

MBZ Speech
September 16, 1996

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IN THE POST COLD WAR ERA, ECONOMIC CLASHES HAVE REPLACED IDEOLOGICAL AND MILITARY CONFLICT AS THE PREEMINENT ARENA FOR GLOBAL CONFRONTATION. THE NEED FOR ECONOMIC INTELLIGENCE IN THIS CONTEXT, TO HELP MAKE POLICY, SHOULD BE SELF-EVIDENT. A FEW EXAMPLES OF THE NATIONAL SECURITY BENEFITS OF UNDERSTANDING THE POLITICAL CONSEQUENCES OF ECONOMIC FUNDAMENTALS WILL SUFFICE: THE FINANCIAL FAILURE IN MEXICO, THE CONDITIONS OF THE ECONOMIES OF RUSSIA AND CHINA AND THEIR IMPLICATIONS FOR THE LEADERSHIP IN THESE COUNTRIES AND THEIR POLICIES, THE ABILITY TO ASSESS ECONOMIC PRESSURES ON THE POLITICS OF IRAN OR IRAQ, THE ABILITY TO ASSESS THE POLITICAL CONSEQUENCES OF ECONOMIC SANCTIONS, AND THE LONG TERM ECONOMIC DIRECTION OF MAJOR PARTNERS AND COMPETITORS--SUCH AS JAPAN, KOREA, AND THE EUROPEAN UNION.

THAT KIND OF INFORMATION DOES NOT NECESSARILY, OR EVEN LARGELY, COME FROM PENETRATING THE INNER CIRCLES OF ANOTHER GOVERNMENT--ALTHOUGH SOME OF IT MAY. THE BULK OF IT COMES FROM COLLECTING, ORGANIZING, ANALYZING, SUMMARIZING, AND EVALUATING THE SHEER VOLUME OF PUBLIC OPEN INFORMATION THAT ALREADY EXISTS AND THAT CONTINUES TO BE CREATED AT A STAGGERING RATE. THERE ARE VERY FEW CENTERS WHERE THIS INFORMATION, HOWEVER, CAN BE SYNTHESIZED AND PREPARED AS A BASIS FOR UNDERSTANDING POLITICAL CONSEQUENCES OR POLICY IMPLICATIONS. WE DO NOT NEED ALWAYS TO SPY. WE WILL DO WELL JUST TO LOOK. OF COURSE THE LOOKERS MUST BE TRAINED SO THAT THEY KNOW WHAT TO LOOK FOR AND KNOW WHAT THEY

SEE WHEN THEY SEE IT. BUT WE MUST LOOK.

WE ARE NOT TALKING ABOUT GOVERNMENT SPYING ON BEHALF OF PRIVATE AMERICAN FIRMS. THE ARGUMENTS AGAINST THAT ARE WELL KNOWN AND REQUIRE NO REPETITION HERE. WHAT WE ARE TALKING ABOUT, QUITE SIMPLY, IS THE ROLE OF ECONOMIC INTELLIGENCE AND THE NEED FOR IT. IT DOES NOT TAKE A GREAT HISTORIAN TO FIND A RATIONALE THAT WOULD SUPPORT SUCH A NEED, WHETHER IT BE THE WRONG-HEADED CONVICTION BY THE BRITISH GOVERNMENT THAT A NAVAL BLOCKADE OF GERMANY, DURING ANY WORLD WAR, WOULD SOON CAUSE THE GERMAN ECONOMY TO COLLAPSE, LEADING THEM TO RATIONALIZE THE REJECTION OF RECOMMENDATIONS BY THE BRITISH GENERAL STAFF TO ENHANCE MAJOR LAND FORCES; OR TO THE ASSUMPTION ON THE PART OF THE GERMANS THAT A SUBMARINE BLOCKADE OF BRITAIN COULD STARVE BRITAIN INTO SUBMISSION WITHIN SIX MONTHS, BASED ON THEIR PROJECTED ABILITY TO SINK 600,000 TONS OF BRITISH SHIPPING A MONTH.

MORE RECENTLY WE HAD THE DISCUSSIONS ABOUT THE EFFICIENCY OF ECONOMIC SANCTIONS TOWARDS IRAQ IN 1990. MANY THOUGHT THEY WOULD BE SUFFICIENT TO COMPEL IRAQ'S WITHDRAWAL FROM KUWAIT--PROBABLY WITHIN 18 TO 24 MONTHS--AND THUS AVOID THE NEED FOR AN ARMED CONFLICT. THE C.I.A. CONCLUDED OTHERWISE. THEY BELIEVED THAT ALTHOUGH SANCTIONS COULD DEAL A SERIOUS BLOW TO THE IRAQI ECONOMY, THERE WAS NO ASSURANCE OR GUARANTEE THAT ECONOMIC HARDSHIP WOULD COMPEL SADDAM TO CHANGE HIS POLICIES, OR THAT SUCH HARDSHIP WOULD LEAD TO AN INTERNAL UNREST THAT WOULD THREATEN HIS REGIME--PARTICULARLY BECAUSE THEY CONCLUDED THE IRAQI MILITARY WOULD BE AFFECTED ONLY AT THE MARGINS. IN THE FIVE YEARS OF

SANCTIONS SINCE THE WAR THAT WERE IMPOSED ON IRAQ, WE HAVE LEARNED OF THE WISDOM OF THAT JUDGEMENT. WE STILL, OF COURSE, USE ECONOMIC SANCTIONS WITH LIMITED EFFECTIVENESS VIS-A-VIS SUCH COUNTRIES AS IRAN AND LIBYA.

