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Keynote Address:
"Time Bombs and Banana Peels-Looming Global Economic and Financial Issues and Concerns"

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The business cycle of the 1990s put the U.S. in a position of ascendancy; the cycle was good for our economy and good for our stock market. We were the magnet for global investment flows. We were the safe haven. We had the political system that seemed to be stable. We had both a broad consensus on macroeconomic policy and an independent central bank. Alan Greenspan's leadership at the Fed was leading to low inflation and strong growth. We had a commitment to budget discipline and we ended the decade with a very substantial and enduring budget surplus, which would have been unimaginable in other times. If I had gone to a group like this ten years ago and said that within ten years we were going to have a budget surplus of over two hundred billion dollars, I would have been considered a hopeless case. Today, we have a commitment to open markets and a bipartisan acquiescence to business reform. American businesses have taken the lead in transforming themselves. Though some of these reforms have been done under the threat of insolvency and bankruptcy proceedings, many have been undertaken as a result of objective calculations of how a company could best survive. The widespread success of American business in the last decade has led to a certain amount of hubris on the part of Americans. As a result, many nations, particularly in Europe, have started to resent American success and have hoped for an event which might check that success: a time bomb or a banana peel.

For our purposes, a "time bomb" can be defined as an area of economic, financial, or political vulnerability that could pose a serious policy challenge if not recognized early and acted upon. By contrast, a "banana peel" connotes a seemingly minor event that happens either randomly or accidentally but that can have a very dangerous repercussions.

One of the best examples of a time bomb is the European pension system—it is largely unfunded, each country has its own set of problems that need its own solution, and the general public has not been alerted to the significant changes that are required. It is a problem that Europeans will eventually have to deal with more forthrightly than they have up to now. There are many other such economic and financial time bombs all over the world.

One of the most obvious banana peels of recent months has been the California electricity crisis. The lack of rain and snow in the Pacific Northwest diminished the availability of hydroelectric power to supply the incremental energy needs of California and resulted in a big power crisis. In this case, a time bomb was also present in the form of an unwillingness, either because of shortsightedness, a lack of political courage, or both, to build enough power plant capacity in California to meet the needs of the state.

The same sort of thing is unfolding in Brazil right at this moment. Brazil's absence of rain coupled with its dependence on hydroelectric power has necessitated a systematic nationwide electricity rationing program predicted to last at least six months. Banana peels tend to show themselves suddenly and unexpectedly.

Having introduced the concepts of time bombs and banana peels, let me begin by explaining the situation in the United States and how developments in this country will lead to problems for the rest of the world. In a word, the high-tech bubble is in the process of bursting. Business fixed investment was the leading sector fueling growth during the long economic expansion of the 1990s. This is evidenced by the pronounced increase in capital spending as a percent of the GDP. Especially strong were purchases of producers' durable equipment (PDE)—meaning all the equipment that goes into the factories and offices aside from the actual buildings themselves. PDE has two components: high-tech and low-tech. During the boom of the late 1990s, the high-tech component mushroomed. From little more than one and one-half percent of GDP, the ratio surged to seven and one-half percent of GDP by 2000, an unprecedented rise. On the other hand, investment in low-tech PDE, which includes such traditional capital goods as stamping machines, milling machines, and oil refineries, has stayed essentially stagnant at around four and one-half percent of the GDP. So what we experienced was a huge lift in high-tech investing, which is now in the process of slowing very suddenly, if not ending entirely.

There are three principle elements which have contributed to the boom and bust nature of the high-tech growth bubble. The first is Y2K. Before the year 2000, software programs all over the world were at risk of being destroyed, or at least badly mangled, by date-related glitches, and as a result there was a huge build-up of capital expenditure in order to obtain and effectively operate new Y2K-safe software. But this date scare was a single event with a definite time-horizon, and once the Y2K problem was solved, some portion of high-tech capital expenditure had to be phased out.

The second temporary factor that created a transitory bulge in high-tech capital expenditures was the one-time nature of website construction. Within a four year period, from about 1996 to 2000, nearly every corporation, law firm, government agency or non-profit organization, small or large, built its first website. That was an expensive undertaking, requiring large outlays for both the software and the hardware, the routers and the servers which make it possible to connect to the Internet. But once you have built your first website you do not have to build another one right away—you can improve the existing one. In fact, your customers probably would prefer that you not build a brand new one because once they have gone through all the wear and tear on their psyches of learning how to use your first one, they probably would rather not have to do that all over again! So unless your first website was a dismal failure, you are actually better off not replicating the initial investment.

