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OPENING TRADE IN FINANCIAL SERVICES—THE CHILE AND SINGAPORE EXAMPLES

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OPENING TRADE IN FINANCIAL SERVICES—THE CHILE AND SINGAPORE EXAMPLES

Tuesday, April 1, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:01 a.m., in Room 2128, Rayburn House Office Building, Hon. Peter T. King [chairman of the subcommittee] presiding.

Present: Representatives King, Biggert, Manzullo, Ose, Feeney, Hensarling, Murphy, Barrett, Harris, Maloney, Sanders, Sherman, Hooley, Velazquez and Frank (ex-officio).

Chairman KING. [Presiding.] The hearing will come to order. I welcome all of you here today.

Today, the Domestic and International Monetary Policy, Trade and Technology Subcommittee meets to discuss the financial services-related aspects of the recently announced free trade agreements. While the issue of trade is generally the ambit of other committees, this subcommittee is specifically responsible for international investment policies, both as they relate to U.S. investments for trade purposes by citizens of the U.S., and investments made by all foreign entities in the United States. This also includes trade as it relates to the U.S. financial sector as a key service industry.

Today, the subcommittee examines the recently concluded free trade agreements with Chile and Singapore. The United States reached agreement with these allies on December 10, 2002 and January 15, 2003 respectively. Many have suggested these agreements will help provide a framework going forward from which the United States can negotiate with other countries and regions. Specific to financial services, these agreements will provide much-needed certainty and transparency to allow U.S. investment to operate with confidence in these expanding global markets. National treatment, capital controls, transparency of financial regulation and efficient administrative review are just some of the many complex issues that U.S. negotiators have addressed in coming to resolution on these specific FTAs. I commend Ambassador Zoellick and his team at USTR and the Treasury for the work they have done on behalf of the working men and women of this country. As a sup-

porter of U.S. free trade, I look forward to working with the administration to ensure implementation of these agreements.

I recognize that with any negotiated agreement that there will be some who disagree with its provisions. While we can agree to disagree, I hope that if there is discussion on these disagreements, it will be based on facts and conclusive evidence. Today, we have a strong two-panel group of witnesses ranging from administration officials to academia to the private sector. I look forward to a lively debate on the merits of these trade agreements and would remind members that as the Financial Services Committee, we would greatly appreciate that the topic of discussion remain focused on financial service trade issues.

I now recognize my New York colleague and ranking member, Mrs. Maloney, for opening statements.

Mrs. MALONEY. Thank you, Mr. Chairman, for granting this hearing, and thank you especially, Ranking Member Frank, for working to include this topic in the subcommittee's agenda. I know it is an area that you have great expertise and have done a great deal of work.

As the lone world superpower and with U.S. forces engaged militarily around the world, the importance of using U.S. economic strength to spread American values gains heightened importance. Through promotion of rules-based fair trade policies, the U.S. has had an opportunity to lead the international community for the benefit of both rich and poor countries, while at the same time increasing opportunities for U.S. businesses and workers. By and large, the bilateral trade agreements between the U.S. and Chile and the U.S. and Singapore advance this effort. Both agreements knock down restrictions on domestic markets that serve to increase in efficiency and punish consumers who often pay the cost of protectionist policies. In financial services, these bilateral agreements offer U.S. companies exciting new opportunities in areas as diverse as excess to ATM networks, to increased opportunities to compete in new insurance markets.

Given the many positives in these agreements, it is disappointing that our trade negotiators held out for a controversial position on capital controls that seeks special protection for U.S. investors. The trade agreements contain investor-state dispute settlement procedures that determine how U.S. investors can win damages if Chile or Singapore violate the free transfer provisions in each agreement. Reports indicate that these protections for U.S. investors were included at the urging of the Treasury Department, and that these negotiations over these provisions were some of the most contentious areas in the negotiations. Effectively, these provisions allow U.S. investors to seek damages in the event that Chile or Singapore take measures to limit capital flight in the event of a reoccurrence of an Asian financial crisis-like emergency. While Chile and Singapore are unlikely to need to impose capital controls, many economists have expressed the concern that the administration will insist on these provisions as a template in future trade negotiations with less stable countries.

