S. HRG. 105–808

CONSEQUENCES OF THE ASIAN FINANCIAL CRISIS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

FEBRUARY 4, 1998

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

53–296—CC WASHINGTON : 1998

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-058006-4

COMMITTEE ON FINANCE

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CONSEQUENCES OF THE ASIAN FINANCIAL CRISIS

WEDNESDAY, FEBRUARY 4, 1998

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, Nickles, Jeffords, Mack, Baucus, Rockefeller, Graham, Bryan, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

We have a very difficult morning because we have a number of distinguished guests to testify, but we also have, I understand, five votes this morning. So it is going to take some juggling.

I regret that Senator Moynihan cannot be here because he has the flu. But we have Senator Rockefeller here, that is very true. I am here, but I have almost lost my voice, which probably is a break for everybody.

But I do want to welcome our distinguished guests and I want to thank you all for taking the time from your schedules to share your expertise with the committee on the critically important topic of trade and economic consequences of the Asian financial crisis.

Before opening the hearing for the testimony of the witnesses we have before us, I would like to comment on my own recent trip to Asia. To my mind, the financial crisis that has overtaken a number of Asian countries and the risk that it might spread presents one of the most profound challenges to American economic policy making we have faced during my lifetime.

A region that was only a short time ago held up as a model of economic development has confronted what may be the sharpest reversal of fortune in our experience in the absence of war or civil strife.

In my visits to South Korea, Thailand, and Malaysia I was impressed by the efforts the governments had made thus far to tackle the problems they face. I was also impressed by their commitment to take the steps needed to put their economies on a sounder economic footing for the future.

That said, there is still a long, long way to go and there are certainly risks involved, both for our Asian trading partners and for U.S. interests if we fail to pursue the right course of action.

In my conversations with government officials in Asia, I emphasized three basic points that are based on our own experience here in the U.S.

The first, was the need to take quick, comprehensive action to address the underlying problems that gave rise to the current crisis. Our own experience with the U.S. savings and loan crisis of the 1980's is an object lesson, and the need to move sooner rather than later to make the fundamental changes that are required. Delay is the enemy of progress in reviving the Asian economy.

The second point I stressed, was the need for opening their markets, deregulating their economies, and giving the private sector, rather than government bureaucrats, a central role in their economic revitalization. There can no longer be any dispute that the so-called Japanese model which relies on a government-active intervention in the market is broken and cannot be fixed.

The third point I stressed, was the importance of strengthening their financial sectors by requiring greater transparency about the financial conditions of both the banks and the companies to which they lend. That, frankly, is the key to encouraging investors to put their money back into the countries and to kick-starting their economies.

Not surprisingly, the question I faced most often while I was in Asia was about the U.S. role and that of the International Monetary Fund. The IMF has become a particular target, both here because of the administration's request for further money for the fund, and in Asia due to the economic advice it has been dispensing.

In my view, those of us in Congress should closely scrutinize any program the administration wants to fund with the U.S. taxpayer money. That debate is both necessary and appropriate.

At the same time, we must ensure that the debate over IMF funding does not ignore our real economic interests. At the end of the day, we owe it to our constituents to explain what is at stake, for the U.S. economy and American interests in Asia generally, if we are to ask them to support any intervention in the Asian financial crisis.

There seems to be an emerging consensus that the Asian flu will slow our growth as much as 0.5 to 1 percent. For the American worker, that could mean a significant loss of employment opportunities. For certain industries that could mean lower profits, less investment capital, and loss of market share. Consumers, on the other hand, will benefit from increased price competition.

Clearly, America has a real stake in events in Asia. Our own economic interests have become closely linked to those of our Asian neighbors. The current crisis affects American jobs, American investment, and America's future. How our Asian trading partners confront the challenges they face has significant economic and political implications for our own interests in the region.

This is the point of the hearing before the committee today. I hope we can explore not only the current situation and how it came about, but what are the trade and economic implications of the crisis for the United States.

I hope we can gain a better understanding of why our Asian trading partners found themselves in this situation, how American interests would be served by assisting our Asian trading partners, and what changes we might expect as a consequence of the current financial crisis that might offer benefits to U.S. commerce in the future.

Now, Senator Moynihan is not here. If someone has some short opening remarks.

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I appreciate your statement and holding this hearing.

Mr. Chairman, like you, I recently returned from a visit to Southeast Asia. I have a couple of observations.

First, recovery in Asia is important to American national security. In the past 100 years we have fought 7 foreign wars; 5, in whole or in part, were in Korea and Southeast Asia, the places hit by this crisis.

But in the past 20 years, we have not had to fight. That is because these countries have become richer, stronger, and more stable. A long period of recession, high unemployment, and high inflation could reverse these trends and we might suffer because of that.

Second, recovery in Asia is important to jobs here. We will lose at least half a point of GDP growth next year because of the crisis and see our trade deficit grow to perhaps $300 billion.

Korea, for example, is our second-largest export market for beef. The Philippines buy more from my State of Montana than any country in Europe, and we do not want to lose the jobs and income these markets create.

Third, our efforts to promote recovery are working. The officials I met in Southeast Asia told me they believe the IMF plans were right for their countries. They know they got themselves into this problem, they know the hard work ahead of them, and including the IMF program is necessary to get them out of it.

Those countries that have stuck to the plans are beginning to bottom out. I know, for example, that the Thai, Korean, and Philippine currencies have stopped declining and the Thai stock market has risen from a low of 330 last month to 550 this week. So we have some good signs and we should not back off now.

However, we need to see more. Japan, in particular, needs to start importing more from these countries as well as from the United States and other countries in the world.

For example, Japan could begin with emergency purchases of rice from Thailand. Indonesia needs urgent attention. Their implementation of their foreign plans, and consequently their recovery, is well behind that of Korea, Thailand, and the Philippines. If the economy of a nation of 200 million collapses, we will chaos throughout the region.

Fourth, and finally, we need to learn some lessons for the future. We failed to predict this crisis, we were slow in reacting to it, and failed to help Thailand with it problems last summer. That may well have made the crisis worse.

We have now before us a larger quest for new IMF funding. I am inclined to believe that it is justified. However, as I review their requests, I want to be sure we have thought through the lessons of this crisis so that we do better in the future.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

As I already mentioned, we have five votes coming up at 10:30. So the permission of the group we are going to move to our first panel.

I want to say how much we appreciate both of these gentlemen being here. First, we have the Deputy Secretary of Treasury, Larry Summers. Secretary Summers has logged as many miles as Federal Express, I think, in recent weeks in Asia. We crossed paths quite a few times.

We are looking forward to hearing your assessments of the situation in Asia and its implications for our trade and economic interests. We are also looking forward to hearing the administration's view of America's role in resolving the financial crisis in Asia.

We are, of course, very pleased to have Stuart Eizenstat, the Under Secretary of State for Economic, Business and Agricultural Affairs. I understand, Stu, that you have just returned last night from Europe, so I want to express my personal appreciation for your willingness to join us in our hearing today.

Today we look to Mr. Eizenstat for an overview of how the situation in Asia may affect our broader economic, political, and security interests in the region. We also look to him to help us understand what actions we should be taking in our own interests to restore economic stability to our Asian neighbors at this critical juncture.

Mr. Summers?

STATEMENT OF HON. LAWRENCE H. SUMMERS, DEPUTY SECRETARY OF THE TREASURY, WASHINGTON, DC

Mr. SUMMERS. Thank you very much, Mr. Chairman. We certainly, on our travels through Asia, at various points both preceded and succeeded your own delegation's travels. I can tell you, there was a great deal of interest in Asia in the way in which the U.S. Senate and the U.S. Congress were viewing the situation there.

I am glad to have this chance to report to the committee briefly on the situation in Asia and the U.S. response. I have submitted a longer statement for the record and I will just summarize my comments, with your permission.

I think there is no question that the United States has a major stake in what happens in Asia. Secretary Eizenstat will speak to the geopolitical and security stake that we have in the situation in Asia. We have a major economic stake as well. A third of our trade is with Asia.

Problems in the Asian economies interfere with their ability to purchase American products. Lack of finance and confidence in Asia, which leads to the large-scale devaluation of their currencies, puts their goods at a substantial competitive advantage because they are our competitors as well as our consumers.

There are also very close financial linkages, as we have seen, between developments in Asian markets and developments in our own asset markets. The prospect for maintaining the kind of strong, non-inflationary growth that we have been fortunate enough to enjoy in the United States for the last few years depends upon the Asian situation being contained.

I think there is no question that strong and effective action to contain this situation is very much in Asia's interest and for this purpose, much more importantly, very much in the American national interest as a trading Nation, as a Nation involved in finance, and as a Nation with a great stake in global security.

Our approach to this crisis rests on four pillars. First, supporting the kind of national policy changes in Asia that can promote a return to confidence and can avoid a return of the kind of problems that we have seen.

That is what is done in the IMF programs, which are structurally focused on identifying some of the key problems: excessive government interference in finance; insufficient transparency; excessive public subsidy of industry; poorly regulated banking systems that have led to this very difficult situation. Those programs provide financial support, but they are conditioned on strong national policies.

I might say, strong national policies of the kind for which there is widespread support in Asia. When I visited Korea, new President-elect Kim Dae Jung handed me a copy of his book, The Mass Participatory Economy, written in 1996.

That book makes an eloquent case for non-inflationary monetary policy, for fiscal restraint, for financial liberalization, and above all, for a reduction in government-industry ties. The president-elect noted that the policies that were being pursued were the policies that he had wanted to pursue in Korea for a very long time.

The second pillar of our policy is financial support, financial support conditioned on the kinds of policies that I have just described. Financial support to permit the stretching out of maturities can make an enormous difference in a situation like this because the problem is, at root, a problem of confidence.

When investors expect other investors to withdraw their funds, everyone wants to be the first one to race out the door. When investors have an expectation that a problem will be worked through, they will remain and their optimism proves to be a self-fulfilling prophecy.

Catalytic finance can make a difference in a situation of that kind. That is why the IMF has been involved in providing financial support in Thailand, in Indonesia, and in Korea.

By supporting financing through the IMF we improve burden-sharing. The United States bears less than one-fifth of the cost. Of course, because of the strong relationship and conditionality that the IMF has, there has not been a default on a major IMF loan in 50 years.

We have made provision as a second line of defense for the possibility of providing American financial support in both Korea and Indonesia, but as yet no funds have been disbursed.

The third pillar of our response. After national policy and international assistance is strong support for the three major economies that are, if you like, the three engines that power the Asian plane: the United States, where our progress in deficit reduction has changed the world capital market profoundly because savings are no longer going into the sterile asset of U.S. Government paper; strength in Japan where it is critical that the Japanese government carry through on its commitment to repair the financial system so as to maintain financial stability, and to stimulate the economy so as to create an environment of domestic demand-led growth. Critical for Japan, critical for Asia, and for the global economy. And in China, where continued economic reform and the maintenance of currency stability is a critical priority and one in which the Chinese have provided the world community with very strong assurances in recent weeks.

The fourth priority that is critical is that we work to continue reforming the global financial system so that we can minimize the risk of problems of this type in the future. This has been a priority for the United States since President Clinton called for a reform of the global financial architecture at the Naples summit. There have been important steps already in terms of increased transparency.

This crisis makes it very clear that further steps are necessary and we will be focusing in on six areas: making global markets function more efficiently by ensuring that they are adequately regulated; transparency and disclosure; prudential standards; improved domestic policy management and surveillance so the countries do not come into crisis; strengthening and making sure there are procedures that the international financial institutions have for responding to crises and making sure that they are appropriate; and providing for appropriate private sector burden-sharing to ensure that when crisis comes, the financial responsibility is placed to an appropriate extent on the private sector.

Let me just conclude by speaking for several moments about what is the key legislative choice before the Congress this year, and that is support for the IMF. The administration is requesting support for the IMF in two forms, the standard quota increase of the kind that has been approved periodically in the past by the Congress, and support for the so-called new arrangement to borrow, a new arrangement that was agreed after Mexico, that would provide for emergency loans to the IMF to respond to crises on a case-by-case basis, bringing in not just the G–10 countries, but also newer participants in the international financial community. It is, in our view, of great importance that these requests be acted on as rapidly as possible.

The presence of an adequately funded IMF that can respond to crises is a crucial insurance policy against future problems in what is clearly a volatile situation. The knowledge that an adequately funded IMF is in place acts as an inhibition to speculative attacks, and a source of confidence at a critical moment.

Conversely, the absence of knowledge that an adequately funded IMF was in place could be an encouragement to reductions in confidence with all that might follow.

I have already stressed that the true costs to American taxpayers of IMF support has no cost because there has not been a major default in 50 years, and because the IMF's loans are backed almost two-thirds by the IMF's supply of gold. That is why the Congressional Budget Office scores zero cost for IMF lending.

The IMF, at the end of these requests, would still be smaller relatively to global capital flows, global trade flows, than it was 15 years ago.

If we are to have an opportunity to influence the policies of the IMF to support the values we all favor—openness, transparency, working for creditor responsibility, economic growth in these countries, free markets—it is crucial that we be in a position to provide support.

I am aware that there are a number of crucial questions that have been asked. Are these programs based on too much austerity? I think that is something that has to be judged on a case-by-case basis. But the focus has certainly been structural measures rather than macroeconomic changes. Where there have been macroeconomic changes they have reflected the imperative of responding to currencies in freefall.

What about moral hazard? That is a crucial question we will have to grapple with in the months and years ahead. But I think it is very important to recognize that the international response to the Asian crisis has involved placing very substantial burdens on investors.

Chairman Greenspan estimated in his testimony on Friday that nearly $700 billion in non-Japanese equity markets had been lost in the last 6 months.

Financial Times reported on Monday that there were estimates that European banks were going to take write-offs of as much as $20 billion on Asian loans. A number of major American banks have revised down their profit forecasts on the basis of losses in Asia.

This reflects a very disciplined policy. Our policy is to provide support to governments and for sovereign obligations, not to provide support to bail out any claim between banks and their private creditors.

In Korea, the banks have agreed with the Koreans to respond, as banks do when there are problems, by extending maturities. That kind of market-based response is appropriate.

There are other concerns which I can take up in the context of questions. But I would just say, finally, that while we will improve our efforts to predict these crises, I think it is important to recognize that the one thing that we can confidently expect is that, in global financial markets, the unexpected will take place.

The United States will be much better prepared to respond to whatever may come if we have an adequate institution based on strong burden-sharing that is in place. That is why it is so critical that the IMF be adequately funded.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Secretary Summers.

[The prepared statement of Mr. Summers appears in the appendix.]

The CHAIRMAN. Mr. Eizenstat?

STATEMENT OF HON. STUART E. EIZENSTAT, UNDER SECRETARY OF STATE FOR ECONOMIC, BUSINESS AND AGRICULTURAL AFFAIRS, WASHINGTON, DC

Mr. EIZENSTAT. Thank you, Mr. Chairman and members of the committee.

I would like to make three basic points this morning. First, our security interests, second, the way our trade and prosperity are wrapped up in this particular problem, and third, how U.S. values and credibility are at stake. With respect to each of these three points, the IMF programs support U.S. interests in a very direct way.

First, with respect to security. This is not just a test of our economic leadership, as important as that is. It is also a test of our political leadership. Our engagement now at a time of political unease helps assure our ability in the future to mobilize support for the countries we are working with on a whole range of political and diplomatic issues of importance to us.

This is a real test of U.S. leadership in the post-Cold War era. Our own security is closely linked to peace and stability in East Asia. We have fought three costly wars there in little over 50 years and our security policy since the end of World War II has been based, in the Western Pacific, on stability and deterrence of conflict.

Four of the world's major powers rub shoulders in Northeast Asia, while some of the most important sea lanes on the globe pass through the confined waters of Southeast Asia.

We have tried to provide a chart which indicates that, with respect to the sea lanes alone, this is a critical way in which our ships get to and from the Persian Gulf.

We have 100,000 troops in the Asia Pacific region today; 37,000 in South Korea, 40,000 in Japan, and 30,000 at sea in the Asia area.

Economic progress has reinforced peace and stability, and a region once characterized by authoritarian regimes now has viable and exciting democracies.

The current economic difficulties, if not halted, could threaten the stability and much of the progress made over a generation. The countries hit are among our closest and most vital friends and allies.

South Korea. As I mentioned, we have 37,000 troops.South Korea, weakened by economic distress, would raise the risk of miscalculation by North Korea and the potential for conflict on the volatile Korean peninsula.

It would make more difficult our vitally important effort, through the agreed framework of 1994 and the Korea Energy Development Organization, or KEDO, to dismantle the dangerous North Korean nuclear program, where a large contribution from South Korea will be necessary and could well complicate our delicate efforts through the four party talks to secure a permanent peace and bring the Korean War to a formal end.

I would like to remind the members of the committee that South Korea is our fifth largest export market. Over the past 3 years we have accumulated a surplus of $26 billion in trade and we have extremely close military-to-military cooperation.

Thailand, which is another country involved, where Secretary Summers has spent so much time, is one of our closest friends in the region. It has been a close and supportive ally since 1954, where we have a treaty relationship. We closely cooperate with Thailand on a whole range of issues, including narcotics, environmental protection, improved intellectual property.

We have air base access in Thailand, Mr. Chairman and members of the committee, which we used during the Gulf War. They gave us oversight clearance. We have one of the largest IMET military cooperation programs in the world and they are major purchases of our military equipment.

Indonesia is also critically important to our security interests. It is the fourth most populist country in the world and it has played a constructive role in the region. It has been a driving force within APEC in terms of favoring trade liberalization.

It is a moderate Muslim state. I think few of the American people realize, it is the largest Muslim nation in the world. Indeed, more Muslims live in Indonesia than in all the Middle East combined.

It spans important sea lanes and airways. It founded the ASEAN Regional Forum, which gives the United States the ability to relate to ASEAN in a security dimension. It has played a constructive role in the Cambodian crisis. It has contributed to Bosnian and Angola peace-keeping. It allows ship repair for our war ships, which is an important part of our forward-based deployment strategy in the Asia Pacific.

The Philippines, also hard-hit, has been a close friend since its independence in 1946, and a treaty ally since 1952.

Likewise, ASEAN itself has grown over its 30 years in stature and is playing a constructive role in areas like Cambodia. When you compare this region, Mr. Chairman, with the 1960's where there were insurrections, shooting wars, and communal killings, ASEAN and the countries that belong to it have contributed to a very different face in Asia.

A peaceful and stable Asia Pacific is a region that will remain open to our influence, to our ideas, and to our trade, if we show continued leadership. But if, during this crisis, we appear disinterested or unengaged, we will cede to others political and diplomatic influence and the economic opportunities that go with that.

Second, in terms of prosperity. The economic health of East Asia is important to our prosperity. Secretary Summers indicated the importance to our exports. Let me mention just a few states.

A large proportion of exports from our west coast go to East Asia. In 1996, nearly 60 percent of the exports from Washington State, 57 percent from Oregon, 51 percent from California, went to East Asia.

Even more remarkable are the high numbers in other parts of the country: 45 percent from Nebraska, 42 percent from Utah, 37 percent from Louisiana, and almost 20 percent from your State, Mr. Chairman, Delaware.

Continued deterioration of Asian economies and the further depreciation of their currencies would mean lower U.S. exports, fewer contracts for U.S.-supplied services, and job loss here at home. There would be more pressure on our balance of payments, and we will already see a noticeable increase in our trade and current account deficits.

The IMF programs which Secretary Summers summarized, if fully implemented, offer the best chance for these countries to resume their impressive economic growth. For this reason, it is not only in our economic interests, but our political security interests, to support the programs Secretary Summers mentioned.

Let me mention as well one point on the trade issue, because in many ways the IMF in just a few months has accomplished things that the U.S. bilaterally in the trade area has been trying, with only partial success, to accomplish for many years.

As a condition of their programs there will be an elimination of trade-related subsidies, a harmonization of import certificate procedures, binding liberalizations of financial service officers, increased opportunities for foreign investment, the elimination of import monopolies which have made it difficult for us to penetrate those markets, reduced tariff levels, the end of directed lending, which has made it very difficult for us to compete. In all of these areas, the IMF programs are exactly compatible with our trade interests.

Third, are U.S. values. This may be less tangible, but of equal importance. Countries like Taiwan, Thailand, South Korea and the Philippines have made impressive advances in democratization.

This, in turn, has been, we believe, supported strongly by the economic progress and the creation of new emerging middle classes. They are the greatest hope in the entire region for the development of more democratic institutions and greater respect for human rights.

The very course of development on a bipartisan basis that we prefer, more open and democratic societies and more open and competitive economies, are jeopardized by the present turmoil.

Leadership is not divisible. We cannot lead on critical security issues or on opening markets while abdicating our leadership in maintaining international financial systems.

To turn from the task at hand not only would risk stability abroad, but would threaten our prosperity at home. It would breed resentment toward what would be seen as our indifference to the plight of friends at the time of their peril. This would not only hurt our ability to push reforms, but would also affect our broader security interests in the region, as I have described.

To conclude, as Secretary Summers mentioned, we are not alone in this. We have been mobilizing other nations, the Europeans, the Chinese, and the Japanese, to help and to join in these efforts.

So in all three areas, security, prosperity, and U.S. values and supporting democracies in the region, we believe that supporting the IMF programs and remaining engaged directly and visibly is vitally important.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Secretary Eizenstat.

[The prepared statement of Mr. Eizenstat appears in the appendix.]

The CHAIRMAN. We will have votes at 10:30. I am going to try to keep the committee functioning throughout the votes so that we can proceed as scheduled.

Mr. Summers, on of the questions one hears constantly is, how can we trust the IMF today when it did so badly in its miscalculation of the financial situation 6 months ago? At that time it was saying that the economies in Asia were sound and expected to be continued. Of course, in the meantime, we have Asian flu.

How can we trust the current estimates of what it needs to address the crisis?

Mr. SUMMERS. Mr. Chairman, I do not think any of us in the economics profession, outside the economics profession, in financial markets can predict with confidence what will happen. These kinds of crises almost, by their nature, come as unexpected events.

The reason it is so important to provide adequate support for the IMF is not because there is a specific scenario that we can foresee that will involve that support, but is precisely as an insurance policy against crises that will come in the future.

There are a set of very important steps that can be taken to enhance our capacity to predict and forestall these crises. The most important of those, in my judgment, is the gathering and open publication of a fuller set of data on countries' financial positions.

For example, it is not appropriate for countries to publish their reserves but not to publish the ways in which those reserves have been encumbered by forward positions or by other kinds of obligations to the local banking system.

It is important to know what a country's total debt is, but it is equally important to know how much of that debt is coming due in the next 3 months, the next 6 months, or the next year.

I think there is no question that our techniques of surveillance have to be improved so that we are getting a clearer set of indicators of countries' financial positions and how those financial positions are evolving.

But, Mr. Chairman, I have to say that I think it is in the nature of a crisis of these kinds that the spiraling almost out of control that we have seen is extraordinarily difficult to predict in advance. We in the Treasury try to monitor very closely not just the judgments of the IMF and of our own economists, but also the judgments of participants in financial markets, private economists, and other observers.

While, particularly in the case of Thailand, there are certainly were concerns expressed, I am not aware of anyone who predicted a crisis of the kind of magnitude and virulence that we have seen. So better transparency, better information on capital flows, and be prepared for the unexpected.

The CHAIRMAN. Let me ask you this. Will the Asian flu spread further? For example, what will happen to Thailand if South Korea and Indonesia withdraw the money that they promised Thailand as a second line of defense? Many of them are concerned, what will happen if China devalues its currency or if Hong Kong eliminates its peg to the dollar. Do you see that happening?

Mr. SUMMERS. Mr. Chairman, there are a number of possible elements of contagion. One, is that when one country devalues or encounters difficulty, investors lose confidence in other countries.

Another, is that when one country's currency declines, it goods are on sale and that puts pressure for the devaluation of other currencies.

Another, is when investors take losses in one country and, because of a need to generate liquidity, they are forced to sell assets in a second or a third country. In all these ways, contagion is very important.

So it is crucial that we recognize this as a regional phenomenon rather than just a phenomenon of individual countries. That is one of the reasons why we have been so focused, precisely because of the contagion risks.

I do not think anybody can predict those contagion risks. What I think I can say, is the best way to minimize them is to support strong policy in each individual country, to provide adequate financial support, and have it be known that there will be a vigorous response if crises come.

And in the special case of China and Hong Kong to which you referred, for us to welcome the authorities' very clear commitments in both of those cases to maintaining the existing exchange rate arrangements, which I think are a very important fire wall in favor of stability.

The CHAIRMAN. On that point, let me ask you, Mr. Eizenstat. China has been very circumspect in all its statements regarding the crisis, and I think has acted quite responsibly so as not to put further pressure on the countries facing Asian flu.

How do the Chinese view the current situation; have they drawn particular lessons for the reform of their own economy, have they imposed any time limit on their commitment not to devalue?

Mr. EIZENSTAT. Well, Secretary Summers, I think, accomplished a great deal on his trip through Asia. None of the accomplishments was more important than the commitment, to which of course he can refer more directly, from China, which I think he felt, and we all felt, was quite unequivocal, that certainly through 1998, that there would be no devaluation.

That is very important because if China were to devalue, it would set off further devaluations by their neighbors. By not devaluing, they will be taking in potentially more of the imports coming from these countries.

Second, in Davos I had the opportunity of talking to some Chinese officials and it is quite clear that they have learned some lessons. They are beginning to reform their own banking institutions. For example, with their own Central Bank, they are duplicating in many ways the organization of our Federal Reserve system. I was told that they are ending political appointments by the party to the regional banks, and the regional banks will be headed by people appointed by the Central Bank, not by the political party.

They also indicated that, in terms of the directed lending—which, as Secretary Summers indicated, is a very real problem in all of these countries, the close link between governments and the private sector—that they are trying to remove that kind of linkage, with the party putting pressure on regional banks for lending. Again, I would defer to Secretary Summers to go further because he actually talked with him during his trip.

But certainly, again, in Switzerland we got a very clear indication and a reaffirmation that they would not be devaluing and that they realized they need to modernize and make more transparent and efficient their own banking system.

Mr. SUMMERS. I would respectfully amend what Secretary Eizenstat said in one way. The discussion of the maintenance of the current exchange rate arrangement was in no way time limited. You made a reference to 1998. There was nothing time limited about the way in which that was described to me and it was, I think, very clearly understood that that carries with it important concomitant actions.

It is not just a matter of political will, it is a matter of actions in monetary policy, it is a matter of actions in banking system reform, and so forth, because in many ways the lesson of this crisis is that you can have a monetary policy that is directed at certain objectives if you want, or you can have an exchange rate that is directed at a certain objective, but the monetary policy and financial policy has to be consistent with the exchange rate or you get into very serious trouble, as we saw in Southeast Asia. I think that point is very clear in the Chinese thinking.

I might also say that when President Clinton met with President Xiong Je Min this fall, one of the things they agreed on was the importance of the United States and China cooperating, not just with respect to each other's economy, but with respect to the broader Asian situation. We have had a dialogue, and my trip was part of that to China, not just with respect to the situation in China, but also with respect to the broader situation in Asia.

The CHAIRMAN. Mr. Rockefeller?

Senator ROCKEFELLER. I have a variety of questions on China and Japan that I would love to ask, but I do not think I would be doing my duty in this short time if I did so.

So rather than that, working from Secretary Rubin's statement, let me just put up the four main objections. I happen to support what you want to do, and will support it. But the four main objections, so that you, Larry and Stuart, as you so choose, may respond to them.

The first one, is we should not help our competitors because falling prices make goods cheaper to Americans.

Mr. SUMMERS. If we do not provide financial support, the exchange rates will fall to the point where it will be very difficult for these countries to be our consumers, and they will become much more formidable competitors because their goods will be placed, if you like, on fire sale because of excessive devaluation.

Furthermore, Secretary Eizenstat made a critical point. These programs provide us with an opportunity to promote the kinds of changes in market practices that we value. For example, the Korean program contains an unambiguous commitment to the elimination of policy lending.

Cheap credits from Korean banks directed by governments have been a major source of excess capacity that has been a competitive problem for us. Through this program we have been able to eliminate that practice. Without providing this kind of support we would not be able to have this kind of leverage to eliminate those kinds of practices.

Mr. EIZENSTAT. I would only add one very brief point. That is, if these currencies were to fall even further it would increase our trade and current account deficit even more than we now anticipate. That would add to protectionist pressures that already exist in the country.

