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# Western Hemisphere Integration: The Global and Political Context

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## I. Introduction.

The failure of the U.S. Congress to approve fast-track authorization for a new round of trade negotiations, and the banking, financial, and currency crisis that began in Asia and gradually spread to many parts of the globe, are two important realities that must be understood to help us create a new, more favorable atmosphere for progress and cooperation in the hemisphere.

Fifteen years ago, many commentators used to point to the economic growth in East Asia as something that could also happen in Latin America–then in the middle of the so-called "lost decade" of inflation, recession, and political tensions. But the current crisis in Asia, which has sideswiped many of the economies in our region, is also an opportunity to learn, but this time, from the mistakes of others. Since I travel frequently in Asia, meeting with senior financial and governmental leaders every year, I thought I would take this opportunity to share with you some observations about the financial crisis in Asia, its causes, consequences, and dangers. Second, I want to say a few words about the current political environment in the United States as it relates to trade policy in the hemisphere and the associated implications and challenges.

In my experience, there are two main causes of the current Asian financial and banking crisis. The Asian development model itself is the main culprit for the distress now unfolding in the region. The so-called Asian development model involves, in fact, various forms of state capitalism, which entail the mobilization and leveraging of capital through the banking system to create and support export-oriented industries, and later construction and infrastructure projects of various kinds. The second cause of the Asian financial crisis had to do with poor collective judgment by creditors–domestic and foreign–of credit risks. Too much money was sent chasing too few truly bankable projects and investments in Asia and elsewhere.

The good part about the Asian state capitalist development model was that it enabled some Asian countries to rapidly grow from a very low base. This happened when there was a huge gap in the level of technology between those countries using the development model, and those in more advanced countries.

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The model was attractive to some Asian governments because originally it allowed local industries to be built without foreign investors and owners. The role for the foreigner was designed merely to provide, wittingly or otherwise, needed technology and later, markets for the goods.

The system worked as long as there was a large gap in the technology between the recipient country and that of more advanced countries. Also, the system functioned as long as the production from the often directly and indirectly subsidized industries involved a relatively small part of the national economies providing the subsidies.

Unfortunately, this process eventually entailed staggering leveraging of capital to provide cheap capital on a huge scale as a comparative competitive advantage to some of those deploying this model of development. In the case of Japan, credit was extended on the basis of collateralizing land values. For example, eventually the tiny plot of land in central Tokyo where the Emperor's palace was located was worth more than the whole real estate value of the state of Florida. Warrants were another favored device to provide cheap capital.

Armed with credit of this questionable nature, vast loans were extended to Japanese and other Asian companies wishing to build factories and buildings. Since interest rates were minuscule, there seemed to be no limit to the new facilities that could be constructed or acquired. To further facilitate comparative advantage, many Asian economies were constructed on a two-tier basis: one tier for that part of the national economy directly involved in the tradable goods section; the other, the vast domestic part of the economy.

The domestic economy was protected by various layers of barriers. The first tier was a tariff wall. When that was forced down through trade negotiations and international pressures, non-tariff barriers–including some imaginative structural ones–were quickly erected to fill their function. When in turn some of them fell, others replaced them. The ultimate barrier was a competitive devaluation of the currency, which avoided even the most sophisticated WTO remedy.

In the case of Japan, a two-tier pricing system existed, where products were often sold domestically at forty to sixty percent above the export price. In China, there was an even greater use of the two-tier economy–one dollar-based, one Yuan-based. Thus, central to the Asian development model was a trade policy of mercantilism, allowing captive domestic markets and various competitive enhancement devices permitting penetration and exploitation of foreign markets.

When it was only Japan playing the game, and others were willing to turn a blind eye to much of the rigging of the system for various humanitarian, developmental, or Cold War motives, it was not such a problem for the developed world. Indeed, it provided the spur of competition to domestic industries which, in some cases, benefitted from this competition. It tremendously forced the pace of innovation and efficiency in the United States and elsewhere. The corpse of the United States television manufacturing industry was a specter that hung over everybody else. You either got competitive fast, or you were out of business. Furthermore, the strong dollar in the early 1980s added more pressure on the U.S. manufacturers.

For Asia, the system worked when only Japan was effectively deploying it on a large scale. But the time soon came when other Asian countries similarly deployed the state capitalist/mercantilist model. Now, however, instead of competing merely against the U.S. domestic companies, they were competing against each other with the same weapons. And to survive, the U.S. companies began to off-shore much of their production to cheaper platforms.

