

# **Implications of the Turmoil in World Markets**

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before the Committee on Banking and Financial Services  
of the U.S. House of Representatives

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Mr. Chairman and Members of the Committee:

I am pleased to take part in the Committee's hearing on the implication of the turmoil in world markets precipitated by the crisis in East Asia.

I will highlight four general observations of what is at stake for the United States and then note six particular issues that I hope will be of interest to the Congress. I will conclude with some suggestions for action.

First, the experiences of 1998-1999 will be the epic event in the lives of a generation of Asians. Much of Asia's emerging middle class—families who built their livelihoods over decades—has been wiped out; almost overnight, tens of millions found their expectations for a better life eclipsed by the specter of poverty. Just as America's actions in Europe 50 years ago established the foundation for a lasting transatlantic partnership, America's performance right now will shape Asian impressions for the next century.

Second, the political and security repercussions of these economic events are far from determined. The extraordinary economic success of East Asia over the past 30 years was part of a much larger process of building nations out of colonies and establishing the legitimacy of regimes and leaders. That legacy is now in question. The initial assumption by some that the crisis would propel these countries toward greater openness, cleaner governments, and democracy could turn out to be way off the mark. As economic consequences follow the financial upheavals, more people will lose their jobs, more companies will shut down, and more families will struggle to scrape out livings. Governments in Asia, Russia, and Latin America—like those in Europe and America in the 1930s—will be tempted to blame others; harsh voices will demand protectionism, raise ethnic animosities, and stir the cauldrons of xenophobia and arch-nationalism. Rather than embrace Western or American models, people may attack them. The global trend toward democracy and market economics—the fruit of the Cold War victory—is now at risk.

Third, and of special interest to this Committee, the crisis has underscored the critical function performed by banking systems in all societies. The failure of banking systems around the world is more than an economic problem: It is a violation of public trust. Until that trust is restored—and until banking systems are recapitalized—people won't put money in banks, and banks will not be able to fulfill the critical role of intermediating between domestic savers and those who need capital to make and market goods and services.

Fourth, even in the midst of this economic and political tumult, the United States must keep an eye on the security context. Security is like oxygen; one only notices oxygen when it's in short supply, and then one can't think of anything else. We are on the frontiers of trouble on a number of fronts. Now that Iraq has thrown out the UN inspectors, and given the leakiness of the economic sanctions, it is only a matter of time before Saddam Hussein develops weapons of mass destruction. And there can be no doubt that someday Saddam will try to use his weapons for revenge, domination, and killing. At the same time, North Korea seems convinced that its tests of missiles, and its threat of weapons of mass destruction, will enable it to blackmail the world. You can be certain that others are watching closely to see whether this formula of threats and weapons pays off. The nuclear tests in India and Pakistan also heighten the risk of destructive war beyond anyone's control.

Turning next to six specific problems I would like to bring to your attention—One, we must expect that Japan, representing about 70 percent of East Asia's economy, will not be a locomotive of growth for the region. The question now is whether Japan will take actions to begin its slow recovery or will slide further, dragging the rest of Asia down with it.

Two, China's growth is slowing, undermining the government's ability to create new jobs to replace those that will be lost when the state-owned enterprises are reformed. The huge bad debts in China's banking system could also overwhelm the moves toward markets. Since the Chinese government's political legitimacy today rests significantly on economic performance and nationalism, one can expect the government to balance reforms with the avoidance of social risks. I suspect China will continue to address the state-owned enterprises and banking system because the government recognizes the vulnerabilities created by these problems, but it will proceed more cautiously with openings to the outside.

Three, the stakes are high in Indonesia, the fourth most populous country and the largest in the Muslim world. Indonesia, a country of 13,677 islands stretching across over 3,200 miles, is astride the primary route for oil to East Asia. Indonesia has also been the cornerstone of the Association of Southeast Asian Nations (ASEAN), which has kept the peace among its members and has provided a useful brake on a possible assertion of China's rising power in the region. But Indonesia will not have an economic revival until there is political stability, and there will not be political stability if Indonesians cannot get food. That will be a serious risk this winter, because of high prices, shortages, and breakdowns in the distribution system.

Four, a great deal rests on the success of President Kim Dae Jung in Korea, a strategic peninsula where the interests of the United States, China, Japan, and Russia all intersect. President Kim has initiated impressive reforms. But the President's highly personal approach to governing leaves him with a heavy load to carry, and has already borne much stress over his 70-plus years. Although some foreigners have invested in Korea recently, the rate of return on capital in Korea's heavy industries has been abysmal, suggesting that Korea's businesses are going to have to accept much lower prices for their assets to draw investors.

Korea's economic revival also depends on the value of Japan's yen. As one Korean summed up the problem: Korea's business strategy has been to produce goods like those manufactured in Japan, but at 95 percent of the quality, to be sold at 85 percent of the cost; at some point between 140 to 150 yen to the dollar, he added, the Korean producers will fail.