Senator ROCKEFELLER. The second criticism of those who oppose doing what I think is right to do, and that is support what you all are proposing, is they say there are not enough sort of core environmental or labor conditions worked into the IMF packages, et cetera.

Mr. SUMMERS. These are critical issues and issues we will be pursuing with Energy in the future. Just as over time American pressure has led to issues of corruption and issues of governance being central in the work of international financial institutions, I believe we can make important progress in these areas in the future.

Indeed, over the last several years at the World Bank we have made such progress. The bank has a policy now on child labor, and on a number of occasions projects have been adjusted to reflect those strong commitments with respect to child labor.

We have succeeded in the Indonesian program in eliminating certain import monopolies that raised food prices artificially and thereby depressed real wages. So these are issues that we have taken up and we will take up with increasing urgency in the future.

I do think it is important to recognize, Senator Rockefeller, that at moments of crisis there is a limited amount that can be accomplished, and that the focus of the programs has to be, and should be, increased financial confidence. But in more normal times and over time I think the international financial institutions can be increasingly effective tools in the labor area.

And I think, with Jim Wolfenson's strong leadership, most people would agree they increasingly have been in the environmental area with much more openness and transparency, much less heavy infrastructure projects, much more emphasis on supporting small, natural farming and a set of other measures.

Mr. EIZENSTAT. To reinforce Secretary Summers' point, we think to overburden IMF programs with goals and other areas during the crisis would complicate and delay the process and reduce the chance of success, but this in no way indicates we are uninterested, quite the contrary.

We are working now with the international financial institutions to create a closer link with the ILO, we are working to strengthen the ILO's surveillance mechanisms in areas of labor rights, and in many ways, Senator Rockefeller, I think the greatest protection we have to ensure that these countries respect human rights and appropriate labor and environmental protections is the openness that the IMF programs are doing and the sustaining of the middle class, which has been the bedrock of the growth of democracy in this region.

If we allow this middle class to fall back into poverty, then the chances of making success in the areas that you indicate are certain to be much less.

Senator ROCKEFELLER. The third argument, simply, is let the free market work, the problem will solve itself.

Mr. SUMMERS. Senator, at the risk of being unfair, I would say that approach was tried in the late 1920's and early 1930's, with very unfortunate consequences. I think you have seen in every country that financial stability is a public good and it requires public efforts at regulation and involvement when necessary. I think the consequences of leaving this to the market would potentially be a spiral of contagion that could engulf us all.

Senator ROCKEFELLER. Without trying to cut off Secretary Eizenstat, the final one is, we should not bail out these countries or foreign bankers and investors from the consequences of their own bad decisions. That argument is raised.

Mr. SUMMERS. We should not. As the statistics cited in my testimony suggest, to a large extent we are not. They are taking very substantial losses in Asia. But it is at times going to be an inevitable by-product of helping an economy get back on its feet. Those who have invested in that economy are going to benefit.

We are going to have to look at mechanisms to ensure investor responsibility in the future, but we have to be very careful in our enthusiasm and very appropriate eagerness to make sure investors take responsibility.

We do not take actions that, at this sensitive and critical moment, spook investors and cause them to withdraw in large scale from other countries in anticipation of possible future action.

That is a balance that has to be struck. I think we have been trying to strike that balance, while at the same time being very mindful that an improved institutional environment that will allow investors to take responsibility to a greater extent is something that would be very desirable.

Mr. EIZENSTAT. I would just say, on the other side, that is with respect to the countries—

The CHAIRMAN. I am going to have to interrupt because we do have a real time problem. I would say to all the members of the panel, that if they do not complete their questions they can be submitted in writing. I face the fact that not only do we have five votes coming up, but the subway system is broken down.

So we will proceed as expeditiously as possible. I hate to cut everybody off at this stage.

Mr. Grassley?

Senator GRASSLEY. Mr. Chairman, thank you for your leadership with this hearing on a very critical issue. I think that we have to see this not only from the standpoint of the ramifications it has on the U.S. economy, but is also impacting most every constituent of ours because of the globalization of the economy.

I am going to ask a question, first, Mr. Summers. But please do not answer for about 3 minutes because I want to give some background, but I want you to think about it.

It centers around ending these incestuous relationships that we have between government leaders and corporate leaders in these countries, between the political leadership and the bankers, and all of this leading to imprudent investments.

I will give you an example of a constituent of mine, the president of IPSCO Steel Company, testifying before the House Banking Committee yesterday. He is concerned that some of the IMF funds going to Korea will be used to subsidize a Korean steel company, in violation of WTO subsidy codes. Will the IMF require that all WTO commitments be adhered to?

Apart from that specific question, how would the Treasury Department ensure that U.S. taxpayers not be used to subsidize our competitors?

I would like to follow on something Mr. Eizenstat said in the way of some opening remarks, referring to Delaware and Washington State.

In Cedar Rapids, Iowa, the Gazette carried a story with this headline two Sundays ago saying how important the Asian situation is in the Midwest. We have an increase of one-third of our manufacturing exports to Asia in just 10 years. We have 30 percent of all our manufactured products going to Asia. We have 45 percent of all of our agricultural products in my State going to Asia.

So, not only as national leader do we have to have interest in this for our country as a whole, but we cannot ignore this problem even for our constituents.

Now, we obviously have a crisis, but I also see it as an opportunity, an opportunity that we took advantage of after the crash of 1929, after the bad experiments with Smoot-Hawley.

We got a great deal of trade liberalization. It has taken 60 years, but it started almost immediately with the reciprocity agreement. So I think we ought to see the Asia crisis as an opportunity.

Financial reforms, which most of this hearing has talked about, absolutely, yes. But also an opportunity to open markets, an opportunity for trade liberalization. We should not miss this opportunity.

I followed on with Senator Baucus and Senator Roberts through a letter that they sponsored to our Leaders about using this opportunity to break down the barriers that we have in these countries to agricultural exports from our country to there.

So we learn from history. We know that trade shrunk between 1929 and 1933 from more than $3 billion down to less than $1 billion. We cannot let trade shrink with this crisis. We have got to avoid a like situation with the Asian flu.

Asia probably will flood America with cheap exports, so in return, it seems to me, trade liberalization demands that, under U.S. leadership, with the help of the IMF or to make sure that the IMF does it, to open up markets to U.S. trade because trade is a two-way street.

Bail-out, yes. But we need to make sure that we get something for it, something for our farmers and something for our workers, and that is open markets. That will create jobs and opportunity.

That is the background for my question, which is a little more specific, Mr. Summers.

Mr. SUMMERS. Senator Grassley, we agree with the thrust of your question and the thrust of your comments. The IMF programs in both Indonesia and Korea do include important measures directed at trade liberalization, such as a cut of food import tariffs to 5 percent effective immediately in Indonesia, such as a commitment on Korea's part to an import diversification program, and to eliminate trade-related subsidies. These are crucial issues of openness that benefit not just these countries' trading partners, but benefit these countries themselves.

The second point I would make, is that there are close links between the financial issues and the trade issues. By eliminating, as the program does, the provision of policy loans in Korea, we discourage the kind of inappropriate subsidies that have taken place in the past and put American producers at an unfair disadvantage.

The third point I would make, which really applies to your question and might also in reference to Senator Rockefeller's earlier question, is to imagine what would happen if we did not provide this support.

If we were not providing this support, there would be no conditions for trade liberalization, there would be larger devaluations, there would be further reductions in the size of these markets.

There would be greater protectionist pressures because that is what always happens when countries are not able to get finance, as we saw in the example you cited of the late 1920's and early 1930's.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Thank you.

Mr. Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I have a basic question for both of you, but, first, would like to compliment both of you personally and the administration on, I think, doing a very good job. This is a matter which is very complicated. There are no perfect answers. We cannot let perfection be the enemy of the good. We have to choose among various alternatives.

You have outlined what those alternatives are and I think that you have chosen the correct one, that is proceeding and doing the best we can with the restructuring, et cetera. I think our country really does not have much choice here and we are pursuing the correct choice, given the alternatives.

Second, to those who say, let the market take its course, I ask them if they want to abolish the SEC or whether they want to abolish the CFTC. I do not think we do. There are mechanisms in place to keep orderly markets.

The bigger question I have is, what are some of the future potential problems that we have not discussed today? I mean, this whole discussion this morning assumes that we are bottoming out. That is sort of the undercurrent of this discussion.

We underestimated the problems that some of these countries faced. I mean, Korea, for example. The Korean problem was much worse than we originally thought. Indonesia is another example. There are great presidential succession problems in Indonesia.

I have received briefings that China is in much more hurt than has been discussed openly, and the same is true of Japan. Because of the lack of transparency and some of the similar problems we have been discussing in both China and Japan, there could be real problems there.

So I just think, if we are going to get to the bottom of this and do the best we can, it would be helpful. I know you do not want to start a rush on the markets in any way, but if you could just tell us the best way you can, to keep us as well informed as we should be, as to where are some of the other alligators that are out there, what should we be looking at in order to anticipate, prevent, and minimize future problems within the Southeast Asia, China, and Japan financial gambit.

Mr. SUMMERS. Senator Baucus, as you suggested in raising your question, I think for reasons you can appreciate it is difficult for me to be in the position of identifying particular countries as possible risk points.

I would just make two points in this forum. One, is that it is important that the countries that have also been the beneficiaries of substantial capital flows recognize that in this global environment the risks are greater than they were before and take appropriate policy action.

A number of countries, particularly those in Latin America, have responded in recent months quite strongly by making various adjustments in their policies to improve confidence. I think that has been a very welcome and encouraging development.

In general, I think, countries do need to recognize that there is greater uncertainty in the investment community than there was a year ago and, because markets sometimes overreact, as President Sedillo has said, that means the policy may need, in some cases, to overreact as well.

I take your invitation to reiterate the great importance we attach to developments in Japan and China, both of which the United States is following very, very closely.

In Japan, the imperatives are twofold. One, providing confidence that stability in the banking system is in place. In that context, the recent announcements of substantial infusions of public money are welcome, but what will be crucial is that that money is used in an effective way to provide confidence.

Two, it is also crucial that Japan take steps to meet the commitment to domestic demand-led growth. As long as the Japanese economy is not growing rapidly it will be a source of concern and problem.

I think in China the imperatives involve the continuation of the process of economic reform and involve, as we discussed earlier, the importance of exchange rate stability.

But, more generally, what happens in each one of these countries affects each other country because of the contagion mechanisms that I described a little earlier. That is why it is extra important that we support strong policy on a case-by-case basis.

Mr. EIZENSTAT. Just an additional point on Japan, Senator Baucus, to what Larry mentioned. That is, it underscores the imperative of Japan generally deregulating. What the IMF is doing by imposing conditions in Korea, Thailand, and Indonesia is, in fact, opening up those economies in ways they have not been, phasing out the chaebols, the bulogs.

This is an opportunity, if Japan wants to recover from its 7-year growth recession and do its part to help the Asian problem, in addition to the points that Larry made, the urgency of following through on Prime Minister Hashimoto's own commitment to deregulate and open up this market.

Senator BAUCUS. I appreciate that. I just urge you to keep going. Do not let up on the problems that have not yet been confronted in the newspapers.

Thank you.

The CHAIRMAN. I have to point out that a member of the administration said to me, what Japan needs is a Kemp-Roth tax cut.

Mr. Kerrey, please.

Senator KERREY. First of all, I, like Senator Baucus, appreciate very much both your previous work and your testimony today. I agrèe that U.S. values are at stake, I agree that U.S. security is at stake, and agree that U.S. trade and prosperity are also at stake.

It seems to me that the IMF would not likely be given as much attention—I mean, one of the things we have to note is that the original decision by some members of the House to cut the $3.5 billion contribution last year came as a result of links with family planning, nct as a result of concern about what the IMF is doing with the money, since we have never lost any taxpayer money at all. Indeed, there has been some return on the investment made.

Taxpayers should know of an $18 billion contribution that we expect to lose. Indeed, it really is not a contribution in the normal sense of the world. So I think one of the things that the taxpayer needs to understand is how this $18 billion is going to be used.

The concern that I have got, and like Senator Baucus and Senator Rockefeller I do intend to support what you are trying to do, is A) I do not find the 1920's and 1930's analogy to be terribly appropriate given that what we have, it seems to me, is the question before us, what do we do to help? What is the most important thing we can do to help?

As I look at it, we have, what $2 trillion worth of transactions a day in currencies, with tens of thousands of people all over the world sitting in front of computer screens trying to figure out what to do, what not to do, and that is the most important discipline.

It is a huge change in the way that the market is functioning, the capacity to make decisions and distribute those decisions all around the world.

If I get into the debate of whether or not Jeffrey Sachs or Michelle Camdeseau is correct, I mean, I do not know. So A) I am dealing with a situation that I say, people other than me know better and the best thing that I can do is to say that I am not going to protect people from their decisions. I mean, I do not want the IMF to become a shield that protects either me, as a politician, or somebody out there as an investor from making a bad decision.

I mean, it seems to me the more that we can allow those individuals out there who are making investment decisions to make a judgment, just as in 1993 we all had this big, ferocious debate about the deficit reduction bill. One side said they were right, one side said they are wrong. The market hit it.

No matter what we said about who was right, who was wrong, the market ultimately made a decision about the wisdom of that particular piece of legislation and they bid it up. Had they bid it down, we would all have been wrong. But they bid it up.

I find the most exciting thing in America today, although I take credit for the economic recovery when I issue my press releases, the last 6 or 7 years the transformation of the American economy has been enormous and it came as a consequence of people saying, we made a mistake.

The market wants quality, the market wants price, and we are going to give them both quality and price, otherwise we are not going to be able to sell our goods and services. We are not going to turn to the government, to the Congress, and ask them to protect us in the marketplace.

We have got to give the market the highest and best goods and services. That is what has happened, it seems to me, in the last 6 or 7 years. There has been a tremendous transformation of the American economy. It produces uncertainty, it produces some insecurity, but in some ways, if you are going to be competitive, insecurity and uncertainty is good.

So the concern that I have got is one, even the $118 billion seems a relatively small amount of money against a $2 trillion a day transaction. Second, do we need to be careful that the IMF not become a means to protect either politicians, whether it is Bob Kerrey or Suharto, from making bad decisions or investors from making bad decisions.

Mr. SUMMERS. Senator Kerrey, I think your comments about the new age of the markets relative to 50 years ago are exactly on point. In a sense, your first question is a partial answer to your second question.

The size of the markets is so large that no plausible set of IMF programs are going to provide insulation for the vast majority of market participants. That certainly would not be our intent. I suggested that nearly $700 billion had been lost in Asia in equity markets alone just in the last 6 months.

I think the question that you face is very much the question that one faces in a situation domestically where there are bank failures. On the one hand, there is the desire not to bail out the large depositors of banks who made deposits in an unsound bank, but where there is, on the other hand, the imperative of not setting off contagious bank runs that could have a substantial effect in bringing down the system.

That is the balance that one has to strike and that is the balance that there has been an attempt to strike in these cases, and in a number steps. In the case of Korea and the case of Indonesia, there have been measures that called on the banks to very substantially stretch out the maturities of their loans and not to be paid in the way that was originally intended. I think that kind of thing helps to create exactly the sense of responsibility to market forces that I think we all agree is important.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

An observation, if I may. Secretary Eizenstat, you were indicating some of the impact of the Asian crisis on some of the economies represented by some of our colleagues here.

Not only does it have an impact in terms of traditional export markets, whether they be agricultural or manufactured products, but in an economy such as my own which is heavily dependent upon tourism it has been estimated that as much as 6 percent of the operating income of the larger hotel properties in southern Nevada are reliant upon that market. Because that sector of our economy contributes more than 40 percent of the revenue which State government operates on, that can have a potentially significant impact as well.

My question is twofold. I think for all of the reasons that you have indicated and others have suggested, we have very little choice and I am going to be supportive of the proposals.

My concern is, you, Secretary Summers, indicated in response, why did we not see this, I think you indicated that there are some things that are unpredictable, that not even the finest economist in the world can anticipate that.

That leads to a conclusion that there may, indeed, be another crisis in some other part of the world in which we have equally vital interest, that can have an equal if not greater impact on the economy. If we go forward with the proposals that you have advanced, what is the discipline in the future? Why would not other economies in the future say, well, look, they bailed out the Asian economy, they took care of the Mexican economy. How do we get ourselves out of this?

As you know, some very thoughtful people—the Wall Street Journal had an article yesterday—Walter Ristin and former Secretary of State George Schultz, former Secretary of Treasury Bill Simon, cautions that we ought not to be getting into this. Your thoughts as to how we get out of this in the future, if we indeed continue to bail out these economies that get into trouble.

Mr. SUMMERS. I think it is a very real and important problem that you raise, Senator. It is what, in the technical discussions of this, is referred to as the moral hazard problem and it really is on two sides.

One, is the question of whether countries will pursue imprudent policies in expectation of a bail-out. There I think the feeling is that the degree of pain that Mexico went through, the degree of pain that Thailand is going through, that Korea is going through, the degree of pain that many of the officials who pursued the wrong policies have gone through, is such as to act as a very substantial inhibition against the wrong policies.

I think the more troubling question, is whether investors are insufficiently vigilant or could be led to become insufficiently vigilant in anticipation of bail-outs in the future. That is why we have to be as rigorous as we can, consistent with the contagion problem that I referred to earlier.

I think we will be exploring what Secretary Rubin has said and Chairman Greenspan has said—this is an enormously complex subject—the feasibility of mechanisms to, in a more institutional way, provide for creditors not receiving prompt repayment and stretching out maturities in the event that a crisis comes. But it is a balance that we have to strike with very great care right now for fear of spooking those who have invested in other countries. I sense that there are some votes under way.

Senator BRYAN. I think there is. This is an enormous power for a very junior member of this committee to have. [Laughter.]. I am savoring this moment.

Mr. SUMMERS. Perhaps, Senator Bryan, you could arrange for a unanimous vote from this committee on this issue.

Senator BRYAN. I would think so. If there is no objection. [Laughter.].

Mr. SUMMERS. Perhaps we might take advantage of this opportunity to discuss some issues in the tax area as well. [Laughter.].

Senator BRYAN. Or to move some legislation forward in the committee.

Thank you very much for your thoughtful presentations. Let me say that we will be at recess, subject to the command of the Chairman.

[Whereupon, at 10:50 a.m., the hearing was recessed to reconvene at 10:55 a.m.]

Senator CHAFEE. If we could continue. I have a couple of questions, then we will go to the next panel.

Things are a little confused. One of the subways is broken, so it makes for long delays. And to have four votes right on top of each other is also difficult.

Gentlemen, my question, and perhaps this has been covered but I do not think so, it is my understanding—I will start with you, Mr. Summers—that the U.S. involvement in the IMF is 18 percent. It may be 19. Right in that area. Am I correct?

Mr. SUMMERS. Yes.

Senator CHAFEE. So somehow the impression is that we are carrying this load ourselves, but it is 18 percent and, therefore, the balance, 82 percent, is divided up how? In other words, the United States being such a large Nation and such a rich Nation, being in only for 18 percent surprises me. But that is some kind of a quota that has been worked out.

Mr. SUMMERS. We will get you the exact information on that 18 percent. Senator Chafee, the United States is the largest country. I am told that the total share of the European Union countries, for example, is 29 percent, and then other countries around the world play their part. But it means that each dollar that the United States contributes, in a sense, levers $4.50 from the rest of the world, which makes this a particularly cost-effective way to respond, if we have to respond to these kinds of crises.

Senator CHAFEE. Well, I am an ally of yours in this. And it just seems to me that we have got to get out that statistic, which if you had asked me ahead of time what would be a fair share for the United States in a deal like this, I would have thought we would end up with more than 18 percent. But to be at 18 percent when the rest of the world is carrying the balance indicates that we are not going alone in this thing by a long shot.

I do not know whether this falls in your jurisdiction, Secretary Eizenstat or Mr. Summers. I guess, in yours, Mr. Secretary. The question was raised here about core environmental and labor issues, and some touch of human rights. I fully appreciate that, in dealing with these things, this is a trade matter, essentially it is a financial matter.

But certainly there is deep concern amongst constituents of mine about the situation in East Timor, Indonesia's conduct there. The request is made of me to see that we can go as far as we can, as far as seeing in this deal which Indonesia is going to benefit from, that they pay some increased attention to the human rights situation in East Timor.

I do not know how far you can press these things. Again, we are in for 18 percent, so the rest of the nations are in for 82 percent. They may have no interest. What can we do, Mr. Secretary?

Mr. EIZENSTAT. We are very cognizant of the human rights concerns in Indonesia and with respect to East Timor. We support U.N.-sponsored direct discussions aimed at facilitating a peaceful resolution of the problem there. But in particular on the human rights side, just in the last 2 or 3 years, Senator Chafee, a human rights commission has been in Indonesia. It has 25 eminent Indonesian citizens. It has received over 1,000 complaints. It has investigated those complaints very forcefully.

So we not only directly deal with the Indonesian government on human rights problems, we publish our annual human rights report which highlights deficiencies. But, in fact, there has been improvement. This Indonesian human rights commission is a very good example of it.

Senator CHAFEE. And that would touch on East Timor?

Mr. EIZENSTAT. Yes, sir, it does. It deals with human rights everywhere. We have urged the government of Indonesia to continue to open East Timor to visit by human rights groups, including this commission, to journalists, to reduce its military presence and to use restraint when dealing with civilian crowds.

If I may also make a broader point on human rights. The IMF-led programs, in effect, commit governments to increased transparency and good governance. That, in and of itself, by ending these kinds of monopolies and the kind of directed lending that Secretary Summers indicated, will promote the wider sharing of power and greater citizen participation. So that, likewise, will have a positive impact on human rights.

Senator CHAFEE. Well, you touched on that in your strengthening of the middle class comments and the increased openness of the society.

Now, where do we stand with this legislation? Do we physically have legislation from the administration here?

Mr. SUMMERS. Yes. I believe a formal request has been sent up, Senator Chafee.

Senator CHAFEE. All right. Well, thank you both very, very much for coming. I have no further questions. I think your testimony has been very powerful and helpful to us as we deal with these. We appreciate you both coming.

Mr. EIZENSTAT. Thank you, Senator.

Mr. SUMMERS. Thank you very much.

Senator CHAFEE. Now, could we have the next panel come forward. If we could take our seats now. In this panel is Dr. Bergsten, Dr. Makin, Dr. Sinai, and Mr. Zoellick. We will go in that order. We will start with Dr. Fred Bergsten, director of the Institute for International Economics.

Each of you will have 5 minutes. You know what the situation is, and I apologize that our Members will be coming in and out. If we could delay one minute, I have just got to see what vote they are on now. All right.

If you would please proceed, Dr. Bergsten.

STATEMENT OF DR. C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. BERGSTEN. Mr. Chairman, I will try to briefly address three issues in my opening remarks, and would be happy to submit my full statement for the record and answer more detailed questions later.

The first question is, where do we stand on the Asian crisis today? In terms of the markets, I think there is reason for cautious optimism that we may have hit bottom. Both the exchange markets and the stock markets in most of the Asian countries have begun to bounce back, in some cases quite substantially. The exchange rate certainly had overshot, gone way lower, then they will level out for the longer run, so we should expect some bounce-back. I think we may have hit bottom..

However, it takes time to stabilize even the markets. In Mexico, it took about 6 months after they addressed their crisis in early 1995. So I suspect we will still have a lot of market turbulence during the first half of this year.

More importantly, however, what will be the real effects of the crisis in Asia? There, I would submit, we are only beginning to see the difficulties.

Over the course of 1998, and probably 1999, there will be millions of lay-offs, hundreds, if not thousands, of bankruptcies, lots of political disruption, literally, in some cases, blood in the streets.

So even if the markets stabilize, we should not be lulled into thinking the crisis is over because in terms of the real economic impact, the crisis is just beginning. The programs that the countries are putting in place to resume economic stability, to put their houses in order, are only beginning to take effect.

My guess is we will see zero or negative economic growth in most of Asia, excluding China, at least for 1998, possibly for 1999 as well. That is very important for the world economy because Asia has provided literally half of all global economic growth in the last 5 years. So a sharp fall to zero or negative growth in Asia is going to have big implications for everybody else.

The second point I would like to address, and this is the focus, in a way, I guess, of these hearings and of the committee, what are the implications for us, world trade, and American trade of the Asian crisis?

As I indicated in my statement, I think one has to distinguish between three time horizons. In the short run, by which I mean what has happened so far, the impact of the Asian crisis has actually been favorable for trade policy.

The Asian countries have realized that weakness in their financial system has been at the heart of their problem. They have realized they had to reform their financial systems to get back on track. They, therefore, all agreed to liberalization as part of the global agreement in the World Trade Organization that came to fruition in the middle of December.

In addition, the APEC countries, at their summit in Vancouver in late November, agreed to eliminate barriers on nine major sectors during the course of 1998, with a total world trade value of something like $1.5 trillion.

Now, that may not happen, Mr. Chairman, unless the U.S. pursues fast-track authority and gives the President authority so the U.S. can participate. But if we are able to do so and follow up on our own initiative, the Asians seem ready to continue trade liberalization.

In other words, so far, so good. Despite the crisis, it looks like the Asian countries are ready to continue opening trade, reducing barriers, and indeed see that as an essential part of their recovery from the crisis.

Likewise, in the long run, I think the implications for trade policy are positive for basically the same reason. Every one of the IMF programs, every one of the national adjustment strategies, with or without the IMF, so far recognizes that the countries have to liberalize their economies further to trade, to investment, to more transparency, to greater accountability throughout their societies.

All that suggests is that, at the end of the day, we will come out with more open and congenial trade and investment environments in the Asian countries, which will be good for our own firms, our own trade prospects, our own investment opportunities, and the like.

Indeed, as I have talked to corporate CEOs around the world about the Asian crisis, they are amazingly positive in their response. Very few are backing away from Asia. To the contrary, many are saying the outcome will be favorable, it will be a better environment, we may get some cheap bargains in the meanwhile, so let us proceed.

The problem is going to be in the medium run, because as these adjustments take place, as I described at the outset, over the next couple of years there are going to be some very big swings in trade balances and some very big pressures on trade policy.

Several of my colleagues at my institute have just run a general equilibrium model of trade flows to try to discern the impact of the current crisis, the currency changes, and the like on trade balances. The results are strong.

In the United States, we are likely to see a deterioration of our global trade balance by at least $50 billion in nominal terms, and maybe $100 billion in real terms after you correct for price effects. That, of course, will drag our economy down to some extent over the next year or two.

Now, some people feel that that is actually a good thing because it will reduce the pressure of excess demands on our economy, reduce the risk that the Federal Reserve will raise interest rates, and the like.

But there will be a negative impact, and I think more than 1 percent of GDP probably in both 1998 and 1999. That will, of course, add to the pressures for restrictive trade policies here. We will see a lot of antidumping cases. We will get further difficulties in passing fast-track or other forward-looking U.S. trade legislation and trade policy.

One piece of good news, is that we are not alone. Our model shows that the European Union will be hit to an even greater extent than we will. Their trade balance is likely to deteriorate by more than $100 billion.

But, since Europe starts from high unemployment and rather modest economic growth, the prospects that they might adopt protective trade measures is greater than here. That, in turn, of course, would hurt us further and put pressure on us. We have got to work closely with the Europeans in this picture.

The final point I make, and the biggest piece of bad news, is Japan. I view Japan, Senator Chafee, as one of the biggest elements in the whole problem. Far from helping resolve it, they are adding to it. Japan is, in my view, the number one villain in the whole drama in Asia.

Japan accounts for two-thirds of the Asian economy, yet its own economy is dead in the water, has been now for 7 consecutive years. Our model shows its trade surplus will grow by a further $50 billion or so as a result of the currency changes, economic changes, and other results of the crisis in Asia. That, of course, puts more pressure on us and puts more pressure on the world trading system.

The Japanese seem unable and/or unwilling to reform their own financial system, expand their own economy through proper macroeconomic policy. In short, they are a big, big impediment to resolving the crisis.

So at the end of the day, I think the answer is a big set of difficulties portrayed in our own economy over the coming 1-2 years as our own trade balance deteriorates further sharply. Europe does so as well, and that may lead to some protection pressures there. Japan gets a big further increase in its already huge surplus, putting pressure on the world economy as a whole. This will be a difficult period to navigate, both in trade terms and economic policy terms, as we look to this next year or two period.