The third factor behind the high-tech bubble was the broadband buildup. All kinds of companies participated in that buildup in this country, many of them with little or no actual experience in telecommunications. Many companies simply had unrelated systems, such as natural gas pipelines, which could be used as carriers for fiber-optic cables. Up until now, most of that investment has proved to be misguided. Notwithstanding the breathless predictions of Internet evangelists, household-sector demand for broadband has not materialized. Moreover, scientific advances permit more signals to be compressed through optical fibers, thereby effectively magnifying further the excess capacity that weighs on the industry. Educated estimates indicate that at most 10 percent of broadband is in use.

These three elements were major contributors to the spike in high-tech investment expenditures at its very peak. Right before the bubble burst, growth rates in real terms were close to twenty percent per annum. By early 2001, growth had been halved to ten percent, and all the information now available suggests that growth will slow further. This change is of monumental importance to the whole world because of its effect on trade. Countries in East Asia are heavily involved in the manufacturing of the components of high-tech. In many Asian countries, there have been absolute declines in the production of electronic equipment, and this loss of industrial output presages substantial drops in overall economic growth rates. South Korea, China, Malaysia, and Taiwan have all been victims because of their high concentration in manufacturing the electronics that go into high-tech goods. That lack of production diversification was a time bomb that has now revealed itself. This is especially significant because many of the manufacturing companies hit by this shift were the same companies that were hit by the Asian debt crisis of 1997-8. These companies had not quite made the necessary transition; some progress had been made, but not enough. The collapse of demand for high-tech capital goods in the United States is beginning to reignite financial problems for many companies in East Asia.

Even the most optimistic market participants focused on Asian investing—and many are still very optimistic for the long-term—are scaling back their investment programs because of these risks. This cutting back of investments in East Asia will further expose some of the fundamental weaknesses in the region. For example, in China the shift away from established state-owned enterprises will be a major source of worry for the long-term, both with regard to Chinese politics and to Chinese banks. For you at the International Insolvency Institute, the Chinese banking system could be seen as the "mother" of all looming insolvencies.

Now let me shift back to address other vulnerabilities on the U.S. side. Real disposable income in the United States fluctuates quite sharply over time, even during economic expansions. But ominously over the past few months, the growth rate appears to have stalled altogether. This is not to say that the U.S. economy has plunged into a full-fledged a recession; in fact I do not think we are in one and I believe that because of policy initiatives already taken by the Federal Reserve and the U.S. government we will be able to avoid a recession. But there is no doubt whatsoever that the growth pause we are in could continue for some time.

Another potential problem is the trend towards a lower and lower personal savings rate in the United States; this could easily end up as another true time bomb. Why is it that the personal savings rate—as measured by the government—is negative? It is because people have been rapidly increasing their debt. The financial system is very open and free in our country, and ordinary people have ample access to credit and are able to borrow. Sometimes they borrow against income, normally by using their credit cards. Others borrow against their stocks. But most often Americans borrow against their houses.

What does this new climate mean for the household sector? The ease with which the American public has recently been able to increase its debt against the housing stock, through both mortgages and home equity loans, makes for a potential time bomb of insolvency for the household sector. As long as the housing market and housing prices hold up, it does not matter what happens to the stock market, because by and large the public here is not borrowing against stocks, but against their houses. However, if housing prices were to crack, the U.S. economy and financial system would be in serious trouble. Such a crisis has happened before, but it has usually been geographically localized. In the 1980s we had these issues in Oklahoma and Texas because of volatility in oil prices; we also had them in the New York metropolitan area at the time that the junk bond market collapsed and commercial real-estate problems developed. Though there are these specific examples, a nationwide housing price shock has not occurred since the 1930s.

Housing values have done exceedingly well, so the borrowing, on the whole, has been sustainable. While people ought to be able to make their own decisions about how they manage their lifetime consumption; the recent bulge in consumption relative to savings is probably not sustainable for the long-term. At some point, U.S. consumers will start saving more, and U.S. growth prospects will be further reduced, resulting in a negative feedback on other countries—particularly in Asia and Latin America.

