

Dangers Lurk In the Global Economy

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When the world's top financial officials begin gathering today in Hong Kong for the annual meeting of the International Monetary Fund and the World Bank, they are likely to express considerable bullishness about the world economy. The World Bank's newest report, for example, is projecting growth between 5% and 6% in the developing world for decades to come. But significant dangers threaten the optimism and prosperity to which we in the U.S. have become accustomed.

It is true that among all countries, the U.S. stands out for its stellar economic performance--low inflation, low unemployment, a vanishing budget deficit, a strong currency, a booming stock market, steady growth. The new Fortune Business Confidence Index shows an unprecedented 90% of the executives polled expressing confidence that the economy will continue to expand over the next few years. The Conference Board's consumer confidence index is close to a 28-year high.

But do the finance ministers and central bankers in Hong Kong realize how easily it could all turn bad? Do Americans pouring money into overseas mutual funds, and U.S. firms making large bets on foreign markets?

Financial Turmoil

Start with the situation in the much-heralded emerging markets. It is in these high flyers that U.S. investors have been banking on expanding markets and high returns. In 1996 the U.S. exported goods and services to emerging markets worth as much as exports to Europe and Japan combined. Between 1991 and 1996, when the annualized return of the Standard and Poor's 500 was 15.2%, Indonesia's stock market returned 19.4%, Brazil's 29.7%.

Today, however, financial turmoil is spreading in East Asia. Deep currency devaluations in Thailand, the Philippines, Indonesia and South Korea have been matched by stock market declines of 20% to 30% this year. Even Hong Kong, with massive reserves, has been buffeted by financial markets.

It turns out that during the "Asian miracle"--when countries from South Korea to Indonesia grew two to three times as fast as the U.S., Japan and the European Union--the Thais and the Malaysians were giving short shrift to banking supervision, allowing their banks to finance all manner of vanity real estate and other dodgy projects. The Asian tigers were also letting their trade deficits get out of hand. They were asleep at the switch as China and India were competing for Western consumer markets with cheaper labor and currencies not so tightly linked to the (strengthening) American dollar. The tigers were also slow to

deregulate their economies, and complacent about the lack of education and advanced training, which their workers would need in the new global economy.

By now it's clear that economic growth in the region may well have masked deep-seated problems that will take several years to address. Moreover, the devaluations will raise the cost of imports to Asia, causing central banks to tighten interest rates to keep inflation in check. Not surprisingly, growth projections are being reduced; in Thailand, the most serious case, growth in the gross domestic product may go from a forecast 8% to a recession this year. Big projects like dams and airports are being postponed, and with them many local jobs will be lost. And now that Asian emerging markets are abandoning fixed exchange rates, the investment climate could become much more volatile.

Some say that Asia will export its way out of this mess, because cheaper currencies should make its products more competitive. But most of the Asian up-and-comers are competing with one another, so devaluing together will not pack the expected wallop. There is also the explosive question of trade with the U.S. Already, 20% of U.S. imports come from the Asian emerging markets. How do you think Washington's trade managers will react to a run-up of the U.S. trade deficit with these nations when China is already becoming America's *bjte noire*, and a cheap yen is causing the deficit with Japan to mushroom again, particularly in sensitive sectors like autos?

In Latin America, where U.S. exports are growing faster than any other region, there is ample cause for concern, too. From Mexico to Argentina, the region is critically dependent on incoming capital flows, and any increase in U.S. interest rates would act as a gigantic suction to reverse those flows, causing a continentwide implosion. Throughout the region, millions of people get poorer even as Latin America's the upper and middle classes prosper. In Mexico, for example, some 22 million--25% of the population--live in extreme poverty, with five million being added to that in the last two years alone. In Argentina 15% unemployment has produced some of the largest mass workers' protests in several decades. A populist political backlash--which would lead to more nationalistic attitudes toward foreign investors, a slowdown in privatization and a monkey wrench in the wheels of free trade--isn't inevitable. But now that the region has turned so thoroughly democratic, don't be surprised if it happens.

There are dicey scenarios for the industrialized world, too. In Japan, the world's second-largest economy and the home of one-third of the world's savings, economic recovery has been on the way for a few years now, but it hasn't arrived yet. Last week, Tokyo announced that GDP had been falling at an annual rate of 11.2%, the sharpest decline since 1974. Corporate bankruptcies are still growing, and banks remain wobbly. Equity markets, as well as sales of housing, cars and consumer products, have all been heading down. And the government is just about out of options to stimulate growth. Long-term interest rates on government debt--now at 2%, the lowest for any government over the past 50 years--can't get

much lower. Massive spending on public works has been ruled out on budgetary grounds. All that's left is radical deregulation, something Tokyo has talked about for over a decade.

We hear a lot about economic stirrings in Europe. But the rise of the socialists in France and the policy paralysis in Germany--where unemployment has reached post-World War II highs--are reasons for skepticism. Throughout the continent, expensive social welfare systems and labor rigidities are causing high unemployment, and the technological base is eroding. Overshadowing everything else is the potential impact of the planned introduction of a common currency, the euro. Unless the new European central bank can follow in the footsteps of Germany's Bundesbank and maintain low inflation and a hard currency, the euro will be a bust, creating enormous turmoil in currency markets world-wide. The outcome is anyone's guess at this point.

'Scissors Effect'

Corporate profitability in the U.S. will be highly sensitive to these events abroad. A strong dollar is already cutting into profits of America's most powerful exporters, such as Motorola. In addition, there could be a "scissors effect," with competition from rising imports and slower growth abroad together slicing profits. U.S. interest rates could be affected, too, especially if hard-pressed investors abroad decide to sell Treasury bonds to generate cash, forcing Uncle Sam to raise rates to attract essential foreign capital.

The theme of all these situations is America's growing links to the global economy. The share of U.S. GDP attributable to international trade has doubled in this decade, to 23%, and today, exports are responsible for 30% of our economic growth. During the 1990s U.S. jobs supported by exports will have doubled, to 16 million. Over the last two years foreign investors dramatically increased their purchase of U.S. Treasury obligations. A huge number of American companies, such as Coca-Cola, General Electric and Microsoft, are expecting foreign markets to provide a huge portion of their revenues, often more than 50%. Given the international uncertainties, and no matter what the IMF and the World Bank say in Hong Kong, a wise American would keep his powder dry.

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