THERE ARE OTHER AREAS THAT WOULD JUSTIFY PURSUING ECONOMIC INTELLIGENCE, I.E. VITAL RESOURCES WHOSE SUPPLY MIGHT OR NOT BE PRECARIOUS. AGAIN, THERE IS A LONG HISTORY HERE. IN THE 18TH CENTURY, BRITAIN KEPT A CONSTANT EYE ON THE SUPPLY OF TIMBER FOR ITS WARSHIPS. TO JUMP TO WORLD WAR II, EVERY MAJOR PLAYER WAS STRONGLY INFLUENCED BY A CONCERN ABOUT CRITICAL RESOURCES SUCH AS OIL, IRON ORE, RUBBER, AND TUNGSTEN. PETROLEUM REMAINS AN OBVIOUS EXAMPLE AS A COMMODITY WHERE A DISRUPTION OR DESTRUCTION OF SUPPLIES COULD CAUSE SCARCITIES AND PRICE SHOCKS THAT MIGHT THREATEN OUR COUNTRY'S ECONOMIC HEALTH. GRAIN SUPPLIES MIGHT WELL BE ANOTHER FOR SOME COUNTRIES.

BUT THE LARGEST AND MOST CRITICAL COMMODITY IS MONEY. HERE, I WANT TO EXPRESS MY GRATITUDE TO BILL GREIDER FOR HIS NEW BOOK "ONE WORLD. READY OR NOT."

WE HAVE WITNESSED IN THE LAST COUPLE OF DECADES THE EXPEDIENTIAL EMERGENCE OF GLOBAL FINANCE. MONEY TRANSFERS TODAY GREATLY EXCEED THE VALUE OF GOODS OR SERVICES THAT PASS ACROSS BORDERS. THE GLOBAL VOLUME OF PUBLICLY TRADED FINANCIAL ASSETS (ABOUT \$24 TRILLION) TURNS OVER EVERY TWENTY-FOUR DAYS. THE TRADING IN U.S. GOVERNMENT BONDS, TALLING ABOUT \$2.6 TRILLION, TURNS OVER EVERY EIGHT DAYS. THESE MARKETS HAVE BECOME SO POWERFUL AND SO IMPORTANT THAT WE MUST BE CONCERNED WHENEVER

THERE ARE DECISIVE BREAKS IN THEIR PRICES, SUCH AS WHEN GLOBAL INVESTORS SUDDENLY LOSE CONFIDENCE IN ONE INVESTMENT SECTOR, OR IN AN ENTIRE COUNTRY, AND ABRUPTLY SHIFT HUGE AMOUNTS OF CAPITAL ELSEWHERE, A PROCESS HELPED ALONG BY THE ELECTRONIC SPEED OF MODERN BANKING. UNCHECKED AND/OR UNANTICIPATED, THE RESULTS OF SUCH SHIFTS CAN BE HARROWING. COUNTRIES LIKE THE U.K., ITALY, MEXICO, MALAYSIA, SWEDEN AND SPAIN--EVEN THE TWELVE-NATION EUROPEAN COMMUNITY--HAVE FOUND THAT PRIVATE FINANCE CAPITAL, ONCE IN MOTION, COLLECTIVELY CAN OVERWHELM THE COUNTERWEIGHT OF THEIR GOVERNMENTS AND CENTRAL BANKS WITH DIRE CONSEQUENCES FOR THEIR CURRENCIES AND THEIR ECONOMIES.

WHAT HAS HAPPENED? HOW DID GLOBAL FINANCE GET SO TRANSFORMED? QUITE SIMPLY, THE WORD IS DECONTROL. CAPITAL TODAY IS FREE TO CROSS AND RE-CROSS MAJOR BORDERS IN THEIR SEARCH FOR HIGHER AND HIGHER RETURNS OR LESSER OR LOWER RISKS. SOMETIMES, AS MONEY FLOWS INTO ONE MARKET OR ANOTHER IN THE PURSUIT OF FINANCIAL ASSETS, THESE FINANCIAL ASSETS RISE IN PRICES SUCH THAT THEY DIVERGE FROM THE UNDERLYING ECONOMIC REALITIES, AS OVER-OPTIMISTIC INVESTORS EMBRACE NEW AND MORE SPECULATIVE OPPORTUNITIES.