In Asia, fixation on market share became the name of the game. And while many export industries, such as the Japanese auto industry, became immensely profitable, aided by an undervalued currency, less and less attention was paid to the basic profitability of many individual companies. And the subsidies required to keep this game going became larger and larger in more and more places. In China, these subsidies include recycling the people's savings to the state-owned factories and building developers. In Japan, it involved reducing the interest return on savings to levels that hadn't been seen since the Great Depression, but which permitted debtors and companies to continue their activities without fundamental changes long beyond that which would have been permitted in the United States.

The net result of this process was more debt accumulation, much too much production capacity, and cutthroat competition among the mercantilist countries for market share in more open export markets abroad and within the region. Without the discipline of a rigorous project and banking analysis of individual loans, too much of everything got financed. And even when some of the countries themselves followed reasonably careful macroeconomic policies, microeconomic failure began to undermine the whole edifice of Asian finance.

Too many banks were not carefully regulated by authorities. On the contrary, authorities encouraged profligacy. Too many factories were not required to earn profits. Too many buildings did not require tenants or the likely prospect of tenants in advance. And no one was keeping track of global supply and demand in individual industries.

In the case of Japan, the whole problem was complicated by the decision of the Ministry of Finance to conceal the full extent of the national banking crisis in the hopes that eventual recovery of demand and growth would allow the bad debts to become good debts. But, in the meantime, other countries were adding to the overcapacity in production and financing of many long-term projects with short-term debt–often in foreign currencies.

The full impact of this problem on the already substantial U.S. trade deficit did not hit the United States as early as it might have because of the fall of the dollar in 1994-95, which was caused by relatively accommodative U.S. monetary policies, the overhang of dollars in international markets from the accumulated current accounts deficit, and other factors. Thus the United States was, for a time, shielded from the Asian competition to a degree, and set about rebuilding some domestic manufacturing capacity. Now, of course, all that has changed.

When China devalued the Yuan in 1994, it put the rest of Asia into a competitive disadvantage that threw all earlier calculations out of the window. An attempt to keep the impacted economies going resulted in a construction and real estate boom, encouraged by southeast Asian governments, and financed by foreign and domestic banks and investors. In the end, all it did was to create spectacular urban skylines throughout Asia, many ephemeral personal fortunes, another huge layer of debt to the national economies, and postpone the eventual day of reckoning.

In the case of Japan, the fiscal correction in March of 1997 removed two percent of the GNP worth of fiscal stimulus on the foolish assumption that the economy had revived sufficiently to survive such a shock and to permit self sustained growth and demand. Only the Ministry of Finance was surprised when higher taxes on consumers led to a renewal of the Japanese recession and a collapse of domestic confidence. The Ministry's response to this turn of events was to attempt to gear up another export-led recovery on top of the already large trade surplus. Again, only the Ministry of Finance was surprised when the U.S. government reacted strongly against the idea that U.S. debt accumulation via a trade deficit, rather than Japanese domestic demand, should jump-start the Japanese economy.

## II. The Deadly Politics of the Asian Development Model and the Consequences.

As I mentioned earlier, the good part about the Asian state capitalist development model is that it enabled some countries in Asia to grow rapidly from a very low base. The bad part about the Asian development model was that it proved very difficult to make it work efficiently after a certain level of development and intra-regional competition had been established and when the technology gap had been significantly narrowed. Furthermore, it proved extremely difficult to make a transition from the outmoded model to a more efficient system once these governments had established programmed industrial winners with state directed capital. These governments, in effect, created very wealthy and politically powerful interest groups with a heavy vested interest in the status quo. Many of these entities also grew "too big to fail" without an unacceptable political cost.

Thus, when they ran into trouble with highly leveraged financial arrangements it became politically and economically difficult to force the system to allocate capital more efficiently. Instead, the only solution that some governments were able to try was to encourage even more growth, particularly in export oriented industries and construction.

Moreover, when the export industries from countries with widely varying standards of living began to experience painful competition–with each other's exports all trying to penetrate foreign markets–the temptation too often was to continue to go after an increased market share rather than to focus on the bottom line of individual company profits. For example, a year ago, I attended a meeting at the OECD in Paris on the subject of excess capacity in the automobile industry worldwide. Everyone there knew that there was shortly going to be 20 million units of excess global auto production capacity per year, but everyone at that meeting of government and industry had plans to build more auto plants. Korea and Japan had the most ambitious plans. Alas, this was also true of other industries.