Like U.S. households, U.S. businesses also dramatically increased their indebtedness during the boom years of the late 1990s and into the year 2000. This extra borrowing partly reflected the ambitious capital expenditure programs they had embarked on, which in aggregate created a large financial requirement than could be financed through the cash profits that companies were able to generate from their existing operations. This discrepancy between what companies earn in their cash flow and what they invest in capital spending is called the "financing gap". This number has exploded in the last five years. Yet, in addition to this already worrisome financing gap, many businesses have increased their debt in order to directly or indirectly buy back their stock. Corporations have bought back shares on a massive scale, averaging some two hundred billion dollars per year during the bubble years, with net withdrawals of equity totaling over one trillion dollars over the last five years. This overall increase in the indebtedness of the U.S. corporate sector represents a vulnerability that may well come to haunt us all within the next several years. A splurge of investment spending financed by debt instead of cash flow has already caused trouble for many high-tech companies—just this year, PSI Net and Winstar have already been victims. While companies with solid capital and financial management are in reasonably good shape, air pockets do exist – a time bomb in the making, perhaps.

The saving grace is that the Federal Reserve has carefully monitored these events and Alan Greenspan, Chairman of the Federal Reserve, and his colleagues are aware of the vulnerabilities and have already brought down short-term interest rates substantially. Lower interest rates will immediately help well-run companies. But, troubled companies will benefit much less. The interest rates they face in the capital markets when they seek new borrowings can stay high, even as the rates paid by top quality credits decline, because investors demand a greater cushion to protect themselves against potential default. And for the riskiest companies, access to new credit can disappear entirely—no yield enhancement is enough to induce investors to put fresh funds with an overextended company.

Some would argue that another potential time bomb is the large and growing U.S. trade deficit. Others would deny that the trade deficit represents a genuine threat. This is not a new debate and so far the evidence has been largely on the side of the latter. However, concerns about the conditions under which the trade deficit is financed are not groundless. There have been episodes in the past when the financing of even far smaller deficits has been a source of tension in financial markets requiring wholesale revisions in U.S. economic policies. [The most dramatic of these episodes was in 1978, when the Carter Administration launched a comprehensive program to defend the value of the dollar after it had been subjected to severe pressures in the foreign currency markets.] Since the debate over the significance of the trade deficit will not soon be put to rest, it is probably instructive to summarize why some think it could be a time bomb. Over the past five or six years the rest of the world has increasingly demanded U.S. financial assets, and Americans have demanded products and services of the rest of the world. On the whole it has been a fair trade, because U.S. financial markets have been more stable and have yielded higher returns than others have been able to yield. U.S. consumers and businesses have also benefited because of low-priced imports and capital goods. This trade has held down the U.S. inflation rate and has helped allow the Federal Reserve keep interest rates low. But while virtuous in the short run, this cycle has left us with a formidable current account deficit which requires financing. That was accomplished rather effortlessly when U.S. asset prices were expected to rise and the dollar was expected to stay strong in the foreign currency markets. But if doubts emerged among investors about financial stability or about the commitment of the U.S. Government to a reasonably strong dollar, there could be a sudden recalibration of investment opportunities and risks comparing the United States to other major industrial countries. Then the potential for a sudden shift from capital inflows to capital outflows could roil the financial markets.

There are other possible sources of vulnerability in the world economy. Oil prices have been high, volatile, and largely unpredicted in recent years. There is no real consensus on what will happen to oil prices from now on. Meanwhile, the prices of every other type of commodity have weakened over the last few years, leaving quite a number of countries that are commodity dependent—producers and exporters—in considerable financial trouble.

Many of these commodity-dependent countries are in Latin America and have suffered because of these prices. Several of these nations have attempted to remedy their problems by putting in place Western-style, market-oriented financial disciplines and scrapping traditional interventionist approaches that underlay the traditional strategies of Latin American governments. Unfortunately, investors cannot take for granted that monetary and fiscal austerity can necessarily survive the winds of political change.

On top of this standard policy dilemma, the largest and most important Latin American country, Brazil, is facing cutbacks in electricity use much worse than those in California. The latest 2001 economic growth forecast for Brazil was reduced by two thirds from 6% to 2%. A 2% growth rate prediction may be a bit on the pessimistic side, but the range of revisions is reflective of a genuine concern over the impact of electricity rationing in Brazil over the next six months— surely a banana peel to the Brazilian economy.

Argentina has maintained a currency board system in order to deal with its long-term inflation problem. Although an ambitious program, the fixed link to the U.S. dollar that it has entailed has left a lot of Argentine companies in an uncompetitive position. They are increasingly vulnerable to big swings in economic activity elsewhere, especially in neighboring Brazil. Because Argentina's economy depends to a large extent on the Brazilian economy, the success of this system has yet to be determined.

Elsewhere in Latin America there are many economies suffering or at risk of suffering economic or political turbulence. In Colombia, violent internal convulsions make for an uncertain economic environment, despite the support the U.S. has provided. In Venezuela, President Chavez's unorthodox actions will determine the future of the country and of the economy.