THIS KIND OF MANIC INVESTING TYPICALLY UNFOLDS TOWARDS THE END OF AN ECONOMIC BOOM WHILE IT MANIFESTS ITSELF IN THE RECURRING DRAMAS OF FINANCIAL MARKET UPHEAVALS, SPECTACULAR DEBT FAILURES, AND GYRATING MONEY VALUES THAT OFTEN DE-STABILIZE GLOBAL COMMERCE AND NATIONAL ECONOMIES. IN THE 1980'S WE HAD THE DEFAULT BY THE L.D.C.'S (LESS DEVELOPED COUNTRIES): MEXICO,

ARGENTINA, BRAZIL, AND MORE THAN A DOZEN OTHER DEVELOPING COUNTRIES WHO DEFAULTED ON THEIR MASSIVE DEBTS TO FOREIGN BANKS. IF YOU THINK WE HAVE LEARNED FROM THE PAST, JUST NOTE THAT THE INTERNAL INDEBTEDNESS OF THESE DEVELOPING NATIONS HAS MORE THAN DOUBLED IN THE 1990'S. IN 1992 SPECULATORS SUCCESSFULLY FORCED THE BRITISH AND THE ITALIANS TO DEVALUE THEIR CURRENCIES. IN 1993, THEY ASSAULTED THE FRENCH FRANC AND OTHER CURRENCIES LEADING TO THE COLLAPSE OF THE EUROPEAN CURRENCY EXCHANGE SYSTEM. IN 1994, THERE WAS A GLOBAL CRASH OF BOND PRICES. IN 1995, MEXICO FAILED AGAIN, TOUCHING OFF A WORLD-WIDE PANIC OF INVESTORS SEEKING TO GET THEIR MONEY OUT OF EMERGING MARKETS. IN 1995, JAPAN FACED A FINANCIAL COLLAPSE AND A BANKING CRISIS BECAUSE OF MASSIVE DEFLATION AND THE ACCUMULATION OF BAD LOANS ON SUCH A MASSIVE SCALE--I.E. WELL IN EXCESS OF \$500 BILLION--THAT THEIR MAJOR BANKS WERE THREATENED. SO THIS IS NOT AN ACADEMIC ANALYSIS.

THERE IS A RATIONAL BASIS FOR THE ESTIMATES OF THE FUTURE THAT UNDERGIRD FINANCIAL PRICES. BUT THE MARKETS THAT MAKE THESE ESTIMATES BEHAVE LIKE CROWDS, SOME MIGHT EVEN SAY MOBS. PARTICIPANTS MUST REACT TO EACH OTHER AS WELL AS TO THE ECONOMIC FACTS FOR EVEN IF A SMART TRADER KNOWS THE HERD OR THE CROWD IS MISTAKEN, HE MUST STILL RESPECT ITS BEHAVIOR SINCE ITS ACTIONS WILL ALTER THE VALUE OF HIS ASSETS AS WELL. BUT SINCE CROWDS CAN GO DISASTROUSLY AWRY, PARTICULARLY IF CARRIED AWAY BY MOB PSYCHOLOGY, OR IF THEY ARE MISLED BY THEIR OWN FALSE ENTHUSIASMS OR FEARS, AND YOU JOIN THAT UP WITH THE HUGE ACCUMULATIONS OF

FINANCIAL CAPITAL IN PRIVATE HANDS, YOU HAVE A MUCH MORE DANGEROUS AND POWERFUL FORCE TO CONTEND WITH.

THE POSSIBILITIES OF A FINANCIAL UNRAVELLING ARE COMPOUNDED BY THE FACT THAT MANY OF THE BIT PLAYERS IN THESE MARKETS ARE MUTUAL FUNDS. E.G. BILLIONS OF MIDDLE CLASS AMERICAN'S SAVING DOLLARS FACE QUICK LOSS IF THERE IS A SUDDEN DOWNTURN--AND THESE LOSSES HAVE TO BE ABSORBED BY THE INVESTORS SINCE THESE MUTUAL FUNDS ARE NOT FEDERALLY INSURED. IF YOU HAVE A RUN ON MUTUAL FUNDS BY THE MILLIONS OF AMERICANS WHO ARE PLAYING IN THIS GAME AS THEY TRY AND CUT THEIR EXPOSURE, YOU CAN SEE A VICIOUS CYCLE EMERGING AS MUTUAL FUNDS SELL THEIR SHARES TO PAY OFF THEIR SHAREHOLDERS DEMANDING LIQUIDITY.

A FEW OTHER FACTS WILL ROUND OUT YOUR SENSE OF THE AGGREGATE VALUE SLOSHING AROUND IN UNREGULATED GLOBAL FINANCIAL MARKETS. ACCORDING TO MCKINSEY AND COMPANY, THE TOTAL STOCK OF FINANCIAL ASSETS FROM ADVANCED NATIONS HAS EXPANDED MORE THAN TWICE AS FAST AS THE UNDERLYING ECONOMIES IN THE LAST FIFTEEN YEARS. THE FINANCIAL ASSETS OF THE O.E.C.D. ARE EXPECTED TO GO FROM ABOUT \$35 TRILLION IN THE EARLY 1990'S--WHICH INCIDENTALLY IS DOUBLE THE ECONOMIC OUTPUT OF THESE COUNTRIES--TO TRIPLE THE ECONOMIC VALUE OF THESE ECONOMIES, IN CONSTANT DOLLARS, BY THE YEAR 2000. WHAT WE HAVE WITNESSED IN THE LAST NUMBER OF YEARS IS FINANCIAL PRICES RISING FASTER THAN THE COLLECTIVE ECONOMIC ACTIVITIES ON WHICH THEY ARE PRESUMABLY BASED, A TREND WHICH IS CONTINUING AS FINANCE SEEMS TO BE OPTIMISTIC ABOUT THE FUTURE.