Recently, while in Japan, I met a top representative of one of the largest U.S. glass companies, who informed me that, every time his company built a new glass factory in Asia, Japan's Asahi glass company built another in the same neighborhood, and then cut prices to the bone.

And this story, in different forms in different industries and in different countries, partly explains why there is a growing glut in so many industrial commodities and products today–a problem intensified by the subsequent recessions in Asia and elsewhere which led to a vicious circle of shrinking demand and devaluing currencies. In violating the most elemental rules of supply and demand, the banks which have financed this overcapacity in everything from cars to glass to office buildings now find themselves in the midst of a serious banking crisis that reaches far beyond Asia. The local banking crisis had caused wealth and markets in Asia to shrink dramatically. Thus, there will be immense continuing pressure on export markets to keep local factories operating and servicing their debts to the banks and other creditors.

Currencies have devalued throughout Asia. Some, like Thailand, because they were forced to do so by events. Some, more or less voluntarily, like Taiwan, to compete in third markets against other regional countries which were also rapidly devaluing their currencies. The devaluations continue.

## III. The Role of Foreign Investors and Banks in the Asian Financial Crisis.

The earlier failure to make sound judgments on overall credit risks helped cause the original Third World Debt Crisis of the 1980s when banks shoveled money into the Third World without paying attention to the ability to service the debts under less than optimal conditions. Banks paid dearly for these mistakes. Ten years later, it is not secret that many in Congress believe that a mistake was made in the handling of the Mexican financial crisis of 1995 in rescuing the unwise foreign investors–the holders of Mexican bonds, particularly the so-called *tesobonos*. That rescue, some believe, gave a false sense of security to many investors and bankers who felt that risks in emerging markets no longer required due caution. The Russian default was only one of many later unpleasant surprises.

A year ago, I attended a gathering in the Caribbean, which included some highly placed friends in the investment world. They reported to me that mutual fund managers were all under immense quarterly pressure to keep up their return on capital. This, they stated, was driving the managers more and more into higher yield areas with greater risks, including domestic and foreign junk bonds. More and more of this money went into Asia, Russia and other so-called emerging markets, chasing fewer and fewer solid investment opportunities. Some tried to protect themselves by keeping loans as short a term as possible. But in the end, all this just puffed up the bubble more and more. And when everybody–including local investors and foreign hedge funds–suddenly started adding up all the problems, realized that the game was nearly up, and headed for the door, the Asian crisis went acute, beginning in Thailand.

Sensing that lots of other countries had similar problems, money began to flee from other places as well. And the crisis spread and indeed is still spreading. It eventually triggered the largest by-volume, one day fall in U.S. stock market history, and the aftershocks were felt in Brazil, Russia, and many other countries. Falling commercial bond prices and currency instabilities added to the strain and set the stage for the most recent tensions in financial markets.

As far as I can tell, the world is about three-quarters through the first phase of this financial crisis but we may not have seen the full impact yet, depending importantly, on what happens in Brazil, Japan, and China in the months ahead. It is important to understand that the hedge funds only helped bring the crisis to a head. The situation in Asia had long become inherently unsustainable for all the reasons cited earlier in this analysis. Had the crisis not happened last fall, the ultimate collapse would likely have been even worse, and had even broader ramifications. In the meantime, the damage from the Asian financial crisis has spread worldwide, impacting many countries in different ways.

There are various categories of countries which have been impacted. Class one is comprised of those countries which suffered from the original financial excesses and excess investment. Class two is comprised of those countries which suffered from the contracting economies and net demand from the class one countries when they imploded. Raw material producers were important members of class two countries, particularly oil producers. The third class of countries are those whose manufacturers and exporters were damaged by competing exports from class one countries with depreciated currencies. But at a certain stage in the process, via the financial system and net loss of demand, all these problems, whatever their original cause, can start into a vicious downward spiral, unless very strong actions are taken to stimulate net demand in places where policy room for this action exists.

Today, however, the U.S. stock market is still above the levels that caused Alan Greenspan to warn about undue exuberance in stock markets with his famous December 1997 speech at the American Enterprise Institute. And the *Economist* magazine for months had urged Greenspan to tighten monetary policy to deflate the stock market bubble. The pain thus far inflicted on the global financial markets is not yet at the point likely to cause G-7 Central Banks collectively to pour large quantities of liquidity in the market–unless there is a sudden collapse of the Japanese financial system, which now looks less likely in the period immediately ahead.

