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**“Time Bombs and Banana Peels” – Looming Global Economic and Financial Issues and
Concerns**

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The Challenge to American Triumphalism

In the last half of the decade of the 1990s, the United States was viewed as ascendant. It was virtually alone in generating a strong economy, low inflation, a roaring stock market, credible monetary policy, and a stable political configuration that was producing a remarkable budget surplus. Admittedly, there were longer-term concerns about a low savings rate on the part of American households and a sizable build-up of debt both by households and corporations. The heavy private sector borrowing supported spending in excess of the production of the U.S. economy, which showed up in large merchandise trade and current-account deficits with the rest of the world. But to global investors fearful of incurring large losses on their investments in Asia, Latin America, or Eastern Europe, the U.S. financial markets appeared insulated against the financial vulnerabilities that plagued others. During the last significant financial crisis – the Asian debt crisis of 1997-1998 that eventually spread to Russia and then Brazil – America’s financial markets were genuinely the safe haven for investors from all around the world seeking to protect their wealth.

There was, however, a dark side to the U.S. successes of the 1990s. A latent resentment toward real or imagined American hubris and arrogance, in no small measure spawned and justified by Wall Street’s long bull market run, gradually percolated just beneath the surface. Many foreign officials, editorialists, scholars, and other opinion leaders secretly hoped that something would happen to “give the Americans their comeuppance.” The collapse of the high tech bubble, and subsequent slowdown in U.S. business activity, has fulfilled those hopes.

Whether as a direct consequence or as a mere coincidence, we have seen a number of tangible manifestations of what we might call “*the challenge to American triumphalism.*” The most dramatic was the reckless harassment of U.S. surveillance aircraft patrolling the South China Sea, causing a tragic accident in which the Chinese fighter pilot was killed, the American plane only barely survived, and its crew were held captive for 12 days. Less theatrical, but similarly indicative of that challenge, was the successful effort, reportedly led by the French, to push the United States off the UN Human Rights Commission.

More such incidents are likely in the coming years.

Vulnerabilities: Actual and Potential

What do we mean by the terms “time bombs” and “banana peels”?

We visualize “time bombs” as long-standing economic, financial, or political vulnerabilities that could pose serious policy challenges if not recognized and defused early. By contrast, “banana peels” characterize those discrete, typically random, often minor events that may turn out to have dangerous repercussions. Here are some timely examples from U.S. experience, beginning with a now well-appreciated time bomb:

- Acquiescing to public opposition to building electricity generating plants created a time bomb that has left the entire economy of California at the mercy of oscillations in the cost of outside sources of power.

What about a banana peel?

- Changes in rainfall patterns in the Pacific Northwest led to a severe reduction in water flow through hydroelectric facilities, with adverse consequences on the cost and availability of power.

Let's apply these concepts to today's global economic and financial environment, starting with Europe:

Europe: One obvious time bomb is the state of the pension system. Generous promises have been made. But most pension plans are unfunded. They represent a huge potential claim on the net worth of corporations. Reforms are urgently needed, but most European governments have been slow to react.

Another time bomb that has been ticking for a long time is the Common Agricultural Policy. It creates massive budgetary costs for the EU, distorts trade, and causes frictions with trading partners, not least the United States. But its potential for disruption is highest with regard to EU expansion. Adding Eastern European countries, notably Poland, to the EU without comprehensive reform of the CAP will either break the EU budget or create severe internal inequities.

A third time bomb is the unwillingness of European governments and elites to counter public attitudes toward scientific advances in the field of biotechnology, especially with regard to genetically modified organisms. Already, the price-tag of this policy capitulation has begun to mount. That includes, with only one or two exceptions, suspension of virtually all serious pharmaceutical research on the Continent and clashes over WTO rulings against EU prohibitions on imports of genetically modified foods.

Examples of "banana peels" in the European equation are the outbreaks of mad cow disease and foot and mouth disease that have left European consumers apprehensive and even more distrustful of the "experts" who somehow were unable to prevent such developments.

Latin America: Heavy external debt loads remain the most conspicuous time bomb. The issue has been played out with the greatest drama in Ecuador, which shocked the world financial markets by essentially declaring itself bankrupt in 1999. Debt concerns continue to swirl around other countries, most recently Argentina where several observers have concluded that the debt

cannot be serviced without substantial forgiveness by creditors. Argentina's bold experiment with a version of a currency board, which effectively precludes a policy of overt depreciation of the peso, also presents something of a time bomb because of a Brazilian decision to allow its currency to float more or less freely, which then caused a substantial loss of competitiveness for Argentine producers and an economic recession in Argentina that continues to drag on.

Notwithstanding its flexible exchange rate policy, Brazil is not yet out of the woods, either in terms of meeting its debt obligations or sustaining adequate economic growth in the face of planned 20% drought-related power blackouts. Thus, it remains susceptible to shifting investor attitudes toward investment prospects.

