often, change makes strange political bedfellows: labor unions in dying industries work with bureaucratic managers in those same industries to lobby governments for protection against change. The inclination of politicians is, as always, to give in. By doing so, they are doing their countries a disservice in the long run. A careful look at the economies of Western Europe should be enough to convince the skeptic that restricting asset mobility is a sure path to economic stagnation, even within nations that are otherwise blessed with the pre-conditions for growth.

In summary: both our countries face significant change over the next decade. The US has already been forced into the knowledge economy, and we must be the ones to show

the rest of the world how to do it, or possibly how not to do it. Korea has a few years before it, too, feels the winds of change blow hard. I have tried to outline in this address what the face of the future will look like, and to suggest directions of change which could help Korea prepare for the opportunities of the 21st century. I thank our chairperson for affording me the opportunity to address you today, and I thank you for your very kind attention.