BUT SOMEBODY'S EXPECTATIONS OF THE FUTURE ARE BOUND TO BE

WRONG. GOVERNMENTS ARE CONTRIBUTING TO THIS. GOVERNMENT DEBT IN THE O.E.C.D. COUNTRIES HAS BEEN GROWING ABOUT 9 PERCENT A YEAR-- MORE THAN THREE TIMES FASTER THAN THEIR ECONOMIC OUTPUT. THEY ARE BORROWING MORE TO COVER THEIR DEFICITS, LEADING TO THE FAMILIAR PROCESS OF COMPOUNDING DEBT, BUT IF THEY BORROW FASTER THAN THEY CAN CREATE A NEW PRODUCTIVE BASE TO PAY FOR THE LOANS, SOONER OR LATER SOMETHING WILL HAVE TO GIVE.

SO WE MAY FACE SITUATIONS WHERE PUBLIC AND PRIVATE DEBT GOES BAD AND ABRUPTLY COLLAPSES, ESPECIALLY IF FINANCIAL ASSETS HAVE BEEN BID TO HIGHER AND HIGHER LEVELS, UNJUSTIFIED BY THE UNDERLYING ECONOMICS. THEN GOVERNMENTS WILL HAVE STEP IN TO MANAGE THESE FINANCIAL CRISES, OR BURSTING OF BUBBLES, BEFORE THEY TURN INTO A GENERAL DEPRESSION. IN FACT, GOVERNMENTS HAVE INTERVENED TO PREVENT A FULL CATASTROPHE IN ONE EPISODE AFTER ANOTHER. SO FAR SO GOOD, FOR THESE INTERVENTIONS HAVE ALLOWED FOR AN ORDERLY LIQUIDATION RATHER THAN A BLOODY UNRAVELLING AS GOVERNMENTS AMELIORATED THE LOSSES FROM PERIODIC DEFLATIONARY COLLAPSES AND CAUTERIZED THE BROADER IMPACT OF EXPLODING BUBBLES ON THE PRODUCTIVE ECONOMY. THEY ACCOMPLISHED THIS BY SHIFTING THE BAD DEBTS OF PRIVATE HOLDERS TO THE PUBLIC. THEY DID IT 1982 WHEN THE THIRD WORLD'S FAILED DEBT WAS BAILED OUT BY VAST NEW LENDINGS FROM THE WORLD BANK AND THE I.M.F. SO AS TO REDUCE THE EXPOSURE OF THE ENDANGERED COMMERCIAL BANKS. THEY DID IT IN 1995 WHEN MEXICO COLLAPSED AGAIN AND GOVERNMENTS ADVANCED A \$50 BILLION CREDIT LINE TO CALM AND PAY OFF PANICKY INVESTORS. BUT THE QUESTION IS, HOW LONG CAN GOVERNMENTS CONTINUE THIS ROLE OF

FIREMAN? IS THERE A POINT WHERE THEY WILL BE UNABLE TO AVERT THE KIND OF GENERAL CATASTROPHE THAT THEY HAVE BEEN ABLE TO CONTAIN SO FAR? THIS RISK IS GROWING BECAUSE OF THIS EXPLOSION IN THE SIZE OF UNREGULATED FINANCIAL CAPITAL.

ONE EXAMPLE IS CURRENCY. NOW MAINTAINING THE VALUE OF MONEY IS ONE OF GOVERNMENT'S MOST IMPORTANT FUNCTIONS, FOR WHEN MONEY VALUES GYRATE, MANY INNOCENT PARTIES ARE INJURED AND POSSIBLY EVEN NATIONAL ECONOMIES. THE NUMBERS ARE ASTOUNDING. IN 1973 WHEN THE OLD BRETTON WOODS SYSTEM OF FIXED EXCHANGE RATES FOR CURRENCIES WAS ABANDONED THERE WAS A TURNOVER OF ABOUT \$10 BILLION TO \$20 BILLION A DAY IN FOREIGN EXCHANGE MARKETS, MAINLY TO FACILITATE COMMERCIAL TRADE. TODAY, IT IS ABOUT \$1.3 TRILLION A DAY.

BY THE WAY, THIS KIND OF EXPLOSION HAS SPREAD TO OTHER FINANCIAL MARKETS. GLOBAL BOND TRADING WENT FROM \$30 BILLION A DAY IN THE 1980'S TO MORE THAN \$500 BILLION A DAY IN THE 1990'S. NATIONAL STOCK MARKETS GREW AT COMPOUNDED RATES OF 17 PERCENT PER YEAR SINCE 1980. AND THE SHEER SUPPLY OF FINANCIAL CAPITAL IS COMPOUNDED BY THE DEVELOPMENT OF COMPLEX DERIVATIVES AS HEDGING DEVICES TO PROTECT INVESTORS AGAINST SUDDEN SWINGS IN NATIONAL INTEREST RATES, CURRENCIES OR OTHER VARIABLES. THESE DERIVATIVES HAVE BECOME ANOTHER SOURCE OF VOLATILITY AND ANOTHER HUGE RISK IN THE FINANCIAL MARKETS.