Senator CHAFEE. If I can be here, and I hope to be here when each of the witnesses are through, one of the questions I am going to ask each of you is, should the United States go ahead with the contributions to the IMF that were proposed by the prior panel.

Dr. BERGSTEN. My answer would be, unambiguously, yes. If the U.S. were to back away from the IMF at this point, it could reignite the whole crisis, certainly devastate our potential and ability to lead in Asia and the world as a whole.

Indeed, I think we not only have to support both IMF contributions, but pass fast-track trade legislation to make clear that we are not backing away from open markets at a time when we are insisting that the Asians open their markets further in the teeth of the crisis.

Senator CHAFEE. Okay. Thank you very much.

[The prepared statement of Dr. Bergsten appears in the appendix.]

Senator CHAFEE. Now, Dr. John Makin, resident scholar, American Enterprise Institute. Dr. Makin, we welcome you here. Why do you not proceed?

STATEMENT OF DR. JOHN H. MAKIN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. MAKIN. Thank you, Mr. Chairman.

I am just briefly going to make a few summary comments that probably will provoke some questions. My full testimony will be as submitted to the committee.

I was asked to focus on Japan and I am going to echo some of Fred Bergsten's comments. Briefly, my points will be that Japan and the IMF are Asia's biggest problems. Unfortunately, the U.S.

Treasury and the U.S. Congress are being dragged into a role in Asia that I think is inappropriate.

Briefly, to anticipate my conclusion, we desperately need to see Japan reflate, that is, print money aggressively in a way that we have not seen yet and have not seen for a long time. The implications of this are that the U.S. is going to have to tolerate a larger trade deficit in exchange for a total collapse in Asia, which is probably not a bad trade-off.

As far as policy goes, I fully support approval of fast-track trade legislation. I do not support the additional funding for the IMF, and my reasons will become clear in my testimony.

First, let me focus on Japan. Remember that Japan is the size of 10 South Koreas. Actually, at current exchange rates closer to 20 South Koreas. As Fred points out, it is a huge portion of world GDP.

What Asia has shown us and what Japan has shown us in the past 7 years is the Japanese model is a failure. The Japanese model is to encourage savings and investment. Sounds like a good idea, but the problem with it is that the savings is forced to stay at home. It leads to the development of too much capacity and a lack of investment opportunities.

This Japanese approach to economic policy led to a collapse in their equity markets as far back as 1990. Recall that the equity market in Japan reached 39,000. It fell as far as 14,000, and now stands close to the bottom at just 16,800, after a concerted and publicly-announced effort by the Japanese government to push it back up. So we have a serious problem in Japan that continues and it characterizes the problem in Asia, in my view.

Another part of Japan's problem, and I agree with Fred Bergsten on this, is just absolutely disastrous macro policy. This committee will understand that, for example, if this committee had enacted in 1997 a tax increase of $160 billion, reversing what had been a very stimulative fiscal policy the year before, we probably would expect to be in a recession now.

Well, that is exactly what the Japanese did in 1997. In addition, they doubled co-payments on national health insurance, forcing households to increase their saving at a time when Japan's big problem is a lack of domestic demand.

This combined set of factors we all here would have expected would have produced a recession in the United States, and it has produced a recession in Japan which is seriously exacerbating the problems of other Asian countries.

Let me now turn to the role of the IMF in Asia. I am not going to dwell on the IMF's failure to foresee the problems there. None of us are good forecasters, and all who try it on a regular basis have plenty of reasons to be humble.

However, the IMF medicine is toxic in Asia. The IMF medicine is very simple. The IMF goes in and insists that domestic demand be restricted very rapidly, with tight monitoring and fiscal policies.

If the problem is essentially an excess supply problem, as it is in Japan, as it is in Korea, as it is in most of Asia because of over-investment, that is, too much investment relative to what can be profitably sustained, if you crush domestic demand, what is going to happen? The markets are going to try desperately to respond to demand by increasing demand in the traded goods sector.

The way to do that is to have the currency collapse. I would submit that in every case where the IMF has gone in—Thailand, Indonesia, South Korea—the currency has collapsed because the IMF medicine is toxic and should not be applied.

Needless to say, I do not think we need more IMF medicine and I certainly do not think an additional $18 billion to support an IMF quota increase is a good idea.

Beyond that, of course, we have the moral hazard problem that Secretary Summers addressed, and I think the IMF has enhanced that problem. I would submit that part of the problem in Asia, and only a small part of it, but a part is simply due to the message that came from the IMF involvement in the Latin American debt crisis in 1995.

Chairman Greenspan has pointed out and has summarized the moral hazard problem as follows. "Similarly, in providing any international financial assistance, we need to be mindful of the desirability of minimizing the impression that international authorities stand ready to guarantee the external liabilities of foreign governments or failed domestic businesses. To do otherwise could lead to distorted investments and could ultimately unbalance the world financial system." I think that is where we are headed, with IMF help.

Let me just briefly say that I think the U.S. Treasury's involvement in pushing for more IMF funding is essentially out of a justified frustration with Japan. Under Secretary Summers and others at the Treasury are well aware of how serious Japan's problems are. I think they have made great efforts to encourage the Japanese to stimulate domestic demand, to deregulate, to do all the right things on fiscal policy. I think they need to push harder on monetary policy.

But I think they are afraid, simply, that the exposure of the Japanese banking system to the Asian crisis—which is substantial, close to $300 billion—means that Asia is vulnerable because Japan is vulnerable. So, there is considerable concern.

Finally, I just want to re-emphasize that there is a clear solution to this problem. When all of a region is in a deflationary crisis, the Central Bank, and here the Bank of Japan, should hold up a sign that says, we are going to print money until prices are higher next year.

Sounds crazy, but it is a very good idea when you have a deflationary crisis. The failure of the Federal Reserve to do that in 1930-1931 precipitated the Great Depression. The Japanese can avoid it by following reflationary policies now.

Thank you.

[The prepared statement of Dr. Makin appears in the appendix.]

Senator CHAFEE. Well, that is medicine we do not usually hear here.

What the situation is, I think there are just a few minutes to go on this vote. I will go over and vote and I know that the others will be back very, very shortly.

So if you will just stay right where you are, Senator Roth or someone will be right back, and certainly I intend to come back, likewise. I apologize. Most of you have testified here many times, so you are familiar with the situation we are in. So we will just have a quick recess.

[Whereupon, at 11:20 a.m., the hearing was recessed to reconvene at 11:23 a.m.]

The CHAIRMAN. Gentlemen, I apologize for the delays. Please proceed.

STATEMENT OF DR. ALLEN SINAI, CHIEF GLOBAL ECONOMIST, PRIMARK DECISION ECONOMICS, NEW YORK, NY

Dr. SINAI. Yes. Nice to have you back, Mr. Chairman. Thank you.

The Asian crisis poses the greatest risk to U.S. and world economic prospects since the oil price shocks of the 1970's and 1980's.

What is going on appears unprecedented for modern economic times, perhaps in all of history, affecting directly at least 6, to as many as 13, countries in what has been the most dynamically growing region of the world, accounting for 30–35 percent of world output.

The crisis is financial and economic. It is likely also to be social and political. It is a bust for the Asia and Pacific regions after a decade of boom.

It is not an ordinary bust. It is filled with all of the financial fragility, financial crisis, debt deflation, asset deflation, bank failures, crunches, and every financial difficulty that I have ever seen in any specific instance.

Asian footprints are already showing up clearly in some U.S. economic indicators. The S&P 500 company earnings report surveys, like the Federal Reserve beige book, National Association of Purchasing Managers, anecdotal in certain States and in a number of non-U.S. countries.

The footprints of Asia on commodity price deflation are also very clear, ranging from oil, to energy, to the CRB index, to nickel, zinc, or copper, to the prices paid component in the most recent NAPM surveys, to PPI deflation, to unchanged commodity prices in the CPI. This is a recessionary and deflationary event, with ripples reaching out already. The bulk of the impact is yet to come. It will come over the next 2–3 quarters.

From a monetary policy point of view, the Asian crisis appears salutary. From the Asian point of view, it is truly a crisis, a tragic one, with unknown fallout economically and politically.

For our expansion we will be dented, we will be troubled, but we are very resilient. The risks, though, are very high and I want to underscore that I think this is a very bad event with very potentially dangerous economic consequences for lots of regions of the world.

Now, to size the effect on the U.S. economy and trade is very difficult. This is an unprecedented ahistorical business cycle event. As many as 13 countries are involved. There is nothing like it in our history. It is difficult to forecast it, it is difficult to find the right policies to deal with it.

In sizing the Asian situation, because of the intense trade and financial interactions between countries and very high export ratios between them, our analysis leads us to say the following about Asia and the Pacific region for 1998: recession and stagnation.

Specifically, recession, depression in Indonesia and South Korea, recession in Thailand, Malaysia, and Japan. Japan is in a recession now. Major slow-downs in the Philippines, Singapore, China, and Hong Kong.

With a risk of recession in Hong Kong, slow-downs in Taiwan, India, Australia, and New Zealand. Thirty to 35 percent of world output is sliding during 1998, and the bulk of this slide we will see in coming quarters.

Various regions of the world will be affected, not just the United States. Of course, Japan is a key. Japan is at the center of the storm. Japan is the major buyer and seller in Asia and Japan's economy is in recession. Japan's economic policies, unfortunately, have been too little, too late, and not on the mark. That appears to be still the situation in Japan, that Japan's revival in its own domestic economy is essential to help the rest of the Asian situation.

There is a problem in Latin America, a contagion. Risky countries are pummeled in the financial markets by the association with Asia, whether or not there are fundamental problems. Brazil does have some fundamental problems. Asian growth, because of financial fall-out, will be weaker in 1998 and that will take some steam out of our exports. Latin America is a big market for us.

On a 1 percentage point drop in Latin American growth, we calculate U.S. exports in growth and U.S. GDP would decline by a tenth or two.

Canada, too, has exposure to Latin America through commodity-priced deflation and lower export revenues. Canada is our biggest trading partner.

Looking at Asia, looking at the effects in other countries besides the U.S., and taking account of the impact on the U.S., world economic growth in 1998 is likely to be under 2 percent, and that is a big decline from over 3 percent in 1997.

Now, for the U.S., the Asian meltdown is an external shock. Early in the year, consumers actually benefit because of lower import goods prices and lower interest rate effects that radiate out from the Asian event. We have seen CPI inflation decelerate and interest rates decline, and that increases consumer purchasing power. They will feel good early in the year.

Later on, though, if U.S. economic growth weakens, as I think it will, there will be cutbacks in jobs and consumer income and sentiment and spending would weaken.

The main mission mechanism to the U.S. is through trade, where exports to the Asia Pacific and Japan regions will be hard hit. U.S. exports are now a record-high percentage of GDP, 13.7 percent, $1 trillion. Three hundred and thirty billion, approximately, go to Asia and the Pacific region, the 13 affected countries that I mentioned.

The exports at risk exceed all of U.S. residential construction, which is $287 billion, and are almost half of what we spend on producers' durable equipment. Exports are a big deal now in our economy. There are a lot of jobs tied up with it. So the risks to us of the unknown of this event is much greater than it might have been 5 or 10 years ago.

We also look at the micro effects, the S&P 500 industries. We have calculated 44 out of 104 S&P 500 industries at risk, more or less, to Asia on top line and on net operating income. In the testimony there is a table ranking them so you can see what industries are affected.

One hundred and fifty S&P 500 companies have Asian exposure, and there are perhaps 100 more, suppliers and otherwise, that will feel the effects of Asian problems, and many more companies that are not in the category of the large capitalized companies that show up in these indices.

A number of States. The top 10 States in exports to the rest of the world. For example, California. Fifty-one percent of its exports go to the Asia Pacific; two-thirds of that are in high technology and semiconductors. California may well be affected.

Washington, 56 percent of exports and very much in the civilian aircraft industry. The places where the Asian meltdown will impact on the U.S. are far beyond what we see in the macro data.

Our calculations suggest, and we have done some elaborate quantitative work and there is in this unprecedented situation a lot of imprecision around them, we have estimated trade flows between the various countries in the United States and analyzed with our macro econometric model what it might mean for growth.

We are estimating a loss to growth in the U.S. economy in 1998 compared to otherwise of as much as 1 percentage point. We would expect producer price inflation to be a percentage point lower and actually prices to decline, and a lower inflation rate as well.

The unemployment rate, off that kind of decline in growth and weakness in trade, would be almost a half percentage point higher than otherwise, and over 1998 and 1999, about 1 million jobs lost.

Our economy will, we think, grow this year at about 2 to 2.25 percent. That compares with 3 and 3.25 last year. This takes account of almost a percentage point estimated decline off the Asian problem.

What should policy do in a situation like this? It really is too late now to employ the kind of forward-looking methods——

The CHAIRMAN. Would you please try to sum up.

Dr. SINAI. I am very quickly going to do this on policy.

I think the task for policy is very difficult when you have an unprecedented historical event like this one. It is off the map in terms of anything we have seen before. No matter how good the policy makers are, it really is a no-win situation. The trick is to cut the losses and move forward from there.

I think the use of the IMF as the major spear-carrier on behalf of a number of nations whose interests are at stake is probably the only way to go. Therefore, I do support the $18 billion appropriate to the IMF, not because I necessarily think world policy bodies will do a great job in the circumstances compared with markets, but because there really is no other choice.

I think for the IMF I am critical of one approach to every country, and do think a more flexible approach, taking account of the specifics of each circumstance, would be more useful.

In a sense, the IMF approach, which involves a good deal of austerity, is pro-cyclical. It intensifies the economic pain and downturn rather than alleviating it when used in an inflexible, one-dimensional way.

Generally, though, a framework of approach which involves reform of the system conditions for the long run as a part of lending is important. We have much at stake in the Asian crisis, economically, politically, and as a world leader at a time when we are doing well, the economy is resilient and can cushion the Asian negative economic shock and benefit from lower inflation. We will benefit from lower inflation, lower interest rates. I think we can handle the $18 billion funding.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Sinai appears in the appendix.]

Senator MACK. Mr. Chairman, I wonder if I could ask a question.

The CHAIRMAN. Sure. Let me apologize to Mr. Zoellick. He was the first to come and he is the last to testify. There is no fairness here.

Go ahead.

Senator MACK. Again, I apologize for interrupting your testimony this morning. We do value what you have to say and we are going to be working our way through this very difficult issue over the next several weeks.

I think it is appropriate that there be an expression from two points of view here. One, is that I believe that a great majority of Republicans are prepared to support the request by the administration for additional funds for the IMF, but I do want to say that there are a number of us who believe that there are conditions that ought to be placed on the International Monetary Fund.

I think from a practical standpoint, as we look to how you are going to put the votes together to pass something like this, there are going to be Democrats and Republicans on both sides of the aisle that are not going to vote for this, period.

So the issue becomes, where do you find 51 votes? I am just suggesting, in order to get 51 votes we are going to have to come up with the administration saying we can get these kinds of reforms. But I think it is important for the Senate, and I think particularly for Republicans to make a statement, that we support our involvement in international institutions.

I feel strongly about that, so I think we have got to find a way to make this happen. Maybe it happens in tranches. Maybe there is a certain amount of money that goes forward. We work on a second set of contributions, if we get certain modifications to the present system.

A third tranche, if you will, when there are some major things that have to be accomplished the moral hazard thing is something that has to be addressed and probably will be what would take the longest period of time to really come up with how we do that.

I am merely throwing out these ideas to suggest to people that I think if we are going to end up passing it, and if we are going to get the House to pass it, something is going to have to be different than just, we have requested $18 billion and the Congress saying, all right, here it is.

My last point, and I really wanted to raise this with Larry Summers earlier, is I heard very little about the role of exchange rates or devaluation. I guess I am thinking about, if I were an entrepreneur in these last 10 years, where we saw the value of the yen vis-a-vis the dollar strengthened to the point of 80 yen per dollar, now today 125 or so yen per dollar, and I do not know, but I hear people say to me that governments have gotten together and said, the yen is too strong, we need to weaken the yen, so it went from 80 to 125.

I mean, what role does this have? We have a tendency to focus on the IMF, but I think there are a lot of other questions out there that have to be answered before we just say, yes, all right, here is $18 billion. You all know that the only time that the Congress acts is when there is a crisis.

So if we do not really start asking the questions now and in essence demanding that there be some changes in order for this to move forward, I think we are making a mistake.

Again, I apologize for interrupting the presentations that are being made here this morning, but I am going to have to run.

Senator JEFFORDS. Mr. Chairman, may I make a small interruption before the comments?

The CHAIRMAN. Well, I am trying to move everything on. Would you make it brief, please.

Senator JEFFORDS. Yes, very brief. I will be unable to come back, probably. But my concern is, if we do not give the IMF what is necessary, what is the down side and how do we protect ourselves against it? In other words, we could anticipate a huge flow of cheap goods coming in and things like that.

Do we have anything in the law now that gives us any kind of protection from that aspect? Or, second, what could we do, assuming that that event occurs, that starts to really foul up our economy?

Thank you, Mr. Chairman.

The CHAIRMAN. Well, with that we will call on you, Mr. Zoellick, to please proceed.

STATEMENT OF ROBERT B. ZOELLICK, OLIN PROFESSOR, UNITED STATES NAVAL ACADEMY, AND FORMER COUNSELOR TO THE SECRETARY OF THE TREASURY, AND UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS, WASHINGTON, DC

Mr. ZOELLICK. Thank you, Mr. Chairman, Senator Jeffords, and Senator Mack. I think both the points that you raised are going to be very, very important in this process.

I just finished testifying on the House side, Senator Mack, and the points that I have concluded with in the statement actually tried to list 10 suggestions, some of which may be part of a Congressional/administration dialogue, which you can work to pursue the objectives I think we both commonly seek.

My statement tries to address four questions. One, what happened to the economies of East Asia? Second, what are the key developments to watch in the future? Third, why do these events matter to Americans, to your constituents? Fourth, what should the United States be doing?

In the interest of time I am going to skip the first two questions and I am going to just summarize my points on the third and the fourth.

I suspect that the members of this committee have been asked, and will themselves ask, how these events in Asia affect their constituents. Why does it matter to us? My reply would have three parts: the big risk, the economic effects, and then the political security effects.

When markets slip into freefall, no one knows where they will stop and what havoc might be wreaked along the way. Sometimes markets bounce back, yet at times big declines become panics, setting off massive, destructive chain reactions that extend far beyond the initial explosion.

Over the past 60 years, East Asia was important enough to the United States to warrant 3 wars, over 100,000 troops who did not return home, and billions of dollars of defense expenditures. I do not believe U.S. interests in the region have lessened over time.

I hope the financial situation in East Asia will stabilize, but no one can assure you of that with certainty. That doubt sets up the big risk, a loss of confidence that leads to a greater collapse of currencies and markets, with ripple effects turning into waves that lead to more bankruptcies, bank failures, and to deeper recessions.

Even events to date, however, will affect the United States and world economies. The consequences include the following. First, the Asian economies will buy less from the United States and others, hurting U.S. exports and increasing the U.S. trade deficit. Second, East Asia's financial problems will spill over to developing country markets.

Third, the devaluations and excess production capacity in East Asia will lower prices for many tradable goods. These are things like steel, petrochemicals, electric goods, semiconductors, footwear, textiles. It is a long list.

The competition will hurt exports from other developing countries, particularly in Latin America and Eastern Europe. Some U.S. firms will benefit from lower prices from imports and others will face price cutting for their goods.

Fourth, I suspect that the drop in U.S. exports and low import prices will squeeze the earnings of some U.S. companies, especially when combined with slowly increasing U.S. labor costs. I think this is going to affect the equity markets.

Fifth, investors fleeing foreign securities have been turning to the safe haven of U.S. dollar securities, especially the debt of the U.S. Government. This inflow has helped hold down U.S. interest rates and increased the value of the dollar. Over time, however, if the U.S. trade deficit grows to a size considered unsustainable, investors are likely to move out of U.S. dollars, reversing the drop in interest rates.

The political and security effects of the economic crisis in East Asia are likely to be wide ranging, and I think they are only just starting to be perceived. As I think everyone on this panel has mentioned, so far most of the press attention has focused on financial markets. But the serious blows to the real economies of Asian countries will be felt throughout this year, with political implications.

One key way of understanding this, is to realize that this crisis has severely squeezed, and in some cases wiped out, middle classes that have been developing in Asian countries over 25 years.

Historically, such trauma to the middle class unleashes perilous forces. Asia's trial will be heightened because many Asian political leaders have based their domestic legitimacy on records of improving their citizens' prosperity.

One possible recourse is for people to challenge their political leaders, either promptly or during the next transition of power. Countries may move towards more open political systems and against corruption and crony capitalism, but established groups usually do not cede their authority gracefully.

The countries of East Asia are now depending openly on the United States for help, in striking contrast with the rhetoric of recent years about the decline of the United States.

Although it may be tempting for some to teach Asia a lesson, a policy of spite would leave a terrible legacy for the United States in the post-Cold War world. Indeed, the United States would be ignoring its own successful lesson from the far-sided approach chosen after 1945.

Great powers cannot ignore upheavals in regions of vital interest without giving up the influence that compensates for their labors.

Specific political and security issues that could be triggered by the economic events include the following. Indonesia's continuing difficulties are based, in part, on the uncertainty about President Suharto's future and who may follow him.

The ethnic Chinese in Indonesia, comprising an estimated 3 percent of the population, control much of the country's wealth, with some reports ranging up to two-thirds.

During the upheavals of 1965 that propelled Suharto to power, hundreds of thousands of Indonesians were killed, many of them of Chinese origin. The slaughter has been traced to fear of Communism in China, but also to resentment of local Chinese wealth. Ominously, China recently issued a warning against threats to ethnic Chinese in Indonesia.

For those concerned about the rise of China and ultimately what course it will take, they should be keenly interested in the political stability of Southeast Asia, and Indonesia is the cornerstone of that stability.

Korea's president-elect has been an outsider in Korean politics. Most of his statements since the election have signaled plans to implement serious economic reforms. But he will certainly face resistance from traditionalists in bureaucracies and the corporate conglomerates.

At the same time, the powerful Korean labor movement with which Kim has ties, are likely to object to the upheavals that will follow from the corporate restructuring and recession. Moreover, Korea has a northern neighbor that is a heavily-armed economic basket case, and no one can be complacent about the political stability.

Because China's currency is not freely traded in world capital markets, it has been spared financial assault. But China faces enormous economic challenges. Indeed, China's bad debt and banking problems dwarf those of the countries that have already been badly hit, and now it is going to face export competition and the prospects of less investment from Asia than perhaps elsewhere.

Hong Kong, in the aftermath of its return to China, is struggling to maintain the confidence that is fundamental to its special status. If the Hong Kong dollar loses its peg to the U.S. dollar, market confidence, and Hong Kong's confidence in itself, will deteriorate sharply.

Across the region, political tensions about open trade and foreign investment will be rife. Some Asians believe that openness, competition, and deregulation will counter crony capitalism, corruption, and mistaken decisions by bureaucracies.

But others will argue that western capitalism is a conspiracy aimed at achieving U.S. domination, or that open markets leave their economies exposed too much to whims of markets.

The CHAIRMAN. Would you please summarize, because we have another vote.

Mr. ZOELLICK. Yes. Some Asians recognize that foreign investment will help restabilize markets over time.

So what should the United States do? Let me just list eight points. First, as everyone on this panel has stressed, the United States should organize a coalition, including the European Union and Asia, to press Japan to stimulate its economy. I would think this is something the administration might do more on because it might do it more with others, which I think would affect Japanese politics.

Second, I do believe we should support the efforts of other countries to stabilize their currencies, including through the IMF.

Third, I believe we need the ongoing high-level dialogue with China about economic events in Asia, including especially avoiding a devaluation.

Fourth, I think it is very important for this committee, in particular, to demonstrate its ongoing commitment to an open trading system. Without dynamism and world trade, the countries of East Asia will have a hard or impossible recovery task.

In terms of growth, price stability, employment innovation, national wealth and power, the United States has benefitted enormously from a liberalized global trading system.

I will just rely on the end of the statement.

[The prepared statement of Mr. Zoellick appears in the appendix.]

The CHAIRMAN. I apologize to all of you for the interference, but it is beyond my control.

One question I would like to ask, particularly you, Mr. Zoellick, but any members of the panel, what do you see as the most significant risk to U.S. political and security interests in the region? To what extent is the United States being blamed for the onset of the crisis or the remedies put forward by the IMF?

Mr. ZOELLICK. I think that is a very important question, Senator. I think, as I have reflected on this, we certainly will run a big risk if we do not act. As you and others who have returned from the region know, this is, in some ways, a unique moment over the past 30 years where people are looking to the United States for leadership.

However, if we do act we also run the risk that people will blame us for actions they have to take. Therefore, I think, as in many cases of U.S. foreign policy, what we have to focus on is our judgment of what is the best outcome for us, the region, and the world as a whole.

I think that involves the insurance policy of making sure the IMF has the resources to prevent this from spreading; second, involves the reforms that people have talked about to try to change the structure of the economy; third, on the political security side, I think one has to have particular eyes on Korea and on Indonesia for the reasons I mentioned; fourth, and final, I think the United States should be organizing an effort involving the region in Europe to try to press the Japanese to do what all of us believe is in their interest and the region's interest.

The CHAIRMAN. Dr. Bergsten?

Dr. BERGSTEN. I think the biggest risk to us, Mr. Chairman, is if we cop out, if we fail to support the IMF with new funding, if we fail to keep our markets open and move forward toward more liberalization with fast track.

If we fail to do those things from our strong economic position when they need our help to get out of their weak economic position, we are going to be severely discredited. We are urging—indeed, insisting—that they make market reforms, open their economies, and integrate more with the world economy.

If we back away from those same strategic objectives while urging them to do it, we will not only look bad, we will be viewed as copping out. When the U.S. did not participate in the original Thailand program, we got in big trouble, as you know. If we were to cop out now across by the board by failures at home, it would be devastating to our position abroad.

The CHAIRMAN. Dr. Makin?

Dr. MAKIN. I guess I disagree with all the other members of the panel on the IMF, but I certainly agree with the need to encourage fast-track legislation.

I find it incredible that after the IMF's performance in A) failing to foresee this crisis, B) saying that the crisis would be contained, first in Thailand, then in Indonesia, then in South Korea; and finally, their application of policies that have been toxic. Look at the results of what the IMF has done so far: wherever they went, the currency collapsed. There are very good economic reasons for that that I explained in my testimony.

I would also submit that in Germany, for example, where the exposure of German banks and German companies to Asia is just as large as it is here, there is no call for more money for the IMF. They would follow us if we were willing to put up some money, but they are not anxious to see additional funds for the IMF.

So again, I find this incredible, I think. I do not see what the rationale is. All I hear is, oh, if the IMF does not do it, it will be a real disaster. There is absolutely no reason why the many banks and other financial institutions in the private sector that have lent substantial monies to Asia cannot sit down with their borrowers in Korea and elsewhere and work out the problems.

We have never tried it, so of course it's a counterfacial proposition. But I just find incredible the sort of notion that somehow $18 billion more for the IMF, if we have problems as serious as Mr. Zoellick says they are, $18 billion more for the IMF is not going to solve them. I think they are going to make them worse.

Dr. BERGSTEN. Mr. Chairman, as you leave, and Senator Chafee, could I just say, Makin is wrong.

Senator CHAFEE. That is the kind of frankness we want here.

Dr. BERGSTEN. Factually. He said Germany is putting up its share of the IMF quota increase, its share of the new arrangement to borrow.

Dr. MAKIN. Fred. Fred.

Senator CHAFEE. Now, wait. One at a time.

Dr. BERGSTEN. Its contribution to the individual support packages in Asia. He says Germany is not putting up more money. Yes, it is. Germany is putting up its share of the packages, and without the domestic hassle that we are having here.

Dr. MAKIN: Fred, if——

Senator CHAFEE. Why do you not address the Chair, and you and Fred can talk later on.

Dr. MAKIN. I am sorry. Mr. Chairman, may I respond?

Senator CHAFEE. Yes.

Dr. MAKIN. If the U.S. does not provide the extra funding for the IMF, I submit that Germany will not either. They are willing to go along. They are willing to go along, but they think it is a stupid idea. And it is a stupid idea.

Senator CHAFEE. All right. Dr. Sinai, you have not given your views.