But the country that worries me most from the point of view of both time bombs and banana peels is not in either East Asia or Latin America. It is Turkey. Turkey has been, and will continue to be, a very interesting test for the new Bush administration. Initially, the Bush administration was vocally against IMF bail outs. The first opportunity for them to show what they really meant came with Turkey. Turkey had been plagued by inflation for many years, and finally, in December 1999, Turkey signed an agreement with the IMF in order to help stabilize the situation. But, Turkish politicians never took the agreement seriously and within nine months its banking system was in ruins. After four or five months of slow changes in political mentality, Turkey pleaded for a new IMF program. And despite the Bush administration's stated policy against bail outs, they basically did exactly what the Clinton administration had done with Turkey—ask the IMF to write a big check.

The Bush administration's behavior on the Turkey issue raises larger questions about the future: how will our international financial arrangements work; and how is discipline going to be exerted— through the market or through the bureaucracy of the IMF? Getting the balance right will pose a stern challenge to the administration, because there are dangers in relying exclusively on either.

Though these remarks have painted a somewhat negative picture of the world, I don't see all negatives. There are some positives. Europe, while slowing down, is making some progress toward genuine restructuring of its economy. European companies are consolidating, divesting, and changing. Japan has also taken a big step in the direction of reform by selecting Koizumi as prime minister. After years of shying away from reform out of fear of its negative consequences, the current popularity of Koizumi is evidence of a fundamental shift in Japan. While the other candidate for prime minister, Hashimoto, would have basically tried to muddle through without any substantive reforms, Koizumi has rejected that as an option. And this new approach has been accepted despite the fact that it will probably cause more pain in the short-term for the Japanese population than the alternative.

I was in Japan in March and talked to a lot of people in government, parliament, and business, and they all impressed upon me the urgent need for reform. In their opinion, there is no time left for Japan; reforms have to be made as soon as possible. So in the short-term Americans, Asians, and investors from all other nations, will have to live through this transition in Japan. But as we saw in Mexico, when you have a reform-minded leader with public support, such as President Vicente Fox, that leader can act as an agent for change. If it could be confirmed that Koizumi is that change agent for Japan, then my outlook would be even more optimistic for the region.

But, in the current state of uncertainty, I must end by saying that you at the Institute for International Insolvency are in the right business at the right time—there will be plenty of opportunities to deal with insolvencies as at least some of these time bombs explode and governments and companies slip on a few of these banana peels.

Questions and Answers:

Question: I have been reading about the trade deficit as a coming time bomb as long as I've been practicing law— do I need to worry about the trade deficit time bomb exploding during my lifetime or can I leave this problem to my descendants?

Answer: How worried you should be depends entirely on the behavior of the financial markets, rather than on the magnitude of the trade deficit itself. When I worked briefly in the Carter administration, the trade deficit was a major concern, though it was only about one-tenth the size it is now. The U.S. dollar had just gotten hit by substantial capital outflows—to put it simply, when the Saudis and other large oil producers decided they could no longer accumulate dollar assets indefinitely without some assurance that the exchange rate for the dollar would not be allowed to depreciate sharply. The result was a substantial financial crisis in 1978, in which the U.S. financial authorities approached the IMF for support and decided to issue foreign currency-denominated bonds to offer some exchange rate protection to creditors. While the policy worked well for a period of time, it did not fully restore market confidence. As the U.S. rate of inflation started to climb, conditions in the financial markets soured. Eventually, it led to the hiring of Paul Volcker as Federal Reserve Chairman. According to contemporary accounts, he was not President Carter's first or second choice because his appointment would almost guarantee a significant tightening of monetary policy. But at that point, the White House understood that a new monetary policy approach was necessary in order to repair confidence in the foreign exchange markets.

This time around, we have been very fortunate. Global investors have taken for granted that when push comes to shove, Federal Reserve Chairman Greenspan will have the authority and the flexibility to do whatever is needed to stabilize the value of U.S. financial assets.

But looking ahead, downward pressures on the value of the U.S. dollar are not outside the realm of possibility. While such pressures do not happen frequently, if foreign private sector investors become nervous about the value of the dollar, massive outflows can materialize very quickly. And the fact that the United States has to attract an additional $500 billion per year of fresh capital from private and official sources to finance the trade deficit is a somewhat daunting prospect, because foreign investors already own a net of $3.7 trillion of U.S. financial assets. Of that, foreigners own $1.2 trillion of U.S. Treasury securities, accounting for over a third of the total outstanding. Should foreign investors decide it is time to diversify their assets among other major currencies, as most textbook theories of diversification would recommend, then our financial markets would surely be at risk.