Moreover, North Korea will add to the burden in the South. Despite an estimated two million or more deaths due to starvation and malnutrition (out of a population of 21 million), North Korea shows no sign of improvement. Its treatment of aid agencies is leading these groups to throw up their hands in frustration. There will be no "soft" landing in the North.

Five, as we have seen over the past month, the fall in commodity prices (especially for oil producers) and the retreat of skittish capital from emerging markets has begun to drag down Latin American governments, even those that have pursued respectable reforms. Despite difficult steps after the peso crisis of 1994 which helped Mexico bounce back, President Zedillo's government must now contend with external forces that are dragging the country down. The slowdown will make it harder for Zedillo to work out reforms with Mexico's first opposition-controlled Congress, especially with the approach of Mexico's Presidential elections in 2000.

In South America, Brazil (which has a Presidential election next month) has hiked interest rates to hold off the assault on its currency, but the country's reserves continue to slip and its persistently large budget deficits require financing. If Brazil is forced to devalue, the change will wreak havoc on Argentina. Argentina's substantial exports to Brazil would be hurt by Brazil's devaluation; Argentina could not match the reduction because its currency is linked tightly to the dollar's value through a currency board. So we could see a clash between the policy of regional economic integration and the policy of currency stability through the dollar link. Brazil is the world's ninth largest economy and has half of the continent's population. The United States exports more to Latin America than it does to Asia, and U.S. banks are significant lenders in the region.

Six, events in Russia have shown dramatically how the financial contagion will penetrate points of vulnerability, expanding the cracks until political and economic structures break. Although Russia pursued macroeconomic reforms to lower inflation and steady its currency, the country did not make sufficient headway on creating competition, effective property rights, or a fair system to generate revenue. Today, the average Russian

associates markets and capitalism with monopolies and oligopolies, corruption, crime, the breakdown of society, and a vast gap between a few very rich and very many poor. Moreover, President Yeltsin, ruling by decree, never built a political base through a national party or by negotiating coalitions in the Duma. So when troubles hit, Yeltsin had no backing to mobilize. We are now witnessing a new struggle for power, which will be played out first in the weeks ahead and then (one hopes) in the Duma and Presidential elections of 1999 and 2000, respectively.

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At the end of the Cold War, some observers concluded that America could “come home” and that foreign policy was a luxury. We have just seen a large reversal of fortune in countries where the vast majority of the world’s people live. And the turmoil is not finished. If you consider the myriad implications of these conditions for the United States—on your states, districts, and constituents—I hope you will conclude that our country cannot afford to let events take their own course. As Chairman Greenspan pointed out recently, we cannot expect the United States and Europe to remain as oases of prosperity, untouched by the storms raging around the rest of the world.

The very interconnectedness of these topics will require the Executive Branch and the Congress to do a better job of fashioning common responses. There is **no** other country that can play this role.

In closing, I would urge the Congress to consider the following:

- The Congress should work with the Administration to develop a major humanitarian relief program for Indonesia. This initiative would send a powerful, symbolic, and practical message about America’s concern for the plight of average Asians—not just officials and business magnates.
- Given the risks of further financial and economic turmoil while Congress is out of session, I urge you not to leave the IMF’s coffers empty. If Members believe their questions about the IMF’s performance—or even its proper role and missions—have not been answered, you may wish both to pass the capital replenishment and establish a top-flight outside commission to examine these topics and report back to you. Such a commission might be an important step in rebuilding the IMF’s political legitimacy with the Congress.
- The United States should be a force for trade liberalization to counter the inevitable impulses of protectionism that will arise. If America, the wealthiest and most powerful nation in the world, is unwilling to back open markets with deeds, how can one expect Asians, Latin Americans, and Russians to believe U.S. reform rhetoric? Therefore, I urge Congress to pass trade negotiating authority for the President.

- At this point the most effective way to press Japan to pursue banking reforms and a growth package is to embrace Japan's legislative program in order to give it more momentum. For example, Members of this Committee might visit Diet Members in Japan to convey your concerns directly but also to apply your experience in cleaning up financial systems. In a break from the past, some Diet members are now shaping policy. Many of you could offer useful advice from the U.S. experience to your Japanese colleagues on how to implement the new statutory authority effectively—for example, how to combine protection of depositors and preservation of credit services with the closing down of bankrupt institutions and the disposition of assets. Just as it took the United States years to launch the RTC, so the Japanese banking supervisors are far from ready to put the proposed laws into practice.
- Finally, the United States should pursue policies at home that will maintain our dynamism, adaptability, and growth. As this Committee knows well, market developments have been bypassing our Depression-era banking and financial services laws for almost 20 years now. If the Senate acts on the House's financial modernization bill this year, I hope the Congress will send a final bill to the President for his signature. This action will demonstrate to the world that the United States is willing to act on its own advice, and that America recognizes that the safest course in the world economy is to move forward, not to stand still.

I would be pleased to try to answer any of your questions.