Dr. SINAI. Well, you were out of the room when I did.

Senator CHAFEE. Oh, I am sorry.

Dr. SINAI. On this particular issue.

Senator CHAFEE. I meant to this question.

Dr. SINAI. Yes, to this question.

The biggest political risk to us I think is the economic risk. The biggest political risk to us, which was the question of the Chairman, is the economic risk of the area essentially having a 1930's widespread depression, and the political and social ramifications of that.

So I think we have to do our part as a world leader and it involves authorizing some funds. I think we are pursuing a fairly low-cost operation here in the policy strategy here in the United States compared to some of the other things that might happen and the risks of them.

Now, for example, if the IMF were not involved in the negotiations, which had a lot of participants, on the South Korea roll-over of short-term debt which could not be paid by the South Korean banks, nor taken over by the South Korean government, I wonder whether those banks, financial institutions, securities houses, would really have been involved because the IMF is very much a catalyst and the U.S. is a leader in that role.

South Korea defaults debt moratoria like in Latin America in the 1980's. It carries with it a lot of unknowns that none of us can really predict. But I think all we can say is it would be very bad, it would be very costly. They might cost our economy more than this current situation is going to cost our economy.

So I am a reluctant funder here. I agree with Senator Mack, an unfettered provision of funds is inappropriate. If you can get a consensus on the kinds of things you want the IMF to do in order to give them the funds, provide the funds, or get them to get in return from who they are negotiating with, I am all for that.

But I think we do not have too many alternatives. So far, the U.S. and the approach as a second line of defense with the IMF and 181 countries funding the IMF as the leader of the charge in this very, very bad situation, looks to me to be the lowest cost alternative that we have.

Senator CHAFEE. Mr. Zoellick.

Mr. ZOELLICK. If I could just respond to Dr. Makin's point, briefly. He mentioned that we have not tried his suggestion. Well, we, in fact, did try his suggestion.

My testimony notes a number of crises throughout the United States and the world throughout the 19th century that were operated exactly on the model that he saw, and it led to political instability in this country and much of the world.

We also tried it in the 1930's, and that is one of the reasons why the people who created an international system for the United States and the world, to work very effectively, decided to try to create a different arrangement.

I feel that some of his attacking the IMF for devaluation is like blaming firemen for the fire that has been started somewhere else. I think we all agree that the IMF does have issues that we would like to try to remedy, we would like to change how they approach things. But I think the real question the Congress will face here is, how many risks do you want to multiply? No one knows for certain what is going to happen here.

Does Congress want to be in the position of having the IMF be the lender of last resort, sort of like the international Federal reserve, and have things really go haywire with all of the political and security implications of that in Asia. I think that is the fundamental choice you face.

Senator CHAFEE. Well, I think that is a good summary. Now, as if often the case, people say that is a good summary because they agree with it.

Let me ask each of you. You have all scolded Japan, yet our Treasury folks have been pushing Japan to no avail. So what can we do? Mr. Zoellick?

Mr. ZOELLICK. Well, this is a point I was trying to allude to quickly in my statement. We all know how difficult it is to move Japanese politics on any issue, and it would be utterly impossible if there were not groups within Japan who would be supportive.

But you do have some groups within Japan that want to take some of the same policies we are arguing, some of the business community, some of the journalist community which is a surrogate for public opinion, some in the LDP. The ruling party has made sounds about wanting to do more.

Our history with Japanese politics is, in that environment, giatsu, foreign pressure can be significant, but I do not think that U.S. pressure alone will work. What I would very much urge the administration to do here is to organize a sort of effort in the G-7 and with the APEC countries to send a common message together to Japan that will strengthen the hand of those in Japan who want to stimulate their economy.

I would not do this as all one combined letter, so that might push the Japanese to feeling they are in a corner. But this is how you affect the Japanese political system, if you are going to affect it.

Senator CHAFEE. What do you say, Dr. Makin?

Dr. MAKIN. Well, I agree that it is difficult to move the Japanese. I think, actually, a letter has been sent and the Japanese did not even reply. But I do want to emphasize that the policy mix in Japan is important and the use of much more expansionary monetary policy, and by this I mean printing money as opposed to lowering interest rates, has not been tried.

The fiscal policy approach, the public works policy approach in Japan has totaled the outlay of $600 billion over the past 5 years and has driven Japan's budgetary situation to be by far the worst in the G–7. It has not worked. Take note, U.S. Treasury. It has not worked. Try something else, like a much more expansionary monetary policy.

Again, alluding back to the Great Depression. If those policies had been followed at that time rather than the restrictive policies with regard to the quantity of money that were followed by the Federal Reserve we might have avoided the problem.

I will say, I am not sanguine about moving the Japanese. Three or four times a year I go to Japan. I essentially go on a mission that says, are you ever going to do anything right. When I address high-level policy makers in Japan I come away with the feeling that they do not understand the problem. So I urge us to keep trying.

The deregulation is a good approach, but in this situation it is a bit too slow. What we need is a rapid monetary stimulus. I would say that is far more important to achieve than supplying more funds to the IMF.

Senator CHAFEE. Dr. Bergsten.

Dr. BERGSTEN. I think we need to both elevate and broaden the pressure on Japan. By elevate, I mean at the highest level, heads of state. The Japanese have responded to U.S. pressure in the past, as Bob Zoellick said, but it has been primarily when they got a clear, unadulterated message at the highest level.

When President Clinton put pressure on Prime Minister Hashimoto about a year ago on the exchange rates and some other things he got some positive immediate reaction. It did not last too long, but he got some. It has got to be at the highest level, it has got to be heads of state.

Second, broaden it. Secretary Rubin has publicly announced that he is calling a meeting sometime in the spring, not yet defined, of finance ministers from the G–7 and other countries. Those other countries ought to be the other Asian countries, Japan's neighbors in Asia, including China, including Korea.

If Japan's Asian neighbors with whom it has to live every day, plus the rest of the industrial world together does it, and at the highest level, maybe there is a chance. It seems to me those two changes in the tactics are required.

One point on substance. I agree with my colleagues about the need for stimulus of the Japanese economy, fiscal and monetary. But I think the problem is even more fundamental. I think that until they restructure their own financial system, they are not likely to get much economic growth.

Japan has had 6 consecutive years of virtually zero growth, despite living in the fastest growing neighborhood in the world, despite huge fiscal stimulus, despite zero interest rates, despite a huge trade surplus. It is almost a miracle to achieve that if you tried. Something is structurally and fundamentally wrong and I believe the heart of it is Japan's rotten financial system.

Now, finally, they say they are going to put public money into it. But I am afraid they are going to shore up the bad banks and perpetuate the problem rather than resolve it.

So even before we get the new stimulus, which is essential, I think they, like the other Asians, have got to make structural changes. So to me, the priority emphasis from the heads of state level, from the broader group I talked about, has got to be twofold, financial restructuring and reform of Japan, and then building on that fiscal and monetary expansion.

Senator CHAFEE. Do you want to add anything to that, Dr. Sinai?

Dr. SINAI. I think the mechanism is really G–7 at the highest levels to keep on pushing the Japanese to do the fiscal stimulus they have not done, which is a good-sized permanent reductions in income taxes. The Japanese consumer households are totally shattered in their confidence. Pumping the money in, they will not spend it, they just save it. Asia is going to take down Japanese exports. So the only thing to do, is to get them to lower income taxes and do a permanent tax cut, not the temporary one that Hashimoto has said.

The Japanese seem truly confused, and it is partly the structure of this society. They cannot move until they get something from the top. It is kind of like follow the leader: the leader leads the followers in that consensus way of thinking. So Fred is very right, it has to be very much at the highest levels, coming from president to president. G–7 is really the place to do it.

Senator CHAFEE. Gentlemen, we want to thank you all very, very much. I apologize for the confusion that existed here. As I say, you are all veterans so you have seen this before. You have testified many times.

We thank each of you for coming, and that concludes the hearing. Thank you.

[Whereupon, at 12:05 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of C. Fred Bergsten

The Asian financial crisis will have a series of important implications for trade flows and trade policy, both globally and for the United States. The immediate, medium-term and long-run implications may differ substantially.

CONTINUED LIBERALIZATION IN THE SHORT RUN

It is still too early for the crisis and policy responses to it to have had much impact on trade flows. Korea has already shifted into current account surplus. There are a few early indications of deterioration in our trade balance. But major changes in our position will probably not show up until later this year, so I will deal with them below.

There have been some effects on trade policy, however, and to date they have been largely positive. Despite concerns in some quarters that liberalization of national financial markets was a cause of the crisis itself, the members of the World Trade Organization—including all of the crisis countries in Asia—agreed in early December to further opening of that key sector.

The crisis in fact seems to have had a favorable impact. Weaknesses in financial sectors were a central cause of the difficulties in every Asian country. It was universally recognized that further reforms, including opening to foreign institutions, was a necessary component of adjustment programs that would restore confidence in the countries' currencies and economies.

The crisis promoted financial liberalization in two very direct ways. The heightened need for foreign investment, to finance continuing current account deficits in a sustainable manner and to recapitalize weak banking systems, added powerfully to the case for liberalization. And the International Monetary Fund strongly reinforced the WTO agreement, and in a number of instances required reforms, that went well beyond it in its support packages for the troubled countries.

A second positive development was the decision of the 18 APEC countries, at their annual summit in Vancouver in November, to designate 15 major sectors including automobiles, chemicals, energy goods and services, environmental goods and services, and medical equipment for early liberalization. They also agreed that detailed plans for eliminating barriers in nine of these sectors, totaling over $1.5 trillion of global trade, should be agreed by the middle of 1998 and implemented in early 1999. Some of the Asian members of APEC are of course the countries hit most directly by the crisis and it is extremely encouraging that they were willing to continue, and even accelerate, their progress toward achieving the agreed APEC goal of "free and open trade and investment in the region" by 2010/2020.

To be sure, there has been some modest increase in trade barriers as well. Most notably, Mercosur increased its common external tariff by 25 percent from 12 to 15 percent as part of its effort to avoid greater contagion from Asia. The failure of the United States to pass fast track legislation last year was also a negative development (to which I return later).

On balance, however, the bicycle of trade liberalization has continued to move forward over the past six to eight months despite the Asian crisis. The bottom line is "so far, so good."

A BETTER POLICY FRAMEWORK IN THE LONG RUN

The trade implications for the longer run are also favorable. As the Chairman and I pointed out in our recent op-ed in the Washington Post,[1] the potential silver lining on the cloud is the considerable further liberalization that countries will have to adopt to restore their economic prospects and thus to overcome the crisis.

It is noteworthy that every problem country in Asia has clearly indicated its intention to move in this direction, whether with the IMF (Indonesia, Korea, Philippines, Thailand) or to avoid it (Malaysia, perhaps China). The reforms will include increased transparency and accountability of financial systems and corporate governance, reduction of impediments to trade and investment, and corresponding domestic measures.

At the end of the day, the trade and investment climate should be considerably stronger throughout Asia as a result of the crisis and policy responses to it. As the Chairman and I concluded in our op-ed, "the crisis will accomplish enormously more for trade expansion than decades of effort by US negotiators."

TROUBLE IN THE MEDIUM TERM

There may be major problems in the medium run, however, both in the crisis countries themselves and in the rest of the world as a result of impact of the crisis on trade flows. Over the next one to three years, the huge currency depreciations in Asia will sharply improve the competitive position of virtually every country in the region—starting with Japan and Korea. These exchange rate swings, along with their plunging economies, will produce very large changes in national trade balances.

A new study by my Institute colleagues Marcus Noland and Ligang Liu, along with Sherman Robinson and Zhi Wang, uses a computable general equilibrium (CGE) model to assess the prospects for trade even if the Asian currencies rebound to some extent from their present levels. Their results include:

- an increase of almost $100 billion in the United States deficit in real terms;[2]
- a similar reduction in the surplus of the European Union;
- an increase of about $50 billion in the surplus of Japan; and
- a similar swing of almost $50 billion in the position of Korea, converting it from large deficit to large surplus.

These swings will occur at a time when trade policy is already under substantial pressure in many countries. The US Congress failed to approve new "fast track" negotiating authority for the President in 1997 despite the stellar performance of the American economy, and the prospects for resurrecting the legislation this year are highly uncertain. Europe continues to face very high unemployment and is preoccupied with the creation of the euro and the expansion of its membership. As noted, Brazil and its Mercosur partners raised their common external tariff by a quarter as part of their effort to avoid contagion from Asia.

The largest problem is Japan. As the world's largest surplus and creditor country, it should be reducing its trade surplus sharply rather than increasing it. Instead of proposing new funds that would make $100 billion of capital available for the rest of Asia, it should be importing an additional $100 billion worth of products from the region. China and Taiwan could also afford to run modest deficits, rather than their current sizable surpluses, to help with the regional adjustment processes.

The first trade policy casualty of this process could be the Second Summit of the America, in Chile in April. Negotiations to create a Free Trade Area of the Americas could still be launched but nothing serious will happen until the United States obtains fast track authority and Mercosur decides to extend its liberalization beyond the grouping itself. A second casualty could be the WTO Ministerial Conference in Geneva in May; the fiftieth anniversary celebration of the GATT/WTO could be reduced to nostalgic platitudes rather than commencing serious planning for Sir Leon Brittan's Millennium Round. A third casualty could be the APEC liberalization program cited above because the United States needs new negotiating authority to pursue a number of the sectoral initiatives and the Asians may retreat from the process if the United States is unable to pursue them effectively.

The United States and European Union will have to accept temporary deteriorations in their trade balances to enable the emerging marker economies in Asia to successfully engineer the needed adjustments. Congressional rejection of fast track

[1] William V. Roth, Jr. and Fred Bergsten, "The (Potential) Asian Silver Lining," *The Washington Post,* December 28, 1997.

[2] The nominal impact will be less because of large favorable changes in the U.S. terms of trade. Changes in the real impact are what count for GDP growth, however, and probably for trade policy sentiments as well.

authority would signal that the United States may not be prepared to do so, however, and this could induce Asian policymakers to reconsider their commitment to market-oriented strategies jeopardizing both their prospects for resolving the current crisis and the favorable long-term outlook cited above.

The World Trade Organization will also be severely challenged by the new trade policy threat. It has completed the carryover business from the Uruguay Round with its sectoral agreements on telecommunications, information technology and financial services. Wholly new initiatives will be needed to keep the bicycle moving forward and the still-new institution from becoming moribund for a prolonged period, as its predecessor GATT did after completion of the Kennedy and Tokyo Rounds.

At a minimum, the major industrial countries the United States, the European Union, Japan and Canada should agree to avoid adopting any new trade restrictions in the wake of the Asian crisis. The OECD members took a similar "standstill" pledge after the oil shock of 1973 when they realized that it would be foolish to try to pass around the resulting deficits among themselves. The impact of the Asian crisis could be at least as sizable as that initial oil shock and the OECD membership should resolve to avoid beggar-thy-neighbor trade responses.

All this also implies a major challenge to the continued march of globalization. Anti-globalization forces are mounting in both the industrial countries, where they are celebrating the defeat of fast track negotiating authority in the United States as a "historic turnaround in attitudes toward international integration," and in many emerging market economies due to the onslaught of yet another financial crisis. Both the intellectual underpinnings of globalization, and the policies to implement it, are likely to be questioned more severely than at any other time in the past two decades. The global outcome for several decades ahead will turn on the outcome.

CONCLUSION

There are thus a number of potentially significant trade implications from the Asian crisis. We will shortly be moving into the period where countries both inside and outside the region may be tempted to turn to trade restrictions, or at least to avoid new trade liberalization, to help them through the difficult adjustment period.

In such a situation, the best defense is a good offense. The crisis countries need to liberalize further, to restore market confidence in their economies and to fulfill their IMF programs. The industrial countries need to do so too, to make clear that they will accept increased Asian exports and to encourage the Asians to maintain their market-oriented adjustment strategies. New initiatives to maintain the momentum of liberalization are acutely needed, particularly in the WTO but in regional contexts such as APEC and the FTAA as well.

The United States must lead this process. For all our problems, including our excessive trade deficit, we have by far the strongest economy in the world. Indeed, some of our major competitors (including Japan) have now been weakened substantially by the crisis. Hence further trade liberalization is highly desirable from our standpoint because it will enable us to fully exploit our strong competitive position. Any US backing away from our previous commitments, such as the pursuit of free trade in the Asia Pacific region and the Western Hemisphere, would send an enormously counterproductive signal to weaker economies that they too could and even should backslide.

Hence the coming year or two will present both major challenges to, and major opportunities for, the trade policy of the United States. I urge this Committee to continue its strong leadership of a constructive approach that will enable the world, as well as the United States itself, to emerge from this period in an even stronger position. Rapid passage of fast track authority, along with the provision of resources for the International Monetary Fund, is the place to start.

PREPARED STATEMENT OF HON. STUART E. EIZENSTAT

ASIAN FINANCIAL CRISIS: BROADER IMPLICATIONS

Mr. Chairman and members of the Committee. It is a privilege to appear before you today. By including the Department of State in a hearing on the Asian financial crisis you recognize that for the United States, the ramifications of the current economic difficulties in Asia affect much broader interests.

Mr. Chairman, as we consider the United States' proper role in confronting this situation and what actions are necessary and appropriate for us to take, we must fully understand the broad dimensions and implications of this crisis. Vital U.S. interests of great importance to the security, the prosperity and the values of the American people we all serve are at stake. Therefore, we believe strongly that it is in our own interest to lead and act in the international effort to address the financial crisis in East Asia. In this effort, the leadership of the Congress is also crucial and we look forward to working with you on this important issue.

The role of the United States is not just a test of our IMF leadership or international economic leadership, but our political leadership in a changing global environment as we enter the 21st century. Our engagement now at this time of financial unease helps assure our ability to mobilize support in the future for a whole range of issues important to the United States and enhances our capacity to promote greater openness, democracy, and support for human rights in Asia. On the other hand, if we shrink away from our leadership responsibilities, other forces may prevail.

Security

Mr. Chairman, our own security is closely linked to peace and stability in East Asia—in a little over fifty years we have fought three costly wars there. Since World War II our security policy in the Western Pacific has stressed stability and the deterrence of conflict. Nearly one half of the earth's people live in countries bordering the Asia Pacific region and over one-half of all economic activity in the world takes place there. Four of the world's major powers rub shoulders in Northeast Asia while some of the most important sea lanes on the globe pass through the confined waters of Southeast Asia. We are a Pacific nation, as well as an Atlantic nation, and what happens in the Asia Pacific region directly affects us and has a profound impact in the U.S. and throughout the world.

Today we have 100,000 troops in the Asia Pacific region. Our forward military presence and active engagement in the western Pacific has increased and bolstered stability in the region. This stability has been the essential foundation for unprecedented economic, political and social progress in East Asia.over the past several decades -progress from which we have greatly benefited.

However, it goes further. Just as increasing peace and stability have enabled economic progress, so too have economic progress and the better life it has brought to hundreds of millions of people reinforced peace and stability. A part of the world once known for authoritarian governments, internal strife and international tension is one now characterized by viable exciting democracies—in the Philippines, Thailand and South Korea—that are adopting more open economic policies, alleviating poverty and modernizing.

Mr. Chairman, the current economic difficulties, if not halted, could threaten this stability and much of the progress made over a generation. The markets are not only looking for economic adjustments, but also for the political will in these countries to implement tough structural reforms. The economic and political dimensions of this crisis are closely intertwined—the markets will respond favorably when they see the sustained political will to make the reforms work.

The countries hardest hit are among our closest and most vital friends and allies—including South Korea where 37,000 American troops remain deployed to ensure an uneasy peace in the face of the continuing threat from North Korea. A South Korea weakened by economic distress raises the risk of miscalculation by North Korea and conflict on the volatile Korean Peninsula. It makes more difficult our vitally important effort through the Agreed Framework of 1994 and the Korean Energy Development Organization (KEDO) to dismantle the dangerous North Korean nuclear program, where a large contribution from South Korea will be necessary. It could well complicate our delicate efforts through the Four Party Talks to secure a permanent peace and bring the Korean War to a formal end. The economic crisis could also strain the ability of countries such as South Korea and Japan to continue to share the financial burden of maintaining security in the region.

Thailand is one of our oldest friends in the region and has been a close, supportive ally for many decades—from the Korean War through the Indochina conflict all the way to the present day. We have a treaty relationship with Thailand dating from 1954. We enjoy very close military-to-military relations and access as needed to strategic airbases in Thailand. Thailand provided essential overflight clearance and the use of airbases during the Gulf War and subsequent actions against Iraq. Our longstanding friendship has resulted in close cooperation on a broad range of issues, including most recently in counternarcotics where Thailand has extradited an unprecedented 11 indicted traffickers to the U.S. since 1996, environmental protection, and improved intellectual property rights enforcement.

Indonesia, the world's fourth most populous country, has in recent decades played an influential and constructive role in the region, which serves our interests as well as those of the people throughout the region. Indonesia spans important seaways and airways and possesses rich natural resources, which give Indonesia broad strategic value. It has provided the moderate leadership which has allowed ASEAN to prosper and more recently has been a driving force within APEC in favor of trade liberalization. Just as importantly, Indonesia, a land of many diverse peoples, languages and cultures, is a moderate Muslim state—the world's largest Muslim nation with more Muslims than the Middle East nations combined. We want to help Indonesia overcome its social problems—problems which could exacerbate social tensions.

The Philippines has not been as hard-hit by the financial turmoil as Thailand and Indonesia, but remains vulnerable to continued turmoil in the region. The Philippines has been a close friend since its independence in 1946 and a treaty ally since 1952. In recent years it has achieved remarkable success in the difficult task of rebuilding its democracy and economy following the final, chaotic Marcos years. We do not want that record of success undermined.

The core countries of ASEAN—Thailand, the Philippines, Malaysia, Singapore and Indonesia—are long-time friends whose prosperity and progress have contributed to increasing regional stability. ASEAN, founded 30 years ago to bolster regional stability, continues to grow in stature. Evidence of its growing maturity is ASEAN's constructive role in Cambodia. Through our bilateral ties with the individual members, our participation in the ASEAN Regional Forum, our other high-level dialogues with ASEAN and by our active role in APEC, the United States has been able to strengthen its overall relationship with ASEAN.

We should not take ASEAN's success for granted. The peace and progress it has helped bring to Southeast Asia may seem natural. But go.back to the mid-1960s—there was tension, there were insurrections, there were shooting wars, such as the Indochina conflict and Indonesia's policy of confrontation with its neighbors, and communal killing. The changes since then have been astounding, but prolonged economic crisis and the attendant joblessness, impoverishment and despair could revive internal instability in these countries and provide fertile ground for extremism. Millions of foreign guest workers work in some of these economies, while other ASEAN countries provide large number of workers to their neighbors. There already exists increasing pressure to send them home. Prolonged instability will generate an increased flow of economic refugees. In a region where old suspicions and ethnic rivalries persist, the risk of instability spreading is real.

With the end of the Cold War the security landscape in East Asia is evolving. During this delicate transition period it is important that the nations of the region remain strong and that confidence in U.S. leadership remain firm. A peaceful and stable Asia Pacific is a region that will remain open to American influence, American ideas and American trade, if we show continued leadership. But if we appear disinterested or unengaged, we will cede to others political and diplomatic influence—and the economic opportunities that go with this influence.

Prosperity

Mr. Chairman, I have begun by discussing security and political issues. However, security is not just an end in itself but a means of assuring the welfare and prosperity of our own citizens, one of the principal duties of any government. The economic health of East Asia is important to our own prosperity. The dynamism of the region has provided increasing trade and investment opportunities to American companies, creating jobs here at home. The growth of exports has helped fuel our economic expansion. In recent years, our participation in the global economy has been fundamental to our sustained growth, low unemployment and low inflation.

Let me share with you just a few statistics, Mr. Chairman, which illustrate the importance of trade and exports to our economic well-being:

- Last year total imports and exports reached about 25 percent of our gross domestic product—up from just 8 percent in 1950 and 11 percent in 1970.
- Since 1993, the increase in U.S. exports has accounted for more than one-third of total U.S. economic growth and created one in seven new jobs; nearly 20 percent of U.S. exports go to the East Asian emerging markets.
- In global terms, more than eleven million Americans now work in jobs supported by exports; these jobs pay 13-16 percent above the national average wage. The western Pacific is our most important regional market taking 30 percent of U.S. exports.

A look at individual state figures further underscores the importance of trade to this region. A large portion of the exports from our west coast states goes to East Asia -in 1996, nearly 58 percent for Washington, 57 percent for Oregon and 51 percent for California in 1996, with a total value of some $76 billion. Even more remarkable are the high numbers in other parts of the country—45 percent for Nebraska, 42 percent for Utah, 37 percent for Louisiana, 21 percent for New York and 18 percent for Delaware.

The benefits of this growing trade have been widely spread, and so would be the costs of a downturn. Continuing deterioration of the Asian economies, and the further depreciation of their currencies which makes their goods cheaper and hurts our competitiveness, will mean lower U.S. exports, fewer contracts for U.S.-supplied services and ultimately job loss here at home. There will be more pressure on our balance of payments as Asian economies buy less but seek to export more. We will see a noticeable increase in our trade and current account deficits. This will create economic challenges and political problems as well, fueling protectionist pressures.

A further hazard from the financial crisis lies in the fact that the longer the uncertainty and instability persist, the more chance there is that other economies will be pulled down as well. This contagion factor could spread the crisis beyond the immediate region, increasing the likelihood of more severe global costs and more severe costs to us. Mr. Chairman, when an infectious disease breaks out, counter-action to limit the spread of the disease and panic must be swift, determined and comprehensive. Only the international community and its multilateral institutions can perform this critical task—again underscoring the critical importance of Congressional approval of the IMF package. Only the United States can provide the leadership

We have been engaged in assisting Asia to recover through our economic leadership in the International Monetary Fund (IMF), in addition to offering a second line of defense to Korea and Indonesia, not only because they are our customers, but because they are our security partners. The IMF programs, if fully implemented, offer the best chance for these countries to resume their impressive economic growth—that made them the envy of the world—on a more sound, sustainable basis. For this reason, it is not only in our economic interests, but our political and security interests, to support the IMF New Arrangements to Borrow and the Quota Increase—neither of which will cost the U.S. taxpayer a dime, but will pay rich dividends over time.

As a founder and the largest shareholder, our active involvement and support is essential to the IMF's efforts to solve the East Asia economic crisis. If we appear to turn our back on an institution we created just when the IMF is playing an essential role in this recovery, we will send a negative signal to the markets and a devastating message about U.S. leadership and engagement in the post-Cold War era.

Benefits for U.S. Trade and Investment

For years we have argued that open trade and more open economies are the path to greater prosperity. There has been resistance to this view—the political and economic structural reforms needed to accomplish this can be difficult and painful for all of us. This crisis has shown the merits of more open, transparent and rational economies and the cost of allowing distortions to continue. The reforms and corrections required in IMF-led programs should address these issues and lead to greater trade and investment opportunities for all of us—including the United States.

Many of the measures required by the IMF to restructure the domestic economies of East Asia will provide expanded opportunities for U.S. companies doing business in Asia

- from elimination of trade-related subsidies to harmonizing import certificate procedures in accord with WTO standards;
- from binding liberalization of financial services to increasing opportunities for foreign investment;
- from eliminating import monopolies to reducing tariff levels.

U.S. Values and Credibility

Less tangible but of equal importance is the fact that many of the countries in deepest crisis are societies that have been opening up not only economically but, in many cases, politically as well. This is certainly true of Thailand, South Korea and the Philippines where major advances in democratization have been made. Even in Indonesia, where our concerns are well known, there is hope for progress. The downturn in these countries will have its greatest impact on the emerging middle class and those struggling to climb up from poverty. These groups represent the region's greatest hopes for the development of more democratic institutions and greater respect for human rights. The course of development we prefer—open, more democratic societies coupled with open, competitive economies—is jeopardized by the present turmoil. This is true not only within these countries, but for others in the region as well. It is critical that less open countries such as China, Vietnam and Burma not draw the wrong conclusion from the current difficulties.

In this regard the environment, labor standards and human rights are critically important issues which we have been advancing in many ways. We work with the international financial institutions and others throughout the world to promote progress in these areas. In themselves, IMF-led programs commit governments to increase transparency and good governance. These measures promote accountability, the wider sharing of power and citizen participation and the effects can go well beyond the financial realm. The immediate crisis is economic and IMP programs must of necessity focus on immediate actions to restore economic stability and market confidence. To overburden IMP programs with goals in other areas during a crisis would complicate and delay the process, greatly reducing the chance of success.