But global financial markets are still very nervous, and the Federal Reserve lowered the interest rate twice in recent weeks. This happened because, while the broadest measure of the U.S. money supply by historical standards is relatively generous, serious and potentially dangerous liquidity problems began to develop in selected financial markets. When stock and bond prices began to decline in August, it triggered high losses among various investment houses and their bankers. This forced sales of additional assets, particularly among those hedge funds and investment banks which were highly leveraged and vulnerable to margin calls. Those who borrowed large amounts of Japanese yen to finance their investment and speculative activity suddenly had to repay those yen to cover their losses. This, in turn, triggered massive shifts in dollar-yen relationships and caused many more who had borrowed yen, for whatever purpose, also to have to repay those yen loans urgently. This further depressed the currency ratio and forced still other fire sales. The Russian default put added strains on the investment community, and there was fear that default could later spread to other countries with serious economic problems.

U.S. banks then ceased any even marginally risky lending, while many other investors ran for cover into cash and short-term treasury bills, not knowing when the next shoe was about to drop. It became almost impossible to borrow money to finance normal Wall Street transactions. The inability of the governing board of the IMF and World Bank to reach definitive solutions at their meeting further spooked markets. There was some danger that the resultant Wall Street liquidity shortage, and general market uncertainties, could trigger broader problems. Thus, the Federal Reserve acted to increase the liquidity in those financial markets to calm fears.

In doing this, Chairman Greenspan and his colleagues appear wisely to have bought time for a more orderly adjustment to take place–one based on rationality rather than panic and uncertainty. However, it does not seem likely to me that the answer to the current stresses in global financial and currency markets is going to come mainly from the U.S. Federal Reserve or from the Euro-zone Central Banks. The control of inflation will still remain the most important bottom line for these monetary authorities. Thus, a heavy policy burden is still going to fall on many individual countries with macroeconomic imbalances, current account deficits, or other problems in need of correction.

It is also clear that in some countries, official statistics on current accounts, budgetary projections, exchange reserves, or monetary emissions have what we call a "fudge factor" built into them, which understates the full extent of the local problems. But as we have seen in Asia and elsewhere, fiddling with the numbers that are fed to the public doesn't make the problems go away. It just makes everybody nervous, including friendly governments, the IMF, and foreign and domestic investors. It is a thousand times better to be candid, and then deal with the actual problems as they evolve.

## IV. Some Hopeful Prospects.

At the recent annual meeting of the IMF/World Bank in Washington, there was an unusual amount of tension, recriminations, finger pointing and soul searching. Many left that series of meetings profoundly exhausted and depressed. As one of those who attended some of those sessions, I did not have this reaction. Quite the contrary. I felt that authorities everywhere were finally facing up to the full reality of the financial crisis that was threatening economies worldwide. Recognition of the problem is always the first step in solving it.

Within days after the conclusion of the meetings, the U.S. Congress approved an $18 billion infusion of capital and secured IMF policy reforms that will ultimately benefit all concerned. Then the Japanese government approved a half trillion dollar fund to help deal with the potentially catastrophic problems in their financial and banking system.

The Brazilian Government announced its intention to deal with their out of control budget deficits, and is obviously carefully examining measures to deal with other problems that are causing capital flight, currency instability, and economic slowdown. The government is also dealing with the problems that threaten to spread to their neighbors, creditors, trading partners and, most importantly, the living standard of the Brazilian people.

Then, the Federal Reserve acted to ease the squeeze on Wall Street. In Europe, political leaders and some central bankers were less categorical than earlier about interest rate reductions under future possible contingencies. Finally, for various reasons, the yen strengthened to the point that the threat of immediate competitive devaluations by China and other east Asian countries to combat the earlier weak yen has temporarily eased. But all together, these new developments represent significant progress in the battle to contain global financial dangers. It is, of course, clear that we are not yet out of the woods.

The erasure of wealth on such a titanic scale and the heavy blows to local banking systems in Asia and elsewhere constitute a serious long-term problem. Moreover, there are still serious threats to currency stability in some countries. The deep recessions in some places also mean continued problems.

All this is going to require careful management of existing problems and volatilities and, in some cases, political leadership skills will be called upon to encourage patience in countries under strain, and cooperation from those in a position to offer assistance. The next year is going to be a critical one. Much of Asia will remain in recession. Europe is lowering its growth estimates, as are the United States and other countries.