BUT LET'S LOOK AGAIN AT THE ABILITY OF THE GOVERNMENTS TO CONTROL THEIR CURRENCIES IN THE FACE OF FINANCIAL SPECULATORS. LET'S LOOK AT THE BRITISH EXPERIENCE IN 1992 WHEN THEY TRIED TO

DEFEND THE POUND BY RAISING INTEREST RATES DESPITE RECESSIONARY CONDITIONS AT HOME SO AS TO ATTRACT FOREIGN MONEY TO SUPPORT THEIR CURRENCY. ON A DAY NOW CALLED "BLACK WEDNESDAY" IN ENGLAND, THE CHANCELLOR OF THE EXCHEQUER RAISED INTEREST RATES BY AN ADDITIONAL 2 PERCENT, ASSERTING IN THE MORNING THAT BRITAIN WOULD NEVER YIELD TO THE SPECULATORS AND WOULD SPEND \$15 BILLION TO \$20 BILLION TO DEFEND STERLING. BUT AS GEORGE SOROS, A WORLD-CLASS SPECULATOR COMMENTED, "THAT WAS ABOUT AS MUCH AS WE ALONE WANTED TO SELL." BY THE END OF THE DAY, THE U.K. GOVERNMENT CAVED IN AND DROPPED THE POUND OUT OF THE EXCHANGE-RATE SYSTEM, LOSING BILLIONS IN THE PROCESS. I SHALL NEVER FORGET A DINNER WITH MARGARET THATCHER IN WHICH SHE RAILED AWAY AT THE LOSS OF 15 BILLION POUNDS IN THE MAUL OF THIS SPECULATIVE ONSLAUGHT. THE SPECULATORS, OF COURSE, HAD CONCLUDED THAT NOT ONLY WAS THE BRITISH POUND OVERVALUED, GIVEN THE BRITISH ECONOMY, BUT THAT, IN POLITICAL TERMS, THE GOVERNMENT COULDN'T POSSIBLY DEFEND ITS POSITION BECAUSE BRITAIN'S FINANCIAL SYSTEM AT HOME RELIED HEAVILY ON VARIABLE-RATE MORTGAGES AND OTHER DEBT INSTRUMENTS WHOSE MONTHLY PAYMENTS WENT UP WHEN THEY RAISED INTEREST RATES TO DEFEND THE POUND STERLING, THUS PUTTING AN UNBEARABLE SQUEEZE ON BRITISH HOMEOWNERS AND BUSINESSES. IN SHEER ECONOMIC TERMS, THE BRITISH GOVERNMENT SIMPLY DID NOT HAVE THE RESOURCES TO BUY POUNDS IN THE FINANCIAL MARKETS AGAINST THE OVERWHELMING FINANCIAL POWER OF THE PRIVATE SPECULATORS WHO WERE SELLING THEM.

CAN WE LOOK AT GOVERNMENTS TO STABILIZE FINANCIAL FLOWS IN THE FACE OF THE POSSIBILITY OF MORE VIOLENT SWINGS IN FUTURE

CAPITAL MARKETS, MORE SUDDEN SURPRISES, MORE CROSS-BORDER PANICS--ALL ACCENTUATED BY THE SPEED WITH WHICH SHOCKS CAN BE SPREAD ELECTRONICALLY THROUGH THE FINANCIAL GLOBAL SYSTEM? THE NUMBERS WILL GIVE YOU SOME FEELING FOR THE DIMENSIONS OF THE RISK: IN 1983, THE FIVE MAJOR CENTRAL BANKS OF THE U.S. GERMANY, JAPAN, BRITAIN AND SWITZERLAND, HELD \$139 BILLION IN FOREIGN-EXCHANGE RESERVES VERSUS AN AVERAGE DAILY TURNOVER OF \$39 BILLION IN THE MAJOR FOREIGN-EXCHANGE MARKETS. TODAY, THE PRIVATE MARKETS DWARF THE RESERVES OF GOVERNMENTS BY ALMOST 3 TO 1--ABOUT \$900 BILLION TO ABOUT \$300 BILLION--AND THE TREND LINES ARE ALL IN FAVOR OF THE PRIVATE SPECULATOR. THE PRIVATE MARKETS CONSIST OF ABOUT 200,000 TRADERS AROUND THE WORLD LINKED ELECTRONICALLY TO SHIFTING MARKET PRICES, POLITICAL BULLETINS, AND TRADERS' GOSSIP. THEY ALL SPEAK THE SAME ELECTRONIC LANGUAGE. THE RESULT IS HUGE SHIFTS IN CURRENCIES, OFTEN ACCELERATED BY DERIVATIVES. THE DOLLAR WAS WORTH 260 YEN IN 1985, 130 IN 1987, 160 IN 1990, 80 IN EARLY 1995, AND NOW IT IS ABOVE 110 IN 1996. HAS ANYTHING IN ECONOMIC REALITY CORRESPONDED TO THESE VIOLENT SWINGS? HAS THE UNITED STATES GOVERNMENT BECOME SUDDENLY 40 PERCENT STRONGER SINCE LAST YEAR THAN JAPAN?