We are nonetheless committed to pursuing these other goals by other means. We will continue to raise human rights and worker rights concerns wherever they arise. In addition, we must be sensitive to the social ramifications of these IMF programs in terms of increased unemployment and widening income inequality, which could lead to political instability. Therefore, we believe it essential to work with the World Bank and the Asian Development Bank to implement supporting programs to establish a social safety net. In this regard the role of the World Bank is as large as the IMF on the financial side.

Mr. Chairman, we have enjoyed many of the benefits of leadership on the world-stage—an ability to protect our interests, to prosper from the global reach of our economic power and to see the values and principles we hold most dear not only endure, but indeed spread. However, this leadership is not divisible. We cannot lead on critical security issues, or in opening markets, while abdicating the lead in the sometimes messy work of maintaining the international financial system. This leadership brings responsibilities and burdens. As the leader of an international system from which we gain so much, others look to us to provide the leadership and our fair share of the resources necessary for the success of the international effort underway.

Early in his Administration President Clinton described his vision of a Pacific community of nations, one in which shared burdens and shared benefits lift us all. To turn from the task at hand not only risks stability abroad, but threatens prosperity at home. Moreover, it would also breed resentment toward what would be seen as our indifference to the plight of friends. With that will be a loss of credibility and goodwill that not only hurts our ability to push needed reforms, but also can affect our broader interests—economic and political—including cooperation on security and other important issues in the region and beyond.

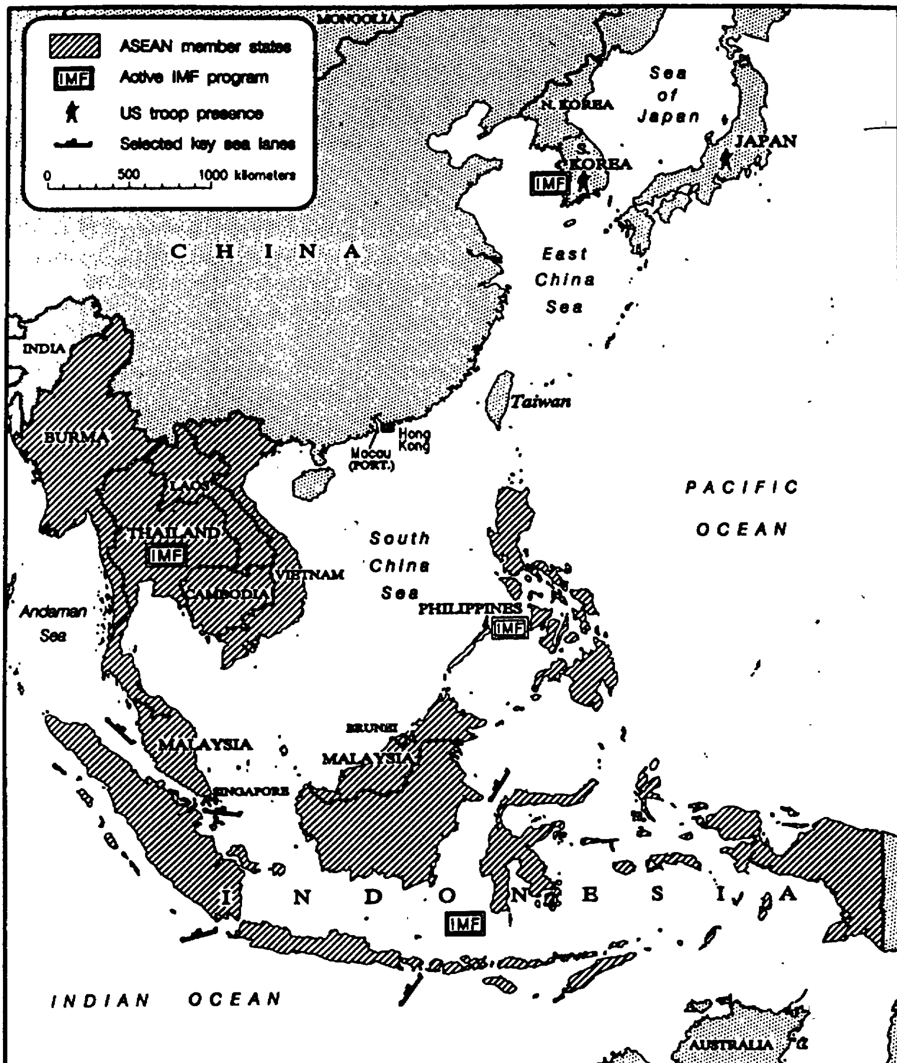
This means more than just cooperating in hard times. It also means moving forward on goals set at the APEC Leaders Meeting in Bogor, Indonesia in 1994—a vision of free and open trade and investment in the region by 2010/2020. We have been working in APEC to turn this vision into a reality. The political support of APEC leaders has been critical to the conclusion of the Uruguay Round and the Information Technology Agreement, opening up markets worth billions of dollars to U.S. businesses and workers. APEC's leadership on the world's trade agenda and its goal of regional trade and investment liberalization could be jeopardized by a persistent, festering financial crisis.

CONCLUSION

Let me sum up what we are doing, should be doing, and should be encouraging others to do to solve the East Asian financial crisis:

- We must be involved in leading this effort as our vital economic, security and political interests are at stake.
- Support the IMP programs underway and ensure that the programs of other international financial institutions, and our own bilateral efforts, help to ameliorate the human cost of these painful economic reforms.
- Provide political support and, where appropriate, technical assistance to help with the necessary reforms.
- Remain committed to open markets at a time when the current account deficit will be on the rise.
- Recognize that an increase in our current account deficit is a natural consequence of this crisis and that the IMP programs will prove the best way to restore demand for U.S. exports in the affected countries.
- Encourage other nations—the Europeans, China and Japan to help us and join these efforts.
- Welcome Chinese assurances that they will maintain a stable exchange rate.
- Urge Japan to take broader responsibility as the main engine of growth in the region. Just as we are willing to do our part, Japan must do the same to stimulate domestic-led growth and open its markets through trade liberalization and effective deregulation.

Mr. Chairman, I thank you for the invitation to give testimony on this very important issue, and I welcome your questions at this time.



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PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Thank you, Mr. Chairman. I expect this to be one of the most important hearings the Committee holds this year. We should all be concerned about the situation in Asia because of its ramifications on the U.S. economy and impact on our constituents. Each one of our states will be affected.

Just ten days ago a local Iowa newspaper, *The Cedar Rapids Gazette,* ran a mailer story analyzing the impact of the Asian crisis on Iowa. Iowa's factory exports to Asia have nearly *tripled* since 1987. And Asia now accounts for about 30% of Iowa's manufactured exports. On the agriculture side, 70% of Iowa's pork export go to the Pacific Rim and over 40% of our total agriculture exports are to Asia. We cannot afford to ignore this problem

Although at this particular time, what is happening in Asia can accurately be described as a "crisis," I also view it as an opportunity. Think of the ways our financial institutions have changed since the stock market crashed in 1929. And how the U.S. had led the world in trade liberalization since the failure of the Smoot-Hawley tariffs.

Sometimes a crisis leads to fundamental, long-term reform. That strengthens a country's economy to a level much higher than could be attained before the crisis.

We have such an opportunity in Asia. But reform will be achieved only if the United States demands change. Apart from the financial reforms required by the IMF, the East Asian nations must open their markets to U.S. exports.

I joined a letter last week led by Senators Baucus and Roberts to Secretary Rubin that highlights the pervasive trade barriers erected against our agriculture exports. Put in place by the same countries that we are now helping through the IMF. These must be removed if real reform is to take place in Asia.

Often in times of financial difficulty, countries choose to close their borders. History has shown that higher trade barriers usually lead to bigger problems. I have a graph here that shows the volume of world trade from 1929 to 1933. As the depression began, countries imposed high tariffs and world trade was reduced from about $3 billion in January 1929 to a low of $992 million in January 1933. In other words, the anti-trade policies accelerated the downward spiral of the world economies. We must avoid this situation in Asia.

Also, it's conceivable that the Asian countries will dramatically increase their exports to the United States in order to help their economies. If that's the case, these countries have a moral obligation to open *their* markets to *our* exports. Trade must always be a two-way street.

I support assisting the Asian nations through this difficult time. But many of our constituents will be wondering why we're spending taxpayer dollars to rescue foreign economies. The least we should get for our money is to give our farmers and workers a fair chance to compete in these markets. Thank you, Mr. Chairman.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, I appreciate your leadership in organizing this meeting. The American people need to understand the causes and the consequences of the crisis along with the appropriate role that we can play to mollify any adverse effects of the Asian crisis on both our domestic economy as well as our foreign policy interests.

I just attended the World Economic Forum in Davos; the Asian economic crisis was among the foremost topics of the conference. Everyone looks to us for leadership. In the minds of many, the U.S. economy still drives the global marketplace.

Our trading partners expect no less guidance from us on global economic matters than many others sought from us on national security issues during the Cold War. The role we play today is no less difficult.

Today, when we intervene in exchange markets to support the U.S. dollar or foreign currency' or when we intervene in Asia, as we did with some vigor in Indonesia and Korea, the U.S. presence is felt in many ways. While some welcome it, others fear us. We saw this phenomenon unfold early in the Korean crisis. Some Korean newspapers expressed concern that the IMF-directed reforms may result in U.S. and Japanese takeovers of Korean banks. There were street demonstrations in Seoul that played exactly that theme. In his statement to the Committee today, Professor Bob Zoellick addresses the security effects of economic crises, cautioning the U.S. to guide assistance efforts around the more obvious dangers, such as domestic unrest.

Of course, there are others who feel the IMF role is either unnecessary, unwanted or unwarranted. I would respectfully disagree. I understand the criticisms of the

IMF—some of which are not without justification. But the IMF forms a centerpiece around which all member-nations can rally. IMF membership vests nations with an interest in the cause of the problem, the cost of resolving it, and a commitment to avoid its recurrence. I know some nations linger in the IMF assistance shadow for excessive periods of time. But the opportunities for economic and market liberalization have never been greater. I cite India and the Philippines as examples where great economic promise resides in talented, entrepreneurial populations just coming "on-line" in the global economy. This is a point that Dr. Bergsten makes quite well in today's statement.

I look forward to hearing from both panels. I have avoided cataloguing the long lists of threats to the U.S. economy because we have a roomful of economists, both on the panels and in the audience, who have studied the consequences of the Asian economic crisis in detail. I, for one, Mr. Chairman, look forward to hearing from them.

Prepared Statement of Hon. Dirk Kempthorne

Mr. Chairman, I would like to thank you and the members of the Senate Finance Committee for affording me the opportunity to speak on the International Monetary Fund's loans to Asian countries, in particular South Korea. This is an issue of critical importance to not only the national and world economies, but more specifically the economy of my home state of Idaho, and several high-technology companies who have direct interests in the developments of these U.S.-backed IMP loans.

Consider the following questions: Would it make sense for United States companies, and their employees, to pay taxes to support foreign competitors on the brink of economic collapse, competitors who have engaged in unfair business practices that are, by many accounts, in fact responsible for the economic crisis? Should the American people support countries and companies who have previously made it difficult for American companies to sell their goods at home and abroad? The resounding answer to these questions, I believe, would be no. These would, however, be the precise ramifications of an IMP loan that fails to require South Korea to stop subsidizing the expansion of its semiconductor industry.

The facts are straightforward. South Korea's economic crisis stems in large part from the government's practice of extending favorable loans to industrial conglomerations to rapidly expand in export-oriented sectors. When world markets could not absorb the resulting excess production capacity in these industries, the prices for South Korea's major export products declined, which in turn threatened South Korea's ability to repay these loans. Such government-directed subsidization for expansion can be seen in the 350 percent debt-to-equity ratio of the three major South Korean semiconductor manufactures, nearly ten times the United States average. This practice of the government subsidizing rapid industrial expansion in overcrowded industrial sectors has threatened American industry. It has allowed South Korea to sell its products at below market costs, jeopardizing American competitors who operate in a free-market economic structure. South Korean "dumping" has been well documented, as seen in the several anti-dumping rulings against the country's semiconductor conglomerations.

The results of these practices have been devastating for domestic semiconductor producers, including those in Idaho. Take for example Micron Technology, America's largest producer of dynamic random access memory computer chips, headquartered in Idaho, which employs more than 10,000 people. From their perspective, a U.S. backed IMF loan to South Korea that does not put an end to some of South Korea's unsound and unfair economic practices would mean that they would pay taxes to bail out foreign competitors who have engaged in business practices designed to undermine the U.S. semiconductor industry. American Microsystems, Incorporated, also in Idaho, would suffer from IMF loans that could be used to support their foreign competitors.

Fortunately, the IMF chose to address these fundamental structural inequities in the South Korean economy when it set the conditions for the South Korean bailout. The country must stop direct lending to businesses, end government subsidies and tax privileges to South Korean industry, as well as reduce the high debt-to-equity ratio of the major industrial conglomerates. These are good steps toward ensuring that this IMF loan to South Korea will not simply be a foreign bailout for America's international competitors, nor will it perpetuate the faulty banking practices that, if not rectified, will only allow for this disaster to reoccur in the future.

The purpose of the South Korea loan was, according to the several Treasury Department officials I spoke with, not to simply bail out the country from a short-term perspective, but rather to save its economy from total ruin, which is in everyone's interest, and to use the opportunity to reform South Korea's faulty economic practices for the long-term health of both the South Korea, American, and world economies. To reach these ends, it is essential that the conditions that have been placed on South Korea in order for it to continue receiving loan payments are strictly enforced through a close monitoring of South Korean economic practices.

Recently, however, some issues have come to my attention that have caused me grave concern. The Wall Street Journal reported that Michel Camdessus, the Managing Director of the IMF, has indicated that he would not object to special loans to the export sectors of the South Korean economy. This comes after I was assured by several Treasury Department officials, including Deputy Secretary Lawrence Summers, that these and other unfair and counterproductive business practices would end.

South Korea, when it signed a loan agreement with the IMF, agreed to reform measures, and various public officials as well as myself were assured that they would be enforced and that the loan would not simply be a short-term bailout for America's foreign industrial competitors. I would like to see that these assurances hold true, and that all austerity measures placed on South Korea are strictly enforced. Certain IMF funding issues will be presented before Congress in the near future. It is my opinion, however, that these requests should not be approved until the IMF makes it clear that it is willing to vigorously enforce the conditions it places on countries receiving IMF loans. In addition, it will be necessary for the IMF to make it clear that any loans it grants, loans which are inherently supported by the American government and in turn the American taxpayer, do not work to bolster foreign competitors of American business and thus undermine American companies and American workers.

Again, I would like to thank the members of this committee for the opportunity to share my thoughts about this matter.

PREPARED STATEMENT OF HON. CONNIE MACK

Mr. Chairman, thank you for holding this hearing on the effect that the crisis in Asia may have on the U.S. economy. Hearings such as this one send an important message: that the U.S. government will not freeze in the face of a crisis and that we are well aware of the potential problems that we have to confront, both in the near-term and in the future.

Fundamentally, the U.S. remains strong. Since President Reagan started us clown the path of lower tax rates, the economy has grown at an annual rate of 3.1% and has created more than 35 million new jobs. Much of the credit for this growth should also go to Federal Reserve Chairman Alan Greenspan, who has engineered a reduction in inflation to levels not seen in more than 30 years. In fact, adjusted for inflation, tax rates on capital are at their lowest point since World War II. In addition, under the Republican Congress, the deficit outlook has changed dramatically, from a predicted deficit of $253 billion for next year, all the way down to a surplus.

Clearly, however, recent events in Asia will pose problems for the United States, particularly in the export sector. By the end of 1997, exports made up almost 14% of GDP. Since 1994, exports have increased 10% per year—about three and half times faster than the overall rate of economic growth. But the failure of many Asian governments to keep their currencies stable means the people in these countries will not be able to buy as much from the U.S. They simply won't be able to afford the things we make. In turn, this slowdown in the export sector may have a negative impact on corporate-profit margins here, leading to fewer new jobs, a slowdown in wage growth and less investment.

I am also concerned about the effect of the Asian crisis on interest rates. In 1994, less than 20% of our federal debt was owned abroad. Now foreign interests own about one-third of our debt. This appetite for Treasuries has kept interest rates down. But will this crisis lead to a sell-off of Treasuries and higher interest rates? I'll be interested to hear the panelists' views on these issues.

It's important to note that with the end of the Cold War and the rise of a more global economy, the United States must be a leader. Our country has a role to play in promoting economic growth, not just at home but also abroad. Why? Because our nation is the only nation which has the beliefs in freedom, justice, democracy, human rights and capitalism. And we're the only nation committed to exporting these Pleas and principles around the globe.

Therefore, we cannot blind ourselves to the positive role the IMP can play. Nor should we serve as a rubber-stamp for any request the IMP makes. Congress' role is to make sure that both the United States and the IMP promote pro-growth policies, including low tax rates, sound banking systems and stable currencies.

This hearing should shed light on these important issues and lead us toward a better understanding of what we in Congress can do to help.

American Enterprise Institute for Public Policy Research

December 1997

Asian Deflation Threat Grows Ugly

By John H. Makin

In just six months, "Asian deflation" has replaced "the Asian miracle" as the platitude applied to the nations representing one-third of the world's economy—East Asia and the members of the Association of South East Asian Nations. Simultaneously, analysts in the rest of the world have taken to minimizing their connections with Asia rather than maximizing them as during the "miracle" days. The most common question is, How will it affect us? "Us" can mean either the economy of the United States or the economy of Europe, not to mention the economies of Latin America, emerging Europe, and Russia. The answer is that it will not affect "us" too much. U.S. exports constitute about 10 percent of output and only a third of exports go to Asia. Given these conditions, the Asian slowdown might subtract 0.2–0.5 percentage points from U.S. growth. Similar calculations for Europe suggest an even more benign result.

In just six months, "Asian deflation" has replaced "the Asian miracle" as the platitude applied to the nations representing one-third of the world's economy—East Asia and the members of the Association of South East Asian Nations.

If this major Asian deflation meant only a 0.5 percentage point reduction in U.S. growth, then, Asian deflation ought to be cause for great celebration for U.S. policy makers focused only on the U.S. economy. After all, Alan Greenspan, chairman of the Federal Reserve, has repeatedly expressed concern that U.S. growth is unsustainably high and needs to come down by about 0.5 percent. Throw in the deflation component in Asia, and unambiguously good news for the U.S. economy is coming out of Asia.

Global Links

Unfortunately, the situation is not that simple. Trade ties are not the only links in the global economy. Financial ties exist too and in the short run are even more important than trade ties. The collapse of a major bank—or, even worse, a major banking system—in Asia has serious negative consequences for American banks, European banks, and, in turn, their ability to conduct normal business.

Total bank loans to emerging markets constitute a larger share of the economy of Europe, Japan, and the United Kingdom than of the United States; this is the reverse of the degree of exposure based on trade flows. In France, for example, bank loans to major emerging markets total $41.2 billion, or 3.64 percent of the gross domestic product. In Germany, the total is $63.3 billion, or 3.06 percent of GDP, while in the United Kingdom, with a large concentration of loans in Hong Kong, the total of $45.9 billion comes to 3.63 percent of GDP. Japan, whose own banks are troubled, has a $186.3 billion exposure to emerging markets, or 4.46 percent of GDP. In the United States, the figure is $53 billion, or 0.65 percent of GDP.

These details about the exposure of banks to emerging markets suggest that calculating the impact on trade flows does not sufficiently answer the question of how Asian deflation will affect "us" when "us" is the United States, Europe, or the United Kingdom. When "us" becomes Japan, the issue is even more complicated because Japan is, of course, part of Asia and is experiencing its own intensifying deflation while simultaneously being heavily exposed to emerging markets.

The contrast between Asian deflation and concerns over U.S. inflation came full circle on November 13, when Fed Chairman Greenspan, along with Deputy Treasury Secretary Larry Summers, appeared before the House Banking Committee to discuss problems in Asia. The conflict between the direction of monetary policy implied by Asian deflation and the alternative direction implied by strong U.S. labor markets and rapidly rising wages had been confronted by the Federal Reserve just the day before at its Open Market Committee meeting.

The escalating concern of U.S. policy makers about the Asian deflation situation can be deduced from Greenspan's testimony to Congress just a month earlier. He had essentially said that the Fed would likely raise interest rates at its November meeting. In just four weeks, the situation in Asia had deteriorated so rapidly that by November 12 the Fed opted to leave interest rates unchanged. The next day the Fed chairman began his testimony before the House Banking Committee by saying that "recent developments in world finance have highlighted growing interactions among national financial markets." By emphasizing the connections among national financial markets, the chairman was tacitly saying that concern about the instability of global financial markets had stayed the Fed's hand.

Trade ties are not the only links in the global economy. Financial ties exist too and in the short run are even more important than trade ties.

Financial markets reacted to the chairman's testimony with a sigh of relief—a relief that required them to ignore a warning about the appropriate role of government in dealing with financial crises. Commenting on the sharp reversals of fortune in the Asian region, the chairman noted that private capital flows to rapidly growing countries "may temporarily turn adverse." He added pointedly, "In these circumstances, companies should be allowed to default, private investors should take their losses, and government policies should be directed toward laying the macroeconomic and structural foundations for renewed expansion; new growth opportunities must be allowed to emerge."

By emphasizing the connections among national financial markets, the chairman was tacitly saying that concern about the instability of global financial markets had stayed the Fed's hand.

Greenspan went on to warn: "Similarly, in providing any international financial assistance, we need to be mindful of the desirability of minimizing the impression that international authorities stand ready to guarantee the external liabilities of foreign governments or failed domestic businesses. To do otherwise could lead to distorted investments and could ultimately unbalance the world financial system."

The Moral Hazard

Thus, Chairman Greenspan reminded markets of the moral hazard problem. Indeed, the financial crisis in Asia's emerging markets may manifest that very problem. In 1995, Mexico and much of Latin America were essentially bailed out of problems resulting from careless financial practices by a large infusion of funds (about $50 billion) assembled by the United States. That exercise has been deemed a success because Latin American markets have recovered, and, with them, Latin American economies.

Possibly encouraged by the large bailout for Mexico and Latin America in early 1995, highly liquid investors subsequently moved even more aggressively into emerging markets in Asia and Eastern Europe. Asian financial problems are considerably larger than those that emerged in Mexico and Latin America. The rapid increase in the exposure of global financial institutions to emerging Asia can hardly be independent of the reassuring message sent to global investors by the large Mexican bailout package.

Chairman Greenspan saw fit to remind investors once again that the resources and ability of the public sector to underwrite the major risks of investments in emerging markets effectively are limited. He also realizes his responsibility to avoid a crisis in financial markets that could permanently harm the real economy. The connection between Asian deflation and real economic activity in the United States and Europe may have been operating over a longer time than we yet realize. After all, over the past year, central bankers in most G-7 countries, with the notable exception of Japan, have been girding for a battle with inflation. Yet, despite high growth rates and low unemployment rates, along with some weak evidence of rising real wages and rising money supplies, inflation has not appeared.

Possibly encouraged by the large bailout for Mexico and Latin America in early 1995, highly liquid investors subsequently moved even more aggressively into emerging markets in Asia and Eastern Europe.

There are at least two reasons for the "just you wait" approach to the inflation watch by central bankers and their staff. One reason is a reflection of the experience in the postwar period, when most central bankers were forming their views on how economies work and what the role of the central bank should be. Inflation, not deflation, has always been the problem in the postwar economy. The other reason mirrors the widespread failure of central banks to comprehend the likely aftermath of a true sustained global investment boom, like the one that surfaced in Japan in the 1980s and then spread to Asia and Latin America and finally to the United States in 1993. (Europe, largely bypassed by the global investment boom, was instead preoccupied with essentially deflationary policies required to prepare for a single money that resembles the deutsche mark as closely as possible.)

The dynamics of the end of an investment boom, essentially a total shutdown of investment opportunity because deflationary events suggest that the capital stock is already too large, is not the typical end to expansion. Rather, the typical postwar expansion has halted with too much exuberance about investment, which puts upward pressure on prices and requires a straightforward tightening of monetary policy.

Lessons about Expansion

But lessons about the end of investment-led expansions are close at hand. The Bank of Japan, beginning in 1989, provided a clear model of how traditional demand-management policies can lead to disaster, given an investment-led expansion accompanied by the bubble in asset and property markets. Bursting the bubble creates incipient, then actual deflation, which is exacerbated by currency appreciation, especially in a country with a chronic current account surplus (chronic excess saving.)

Japan's attempt to reflate between 1992 and 1996 with $600 billion of largely wasteful public spending failed. The public spending served only to recycle Japan's chronic excess savings (relative to domestic investment opportunities) back into the stream of spending. When the recycling stopped by early 1997 with Japan's deflationary momentum still intact, the economy collapsed.

Japan's huge flow of saving became a curse in conjunction with an absence of investment opportunities at home and constrained flows of investment abroad. Money flowed into cash holdings and the government-insured postal saving system as Japan's banks, insurance companies, and brokerages were pushed closer to insolvency. Recently, actual insolvencies have surfaced in Japan at Sanyo Securities, a brokerage house, and, for the first time, at one of Japan's preeminent city banks, the Hokkaido Takushoku Bank. Like corpses anchored to the bottom of the murky swamp by Ministry of Finance mavens seeking to hide them, Japan's insolvent financial institutions are beginning to float back to the surface for all to see.

The Asian deflation of the late 1990s emanating from ASEAN and East Asia was exported from

Japan, beginning with heavy investments in ASEAN and China while South Koreans, copying their Japanese competitors, simultaneously piled on more layers of capacity. When, in 1995, Japan could bear the deflation no longer, the yen was pushed down. Meanwhile, China had pushed down its currency early in 1994. The deflation cycle in Asia had begun just as capital inflows from a growing pool of global liquidity accelerated in 1995. The extra boost for those flows came from the Mexican bailout example provided to global investors. That bailout stood as a beacon signal that the International Monetary Fund and the G-7 governments do not let emerging markets go under. The bait for the Asian moral hazard trap in 1997 was created by the 1995 Mexican bailout.

The Asian deflation of the late 1990s emanating from ASEAN and East Asia was exported from Japan, beginning with heavy investments in ASEAN and China while South Koreans, copying their Japanese competitors, simultaneously piled on more layers of capacity.

In a fast forward to the present, all Asia, including ASEAN (Thailand, Singapore, Malaysia, Philippines, and Indonesia) and East Asia (South Korea, Taiwan, China, Hong Kong, and Japan), displays powerful symptoms of excess capacity with either disinflation or outright deflation present. The round of competitive devaluations continues. China, which until recently was considered immune to Asian problems, is now described by a China newsletter as having "fallen into a deflationary period that could seriously threaten the economy." The South Korean currency fell by nearly 20 percent in November alone, with forward markets expecting another 25 percent devaluation over the next year. Taiwan's currency has been allowed to float down while Hong Kong's defense of its currency has caused the Hong Kong stock market to fall by over 30 percent.

Focusing on South Korea

Financial market participants by mid-November focused on South Korea as an economy with the most acute problems in its financial system that might be the object of another IMF bailout package. Japan's problems are nearly as acute, but Japan is too large for an IMF package.

The ability of the IMF to stem the South Korean crisis, leaving aside the important moral hazard issue, is limited. South Korea is a far more advanced country than, say, Indonesia, which received an IMF-led package totaling some $38 billion, and South Korea has been reluctant to approach the International Monetary Fund. Simultaneously, the IMF must be wondering how it can assemble a financial package large enough to deal with Korea's problems.

South Korea has a large current account deficit, equal to about 3.5 percent of GDP. Beyond that, Korea's external debt of about $120 billion, or nearly 25 percent of GDP, includes about $80 billion of debt due within a year. Meanwhile, the nation has probably depleted two-thirds or more of its $30 billion in foreign exchange reserves during an ill-advised defense of its currency over the past month. And South Korean investors are heavily involved in other emerging financial markets, especially in Russia and Brazil.