The U.S. trade deficit next year is projected to reach $300 billion, on top of an existing cumulative deficit of over a trillion dollars, which must be serviced. Profits and employment will be threatened in those sections, particularly in the manufacturing area, where competition from those exporting in devalued currencies will be keen. Since many service industries are built around the jobs provided by the manufacturing area, the problems in the directly impacted area can make other parts of the American economy spongy.

A $300 billion deficit sustained for a few years can quickly add another trillion dollars to the net U.S. debt. And, to paraphrase the late Senator Dirksen: "A trillion dollars here, a trillion dollars there. Pretty soon it adds up to real money."

These deficits, and the concerns for job security in the United States, have helped undermine the climate in the U.S. Congress for ambitious new trade negotiations. The President's request for fast-track authority was thrice rejected by Congress this year. I'm sure he will try again. But even the modest African trade initiative was defeated in Congress, opposed also by Jesse Jackson and other African-Americans who are concerned about job loss in the United States, particularly in the textile area. Were the North American Free Trade Agreement to be submitted to Congress today, it probably would not pass again, notwithstanding the strong continuing support of many of its original proponents.

It is also clear that the Brazilians are disposed to slow up the process of trade liberalization to enable them to advance with their MERCOSUR objections, and digest the earlier openings on trade and investment. Does this mean that the inter-American economic agenda has ground to a halt? Certainly not. The Santiago Summit of the Americas earlier this year set forth an extensive agenda of action items that merit implementation. This conference will consider many of these important issues.

We also need to be creative on trade policy to give all of our peoples new confidence in the trade negotiation process. We may need, for example, to consider how to factor currency devaluations into the trade negotiation process, so that a tariff tradeoff is not simply nullified by the next currency devaluation. This subject, of course, goes well beyond the normal purview of trade ministries, so we will need to engage our finance ministries in this endeavor as well. Part of the problem can be addressed by stable, sound, sustainable macroeconomic policies in all countries. Similarly, we will need to renew our efforts to deal with non-tariff barriers. German auto manufacturers complain, for example, that thirty percent of the value of every German car sold in Japan is due to the need to overcome non-tariff barriers against imported cars. This amounts to a thirty percent tariff, and is not an isolated example.

But I feel confident, particularly within this hemisphere, that our creative imaginations can overcome many of these problems with enough patience and time. We can all see the result of past hard work and regional cooperation. In 1997, Latin America as a whole had its best economic performance in a generation, with real growth at five percent and inflation at only eleven percent–the lowest in more than half a century.

In 1986, as the U.S. Ambassador to the Organization of American States, I made a presentation to the Conference of Great Cities of the Americas entitled "Obstacles to Investment and Economic Growth in Latin America." At the time, this was a highly controversial paper in many countries in the hemisphere.

Today, thanks in part to President Bush's Enterprise for the Americas initiative, and to some outstanding leadership in Latin America, massive progress has been made on virtually every item in that paper.

## V. Conclusion.

We have all come a long way together in the past fourteen years. But presently, we are facing a major global financial crisis that has ramifications for each one of us. For us to emerge from this problem, all of the countries involved must act on many different levels, remembering the important positive and negative lessons of the recent past.

Locally, it is essential that macroeconomic stability be restored. If another round of currency instabilities begins in this hemisphere, then we potentially face years of problems. Institutions like the IMF can provide emergency loans for some countries under threat. But as in the case of Brazil, $30 billion fled the country in a matter of weeks when concern about currency stability began to undermine confidence. Only sound and sustainable policies can restore that confidence. Otherwise, the $30 billion proposed emergency loan fund of the IMF for Brazil will disappear just as quickly as the $30 billion of the Brazilian investors and savers. During the 1980s debt crisis, the Brazilian government signed eleven different letters of intent with the IMF. It did not honor a single one of them, causing some to recall Lucy, Charlie Brown and the annual disappearing football. This shouldn't start happening again. Otherwise, the problems will spread to all of Brazil's trading partners and to the Brazilian people's living standards.

Similarly, in places where commodity prices like oil have declined, budgets based on higher projected revenues must also be constantly modified to reflect current realistic income projections, to avoid future currency crises and inflation that are otherwise inevitable. Collectively, we must also work together on our common agendas in a way that can elicit the support and confidence of all our peoples. All this will take imagination and effort, but this is what must be done.