THESE SHIFTS IN MONEY VALUE HAVE ENORMOUS CONSEQUENCES FOR COMMERCIAL BUSINESSES AND NATIONAL ECONOMIES. A 40 PERCENT INCREASE IN PRICES, IN REAL TERMS, BECAUSE OF A CURRENCY SHIFT, CAN BRING ABOUT A SUDDEN LOSS OF INTERNATIONAL COMPETITIVENESS, FORCING INDUSTRIES TO MAKE COSTLY DOWNSIZING ADJUSTMENTS, SOMETIMES FORCING THEM INTO BANKRUPTCY, AND OFTEN DRIVING FIRMS

OFF-SHORE BECAUSE OF THE COMPETITIVE DISADVANTAGES THAT MAY BE INDUCED BY THEIR OWN CURRENCIES. THE LATTER IS WHAT HAPPENED TO AMERICAN MANUFACTURING IN THE 1980'S BECAUSE OF THE OVERVALUED DOLLAR.

LET ME POINT TO ANOTHER AREA WHERE EARLY ECONOMIC INTELLIGENCE IS CRITICAL, TO WIT, THE CONDITION OF THE JAPANESE BANKS. AS A RESULT OF A HUGE ACCUMULATION OF BAD DEBT BECAUSE OF THE COLLAPSE IN THE REAL ESTATE MARKET--WHICH HAS GONE DOWN ABOUT 60%--AND THE COLLAPSE OF THE STOCK MARKET--DOWN ABOUT 50%-- JAPANESE BANKS FOUND HUNDREDS OF BILLIONS OF LOANS UNDER WATER, LITERALLY THREATENING THE SOLVENCY OF HALF OF THE NUMBER OF THE LARGEST BANKS IN THE WORLD. THE U.S. TREASURY CAME TO THE ASSISTANCE OF JAPAN'S MINISTRY OF FINANCE TO EASE THE CRISIS. THEY INTERVENED DRAMATICALLY IN CURRENCY MARKETS TO PUSH UP THE DOLLAR AND PULL DOWN THE YEN--WHILE THE JAPANESE BANK ADMINISTRATORS LAUNCHED A CAMPAIGN TO LIQUIDATE THEIR BAD DEBTS AND BAIL OUT THE BANKS. WE WERE LITERALLY FLIRTING WITH A THREAT OF A GENERAL DEFLATION LIKE THE 1930'S. THE GOVERNMENTS WERE MUCH MORE NERVOUS THAN THEY REVEALED FOR, IF THE JAPANESE BANKS COLLAPSED, IT WOULD LIKELY BRING ABOUT A CRISIS FOR THE WORLD'S BANKING SYSTEM. THEY WERE LITERALLY TRYING TO REVERSE A CATASTROPHE.

ANOTHER EXAMPLE IS MEXICO. JUST A FEW YEARS AGO IT WAS REPUTED TO BE ON THE VERGE OF ENTERING THE FRONT RANKS OF TRADING NATIONS, WITH A REFORMING AND MODERNIZING INDUSTRIAL SYSTEM, THE DISMANTLING OF AN OUTMODED NATIONALIST ECONOMIC STRUCTURE AND OF

A POLITICALLY CORRUPT STATE-CONTROLLED ENTERPRISE SYSTEM. THE NEW MEXICO WAS TO BE LED BY REFORM-MINDED TECHNOCRATS--MEN WITH PHD'S IN ECONOMICS FROM HARVARD, YALE, STANFORD, AND CHICAGO--WHO UNDERSTOOD THAT MEXICO MUST EMBRACE GLOBAL INTEGRATION. THIS WAS THE CONTEXT FOR MEXICO'S AGGRESSIVE PURSUIT OF THE NAFTA AGREEMENT. THE ONLY PROBLEM IS THAT THE UNDERLYING FACTS TURNED OUT TO BE FALSE. WITHIN A COUPLE OF YEARS MEXICO'S ECONOMY WAS IN A MAJOR RETREAT, FROZEN BY A BANKING CRISIS THAT WAS DEVOURING BOTH FINANCIAL INSTITUTIONS AND INDUSTRIAL FIRMS. SEVERAL MILLION JOBS WERE DESTROYED. INCOMES FELL IN VALUE BY NEARLY A THIRD, WHILE AS MANY AS TWENTY PERCENT OF MEXICANS FELL DANGEROUSLY BEHIND IN THEIR LOANS FOR CARS, HOMES, AND BUSINESSES. MANY OF THE REFORMERS TURNED OUT TO BE CORRUPT THEMSELVES. THE PRESIDENT, CARLOS SALINAS, A HARVARD PHD, IS NOW IN DISGRACED EXILE. HIS BROTHER IS IN PRISON, ACCUSED NOT ONLY OF STEALING HUNDREDS OF MILLIONS OF DOLLARS IN STATE ASSETS BUT ALSO OF COMPLICITY IN MURDER. HE IS STILL TRYING TO EXPLAIN HOW MEXICANS WHO BENEFITTED BY THE BILLIONS FROM THE GOVERNMENT PRIVATIZATION SCHEMES SOMEHOW OR OTHER TURNED OUT TO BE THE BIGGEST CONTRIBUTORS TO HIS SO-CALLED SECRET "INVESTMENT FUND." I AM NOT EVEN COMMENTING ON THE FACT THAT A MAJOR SECTOR OF MEXICAN COMMERCE SEEMED TO BE INVOLVED IN DRUG TRAFFICKING.