Aside from the important question of whether the IMF should assemble a South Korean package, there are serious questions about its adequacy. The maximum aid that the IMF, by itself, could extend to South Korea would be about $6 billion, or 500 percent of the Korean quota at the IMF. America's ability to contribute to a Korean package is limited by the resources available in the Exchange Stabilization Fund, since Congress is not prepared to provide additional resources to the IMF. The Exchange Stabilization Fund has about $15 billion in cash reserves, and another $15 billion worth of foreign currency reserves largely composed of deutsche marks and yen. Of the $15 billion in cash reserves, $3 billion worth is already committed to the Indonesian package.

In view of these constraints, and the possibility that still more packages would be required for other nations, the United States could not likely commit more than $5–6 billion to a Korean package, even if it were willing to do so. A $6 billion U.S. contribution would leave only an additional $6 billion available for other packages, unless the Clinton administration is prepared, as with Mexico, to borrow against its foreign exchange reserves to participate in a bailout package for an Asian economy whose borders are far from the United States.

In sum, even a South Korean bailout package leaving all other Asian countries aside is problematic. Nor is South Korea alone as an East Asian nation that might require assistance to stem a financial crisis.

With $6 billion from the IMF, perhaps $6 billion from the United States, and another $6 billion from Japan, along with assorted commitments from some other Asian nations themselves in need of considerable help, the package could probably be pushed up to $30–35 billion. That funding would have to be based on strict IMF conditionality, which would require major changes in South Korea's financial and trade practices. Such funds are not meant to meet short-run financing commitments, such as the $30 billion or so worth of loans coming due in South Korea over the next several months. The nation will not expect help from the World Bank or the Asian Development Bank, since those institutions provide developmental assistance to poorer countries.

In sum, even a South Korean bailout package leaving all other Asian countries aside is problematic. Nor is South Korea alone as an East Asian nation that might require assistance to stem a financial crisis.

Japan's Struggle

Meanwhile, Japan is struggling to find ways to employ public money to ensure that no depositor in one of Japan's insolvent banks or nonequity holding customer of a brokerage or insurance company loses money. In the November 17 closure of the Hokkaido Takushoku Bank, the Bank of Japan provided for special loans to preserve the integrity of the banking system. No details were immediately available on the amount of such loans required, but estimates placed the sum at $10 billion through November 19.

Japan's governing party, the Liberal Democratic Party, chose to soften the blow of Japan's first failure of a major bank by suggesting that public pension funds be instructed to buy shares from the banking system to avoid a further crisis. Unfortunately, neither the HK bailout nor the funding from the public pension trusts was carefully worked out; rather, there was a series of reactive moves in a crisis setting. By midweek, Prime Minister Hashimoto had agreed to consider the use of public pension funds to bail out banks, probably in view of the failure of all past efforts to use public funds to help a banking system that is profoundly unpopular with the Japanese public.

Japan's dangerous, reactive approach to solvency problems in its financial system has been driven by a failure to acknowledge their existence. The only way to deal with systemic problems like those facing Japan is to close failed financial institutions with the government protecting depositors in banking institutions to prevent runs on banks. The assets of the closed institutions can then be repackaged and auctioned off, or "securitized," to use the term popular in financial markets. Proceeds from the auction help to defray the costs to the public sector of the bailout. This model was successfully employed by the United States in the early 1990s to deal with the savings and loan crisis. Japan needs to apply a similar approach, albeit on a much larger scale, to its own banking system. The country also needs to face difficult problems in the insurance industry, where policyholders undoubtedly deserve some protection. In all these cases, shareholders in the institutions must be sacrificed, since they purchased shares knowing that their funds were at risk.

Japan's dangerous, reactive approach to solvency problems in its financial system has been driven by a failure to acknowledge their existence.

Until recently, the analysis of emerging deflationary and excess capacity problems in Asia has mistakenly tended to look at those problems one at a time instead of systemically. When the crisis in Thailand emerged early in July, analysts suggested that the danger would be contained within Thailand. When it spread to other ASEAN countries, the suggestion was that the contagion would end there. Then in September, with the emergence of pressure on the currencies of East Asia, again the implication was that the contagion would end there and not spread either to Latin America or to Russia and Eastern Europe. Unfortunately, the contamination persisted precisely because of the close ties in financial markets, regardless of the closeness or looseness of trade ties among emerging-market countries and between those countries and major industrial countries.

Another Stage of Crisis

With the admission by the Bank of Japan that emergency funding for the HK bank was justified by systemic risk in its financial sector, the Asian financial crisis has entered a new stage. Clearly, if the financial sectors of countries representing over a third of global economic activity cease to function as financial intermediaries, we will face not only a systemic problem within Asia but also a global systemic problem. The solution to a global systemic problem, however, is to place considerably less emphasis on large infusions of funds that, in effect, enable Asia's badly flawed financial institutions to carry on with their previous practices.

Asia's financial markets and banks as a group are badly in need of reform and progress toward far more transparency. Asian policy makers have acted for too many years as if the laws of economics did not apply to Asia. Banks have been allowed to undertake activities that would not pass the standards of prudent banking behavior under any set of reasonable standards. Accounting standards are largely nonexistent and result in fraudulent financial reporting by institutions in many Asian countries. None of this seemed to matter when Asia was growing rapidly and was providing a great opportunity to diversify investment into the world's fastest-growing region. We are now discovering that the world's fastest-growing region has built far too much capacity and has created a deflation problem that, if it is not stemmed, will also put the lie to the idea that significant diversification gains are available anywhere.

Global financial markets are so closely interconnected that a more serious problem exists in Asia than envisioned as recently as late October. This discovery is no cause for celebration anywhere, even if it removes incipient inflation pressure in the United States or Europe. Central bankers in major industrial countries, especially those in Europe, who have continued to fuss about incipient inflation in a deflationary or disinflationary world, need to focus on the prospect of the systemic risk before that possibility is even mentioned in the financial markets. In short, central bankers must rapidly unlearn all the lessons of the past fifty years, when a central bank's main task was to avoid inflation. Central banks also need to guard against deflation because once it starts, deflationary momentum is even harder to break than inflationary momentum.

The recent rapid elevation of financial problems in East Asia, especially in South Korea and Japan, should provide enough warning for the world's central banks and finance ministries of two requirements: (1) to recognize that incipient deflation is the major problem facing the Asian economy and (2) to include in any remedy widespread provisions in each country to protect bank depositors to avoid financial panic.

Central bankers in major industrial countries, especially those in Europe, who have continued to fuss about incipient inflation in a deflationary or disinflationary world, need to focus on the prospect of the systemic risk before that possibility is even mentioned in the financial markets.

As Chairman Greenspan warned, "Private investors should take their losses, and government policies should be directed toward laying the macroeconomic and structural foundations for renewed expansion." Asia's financial institutions need to learn to operate with less government direction and coddling, not more. Otherwise, an Asian bailout in 1997 will mean only a larger financial crisis before the millennium.

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#8382

The Asian Crisis: Economic Impacts, Risks, and Policy Actions
by Allen Sinai*

The Asian Crisis—a meltdown of Asia-Pacific currencies, markets and economies—poses the greatest risk to U.S. and world economic prospects since the oil price shocks of the 1970s and 1980s.

What is going on appears unprecedented in modern economic times, perhaps in all of history, affecting directly at least six to as many as thirteen countries in what has been the most dynamically growing region of the world, accounting for 30% to 35% of world output, and including the second largest economy in the world (Japan), the eleventh (South Korea), one of the most populous (Indonesia), and giant countries (China, India).

The Crisis is financial and economic, likely also social and political, a "bust" for the Asia and Pacific regions after a decade of "boom." The collapse of Asia-Pacific financial markets, real estate markets and economic activity also is a major threat to the Japanese economy and financial system which has been stagnant for a number of years, in turn, contributing to the Asia-Pacific downturn.

Tight trade ties between the countries, most very open as measured by the ratio of exports and imports to GDP, extensive financing and transactional arrangements between financial institutions and companies across borders, and heavy regional tourism make the economies of these countries highly interdependent. Closed ownership of companies and financial institutions in countries like Japan, Indonesia, South Korea, Thailand, and others intensifies dependence on own domestic activity and those of other countries in the region. Besides Europe, where interregional trade ties are substantial, there are no other globaregions with so many countries that have such tight economic and financial interactions.

Asian Footprints already are showing up clearly in some U.S. economic indicators, S&P500 company earnings reports, surveys like the Federal Reserve 'Beige Book' and National Association of Purchasing Managers, anecdotally in certain states, and in a number of non-U.S. countries. Striking is the disconnect between S&P500 companies generally in recent earnings reports, more greater-than-expected than less-than-expected, contrasted with the S&P500 companies exposed to Asia where more companies showed disappointing earnings than surprisingly strong. The Footprints of Asia on commodity price deflation also are very clear, ranging from oil to energy to the CRB to nickel, zinc or copper to the Prices Paid component in the most recent NAPM Survey to PPI deflation to unchanged Commodities prices in the CPI-U.

The "recessionary" and "deflationary" ripples of the Asian Meltdown thus are radiating outward, with considerable imprecision for this unprecedented ahistorical bust and its ultimate economic impacts and flow-through to the rest-of-the-world.

Certainly, from a monetary policy point of view, the Asian crisis appears salutary. From the Asian point-of-view, it is truly a crisis with unknown fallout, economically and politically. For the U.S. economic expansion, business activity and profits, cautious optimism exists. But, the risks around this Crisis appear unfathomable and containment of the Crisis through policy actions and adequate support to international financial bodies such as the IMF would seem to be essential.

What is the "Asian Crisis?" Why is it a systemic risk to the economic well-being of the U.S. and the World? What are the trade and economic consequences for the U.S. and elsewhere? For how long? What is the appropriate policy response of the U.S. and world policy organizations, such as the IMF? How can a situation such as the Asian Crisis be avoided?

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Asian Crisis—Cyclically Endogenous to the Asia-Pacific But Exogenous to the U.S. and World

The Asian Crisis arose out of endogenous business cycle processes in a number of Asia-Pacific countries, then was transmitted across them because of tight trade and financial ties.

A central feature in the process has been the high export and import propensities of the countries and regions involved, large portions of many economies tied to external trade and finance, and the direct and indirect effects of the region's economies on one another as growth sinks.

Collapsing business activity, financial squeeze and credit crunches are the bust side of the previous long Asian boom, a big impediment to a halting recovery in Japan, and posing significant risks to economic growth, business activity, and the earnings of many U.S. companies.

The Asian boom was long, creating numerous excesses, outstripping the banking systems in many countries and testing the ability of policymakers to track and fathom what was going on. It will take a long time to unwind, with the bust side of the boom taking a good deal of time to reverse.

For numerous countries, an extended boom and exchange rates fixed to the dollar had produced overextended activity, rising current account deficits, heavy indebtedness denominated in dollars and yen, unhedged contractual arrangements because of fixed exchange rate regimes, and too aggressive financing by banks and other financial institutions. Over time, the currencies of numerous countries, e.g., Thailand, the Philippines, Malaysia, Indonesia, South Korea became grossly overvalued, leading to rising current account deficits and increased foreign debt burdens.

The currency crises, endogenous market events induced by high current account deficits, heavy indebtedness and slowing economic activity, set in motion a wave of negative effects including higher interest rates and negative inflation shocks to domestic spending from the currency devaluations, government austerity, voluntary or involuntary when imposed by the IMF, huge increases in effective debt burdens in dollar- and yen-denominated credits, financial fallout of bankruptcies and failures, the inability to roll over short-term debt in rudimentary and generally unsupervised banking systems, and the fallout on domestic activity and import demands from these processes.

On top of the cyclical downturn in activity and crunch from heavy indebtedness made more pronounced because of falling currencies, financial market meltdowns and real estate declines have eroded the asset value of collateral, throwing the loans of banks and other financial institutions into an uncollectable state and bringing about a credit crunch on the part of banks to maintain adequate capital.

In all, thirteen countries are involved and at risk—Thailand, Malaysia, the Philippines, Indonesia, Singapore, South Korea, Hong Kong, Taiwan, China, India, Australia, New Zealand and, of course, Japan, by virtue of its importance in the Asia-Pacific as a buyer and seller of goods and services, and as a financier.

For Singapore, basically in good shape before the start of the unwinding, its economic growth must weaken because of an 18% share of exports to a declining Malaysia and a large role for net exports, 15.4% of GDP. In addition, Singapore sends 8.2% of its total exports to Japan, where economic recovery and domestic spending have faltered. Korea, suffering separately from banking system difficulties, private sector bankruptcies and failure fallout, also is a buyer of Singapore exports, 3% of the total. Hong Kong, where higher interest rates and asset price deflation threaten its economy, buys 8.9% of Singapore's exports.

The four ASEAN countries, Singapore and Korea together account for 23% of Japanese exports. Hong Kong another 7.1%, Taiwan 6.7%, for a near 37% total exposure. As those economies decline in growth, Japanese exports, the only source of recovery lately for the Japanese economy, should weaken, especially given the sharp depreciations of the Thai Baht, Malaysian Ringgit, Indonesian Rupiah, Philippines Peso and new Singapore Dollar against the yen. With no major policy stimulus from the Bank of Japan (BOJ) or Ministry of Finance (MOF), the Japanese economy has fallen back into recession.

The failure of the Japanese economy to recover, in turn, is reverberating negatively on the major ASEAN countries, Korea and Taiwan, from which Japan buys over 19% of its imports.

All the countries together—five ASEAN including Singapore, Japan, Korea, Taiwan and Hong Kong—account for 51.6% of Australian exports. 18.4% of Hong Kong exports go to ASEAN countries, Japan, Korea, Taiwan and Australia. Australia and New Zealand thus also will suffer slowdowns, principally from export exposure to the region.

Hong Kong, therefore, also will suffer weakness. With a fixed exchange rate, tumbling stock and real estate markets are damaging a transactions-oriented Hong Kong economy. And, given the big declines in Asian currencies, an overvalued Hong Kong dollar prevents competitive pricing. The fixed Hong Kong currency to the U.S. dollar has made Hong Kong goods and services extremely expensive for other Asia-Pacific countries and the rest-of-the-world, in general.

Add to this mix the enforced austerity of the IMF as a condition of lending to Thailand, Indonesia, the Philippines and South Korea, and perhaps some other countries before all is over, tumbling stock markets, high short-term interest rates, banking and private sector failure fallout, potential political instability, and the resulting situation is a grab bag of troubles, uncertainties and risks.

The Southeast Asia and Japan troubles are very different from the one in Mexico several years ago. The Mexican experience was encapsulated, with its own financial crisis and economic collapse pretty much self-contained, not tied deeply and heavily through trade to other countries as is the situation in the Asia-Pacific and Japan. In fact, the biggest trade ties with its neighbors were to the North, the United States, some 85% of exports, also Canada, where better times permitted a quick buying of exports as they became cheaper and reinvestments in Mexico as it quickly came to grips with its difficulties.

In the Asia-Pacific and Japan, the intertwined nature of trade and financial flows between so many countries and inability of the existing governments and world policy bodies to fully cope with the situation augur for a long workout period.

Asia-Pacific and Japan Downturns: Recession Risk to the U.S. and World Economy?

Asian, Japanese and Pacific-Rim financial markets and economies have been melting down—the "bust" side of a near decade long "boom" that seemed to have no end.

The Asia-Pacific "bust" is more than the typical recession that follows a business expansion. It also contains a heavy dose of financial troubles—collapsing currencies, sudden and massive increases in external debt burdens, tumbling prices of stocks and real estate, and erosion in the asset values of collateral that backed billions of dollars of debt and debt service. Credit crunches and wholesale liquidations of assets to raise funds have been one consequence; inability to roll over maturing short-term indebtedness another. Austerity, cutbacks in business and government outlays, massive layoffs, and big declines in economic growth also are a consequence. Bank failures, business bankruptcies, losses and diminished cash flows will intensify the coming recessions and slowdowns. Where international lenders, such as the IMF, World Bank and private sector financial institutions are providing funds to help the situation, the conditions attached are intensifying the negative economic fallout.

Many countries are involved—at least six to as many as thirteen—including Thailand, Malaysia, Indonesia, the Philippines, South Korea, Japan, Hong Kong, Singapore, Taiwan, Australia, New Zealand, India and China. Japan is back in recession now. The other countries are headed for recessions, depression-like conditions, and major slowdowns; at best, just slowdowns. The affected countries account for about 33% of world output.

The number, size and scope of the Asia-Pacific Meltdown are without historical precedent—numerous "bubbles" bursting at once, not just one, the case of Japan in the early 1990s, or

Mexico in 1994—making the Asian episode and its effects on world economies potentially quite sizeable.

The reality is that a chunk of the world economies in the Asia-Pacific and Pacific Rim is headed for some combination of recession, slowdown, and stagnation. *The risk is something worse if the downward spiral is not somehow contained.*

Table 1 shows the Primark Decision Economics, Inc. (PDE) estimates of economic prospects for Asia, Japan and the Pacific—last May and now for 1998 and 1999.

Table 1
Asia-Pacific Prospects: Then and Now

Country	May 1997 Forecast 1998 (Growth Rate, Percent)	Current Forecast 1997	1998	Chg. (Pctg. Pts.)	1999
Thailand	6.3	2.2	-2.0	-4.2	-0.5
Indonesia	6.0	5.6	-5.5	-11.1	0.5
Malaysia	8.0	6.0	-0.5	-6.5	1.0
Philippines	6.0	5.3	1.0	-4.3	2.2
Singapore	6.0	7.5	4.9	-2.6	4.4
South Korea	6.2	4.6	-2.2	-6.8	1.5
Hong Kong	5.9	5.2	3.5	-1.7	3.3
Taiwan	5.7	6.4	5.3	-1.1	4.2
Japan	3.3	0.8	-0.8	-1.6	0.7
Australia	3.2	2.9	2.5	-0.4	2.7
New Zealand	3.0	2.5	2.2	-0.3	2.3
China	10.2	8.8	6.3	-2.5	6.0
India	6.0	5.9	5.0	-0.9	4.5
Average	5.8		1.5	-4.3	

Source: PDE

The forecasts suggest the following for the Asia-Pacific region:

Recession-Depression:
- Indonesia
- South Korea

Recession-Bound:
- Thailand
- Malaysia
- Japan

Major Slowdown:
- Philippines
- Singapore
- China
- Hong Kong

Slowdown:
- Taiwan
- India
- Australia
- New Zealand

Sizing the Asian economic slide is not easy, since the nature of the bust and financial fragility that characterizes the region suggests nonlinear, highly dynamic processes, with in some cases a literal shutting down of economic activity. That has been seen already in Indonesia and South Korea, also Thailand.

With so many countries involved and so many downturns simultaneously in process, the risks to other countries through trade, finance, and transactions must be viewed as quite considerable. Contagion effects, the spreading of the financial meltdowns on account of investor flight from high risk areas, make the Asia-Pacific Crisis a very real external recession risk to the U.S. and rest-of-the-world economies.

Some Perspectives on Other Globaregions and the World Economic Outlook

For the U.S., over 30% of exports go to the Asia-Pacific and Japan, with the risk to growth in real GDP over the next year estimated at 0.5 to 1.0 percentage points, depending on how bad is the downwave in Asia-Pacific growth, how long it lasts, and the economic and financial ripple effects in other regions of the world.

One key is Japan—whose export elasticities to affected countries are large. With no pickup in the Japanese domestic economy, potentially weaker exports, considerable new exposure of Japanese banks and financial institutions to loans outstanding that could be nonperforming, to nonpayment of debt service, and with fundamental weakness in the region—*how badly will the Japanese economy and financial institutions do*?

Another is Singapore, where generally good times in a balanced, relatively healthy economy have been the case—*how much damage there*?

Then, *there is Hong Kong*, caught between a "rock and a hard place," being priced out of the region with defense of its H.K. dollar and the peg hurting the Hong Kong economy; if the currency peg is let go, hurting the Hong Kong economy worse.

Finally, *will China suffer significantly less growth* as well? Currently, the Chinese economy appears to be fading quite rapidly and with price deflation, possibly a very destabilizing situation.

Europe is estimated to show some loss in economic activity; not much, however, given less overall exposure on trade to the Asia-Pacific and Japan and so much intraregional trade; 0.2 to 0.4 percentage points less growth for the EU.

Latin America has negligible trade and economic ties with the Asia-Pacific and Japan, most with North America, Europe, and, to some extent, with each other, e.g., Brazil and Argentina.

The problem for Latin America is contagion and spillover effects from EMG Asia into financial markets from EMG risk, as monies seek safe havens, booming financial markets correct, and then derivative restraint in economic activity. Financial stress can take down economic activity in several countries. *Brazil actually has run into fundamental economic problems similar to those in the Asia-Pacific* and is employing fiscal austerity in reaction. Latin American growth in 1998 is estimated at 3-1/2%, down from last year's 5-1/2%.

On a one percentage point drop in Latin American growth, U.S. exports and growth in GDP is estimated to decline by 0.1 to 0.2 percentage points.

Canada, too, has exposure to Latin America—in one way through commodity price deflation and lower export revenues. To the extent U.S. economic growth slows down, Canadian exports also will suffer. With 43% of Canadian GDP in exports and so much exposure to the U.S., Canadian economic growth may decline as much as one-half percentage point because of the Asian Event. Canada is the second largest buyer of U.S. exports.

Based on these calculations and estimates, the PDE forecast for world economic growth in 1998 is about 2%, down significantly from the 3.2% of 1997. World inflation is expected at 2.8%, 0.3 percentage points below the 3.1% of 1997. In 1999, assuming the worst is over for the Asia-Pacific downturns, world growth is forecast at 2.4%.

U.S. Trade and Economic Effects

How will the U.S. be affected? *For the U.S., the Asian Meltdown is an "external shock"* that will diminish economic growth, reduce inflationary pressures, lower corporate profits, eventually make the labor market more slack and probably also lower interest rates. It is a recessionary and deflationary shock.

Sectorally, consumers will benefit early from the Asian Meltdown, because of lower prices of imported goods and lower interest rates. Already, CPI-U inflation has decelerated and interest rates declined, increasing consumer purchasing power.

Later on, however, should weaker U.S. economic growth lead to cutbacks in jobs, consumer incomes, sentiment, and spending would weaken.

There are numerous other dimensions of effects from the Asia Crisis, trade and otherwise.

The main transmission mechanism is via U.S. trade, where exports to the Asia-Pacific and Japan will be hard hit because of the Asian meltdown and imports from Asia will rise significantly. Exports, capital goods industries, and companies with business and transactions in the Asia-Pacific should feel the effects.

U.S. exports now are a record-high percentage of GDP, at 13.7%, one trillion dollars, with about one-third, or $330 billion, going to the thirteen affected Asian and Pacific-Rim countries. The exports at risk exceed all of U.S. residential construction ($287.1 billion) and are almost half of what the U.S. spends on producers' durable equipment ($678.5 billion). Thus, exports now are a big part of the U.S. economy; also responsible for a lot of jobs.

S&P industries that could be affected are shown in Table 2, along with their exposure to Asia. Other industries can benefit from lower production costs, either from production facilities located in the Asia-Pacific or in the U.S. that buy from that region, or because of lower interest rates.

Over 150 S&P500 companies have Asian exposure, directly in sales and earnings and many more indirectly, perhaps 100 more, suppliers and otherwise, that will feel the effects of Asian problems. This includes major banks and other financial institutions who have lent heavily into Asia and who have sales and earnings that are based on transactions in that part of the world.

Table 2
S&P500 Industries Exposure to the Asian Crisis
(Top 25 by Percent of Operating Earnings Derived from Asian Operations and Top 12 Exposed on Price Deflation)

S&P500 Industry	Percent Exposure Far East Share of 1996 Operating Income for All S&P500 Firms in the Industry (%)
Equipment (Semiconductor)	51.1
Computers (Peripherals)	45.8
Electronics (Semiconductors)	28.9
Aluminum	26.0
Electronics (Instrumentation)	22.6
Beverages (Non-Alcoholic)	15.3
Insurance (Multi-Line)	13.1
Leisure Time (Products)	12.7
Restaurants	12.4
Banks (Money Center)	11.1
Footwear	10.6
Manufacturing (Diversified)	9.0
Health Care (Medical Products & Supplies)	8.8
Services (Advertising/Marketing)	7.8
Computers (Hardware)	7.1
Foods	6.7
Engineering & Construction	6.2
Investment Banking/Brokerage	5.3
Chemicals (Specialty)	5.0
Health Care (Diversified)	4.9
Health Care (Drugs-Major Pharmaceuticals)	4.8
Household Products (Non-Durables)	4.5
Computers (Software & Services)	4.2
Manufacturing (Specialized)	4.0
Oil (International Integrated)	3.4

Paper & Forest Products	Agricultural Products
Iron & Steel	Aerospace/Defense
Gold & Precious Metals Mining	Air Freight
Oil (Domestic Integrated)	Computers (Networking)
Oil & Gas (Exploration & Production)	Automobiles
Metals Mining	Lodging-Hotels

States such as California, Washington, New York, Louisiana and Massachusetts, contain companies that do a lot of Asian business, and these regions will lose activity in 1998.

Table 3 lists the states and their exposures. For Washington, the most exposed, at 56.5% of total exports, much of the product is in transportation and civilian aircraft. For California, also highly exposed, over 51% of its exports go to the Asia-Pacific. Technology is of particular importance, mostly in Northern California. These states are providing anecdotal evidence suggesting impacts already from the Asian Crisis.

Table 3
State Exposure to the Asian Crisis
(Percent of Total Exports to Destination Countries, 1996)

State (In Order of Total Exports)	China	Hong Kong	Indonesia	Japan	S. Korea	Malaysia	Philippines	Singapore	Taiwan	Thailand	Total
California	1.9	3.5	0.8	18.1	8.4	3.1	1.9	5.7	5.4	2.2	50.8
Texas	1.9	1.6	0.8	4.0	2.6	1.3	1.1	2.6	2.6	0.6	19.1
New York	1.3	3.5	0.4	6.6	3.1	0.5	0.3	1.5	1.5	0.8	19.5
Washington	5.4	3.3	0.7	22.3	9.7	1.4	1.5	3.4	5.8	3.0	56.5
Michigan	0.8	0.6	0.1	4.2	1.6	0.2	0.2	0.4	0.6	0.0	9.1
Illinois	2.8	2.3	0.9	8.0	4.6	0.9	0.8	2.8	1.6	1.1	25.8
Ohio	1.0	1.1	0.4	10.4	2.8	0.7	0.4	1.1	1.2	0.6	19.7
Florida	2.4	0.8	0.1	3.6	1.0	0.4	0.3	1.1	0.6	0.3	10.6
Louisiana	4.9	0.6	1.4	14.4	5.8	1.1	0.9	0.8	6.0	1.3	37.2
North Carolina	2.0	1.6	0.6	9.1	1.5	0.6	0.5	1.3	1.4	0.8	19.4
Massachusetts	1.0	2.3	0.4	10.8	3.4	0.9	1.1	2.4	4.3	0.6	27.2

Source: PDE

Tourism data are not available nor included in the state or industry information. But, presumably California, Massachusetts and New York will see the effects from the Asian declines. Services related to tourism, retail, hotel and motel, airlines and education all will be impacted.

Some Econometric Evidence on the Economic Effects of the Asian Crisis

PDE has estimated the trade flow implications of the forecasted declines in Asian economic activity through a series of econometric models on bilateral trade flows between the U.S. and 11 of the affected 13 countries.

Export and import elasticities prove more sensitive and respond quicker to shifts in overall growth rates than to changes in currency exchange rates. But, given the huge swings in exchange rates of the Asia-Pacific countries against the dollar, significant effects on trade flows from changes in exchange rates can be expected relatively soon.

Table 4 summarizes the macroeconomic• effects of the forecasted slide in Asian activity, operating through shifts in exports and imports, declines in commodity prices, and market-related changes of interest rates.

Table 4
Macroeconomic Impacts of the Asian Crisis:
Simulations with the Sinai-Boston Econometric Model of the United States*
(Changes from Baseline)

	1998	1999
Real GDP (% chg.)	-1.0	0.6
Inflation (% chg.)		
PPI	-1.1	-0.5
CPI-U	-0.3	-0.5
Unemployment Rate (%)	0.4	0.3
S&P500 EPS ($/share)	-1.62	-1.02
90-Day T-Bill Rate (%)	-0.7	-0.01
30-Year Treasury (%)	-0.16	-0.07
Nonfarm Payroll Employment (mils.)	-0.751	-0.321
Consumption ($ bils., '92)	-36.9	-4.2
Business Fixed Investment ($ bils., '92)	-24.4	-14.5
Net Exports ($ bils., '92)	-41.2	-25.8

•Export losses to Asia-Pacific and import gains from changes in economic activity and in exchange rates relative to the dollar. Bilateral econometric models used in the determination. No change in Fed policy assumed.