Question: You mentioned that the decline in the savings rate and the rise in principle debt could be seen as a ticking time bomb. Is the time bomb contingent on whether the borrowed money is used for consumption or for investment?

Answer: In the past three years, household debt, including mortgages, home-equity loans, credit card debt, car loans, and the rest of consumer credit, has gone up about 8.5% each year. That is well above the growth in personal incomes. The number has grown faster than the value of homes has risen. So, yes, if households invested the proceeds in the finest new biotech company that's just coming out with something that's going to cure a dreaded disease, then undoubtedly the investment was a wise move and economically sound. But that kind of open-and-shut case is rare. We can't assume that all people made the right investments with the money the borrowed. Some did, but some didn't.

Usually, the most we can hope for is that households are borrowing as wisely as possible based on a thorough examination of risks and opportunities. But I'm worried that a chunk of this build-up in consumer credit has been spent late in the surge in the high-tech wing of the stock market, basically because of all the hype. On a mark-to-market basis, a lot of money has been lost. Now consumers taken in aggregate are being bailed out by the fact that housing prices are holding up. So that's why the household debt build-up is a time bomb and not an immediate crisis. If housing prices normalize, then this benign situation can continue.

As an aside, I think that in the short-run much of the tax cut is going to be devoted toward repaying part of the bulge in debt. If that turns out to be the case, then the rebate checks will not produce a big spike in consumption in the latter part of this year. If people do pay down debt, that is useful over the long-term.

Official statistics sometimes fail to distinguish what portion of household expenditures count as pure consumption and what part has a substantial investment content. For instance, if a family buys a personal computer, that purchase is counted as consumption, but it is hard to say whether it should be treated exclusively as consumption. To be sure, a lot of what PCs are used for is entertainment, but at least some portion serves an educational purpose. To the extent that PCs are educational then they definitely should count as investments in human capital, much like any outlay for educational expenses. So we shouldn't be doctrinaire on this matter of whether households are borrowing to consume or to invest.

Question: You mentioned a good number of different places around the world when you made your comments. You didn't mention anything about Russia or Eastern Europe. Would you make some comments about them and how they fit into the larger picture?

Answer: My view of Russia is that it may be in the process of trying to reassemble an empire, but in an astute manner by applying economic and financial leverage rather than military leverage. Take for example the case of Ukraine. The Ukrainians are broke. They owe the Russians close to four billion dollars for natural gas— a debt which has been unpaid for several years now. The Russians are exerting influence over the Kuchma government in a variety of ways. Former Prime Minister Chernomyrdin has been posted as Ambassador to Ukraine; sitting there in Kiev he has the ability to play a formidable role in the decisions of the Kuchma regime. A similar story is being played out in Georgia. These events make it possible to envision a scenario in which the Russians use what we call debt-equity swaps to reassert Russian control and put together their own kind of Eastern European Union.

But what about other, more advanced countries in the region: what about Poland, what about the Baltic countries? The Poles, already in NATO, are now determined to secure admission to the EU. The Baltic states want to join both.

But you've got a time bomb there in the form of the EU common agricultural policy. We could do a whole separate talk about the frictions agricultural policy causes with regard to EU expansion to the east. That is because EU expansion cannot proceed in an orderly way without the current membership of the EU doing something to reform the common agricultural policy. The French appear to be dead set against any meaningful reform.

On top of this, there is the latest development: Irish voters have turned down the referendum needed to implement the Nice compromise on revising EU governance procedures. This proves that it can be very difficult to sell change to Europeans and that one small country's voters can essentially impede the course of reform.

It is now uncertain what will happen as Russia works on reestablishing its authority in the eastern end of Europe and begins to demonstrate its power in nonmilitary ways. Will Russia's approach open up new conflicts within the region? Will this become an even more dangerous part of the world than the Balkans?

From the perspective of the United States, the issue may seem remote. After all, the primary impact will be on the Europeans themselves, so long as the rivalries stay in the economic and financial realms and don't seep into the foreign policy or national security area.

But this is not to say that the region looked at more broadly is of less importance to the United States. Turkey is especially vital. It is possible that the reason why the new Bush administration was willing to go along with the IMFarranged financial package so readily and without insisting on onerous conditions is that it believed Turkey to be too important strategically to be viewed as just another IMF client. The United States surely desires a strong Turkey in order to counterbalance a reinvigorated Russia. Although Russia was on its knees financially a couple of years ago, oil and natural gas prices are now high and show every indication of remaining high for some time. Given its energy-based economy, Russia will soon be feeling its oats.