THIS ALL CAME ABOUT BECAUSE OF FINANCIAL ARBITRAGE, I.E. INVESTORS BORROWED IN AMERICA AT 5% TO 6% TO BUY IN MEXICO WHERE THEY WERE EARNING 14% TO 18%. NOW THE SMART INVESTORS REAPED FABULOUS RETURNS IF THEY HELD ON FOR A FEW MONTHS. DUMB

INVESTORS THOUGHT IT WOULD LAST FOREVER. AS POLITICAL UPHEAVAL SUCH AS THE MURDER OF THE PRESIDENTIAL CANDIDATE, COLOSIO, CREATED UNCERTAINTY CAUSING THE GOVERNMENT TO LOSE SOME ITS FINANCIAL RESERVES--MUCH OF WHICH WAS CONCEALED FROM THE PUBLIC--THE GOVERNMENT FOUND ITSELF UNABLE TO REDEEM THE MOUNTING SHORT-TERM PAPER HELD BY OVERSEAS LENDERS--TESOBONOS, THEY WERE CALLED--AND THE BUBBLE BURST IN 1994. THE PESO WAS DEVALUED. GLOBAL INVESTORS RUSHED OUT THE DOOR, DUMPING SOMETHING LIKE \$25 BILLION IN ASSETS AS THEY LEFT THE COUNTRY, COLLAPSING THE NATIONAL CURRENCY WHICH LOST HALF OF ITS PURCHASING POWER IN A FEW FRANTIC WEEKS. THIS CRASH SPREAD TO OTHER EMERGING MARKETS IN LATIN AMERICA AND ASIA WHERE GLOBAL INVESTORS ALSO HAD ARBITRAGED THE INTEREST RATE SPREADS. LATIN AMERICAN MARKETS FELL 38 PERCENT IN TWO MONTHS. IN MEXICO, THE GOVERNMENT HAD TO EXECUTE A SERIES OF BAILOUTS FOR THEIR BANKING SYSTEMS AND FOR THEIR LEADING INDUSTRIAL GROUPS--MANY OF WHICH STILL FAILED. NO WONDER THE MOTTO IN MEXICO IS "POOR MEXICO, SO FAR FROM GOD, SO CLOSE TO THE U.S."

HOW WILL WE RESCUE THE CAPITAL MARKETS IF THERE IS A NEW MARKET CRISIS--SOME FAILURE THAT IGNITES AN EXPLOSIVE BURST SOMEWHERE ON THE GLOBE, CARRYING WITH IT ALL THE IMMENSE RISKS OF A LARGER CALAMITY? CAN GOVERNMENTS AVERT A FULL CATASTROPHE?

AGAIN, ECONOMIC INTELLIGENCE, EARLY ENOUGH, IS CRITICAL. BUT WHEN YOU HAVE \$2 TRILLION IN THE EXTERNAL DEBT OF DEVELOPING NATIONS--ABOUT FIFTEEN TIMES WHAT IT WAS TWENTY YEARS AGO, AND WHEN YOU HAVE GOVERNMENTS MIRED IN DEFICITS, ACCUMULATING MORE

AND MORE DEBT--EVEN IN DEVELOPING COUNTRIES--YOU KNOW YOU ARE GOING TO BE FACED WITH SUCH CRISES. THE FEDERAL DEBT OF THE UNITED STATES GREW FROM 35% TO 70% OF G.D.P. IN LESS THAN TWENTY YEARS. ITALY'S IS UP TO 124% OF ITS G.D.P. BELGIUM'S IS AT 132%--AND SWEDEN'S AT 86%. EVEN GERMANY'S DEBT HAS DOUBLED. ALL THIS IN COUNTRIES WHOSE TAX REVENUES ARE NOT GROWING FAST ENOUGH TO SUSTAIN BOTH THEIR SOCIAL COMMITMENTS, WHICH THEY ASSUMED WHEN THEIR ECONOMIES WERE EXPANDING, AS WELL AS THE GOVERNMENT DEBT SERVICE REQUIREMENTS.

THIS KIND OF FUNDAMENTAL FRAGILITY CONSTITUTES THE GROUNDS FOR POTENTIAL PANICS--PANICS WHICH COULD BE TRIGGERED OFF WHEN THE HERD MENTALITY IS ALWAYS LURKING AT THE MARGINS. WHEN YOU HAVE A HERD, IT IS NOT TOO FAR AWAY FROM CREATING A STAMPEDE--A STAMPEDE WHOSE SPEED IS ACCELERATED BY THE TELECOMMUNICATIONS' TECHNOLOGIES THAT HAS ENABLED MONEY TO FLOW SO QUICKLY AND SECRETIVELY THAT NO GOVERNMENT CAN EASILY ASSERT REGULATORY CONTROL. INDEED, THERE IS A REAL QUESTION AS TO WHETHER GOVERNMENTS CAN EVEN MONITOR IT.

THIS IS WHAT THEY MUST LEARN TO DO. THIS IS THEIR CHALLENGE. THE ADVANTAGE IS THAT MOST GLOBAL TRANSACTIONS FLOW THROUGH SEVERAL DOZEN MAJOR BANKS AND BROKERAGE HOUSES SOMEWHERE IN THE WORLD, AND THIS CAN PROVIDE AT LEAST THE BASIS FOR THE THOROUGH MONITORING OF FINANCIAL FLOWS THROUGH INTELLIGENCE SOURCING. WE HAVE THE TECHNOLOGY TO FOLLOW MUCH OF THIS--EVEN IF SOME OF IT MUST BE COVERT. THIS IS ONE AREA WHERE GOVERNMENTS ARE SIMPLY GOING TO HAVE TO BEGIN FOCUSING THEIR INTELLIGENCE

ASSETS.