Source: PDE, Sinai-Boston Econometric Model of the United States, PDE bilateral trade flow models.

These results, which take account of the direct and indirect effects of declines in exports and rises of imports, as well as price and interest rate effects, show a one percentage point reduction in real economic growth in 1998 compared with the Baseline. 60% of the decline in growth is retraced in 1999 as the slower U.S. economy takes down imports and lower inflation and lower interest rates provide delayed stimulus.

Nevertheless, permanent losses in activity show up and the jobs decline is about one million over 1998 and 1999. Inflation is sharply lower, particularly in the PPI where the increased supply of foreign goods, reductions in the costs of production, including oil and energy, and the umbrella effect of falling prices on foreign import goods combine to produce the declines. If the Federal Reserve reduced interest rates in response to this decline of inflation, then larger reductions would show up in the 90-day T-bill rate and 30-year Treasury bond yield. The 1998 result would be mitigated and a sharper upward move in growth would occur during 1999.

These results suggest a significant dent to U.S. economic activity, but no recession, with disparate effects throughout the various sectors of the economy, moreso on the negative turn in trade and also in the U.S. current account deficit, potentially a political issue in 1998. In some quarters, e.g., the Federal Reserve, a decline of these magnitudes might be welcomed, taking a too boomy economy down to a more sustainable pace.

How Long for the Asian Crisis?

Although signs of the worst being over in financial markets are appearing, the brunt of the Asian Crisis in terms of economic downturns has yet to be seen. Asian Footprints are showing up, indicating the beginning of the process of the downturns in Asia and the impacts on the U.S. and other economies. But, the slides of economic activity will take some time, a 1998 event, with the earliest possibility of economic revival not until 1999.

The structural reforms and financial debt restructuring that must be undertaken normally do not take place quickly in situations of this sort.

Two or three years is a reasonable estimate for the Asian Crisis to work its way through economic and financial systems before the previous dynamism of the region might be restored.

Financial Risks—Market Bottoms Past

Fundamentals in Asia have turned better for several countries, principally through a move to current account surpluses, the first step in a process of flooring currencies and providing a prop under equity markets.

South Korea, Thailand and Indonesia are reporting trade and current account surpluses now, for several months. So far, the turn to surplus is largely through plummeting imports and not strong exports. In 1994-95, Mexico's current account surplus turned sharply, but through both strong exports and weak imports.

It is hard to expect improvements in current accounts from export growth when the trade ties between the Asian and Pacific-Rim countries and Japan are so high. Falling imports imply sharp declines in domestic economic activity. In most of the Asian countries except for Taiwan and the Philippines, domestic inflation rates are rising sharply in response to the previous collapsing currencies.

With these improvements in the current account surpluses, however, and early rounds of financial restructuring in place for South Korea and perhaps Thailand, the risks are considerably diminished for further freefalls in the currencies of these countries. The current account surpluses will generate some additional foreign exchange and the wherewithal for intervention to floor the currencies, a logical next policy step, if necessary.

With the fundamentals better for several currencies and heavy reinvestment monies available after Ramaden, Asian equity markets have shot higher. Also, there is undoubtedly some bounce from what was likely overshoot on the downside.

The presumption is that other countries will also show improvements in current accounts and the region's currencies thus may well have hit bottom. If so, some high-risk money can move into Asian equity markets. And, market bottoms most likely have been seen.

But, still unknown in this historically unprecedented episode is how big, widespread, and deep the economic slides will be, and how prolonged. This is yet to come and will have implications for the currencies and equities in these countries later on.

Further declines from current levels are likely, lots of volatility and even the possibility that previous market bottoms could be pierced. The higher odds prospect is lots of volatility and market bottoms having been reached. Straight-up markets are not an implication, however.

Numerous pitfalls lie ahead, not the least of which is the Japanese situation and whether the Japanese economy can recover from its latest recession in a timely fashion.

Policy Responses and Practicing Avoidance

The unprecedented nature of the Asian Crisis and complicated interactions between the economies and financing of the region suggest considerable difficulty for individual country policymakers and world policy bodies in resolving the problems.

Unlike Mexico, which was much cleaner, the current situation is intricate and, to some extent, not containable in any easy manner. Correct policies applied in a given country can go awry because of that country's ties with others where difficulties may continue or intensify.

The size, scope, and widespread nature of the generic processes of downturns and financial fragility make the Asian Crisis a difficult policy problem. Although similar generic cyclical real and financial mechanisms appear at work across countries, some familiar and some less so, the interactions between the economies, financial markets, and banking systems in the various countries make any single approach unlikely to completely succeed.

The history of policy reactions to external shocks when they are new, for example, for the first oil shocks in the 1970s, shows considerable difficulty for policymakers in dealing with the situation. Essentially, the first instances of a particular external shock turn out to be learning experiences.

Thus, it is unlikely that any individual country, the IMF, or any policy body can fully succeed in defusing or containing the full brunt of the Asian Crisis. Though easy to criticize, the policymakers probably are in a no-win situation.

For monetary policy in the United States, there is much experience with external shocks. One lesson is *not* to fully accommodate the shock; in this case, that might mean no easing of monetary policy even if a significant deflationary impulse appears. Or, if the U.S. economy appears very weak, partial accommodation might mean some monetary easing but not to the full extent that might be warranted if the cause were endogenous to the U.S.

For the IMF, one approach to every country cannot possibly succeed, since each has its own particular problem structure, economic, social and political system, interacting with other economies of the region.

Though the generic prescription of the IMF appears correct—reform of the banking system, survival of healthy institutions, the institution of some degree of accountability, funding with conditions that correct current account deficits and too much debt, and monetary and fiscal discipline to keep inflation down—slavish application of similar conditions to all countries might well bring about more fallout than otherwise necessary.

There is no choice, however, except to use a world policy body in such a situation, since the funding requirements are huge. Left to itself, the world economic and financial system might not respond. Debt moratoria, defaults, and fallen governments could be the result, with unknown social and political unrest, then further economic fallout that ultimately would reach the shores of all countries and to a greater extent than could be expected with world policy bodies acting.

The United States has much at stake in this Asian Crisis, economically and politically, and as a world leader. At a time when the U.S. economy is doing well, is resilient and can cushion the

Asian negative economic shock, benefit from lower inflation and lower interest rates, the $18 billion funding for IMF that is being requested should be supported.

For the future, avoidance of the kind of crisis that has cropped up in Asia requires much more transparency by developing countries, greater data collection, a more active IMF that can raise yellow warning flags to the countries involved and also to the public, and increased openness and communication between countries. Fixed exchange rate regimes should be eschewed, and if it is desired to quickly move an economy to low inflation and improved growth, crawling pegs or currency boards with some flexibility on exchange rates would be preferable, along with greater attention paid to the financing and reporting of risky loans, assets and liabilities, by the financial authorities through greater supervision and regulation.

It is inevitable that in developing countries, which are moving toward a mixed capitalistic system with increased intermediation and financial instruments, there will be financial crises from time-to-time. Surveillance and transparency need to be much greater to provide early warning systems and alerts so that policy actions will not be too little and too late, procyclical as much of the IMF prescriptions are now, rather than countercyclical, the way U.S. monetary policy, in its preemptive revolution, has acted in recent years.

Prepared Statement of Hon. Lawrence H. Summers

Mr. Chairman. I am pleased to have this opportunity to discuss recent developments in Asian financial markets and the closely related issue of ensuring adequate funding for the International Monetary Fund—both of which I know have been of considerable interest to this committee and other members of Congress.

Today I would like to discuss the instability in Asia and the risks that a more prolonged crisis would pose to the United States; the Administration's strategy for restoring stability; and the critical need to support the IMF so we can respond effectively, not just to these crises, but to other possible crises down the road.

I. The Risks Posed by the Instability in Asia

As the President said in his State of the Union Address, the Asian economies are our customers, our competitors and our allies. The financial turmoil in the region will have an impact on the growth of the American economy, and the well-being of American workers, businesses and farmers. Our job is to ensure that impact is as small as possible.

Nearly one third of our exports go to Asia—more than we send to Europe. Already major Fortune 500 companies such as Microsoft, General Motors and Boeing have warned of reduced export demand because of the instability in Asia, reduced demand that we can expect to mean fewer new jobs for American workers.

Our economy is in strong shape to withstand these and other short-term effects of the crises as they have developed thus far. But the potential costs will be much larger if these economies prove unable to restore stability and the crises spread to emerging markets in other regions—markets which now account for more than 40 percent of our exports. Prolonged instability in Asian and other markets:

- could threaten American exports and the jobs that depend on them, leading to a cycle of costly devaluations and impeding open trade;
- could affect our own financial markets, and with it everything from investment in tools and equipment for workers to mortgages for new homes;
- and could raise serious concerns for national security, given the proven potential for financial crises to trigger broader conflicts. Under Secretary Eizenstat will be addressing this issue in greater detail.

In short, the risks of failing to respond to these crises—the risks for our economy, the stability of our financial markets and our broader national security—far exceed the risks of action. We can, and we must work with the International Community to help restore confidence and growth as soon as possible—so that these nations can continue to be strong markets and stable allies for the United States.

II. The United States' Approach

Our approach to these events rests on four principles:

- first, that the major responsibility for resolving these crises rests with the countries themselves and the actions they are prepared to take.
- second, that the international community should provide temporary, conditioned financial support for countries as a bridge to recovery;
- third, that in the wake of these crises the major industrialized nations, particularly Japan, and the economies of the region must promote growth in their own economies to support the return of market confidence and growth;
- fourth, that we must act with a view, not merely to the present crises but to the kind of international financial system we want to build for the future, by fostering policies around the world to reduce the risk of contagion and prevent further crises.

Let me say a little about each of these, with a special focus on the first two, which rely heavily on the IMF.

1. National Policy

A strong domestic response is the absolute prerequisite for restoring stability. The reform programs we have supported in Thailand, Indonesia and Korea commit these countries to concrete actions to restore stability and lay a surer foundation for long-term growth.

While each program is tailored to address the specific causes of that country's crisis, the focus throughout has been on making the economy more market-oriented and better able to allocate capital and to allow market forces to operate. Important, long overdue, changes need to be made in the structure of these economies—changes which have been welcomed, in many cases by officials in the countries themselves. The major reform areas include

- measures to strengthen the domestic financial system, through financial sector restructuring, improved transparency and supervision, elimination of the interrelationships between government and business, and opening of domestic capital markets.

- structural reforms to break up commodity monopolies and open protected sectors to foreign competition.
- restoration of appropriate monetary and fiscal policies, and agreement on stable and transparent rules for policy makers for the longer term.

Bearing in mind the strong interest of this committee in the trade aspects of these programs, let me say a little more on this subject.

Indonesia's stabilization package commits the government to eliminating a range of officially-sanctioned import and export monopolies, removing export taxes on resource products, reforming the government procurement process, and accelerating the pace of privatization. Tariffs on food imports have been cut to a maximum of 5 percent, effectively immediately. Similarly, the Thai program includes a greater emphasis on privatization, measures to reduce subsidies to state enterprises, and loosening of the limitations on foreign ownership and exchange controls.

For its part the Korean government has pledged, among other things, to eliminate a string of unfair subsidies to Korean exporters, ease up on import licensing and cumbersome customs procedures, end government-directed noneconomic lending and substantially ease restrictions on foreign ownership of Korean companies.

Mr. Chairman, it is worth taking a step back to consider what these changes represent. The close and preferential relationship between the chaebols, the banks and the government has been one of the salient characteristics of the Korean economy for years. It is at the root of our persistent trade problems with the country—resulting in poor market access, uneconomic investment and excessive concentration and excess capacity in key industries. At the same time, these practices have been very difficult to address using traditional trade policy tools. The reforms in the IMF program will go far toward breaking up this preferential relationship once and for all.

2. International Assistance

When—and only when—countries are committed to pursuing these strong policies, the international community, led by the United States, has a strong interest in helping them help themselves. By providing temporary financial assistance, we can give these economies vital breathing room while those vital reforms are undertaken.

Without this support, even those countries that are committed to reform might face default—either at a government level or the private corporate level—which could have devastating effects on their own economies and significantly raise the risks of contagion in other markets.

The IMF has been and must continue to be the central provider of such assistance, supported by additional help from the World Bank and the regional development banks. It should be noted that in responding to the recent crises in Asia the IMF has been the vehicle for a major multilateral effort to restore stability—reflecting an unprecedented degree of international burden-sharing. In sharp contrast to the situation in Mexico, the International Financial Institutions have been responsible for the bulk of the assistance provided—meaning very limited direct financial exposure for the United States.

We have joined other industrial countries in indicating a willingness to provide additional temporary assistance in some situations if a country is continuing with reforms and unexpected developments call for supplementary resources. To date, none of this "second line of defense" funding has been disbursed, and any disbursements that do occur would be highly short-term in nature and guaranteed.

3. Action by the industrialized economies and by the countries of the region

Strong domestic policies in the countries worst affected will be the key to restoring stability in those economies. But in an era of interconnected markets, other countries have a part to play in supporting a rapid return to growth—and the continued expansion of trade. Given the high levels of regional trade and competition, the largest economies in the Asia- Pacific region have a special responsibility to pursue sound policies aimed at promoting their shared interest in monetary stability and solid growth.

With a balanced budget, the United States government is doing its part, by no longer soaking up $200 billion a year that could be invested in the global economy. Continued strong reforms in China will also be increasingly vital. When we talked recently with Zhu Rhongji, the Chinese Vice Premier, in Beijing we were happy to hear him reaffirm China's commitment to a stable exchange rate, and to dealing effectively with the economic challenges it faces. In the coming weeks and months, though, it will be Japan's turn to step up to the plate—by acting decisively to stimulate growth and by coming to grips with the problems in its own domestic financial sector.

The industrialized nations can also respond more directly to the crises by helping to support trade flows in the region. There is a severe danger that the domestic recession in these economies will be prolonged by a shortage of short-term trade finance. Weighed down by debt, the financial system in some cases has simply ceased to function—making it all but impossible for businesses to obtain credit to import vital goods and materials.

Our own Export-Import bank has led the world in offering substantially enhanced short-term export insurance in Korea and is exploring ways to extend this program to other Asian markets. Providing this support is truly a win-win proposition for the United States: it gives immediate protection to American exports and jobs, while at the same time speeding the long-term recovery of these important markets. Ex-Im is now working to enlist other export credit agencies in a multilateral initiative to support the region's import financing needs.

4. Long-term reform agenda

Mr. Chairman, recent events in Asia leave in their wake an important long-term agenda for the international community. This will not be the last financial crisis. But we need to work to reduce the risks of such events and manage them more effectively when they do occur—we need, in Secretary Rubin's words, an international financial architecture as "modern as the markets."

President Clinton began this effort four years ago at a G-7 meeting in Naples. At the summit that followed in Halifax in 1995, we launched a broad international effort to strengthen safeguards in the global financial system. Two important parts of this initiative are an international program to strengthen disclosure and the development of core principles in supervision in emerging market financial systems.

To modernize our tools for dealing with crises, the United States has also taken a leading role in devising new approaches to the provision of external finance. Indeed, one outgrowth of this process, the Emergency Financing Mechanism of the IMF, has been a core element of the financial support programs in Asia.

At President Clinton's initiative, the United States will convene a meeting later this spring of finance ministers from around the world to continue these efforts and start developing a consensus on policies to deal with new challenges to the international financial system.

The crucial imperatives of this agenda include:

- promoting measures to make global markets function more efficiently, for example through increased surveillance and enhanced national supervision and regulation;
- increasing transparency and disclosure, for example of all encumbrances on foreign reserves;
- strengthening prudential standards, both globally and in individual economies
- improving domestic policy management, exploring ways to manage policy to help avoid crises and deal with crises that occur;
- strengthening the role of the international financial institutions in financial crises, to ensure that the international community can respond quickly and appropriately to problems and act to prevent their recurrence;
- ensuring appropriate burden-sharing by the private sector in the resolution of crises.

These issues are as complex as they are important. Given the high stakes involved, we cannot risk pushing through major reforms before the consequences have been thoroughly examined—nor can we afford to leave the IMF ill-prepared to respond to this and future possible crises until these questions are resolved. However, it is important to note the important progress that we have made in recent months—even in the midst of crisis—toward some of those long-term reform goals:

- to promote transparency, as a condition for disbursements of financial support in Thailand, Indonesia and Korea, we strongly, and successfully, urged that governments publish the "Letter of Intent" outlining the reform measures agreed with the IMF.
- with the United States again taking the lead to ensure that the means of support match the situation, the most recent programs have also rested on the concept of supplemental reserve financing at a premium interest rate—where the aim is to provide the necessary emergency finance and to maximize the private sector's incentive to raise funds for itself.
- by involving the foreign creditor banks in the resolution of the Korean crisis, we have supported an important innovation in the international community's approach to crises of this kind and helped catalyze a major private sector effort on behalf of restoring stability.
- in addition to pressing for the major financial sector strengthening included in the IMF support programs, we have reached agreement with Asian govern-

ments on the development of regional surveillance mechanisms to promote Asian financial stability and increase financial market transparency at a regional level.

To repeat, Mr. Chairman, these and other steps must be seen as part of a rolling reform agenda—in a sense, one that will never be completed. As long as the global economy changes, we will need to ensure that the international financial architecture changes with it.

III. SUPPORT FOR THE IMF

Let me turn now to the immediate need to ensure adequate funding for the IMF at this critical time. On Monday the President asked, as a supplementary request, for Congress to approve supporting the IMF in two important ways: first, through an increase in our quota subscription, and second, by contributing to an augmented emergency facility, the New Arrangements to Borrow, to supplement the IMF's resources to deal with these kinds of crises.

Mr. Chairman, we have responded to these crises because they raise important risks for our core economic and national security interests, risks that will increase the longer the instability continues—and the further it spreads. We must support the IMF as we work through these crises, and ensure it is ready to respond to future crises, because it is, quite simply, the cheapest, most effective way for us to promote those core American interests.

Fifty years of bipartisan support for the IMF has not cost the American taxpayer one cent, because it has not had a major default, and because its lending is backed by very substantial gold reserves. The IMF presently has $65 billion in loans outstanding—and fully $40 billion in reserves. It operates much like an international credit union. We and other countries provide a line of credit, and when the IMF draws on our commitments, we receive a liquid, interest bearing offsetting claim on the IMF. That is why there are no direct budget costs. That is why our contribution does not increase the deficit, or impact other spending priorities.

By imposing conditions, the IMF supports the right policies. By injecting short-term finance it prevents further devaluations—and supports the return of long-term growth. It promotes changes that are in our long-term interest: such as making these economies more open to foreign trade and reducing domestic subsidies. And it provides us maximum leverage: each dollar we contribute levers more than five from the rest of the world. Even with these new funds the IMF's resources would still represent well under 1 percent of global GDP—little more than half what they were 20 years ago.

The IMF needs to be better governed. It needs to be more transparent in its operations and accountable for its decisions if it is to command the confidence of taxpayers and investors. These are aspects of the IMF that are quite appropriately the subject of Congressional examination. And let me be clear: these are aspects we plan to change.

A number of concerns have been raised about our continued support of the IMF. Let me take a little time to address some of these.

Excessive austerity?

There have been legitimate concerns that IMF stabilization programs in Asia have been excessively contractionary and focused too little on the need to restore growth and provide for rising individual incomes and opportunities in these countries.

The primary focus of these programs is structural—on the promotion of policies that will promote growth by allowing markets to operate and market forces to operate. The macroeconomic aspects of the programs are designed to balance the imperative to prevent further declines in markets and a free-falling currency, on the one hand, and the imperative of avoiding further knocks to domestic demand, on the other. There is no guarantee that this difficult balance will be struck correctly. And as we go forward the United States will watching closely to ensure the right balance is being struck as conditions change and confidence is improved. But be clear: these programs are designed with one objective and one objective alone—achieving the fastest possible restoration of growth.

Where a crisis has occurred and adjustments have to be made, it is crucial for us all to recognize that these changes have to be carried out effectively—and equally critical that they be designed to promote an equitable return to growth. In fact, all of the recent programs have been designed to ensure that the necessary adjustments do not come at the expense of the poor:

- in the Indonesian and Thai programs, spending on health, education and social programs have been expressly protected from any fiscal consolidation, and where possible, efforts to target spending on the poorest segments of society have been intensified. In Korea, the program commits the government to strengthening the labor insurance system, and the promotion of active labor market policies to lessen the shock to employment due to the crisis;

- in designing programs to supplement the IMF program, both the World Bank and the Asian Development Bank have been acutely aware of the need to focus on the impact of policy on the most vulnerable, both in the new lending provided to these countries and through the restructuring of existing lending programs to promote urban and rural employment and basic health services. New World Bank lending to Thailand and Indonesia, for example, foresees upwards of $600 million in new loans for improving the social safety net in each of these countries.

Finally, and more broadly, we should remember that these programs center around the urgent need to restore confidence in financial markets—because that is the critical first step to a recovery in growth and investment. In that sense they are aimed squarely at promoting the long-term interests of workers in these countries.

Insufficient concern for core labor standards?

A closely related concern about these programs has been that they fail explicitly to incorporate requirements to improve labor standards in these countries.

Establishing core labor standards and ensuring human rights are vital to successful development—and they have been and will continue to be a critical priority at Treasury. In recent years we have made important progress in pressing these issues within the World Bank and other International Financial Institutions and we are committed to progressing further. To cite just two recent examples:

- we have secured a major World Bank effort to fight against forced and exploitative child labor, and successfully urged the World Bank to publish major policy paper on the subject and to strengthen its partnerships with the International Labor Organization and other labor organizations;
- and we have persuaded the IMF to institute a policy dialogue with the ILO and to undertake a pilot program of in-country consultations on labor market issues and worker rights.

In Indonesia, the United States Executive Director in the World Bank has specifically raised the issue of worker rights in Board Reviews of the Country Assistance Strategy for Indonesia, urging that the World Bank consider and better integrate core labor issues into its Indonesian programs and operations.

Our Executive Director to the IMF has also raised the question of Indonesian labor market practices in the context of the most recent financial package. And just last week, the United States Trade Representative raised worker right issues with officials in Indonesia, outlining an action plan for progress and setting benchmarks on freedom of association and the right to organize.

In Korea, with the strong encouragement of the IMF during their official negotiations—and in addition to the commitments to strengthen labor insurance programs mentioned earlier—the government has created a tripartite business-labor-government committee to negotiate the terms for the restructuring of Korea's chaebol-based industrial sector. This is a ground breaking achievement that puts labor directly at the table in designing the future shape of the Korean economy.

And yet, as Secretary Rubin has said, it is important to recognize that in these types of emergency situations, it is simply not feasible—and almost certainly unwise—to attempt to address these hugely complex issues at the same time as achieving all the steps needed to restore financial instability. To be effective, these programs have to focus on the immediate sources of the problem. They cannot be used as a vehicle to address the full range of other issues that are of particular concern to us, however appealing that possibility might be—much less those of the 180 odd other IMF members.

Fueling moral hazard?

In the wake of these programs, an important concern has arisen that, by providing financial assistance to these economies, the IMF—and with it the United States—may have encouraged irresponsible behavior by governments and investors in the future (the problem of "moral hazard").

Where governments are concerned, all of the economies who have had to seek IMF assistance in recent months face months of severe economic distress and implementation of difficult reforms to restore confidence. Clearly, the overall costs of the crises will far outweigh the fleeting benefit of emergency support.

In the case of investors, the situation is less clear-cut. Creditor banks and other institutions can and have taken significant losses in the wake of these crises; and in Korea, especially, creditors have shared a good part of the burden for restoring stability. One Federal Reserve estimate suggests that investors could face losses of

$700 billion following the decline in equity markets in these economies. Already, three major U.S. banks—J.P. Morgan, Chase, and Citibank—have reported that developments in Asia have had a substantial negative impact on their profits. And a story this week in the Financial Times cited a market forecast, which may or may not prove to be accurate, that European banks alone could face losses of $20 billion on their lending to Asia because of the crises.

However, it is true that in some situations providing support for countries can have the inevitable, and undesirable side-effect of shielding investors and banks from the full consequences of their actions. The trouble is that the alternative, of forcing these creditors to take losses, would raise even graver risks for long-term stability, not merely in these economies but around the world. Banks might withdraw from these economies—and, perhaps, a great many other markets, undermining the continued flow of investment funds to emerging economies and, quite possibly, the stability of our own financial markets.

We can and must work to promote investor responsibility in this new global economy: but we must do this in a way that supports rather than threatens the long-term financial stability in which American workers and businesses have such an enormous stake. In the meantime, we cannot afford to leave the IMF poorly positioned to respond to another wave of instability in Asia—or a different crisis down the road.

Imposing harsh outside remedies?

Finally, there has been widespread unease that, in designing these programs, the IMF—led by the United States—has imposed sweeping reforms without regard for the views and concerns of the governments that must implement them.

Few, if any, of the negotiations leading to the recent reform programs have resembled this description. In fact, the broad outlines of the program—and a large chunk of the specific reform measures—have almost always originated with officials in the countries themselves, many of whom have welcomed the opportunity to undertake long-sought reforms. Kim Dae Jung, the incoming Korean President published a book in 1996 making a compelling case for ending government-directed lending to industry, for promoting non-inflationary monetary policies, for keeping budgets under control, for reforming the chaebol, and for opening up these economies' financial systems—all reforms which the IMF program will now help him to undertake.

Mr. Chairman, there will always be room for disagreement about which policies are the right ones. And the United States will always have a stake in pressing for programs that reflect our core values: the importance of transparency, fighting corruption, promoting the environment and protecting core labor standards. But we will only have an effective voice in the IMF to ensure that it promotes the right policies—and the IMF will only be able to help protect the financial stability we have a stake in—if we do our part to ensure it remains adequately funded.

IV. CONCLUDING REMARKS

Mr. Chairman, these are serious crises that we have seen in Asia. Even if stability is now restored, the effects of the crises to date on the United States will be real. If the instability were to spread or intensify, the potential risks to American jobs, American financial markets and our national security could be grave indeed.

We are in a strong position to withstand the effects of these crises: our economic performance is the best in a generation and unrivaled among the major industrialized economies. The uncertainties in the situation are great: there can be no guarantee that our efforts to restore stability and minimize the effects on our economy will succeed. But—given the risks involved—we have a responsibility to do all we can to protect America's core economic and security interests, by responding to these crises and working to restore stability with the most effective mechanisms available to us.

To fail, at such a time, to fund the IMF adequately would be to take real risks. It would risk our not being able to respond with adequate financial support in the event that this crisis spreads. And it could risk a further shock to the confidence of international investors at a time of considerable market fragility. These are not risks we should take. They are not risks that the American taxpayer would want us to take—especially when we can invest in the protection of the IMF at zero net cost to the budget.

I look forward to working with you, Mr. Chairman, with other members of this committee and with others in Congress as we work to ensure that the IMF continues to promote our core interests in the months and years to come. Thank you.

PREPARED STATEMENT OF ROBERT B. ZOELLICK

Mr. Chairman and members of the Committee:

It is a pleasure to be with you today. My statement addresses four questions:

- What happened to the economies of East Asia?
- What are key developments to watch in the future?
- Why do these events matter to Americans?
- What should the U.S. be doing?

I. WHAT HAPPENED TO THE ECONOMIES OF EAST ASIA?

Each country's circumstances are different. Nevertheless, there has been one core problem throughout most of East Asia: Imprudent credit decisions have led to bad loans.

Some of the bad decisions stemmed from poor banking practices. Some stemmed from flaws in the economic policies and structures of countries. And some stemmed from political influence over lending. However, all the lending problems caused by these mistakes were exacerbated by weak supervision of banks and the lack of transparency (open information) in financial markets.

In Southeast Asia, many of the countries had pegged their currency exchange rates to the U.S. dollar. As a result, these economies were linked to U.S. monetary policies, which during the 1990s expanded credit considerably. In addition, Japanese and European banks were eager to lend. Therefore, the nations of Southeast Asia faced the risks of "easy money"—the temptation of too much borrowing and over-leverage. These risks were compounded by another risk: borrowing U.S. dollars while earning revenues in local currencies. Once local currencies began to fall in value relative to the U.S. dollar, otherwise healthy Asian companies began having a harder (or even impossible) time paying back their dollar debts.