Brazil also provides a good example of a banana peel: In 1998, a careless statement on the part of a Brazilian provincial governor threatening a default by the province on debt servicing obligations to the central government triggered a massive run on the Brazilian real. Before this event, no one participating in the financial markets would have thought that an internal dispute over provincial fiscal technicalities had the potential to ruin a nation's credit rating and precipitate a crisis that required massive external loans, backed by yet another IMF program, to bring under control.

Middle East: Turkey provides a number of actual or potential time bombs. Its multi-party and fractious political system has often proved to be incapable of adopting tough policies to contain high inflation and to stabilize the financial system. A youthful population is swayed by Islamic teachings that are unacceptable to Western-oriented military commanders. Turkish elites have staked the country's future on EU membership, but current domestic economic performance deviates significantly from EU admission standards. Turkey is a dependable NATO ally of the United States but is chastised by human rights groups (even Turkish business leaders criticize the country's human rights record). Also Turkey can't seem to find a route to peaceful resolution of its long-standing differences with Greece. Moreover, Turkish businesses, tired of bearing the brunt of U.S.-led sanctions on Iraq, are already moving gradually toward restoration of trading relations with Iran, despite ILSA constraints.

Any number of banana peels are possible in the Middle East, but one of the most pressing areas of vulnerability may be Cyprus, where Turkish Cypriots bitterly oppose the EU's plan for admitting a Greek-Cypriot led Cyprus into the EU.

There are potential time bombs in Saudi Arabia, as well. Generational change among the Saudi royal family has led to a more anti-U.S. tone in government speeches and a stated willingness to play a more independent role in the region. For example, Saudi Arabia and Iran have concluded negotiations to normalize their diplomatic and economic relationship.

As for banana peels, the Kobar Towers bombing in Saudi Arabia (and further to the South, the attack on the U.S.S. Cole in the port of Aden) vividly demonstrates how vulnerable the region is to terrorism, whether orchestrated by Bin Laden or some other group. With large numbers of Palestinians working in Saudi Arabia who are said to be increasingly disturbed by the escalation of violence in Israel, the potential for a dramatic incident is high.

Former Soviet Union: The time bombs in Russia and the other former Soviet Republics have been ticking for some time, and several have already been detonated. There was the Russian debt default in 1998, the prolonged war in Chechnya, repeated incursions in Georgia, the conflict between Armenia and Azerbaijan, and financial and economic frictions between Russia and Ukraine. For the time being, high world oil and gas prices have given a boost to Russian economic and financial conditions, but instability is bound to resurface when price levels turn down again. Perhaps the biggest test to Western policies would be an overt attempt by Russia to form a new union with Ukraine, which owes billions for past purchases of Russian gas and is nearly totally dependent on continued energy imports.

East Asia: China offers unlimited potential for economic growth, trade and investment. China also contains some of the most dangerous time bombs. State owned enterprises are bankrupt and cannot compete without substantial subsidies, many of which are provided indirectly through state-controlled banks. That has left the banks essentially insolvent. The

commitments China has made to join the WTO would eventually require a fundamental abandonment of this obsolete economic policy. But the social consequences are daunting. Already, millions have lost their jobs as state-owned enterprises have had to start adjusting. Some have found employment in the enterprise sector, but many have not. In addition, millions continue to pour into urban areas from the countryside, as advances in farming techniques reduces the demand for unskilled labor. This tumultuous internal migration, one of the most extensive in world history, leaves the Communist elite in Beijing highly sensitive to any challenge to their power. Hence, Beijing has conducted an all-out assault on the outlawed Falun Gong, persecuted religious figures, and arrested American citizens of Chinese ethnic origin on trumped-up spy charges. The perceived threat to the political elite also explains China's unilateral policy of imposing a 200 mile offshore limit for navigation, several times international norms. This has been dismissed by the United States as patently unacceptable and all other nations in the region have concurred.

The recent incident with the U.S. surveillance plane has damaged U.S.-China relations is serious, but the damage would have been far worse if the U.S. crew members been held as hostages indefinitely and if the Bush Administration had imposed economic and financial sanctions similar to the Iranian freeze of 1979.

Conclusions: The United States has enjoyed a glorious and financially rewarding period. Significant and widely held doubts about the strength of U.S. institutions and its economic model (especially, as compared to Japan's) were put to rest, and the U.S. ability to innovate and generate enormous returns to investors was the marvel of the world. But things have changed; now we have moved into a different, more ambiguous and more dangerous period. Respect for American ways of doing things has frayed, although it has not yet been eclipsed by an alternative model. International willingness to go along with U.S. policies has decidedly diminished, whether in the area of trade policy, international taxation, environmental restrictions, or national missile defense. And vulnerabilities, both long-standing and emergent, will test business corporations and financial institutions alike.

In short, it is a terrific time to be in your business, the business of dealing with bankrupt companies and insolvent financial institutions!