THIS WAS THE BASIS FOR MY CONCERN IN OUR COMMISSION HEARINGS--TO REVIEW THE CHANGING NEEDS FOR INTELLIGENCE-GATHERING. I BELIEVE IT IS CRITICAL FOR GOVERNMENTS--ESPECIALLY FOR THE AMERICAN GOVERNMENT--TO BEGIN TO MONITOR MUCH MORE EXTENSIVELY THAN THEY DO NOW THE FUNDAMENTAL ECONOMIC FACTS AND FINANCIAL FLOWS IN A GLOBAL FINANCIAL SYSTEM THAT TODAY HAS SO MANY INDIVIDUAL COUNTRIES SO VULNERABLE.

OF COURSE, THIS ISN'T THE ONLY CONCERN. ANOTHER CONCERN RELATES TO THE FINANCING OF ILLICIT ACTIVITIES. LOOK AT THE GRAND CAYMAN ISLANDS, OR LIECHTENSTEIN, OR THE NETHERLANDS ANTILLES, AND THERE YOU HAVE SOME OF THE LARGEST BOOKERS OF BANK LOANS AND FINANCING IN THE WORLD. THE LATTER IS A LEGAL HOME FOR SOME OF THE WORLD'S WEALTHIEST INVESTORS. HONG KONG IS ANOTHER FOCUS OF CONCERN. THESE ARE SOME OF THE LARGEST OFF-SHORE BANKING CENTERS. YET, THEY DO NOT PROVIDE AN HONEST ACCOUNTING OF THEIR BANKING ACTIVITIES. MONEY FLOWS OUT BUT THE AUDITORS CANNOT FIGURE OUT WHERE ALL THE MONEY COMES FROM--SO RESPECTABLE CAPITAL MINGLES ALONGSIDE DIRTY MONEY FROM ILLEGAL ENTERPRISES. THE ONLY RATIONALE FOR THESE CENTERS IS TO ALLOW MONEY TO HIDE FROM THE SAME THING: NATIONAL TAXATION AND THE SURVEILLANCE OF GOVERNMENT REGULATORS.

BEYOND THAT, THE VERY SYSTEMS PROVOKED BY THE REVOLUTION IN INFORMATION AND ELECTRONIC CONVEYANCE PROVIDES A NEW SOURCE OF VULNERABILITY. THESE ON-LINE SYSTEMS EXPOSE ENORMOUS AND VITAL AREAS OF NATIONAL LIFE TO MISCHIEF OR SABOTAGE BY COMPUTER

HACKERS AND THEY COULD LITERALLY BRING A COUNTRY TO THE POINT WHERE IT MIGHT NOT BE ABLE TO FUNCTION. I MEAN, IF TEEN-AGE HACKERS HAVE PENETRATED HIGHLY SECRET SYSTEMS IN EVERY FIELD, THE POSSIBILITIES FOR CHAOS ARE ALMOST UNLIMITED TODAY. IF ONE INTELLIGENCE OFFICIAL BOASTED THAT HE COULD SHUT DOWN AMERICA WITH A BILLION DOLLARS AND TWENTY CAPABLE HACKERS, WHAT DOES THAT MEAN FOR OUR VULNERABILITY TO TERRORISTS.

WALTER LAQUER POINTED OUT IN A RECENT FOREIGN AFFAIRS ARTICLE THAT AN ATTACK ON ELECTRONIC SWITCHING CAN PRODUCE FAR MORE DRAMATIC AND LASTING RESULTS WITH EVEN GREATER CONSEQUENCES THAN BIOLOGICAL OR CHEMICAL WEAPONS. IT IS NOT ENOUGH TO ASSERT THAT NINETY-NINE OUT OF A HUNDRED TIMES WE MAY BE ABLE TO AVOID ANYTHING LIKE A COLLAPSE. ONLY ONE WOULD CLAIM MORE VICTIMS AND UNLEASH A FAR GREATER PANIC THAN ANYTHING THE WORLD HAS YET EXPERIENCED.

THE NEW REALITIES OF GLOBAL FINANCE AND INFORMATION TECHNOLOGIES ARE REALITIES WE ARE SIMPLY GOING TO HAVE TO LEARN TO COPE WITH. OUR INTELLIGENCE SERVICES AND POLICY MAKERS CANNOT STAND ON THE SIDELINES OR FALL BEHIND. HELL, IT IS SAID, IS TRUTH SEEN TOO LATE. THE TRUTH IS THERE TO BE SEEN. LET US MAKE SURE WE ARE NOT TOO LATE.

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Previous Mr. Philippe Clerc, Chief of Mission, Competitiveness and Economic Security, General Secretariat for National Defense (SGDN), Republic of France

Next Ms. Melissa Call, Director, Corporate Information Center, Markowitz and McNaughton, Inc., Day to Day Realities and Myths Regarding Financial Research Using Open Sources

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