The low cost of capital, and underestimation of risks, led to a real estate bubble in some Asian markets and the building of excess industrial capacity in others. These lending mistakes were compounded by errors of crony capitalism and corruption.

Moreover, as the value of the U.S. dollar rose, the currencies pegged to the dollar rose as well, increasing the prices of exports from those countries and lowering the costs of imports. Thus the exports from these Asian economies faced stringent competition from China, Latin America, and elsewhere. As a result, they had a harder time generating export earnings to pay back their debts.

Once the speculative bubbles started to burst, and bad debts accumulated (starting in Thailand), investors—and in particular, local investors—feared holding the Asian currencies—so they sold. As the selling momentum increased, turning into panic, investors dumped the currencies of other countries that may have had excess capacity, overbuilding, or even current account deficits that signaled the country was relying on inflows of foreign capital. Some investors sold because they feared the herd actions of other investors in smaller markets around the world that do not have the depth to resist speculation and bounce back. Moreover, once the trouble started, most Asian countries could not raise interest rates (making their securities and currencies more attractive), without causing more strain for borrowers struggling to pay back borderline debts.

Japan and Korea also faced the core problem of bad credit decisions compounded by poor financial supervision. Banking-industrial-government linkages exacerbated the lending problems in these countries; these national economic structures represent deeper problems that will not be subject to a quick or easy adjustment.

Today, Japan has a two-tier economy, composed of a small number of world-class multinational manufacturing companies and an inefficient, overly regulated, costly base of smaller businesses that have not had to compete on the basis of price—especially with the rest of the world. Ten years ago, this protected local market and its inefficient businesses may have offered the large Japanese multinationals a cushion; today, these inefficiencies are holding back the large Japanese firms.

Furthermore, the Japanese government's failure for over seven years to face up to the consequences of huge bad loans on the books of its banks has led to higher costs, suspicions about the banks' strength, limits on lending, and lack of confidence in Japan's recovery. Japan's tax increases then choked off possible growth from spending by consumers and businesses.

Korea's structural situation is even worse. The state-capitalism of the chaebol system produced: capital allocation based on political pressure; high leverage (borrowing) in cyclical industries; union expectations and practices that increased costs and priced Korean firms out of markets; the discouragement of small business; and a poor environment for foreign direct investment that brings technology, know-how, and more reliable equity investment. Korea's national economic system—which promoted large scale efforts to direct capital and labor toward basic industries for export—has been unable to adjust quickly to changing market signals.

Viewing the region as a whole, last year's financial meltdown is becoming this year's economic downturn. Over coming months, you will read more about bank closings, bankruptcies, unemployment, and recessions.

II. WHAT ARE KEY DEVELOPMENTS TO WATCH IN THE FUTURE?

Events in East Asia have been driven by a combination of market psychology and economic fundamentals. Over time, economic fundamentals should guide market psychology, but markets can overshoot and group behavior can, for a time, send markets crashing or soaring. Sometimes the sharp shifts in prices and values can become so extreme, or last long enough, that they seriously disrupt the activities of workers, businesses, and banks. Under those conditions, the psychology that drives markets can indirectly reshape the fundamental economic conditions.

Asia's longer term economic potential remains good, especially if countries make institutional reforms and establish the requisite legal and financial infrastructure. The length of this slump depends in part on how quickly countries adjust prices of assets and companies reflect the changes in their balance sheets. Delays will freeze the movement of funds that healthy businesses need. The depth of the downturn also depends on whether subsequent events subject Asia to new blows or give it an encouraging boost.

Therefore, going forward, it is important to keep an eye on developments that are likely to shape market psychology, economic fundamentals, or both. I suggest attention to five topics.

First, will Asian currencies devalue further? In particular, will countries seek to "compete" by devaluing their currencies to make their exports "more competitive?" So far, all the currency devaluations except Taiwan's appear to have been driven by capital flight. Yet if countries believe they must devalue "to catch up," their actions are likely to trigger another round of attacks on weak currencies. Indeed, this self-defeating pattern occurred in the 1930s, shattering overall confidence in money and prompting more direct forms of protection from foreign competition.

Today, the devaluation question focuses on China. China devalued its currency by about 40 percent in 1994, but that adjustment has been eroded by China's inflation and the sharp declines in currency values elsewhere in Asia. So some in China might argue that its exports—which fuel China's growth and ability to create jobs—require another devaluation. Fortunately, at least for now, the Chinese have stated they will not devalue. The U.S. and others should stress to China that this approach is an important contribution to stabilizing other Asian markets and enabling the rest of Asia to rebound through stronger sales. A devaluation by China would also probably shatter Hong Kong's ability to maintain the peg of its currency to the U.S. dollar, which is important to Hong Kong's business confidence. Another devaluation by Taiwan would also likely trigger a dangerous chain reaction.

Second, will Japan take the steps, especially through tax cuts, to spark Japan's domestic demand and growth? Japan should stimulate growth at home. In the past, Japan has usually relied on exports for growth. But that course will not create the demand in Japan to buy goods from other Asian countries that need the boost. Moreover, a Japanese export-growth strategy is likely to place trade pressure on the U.S. and Europe at a time when their open markets will be key to the rebound of others in Asia. As one colleague summarized, Japan is playing the same role in Asia today that the U.S. played in the world economy in the 1930s. That is not a compliment.

In 1997, fearing a large budget deficit, Japan's Ministry of Finance actually pushed through a tax increase. The Japanese government has now proposed a small one-time tax cut; after criticism of this proposal, some Japanese political leaders have hinted that Japan needs bigger and longer lasting tax cuts. Some Japanese business people and journalists support such economic stimulation. The U.S., others in the G-7, and countries in the region should mobilize pressure that will give these internal Japanese constituencies support for further tax cuts.

Third, will Japan clean up its financial sector and do so in a transparent fashion? The Japanese government has belatedly proposed a 17 trillion yen fund to protect depositors and a 13 trillion yen fund to recapitalize banks. (It has also eased capital adequacy tests.) This package is roughly patterned on measures the U.S. took in the 1930s.

It will be important to watch whether Japan promptly enacts this plan and how the implementation proceeds. Japanese banks are afraid to lend and investors are wary of giving the banks money. As a result, many Japanese businesses are facing a credit crunch. Other Asians are facing called loans. Japan needs to reestablish confidence in its banking system. To do so, it must face up to losses openly so that financial markets can see that the surviving (and probably consolidated) institutions can get back to business. As it confronts these challenges, Japan must also prepare the way for its banks to face outside competition. Opening its markets to foreign financial firms can help draw capital and lessen the deadweight of an inefficient domestic financial sector.

Fourth, will Korea and Indonesia follow through on their IMF plans, avoid debt moratoria, and begin to reestablish confidence? These two countries are particularly important, although Thailand and the Philippines are also working through IMF programs and other countries (e.g., Malaysia) are struggling with the financial fallout. Korea is the 11th largest economy, sitting on one of the most dangerous military fault lines in the world. A further collapse in Korea would fuel negative psychology in Asia and beyond, as well as posing a major political crisis for Korea's newly elected President, Kim Dae Jung, who takes office in March. Expectations have arisen, perhaps unreasonably, that the President-elect's influence with Korea's unions will enable him to maintain labor peace while businesses lay off large numbers of workers.

Indonesia is influential because it is the fourth most populous country in the world, giving it political weight in the region. It is also the largest Islamic nation. Indonesia's President Suharto has been in power for 32 years. As viewers of the movie "The Year of Living Dangerously" will recall, Indonesia does not have a history of peaceful political transition.

In the cases of both Korea and Indonesia, failure of IMF plans would weaken its (and the U.S.'s) credibility and ability to stabilize jittery markets. The inability to stabilize markets would increase costs, lead to the closure of otherwise healthy businesses, and delay countries' recoveries.

Fifth, will the U.S. be willing to support, and where appropriate, lead efforts to stabilize markets, press for reforms, and revive growth? Given America's size and influence, its behavior will also affect market psychology. If the U.S. appears committed to overcoming a problem, it may not be able to counter all threats, but the likelihood of success improves considerably. Moreover, the U.S. has an unparalleled ability to mobilize others to act. On the other hand, signals of indifference, or even retreat, could feed nervous markets that might slide into panic behavior. Recent visitors to East Asia report an overwhelming (and unrealistic) belief in America's ability to save the region from disaster.

Whether we like it or not, America's resources and reputation vest it with great responsibility. Asian officials pressing reforms will seek U.S. attention, encouragement, and support. Reform politicians in Thailand and Korea, just coming into power and taking unpopular actions, will think America will want to stand by them as they confront old and often corrupt power structures. And investors around the globe will scrutinize signals of U.S. commitment and staying power.

This responsibility does not mean the U.S. should try to solve all the problems by itself. The U.S. does not have the capability to do so. Moreover, even if the U.S. could handle that load, it would create a dependency that would be counterproductive for others as well as for America. So the challenge for the U.S. is determining what combination of actions is most important, feasible, and in the interests of the U.S. and the other countries. If the U.S. strikes this balance effectively, it could come out of this crisis with increased power and a better opportunity to shape East Asia's politics, economics, and security in the 21st Century.

III. WHY DO THESE EVENTS MATTER TO AMERICANS?

I suspect that the members of this Committee have been asked, and will themselves ask, how these events in Asia will affect their constituents: why does it matter to us? My reply would have three parts: (a) the big risk; (b) the economic effects; and (c) the political-security effects.

A. The Big Risk

When markets slip into free fall, no one knows where they will stop and what havoc might be wreaked along the way. Sometimes markets bounce back. Other times they recover, but only slowly. Yet at times big declines become panics, setting off massive destructive chain reactions that extend far beyond the initial explosion.

Such waves of financial and then economic destruction were not uncommon in the 19th Century, even though the world was less interdependent than today. Some of these financial events became seminal episodes in U.S. political history—like the panics of 1819, 1837, 1857, or 1873—that crippled American governments. In 1857, for example, the crisis swamped Britain, Sweden, Germany, New York, and Ohio, and then spread to the rest of the United States.

After the international debacle of the 1930s, the U.S. led the way in creating international institutions and regimes to cushion the blows, to contain their effects, and to increase the probabilities of recovery. The U.S. has used this system over the past 50 years for just those purposes. Circumstances differed in each case; remedies varied, too. But the fundamental decision was to activate the insurance policy so that a crisis did not become a calamity.

East Asia is large and important to the U.S.—economically, politically, and in terms of security. Over the past 60 years, East Asia was important enough to warrant three American wars, over 100,000 troops who did not return home, and billions of dollars of defense expenditures. U.S. interests in the region have not lessened over time.

I hope the financial situation in East Asia will stabilize. But no one can assure you of that result with certainty. And that doubt sets up the big risk: a loss of confidence that leads to a greater collapse of currencies and markets, with ripple effects turning into waves that lead to more bankruptcies and bank failures, and to deeper recessions. Such events would not only hurt U.S. exports and slow growth, but could undermine a host of business activities around the world. Such economic events, although unlikely, would certainly have political and possibly security implications. It is definitely in the U.S. public's interest to protect against this scenario.

B. ECONOMIC EFFECTS

Even the events to date, however, will affect the United States and world economies. The consequences include the following:

- The Asian economies will buy less from the United States and others, hurting U.S. exports and increasing the U.S. trade deficit. U.S. exports to Asia totaled about $200 billion in 1996, roughly 3.5 percent of America's GDP. Those sales amount to about 30 percent of all U.S. exports, more than we sell to Europe. U.S. sales to Asia range from capital goods and aircraft to agricultural products, with much in between, and support millions of U.S. jobs. Because Asia will grow more slowly—and many countries will be in recessions—overall global growth will slow, reducing increases in income and purchases around the world.
- East Asia's financial problems will spill over to other developing country markets. Asian capital invested in these markets will be needed at home. (Both Russia and China are concerned about this loss of funds.) In addition, mutual funds and other investors are now more reluctant to put money in any emerging economy.
- The devaluations and excess production capacity in East Asia will lower prices for many tradeable goods (e.g., steel, petrochemicals, electric goods, semi-conductors, footwear, textiles). This competition will hurt exports from other developing countries, particularly in Latin America and Eastern Europe. Some U.S. firms will benefit from lower prices for imports; others will face price-cutting for their goods.
- I suspect the drop in U.S. exports and the low import prices will squeeze the earnings of some U.S. companies, especially when combined with slowly increasing U.S. labor costs. I believe this slippage in earnings will show up more clearly in this quarter's results. The steady increase in corporate earnings has been a key contributor to the increases in the stock market over the past few years.
- U.S. investors in Asian equity markets, including small holders of mutual funds, have already experienced huge declines. Given these drops, some American investors will now perceive opportunities to purchase Asian assets at low prices. However, given the overcapacity, considerable systemic uncertainty, and the lack of good accounting information for most Asian businesses, the capital invested is likely to be tentative and of modest scale compared to the continued drains.
- Investors fleeing foreign securities have been turning to the "safe haven" of U.S. dollar securities, especially the debt of the U.S. government. This inflow has helped hold down U.S. interest rates and increase the value of the U.S. dollar. A higher value for the dollar makes U.S. goods more expensive abroad (cutting exports further) and lowers the cost of imports. Over time, however, if the U.S. trade deficit grows to a size considered unsustainable, investors are likely to move out of U.S. dollars, reversing the drop in interest rates.

These effects will be significant (sometimes disruptive, sometimes beneficial) for individual businesses and sectors. Given the strengths of the U.S. economy at present, however, the changes should be manageable from the viewpoint of the whole country. If the Asian crisis deepens, the risks of greater damage to the United States increases considerably.

C. POLITICAL-SECURITY EFFECTS

The political and security effects of the economic crisis in East Asia are likely to be wide-ranging, and they are only starting to be perceived. Indeed, events could follow very different courses, with contrasting outcomes. To the degree possible, the United States should be steering developments to circumvent dangers and even create opportunities out of tumult.

This crisis has severely squeezed, and in some cases wiped out, middle classes that have been developing in Asian countries over 25 years. Historically, such trauma to the middle class unleashes perilous forces. Asia's trial will be heightened because many Asian political leaders have based their domestic legitimacy on records of improving their citizens' prosperity.

One possible recourse is for people to challenge the political leaders, either promptly or during the next transition of power. Countries might move toward more open political systems and against corruption and crony capitalism. But powerful established groups usually do not cede their authority gracefully. They may substitute new faces without changing the underlying system. The old regime may hand authority to reformers who then pay the public price by taking painful steps to clean up the inherited mess. The rulers may blame outsiders—whether in the form of ethnic groups, other countries, the United States, the IMF, foreign investors, or a host of others. And they may respond to opposition with force.

Since the Vietnam War, the countries of Southeast Asia have come to recognize that each would be better off if all prospered. Through ASEAN, the Association of Southeast Asian Nations, these countries have worked together to dampen possible conflicts, build trust, and promote economic growth. But short-term crises, and the risk of losing control at home, can blind countries to their common regional interest. The combination of excess capacity and rounds of competitive devaluations could lead Asian nations down the blind alley of 1930s-era policies.

As I noted earlier, the countries of Asia are now openly depending on the U.S. for help, in striking contrast with some of the rhetoric of recent years about the decline of the U.S. economy and its decaying society. Although it might be tempting to some to "teach Asia a lesson," a policy of spite would leave a terrible legacy for the U.S. in the post-Cold War world. Indeed, the U.S. would be ignoring its own successful lesson from the far-sighted approach America chose after 1945.

Further economic and political unraveling could lead to breakdowns that would threaten American security. If the U.S. leaves a leadership vacuum in an area of strong interest, regional powers may strive to fill it on their terms. Perhaps others will resist this, or maybe no one would fill the gap, leading to regional conflicts or fragmentation. In any event, Asians would conclude that the U.S. is unreliable, undermining America's abilities to lead coalitions for causes as diverse as conflicts in the Gulf, opening markets to trade, non-proliferation of weapons of mass destruction, bases for the projection of American power, the environment, human and religious rights, or countless others. Great powers cannot ignore upheavals in regions of vital interest without giving up the influence that compensates for their labors.

Nevertheless, U.S. intervention involves risks. Some Asians might resent the U.S. as the agent of painful adjustments. Others may fail to recognize that self-help actions are critical. Ultimately, the benefits and costs for America are likely to depend on the skill of the U.S. performance and the results.

There are also specific political and security issues that could be triggered by the economic events, including the following:

- Indonesia's continuing difficulties are based in part on the uncertainty about President Suharto's future and who might follow him. Suharto recently announced his intention to stand for a seventh term (of five years) as President in the March 11 elections. Speculation about his choice for Vice President has added to the questions about Indonesia's willingness to undertake serious reforms. The future of Suharto's family, which has gained extraordinary wealth and public influence, is inevitably connected to this political conjecture. Moreover, the ethnic Chinese in Indonesia, comprising an estimated three percent of the population, control much of the country's wealth (with some reports guessing the proportion at about two-thirds). During the upheaval of 1965-66 that propelled Suharto to power, hundreds of thousands (and perhaps more) of Indonesians were killed, many of them of Chinese origin. The slaughter has been traced to fear of communism and China, but also to resentment of local Chinese wealth. Ominously, China recently issued a warning against threats to ethnic Chinese in Indonesia. Traditionally, the non-Chinese peoples of Indonesia and other countries in the region have been highly sensitive to China's possible intervention on behalf of overseas Chinese.

- Korea's President-elect, Kim Dae Jung, has been an outsider in Korean politics. Most of his statements since his election have signaled plans to implement serious economic reforms. He will certainly face resistance from the traditionalists in bureaucracies and the corporate conglomerates. At the same time, the powerful Korean labor movement, with which Kim has ties, is likely to object to the upheavals that will follow from corporate restructuring and recession. It is not yet clear whether Kim's new team will have the depth and experience to navigate these powerful, contending currents. Moreover, Korea's northern neighbor remains a heavily armed economic basket case. No one should be complacent about North Korea's political stability. North Korea has the capability, even just with conventional artillery emplaced in the north, to reduce the southern capital of Seoul to rubble. The U.S. has about 37,000 troops in Korea to help deter trouble from North Korea. Shortly after his election, President-elect Kim signaled his interest in reviving North-South talks. But the South now has many fewer resources to devote to assisting the North. Indeed, I expect Korea (and perhaps Japan) will even ask the U.S. and others to help them cover the billions of dollars they pledged to build the nuclear facilities in the North under the Framework Agreement that the U.S. negotiated with North Korea.
- The rampant corruption that permeated Thai politics contributed to the country's financial collapse. But the new Thai government appears committed to cleaning up both the current symptoms and underlying causes. The Thais have been troubled, however, by the perception of the lack of U.S. support, beginning with the U.S. failure to make even a token contribution to their financial package last year.
- Because China's currency is not freely traded in world capital markets, it has been spared financial assault. But China faces enormous economic challenges. Indeed, China's bad debt and banking problems dwarf those of countries that have been badly hit. It will now face tougher export competition and the prospect of less investment from Asia and perhaps elsewhere. Both changes will make it harder for China to close inefficient state-owned enterprises and open new businesses that will create jobs. China's leaders have so far avoided actions that might exacerbate the crisis. And they appear to recognize that China will need to combine a carefully sequenced solution to unprofitable state enterprises, existing bad debts, the absence of an effective financial system, and opening to global competition and capital. Nevertheless, China's leaders will need great skill to manage that awesome combination of challenges.
- Hong Kong, in the aftermath of its return to China, is struggling to maintain the confidence that is fundamental to its special status. Disease, a sharp fall off in visitors, and problems in the property and stock markets each have added to the burdens of transition. If the HK dollar loses its peg to the U.S. dollar, market confidence—and Hong Kong's confidence in itself—will deteriorate sharply.
- Across the region, political tensions about open trade and foreign investment will be rife. Some Asians believe that openness, competition, and deregulation will counter crony capitalism, corruption, and mistaken decisions by economic bureaucracies. Others will argue that Western capitalism is a conspiracy aimed at achieving U.S. domination, or that open markets leave their economies too exposed to market whims. Similarly, some Asians recognize that foreign investment will help restabilize markets and, over time, link their economies to more know-how, technology, and competition. But purchases of Asian assets at fire sale prices will spur resentment and tales of conspiracy, even as it has at times in U.S. history. These vitally important decisions for Asia's future—affecting political as well as economic outlooks—will not depend only on intellectual arguments. The debate will take place with a background chorus of fears, frustrations, and even bewilderment.

In sum, the economic events in East Asia are triggering a host of political and perhaps even security consequences. These developments pose risks and opportunities for U.S. policy. In considering whether to offer financial support, one should consider how many risks one is willing to multiply, given the potential consequences.

IV. WHAT SHOULD THE UNITED STATES BE DOING?

So what should the United States do? Broadly conceived, the U.S. response needs two stages: first, stopping financial contagion that makes all the other problems harder to solve and that could shake businesses, lenders, workers, and governments in all quarters of the globe; and second, laying the foundation for economic and political reforms that can only be achieved over the longer term. More specifically, I have ten suggestions:

First, the U.S. should organize a coalition—with the European Union and countries in Asia—to press Japan to stimulate its economy, preferably with tax cuts, and to clean up the bad debts of its financial sector in a transparent fashion.

These two actions would provide a big boost for market psychology and an engine of growth for Asia. They would help Japan, the region, and the world. Japan's political system appears unwilling to take these steps on its own, but there are constituencies in Japan that are supportive. If internal advocates combine with broad-based foreign pressure (not just the U.S.), there is some chance Japan might assume self-interested responsibility.

Second, the U.S. should support international efforts to help countries stabilize currencies and markets if the countries are willing to take actions to reestablish confidence and to start to address the underlying problems. Markets can and do overshoot; financial panics can crack the real economic foundations of manufacturing, services, agriculture, and other sectors. But the U.S., IMF, World Bank, and others can only assist if countries face up to the actions they must take. The U.S. should be particularly attentive to the prospects of nations whose turmoil might create security dangers and of countries led by reformers who have been propelled into office by the crisis.

Third, the U.S. should continue to signal its close attention to the security of the region. This posture may help deter problems from arising or rash moves by parties seeking to position themselves in the absence of U.S. power. It will reassure governments worried about large-scale breakdowns. And this U.S. security leadership could enhance America's leverage on political and economic topics.

Fourth, the U.S. should continue an ongoing, high-level dialogue with China about economic events in Asia, focusing on Chinese actions (especially devaluation) that would fuel the fire and those steps China can take to help stabilize the situation. This interaction may provide the basis for deeper U.S.-Chinese cooperation on resolving China's bad debt and financial problems, while gradually opening China to the international economy. This contact could lead to a mutually agreed formula for China's membership in the WTO. China is a rising power in the world, and Sino-American association during this crisis could offer a practical demonstration of our common interest in integrating China safely into the international system.

Fifth, the U.S. should demonstrate its ongoing commitment to an open trading system. Without dynamism in world trade, the countries of East Asia, and developing economies around the world, will have a hard or impossible recovery task. In terms of growth, price stability, employment, innovation, and national wealth and power, the United States has benefited enormously from the liberalized global trading system. If the U.S. now hesitates, or worse, retreats, how can we expect others to stand up to those who oppose competition? The President should promptly send to the Congress a renewed request for trade negotiating authority ("fast track"), Congress should grant it, and the U.S. should propose a liberalizing agenda in the G-7, WTO, APEC, and elsewhere to maintain the momentum for reducing barriers to trade. This agenda could provide a multilateral context (and justification) for Asian countries to open their markets in concert with the IMF-World Bank reform programs.

Sixth, the U.S. should be willing to provide financial support for stabilization and reform through the IMF, World Bank, and complementary borrowing agreements. In effect, these arrangements provide an international lender of last resort, like the Federal Reserve does within the United States, for countries facing a liquidity crisis. In exchange for the temporary loans, the countries must agree to take various actions. Although large financial institutions coping with crises inevitably will be subject to criticism, these tools are vital for coping with international financial panics. That is one reason why the U.S. urged the creation of the IMF and World Bank over 50 years ago.

In particular, I urge the Congress to grant the IMF the additional resources negotiated through the quota increase. I also believe Congress should authorize the New Arrangements to Borrow. I hope these funds will not be needed. But given the risks in the world economy today, this is not the time to add to them by leaving the lender of last resort short of funds.

It is also important to recall that the U.S. funding for the IMF is like a payment into a credit union. The U.S. receives an asset, against which it can borrow if necessary (as the U.S. did as recently as 1978). Therefore, the U.S. commitment does not increase the deficit. It is not like foreign aid. It is a form of investment or loan that serves America's self-interest. Indeed, in the 50-plus years the IMF has existed, it has not cost the U.S. taxpayer a nickel.

The IMF and the U.S. should condition their loans on the cooperation of private lenders. Private lenders can ease the payments crisis by rolling over their debts in Asia, as banks have done for Korea. These lenders are seeking to avoid a moratorium on debt payments. As part of the bargaining, lenders have sought various guarantees and higher interest rates in return for extending the riskier debt. Given a general belief that lenders should pay for their errors with losses, these financial institutions would make a mistake by overreaching in these negotiations. On the other hand, a call for the lenders to take large losses now would compound the systemic financial problem by prompting the flight of lenders from Asia and even developing countries in other regions.

Seventh, a primary focus of the IMF and World Bank should be to help the Asian countries restructure their financial systems and institute safety and soundness supervision. This is not easily accomplished during a crisis, because bank closings may provoke depositor panic. Nevertheless, a combination of consolidations, takeovers, closings and clarity on depositor protection in remaining institutions can manage this problem. The reestablishment of confidence in financial intermediaries, and the resumption of lending, is critical to prevent the crisis from spreading into a depression.

In recent years the World Bank has strengthened its capabilities to provide assistance for the establishment and supervision of financial intermediaries. Therefore, the IMF and World Bank should be working closely together. If their personnel resources are not sufficient, the U.S. should consider offering the assistance of teams from its financial supervisory offices.

Eighth, the IMF's emergency packages also have focused on macroeconomic targets—such as budget deficits and interest rates. Some critics have attacked these requirements as a threat to growth. There is no doubt that the IMF has to strike a fine balance: on the one hand, high interest rates can be necessary to keep up the value of the local currency, and big deficits (funded by printing money) might trigger hyperinflation. On the other hand, high interest rates and fiscal restraint can impede a rebound in growth. The U.S. should support steps to prevent hyperinflation, but otherwise push for sufficient IMF flexibility to enable countries to focus on the underlying financial sector problem.

Ninth, while coping with the immediate crisis, the U.S. should be leading an effort to determine what changes in the international financial system might make future crises less likely. We should also consider how to enhance the ability to deal with these situations. One possibility is to develop an international bankruptcy system to cope with such problems. A global bankruptcy mechanism would, however, subject American investors and businesses to controls that might be burdensome. Therefore, some observers have suggested more modest limitations that could be instituted in crises. Others have recommended a reexamination of the debtor negotiation arrangements used in the 1920s. And some are looking at models developed by countries with smaller capital markets—Chile, for example—to limit rapid movements of portfolio capital.

After the 1987 stock market crash, President Reagan established the Brady Commission to review and make recommendations to deal with concerns voiced at that time about the interconnection of markets and institutions. Given the importance of this topic, and the need to develop broad-based support for a workable agreement, I believe the Executive and the Congress should establish a serious commission of outsiders to review possibilities and propose alternatives. This U.S. effort might then contribute to a similar work prepared by the G-7 and perhaps other countries. This analysis might also examine the performance of the IMF and World Bank.

Finally, given the potential scope of the East Asian problems, it is critical for the President and senior members of his Administration to discuss with the American people what is happening and why it matters. Secretary Rubin's recent speech at Georgetown was a good effort, although it would have been advisable to begin a serious educational effort months ago. Secretary Rubin also needs to be joined in an ongoing and concerted way, by the Vice President; Secretaries Albright, Cohen, and Daley; and Ambassador Barshefsky. Federal Reserve Chairman Greenspan, who has earned bipartisan respect, could also inform the public. Perhaps Senators and Representatives will join them in explaining the importance of events in East Asia to their constituents. If the U.S. expects to have an effective foreign policy after the Cold War, its government will have to engage citizens on the changing dangers and opportunities. This crisis involves many elements I expect we will see again, in various forms, in East Asia as well as around the world.

I would be pleased to try to answer your questions.

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