Such a policy could lead to a situation where wealthy U.S. bondholders have legal claims against a country that has imposed capital controls, while all other investors face losses and where the

country's own people are suffering through an economic collapse. This special status for U.S. investors sends the wrong message about promoting free trade and could increase anti-American feelings. Critics of this policy have said its effects are to protect a special class of capitalist, rather than to promote stable capital markets.

In addition to the fairness argument, many economists including some at the IMF increasingly believe that the imposition of limited capital controls can be an effective means of stemming the flight of hot money. In the short term, capital controls can increase stability and reassure investors that economies are not prone to sudden collapse. I note that the witnesses who will express concern about capital controls in their testimony today are otherwise staunch free traders. I think this lends credence to the argument that at the very least, the effectiveness of capital controls is open to debate and the rigidity of the administration's position is a concern of many mainstream trade supporters and economists.

I yield back my time.

Chairman KING. Mrs. Biggert, any opening statements on this side? I recognize the ranking member of the full committee, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

Let me pick up from where the ranking member of the subcommittee left off with her excellent statement. What is striking to me is the number of leading advocates of increased trade who are critical of this inclusion of capital restrictions. We will have a very distinguished economist, Professor Bhagwati; we will have Mr. Tarullo, who helped in the Clinton administration push forward with trade agreements, some of which I did not agree with.

I want now at this point to enter into the record a statement, first from Nancy Birdsall, who is president of the Center for Global Development, a strong supporter of free trade.

[The following information can be found on page 208 in the appendix.]

Chairman KING. Without objection.

Mr. FRANK. I appreciate that.

Secondly, I want to read excerpts from it. I will include statements from Joseph Stiglitz. I must say Professor Stiglitz and Professor Bhatwati are two of the acknowledged experts internationally in support of sensible liberalized trade and a globalization that will take us where we ought to go. It is impressive to me that both of them are quite critical of this particular inclusion of restrictions on capital controls. I will now read Mr. Stiglitz's statement. "The importance of the subject of these hearings cannot be overestimated."

Let me say that he was not able to come because of scheduling problems.

"The provisions of the recent trade agreements with Chile and Singapore limiting government interventions in short-term capital flows are a major source of concern. Everything should be done to eliminate them from the agreements and to make sure that such provisions are not inserted into future trade agreements. Reducing trade barriers can be of benefit to all parties. Problems are encountered, however, when trade agreements go beyond trade issues, as

in this case, forcing countries to undertake measures which should be a matter of national sovereignty. Such provisions have earned trade agreements a reputation for undermining democracy, and I believe that sometimes these accusations are deserved.

"It is of salient concern with a particular provision that risks imposing considerable harm on the country. Much of the instability in global financial markets in recent years, especially in the emerging markets, has been related to short-term capital flows. Capital rushes into a country and just as quickly rushes out, leaving havoc in its wake. The crises in East Asia were largely caused by premature capital market liberalization. The volatility is particularly hard on the poor and serves to create poverty. It is the low-skilled workers who bear the brunt of recessions and depressions. Chile, in its period of rapid economic growth in the early 1990s, imposed restrictions on the in-flow of capital. I believe such restrictions played an important role in its growth and stability.

"By the same token, developing countries in Asia that have grown the fastest, done the most to eliminate poverty and exhibit the greatest stability, have all intervened actively in capital markets at critical stages in their development, and many continue to do so today.

"Let me be clear, while there were financial interests in the United States that might benefit from forcing countries to open up to the short-term capital flows, and there are even some who have benefited from the resulting economic chaos by buying assets at fire-sale prices only to re-sell them at great profit when economic calm has been restored, forcing countries to open up their markets to these short-term capital flows is not in the interests of the United States. It is in our interest to have a more stable global economy. It is in the interest of businesses that are investing abroad that there be greater economic stability.

"Yet economic research has identified short-term capital market liberalization as the single most important factor contributing to the instability in Asia and Latin America. Today, there is a growing consensus among economists against liberalizing capital markets for short-term capital flows for most emerging countries. Even the IMF has recognized this. The extent and form of capital market liberalization is a matter which should be left for each country to decide through democratic processes.

"We can encourage a full democratic debate on these issues with a public discussion of experts in developed and developing countries, debating the advantages and disadvantages. But we should not be using our economic power and the promise of increased investment and exports to impose the viewpoint of a particular set of interests or a particular ideology on our trading partners.

"The arguments for trade liberalization are totally distinct from those for capital market liberalization. They share in common but one word—liberalization. There is an emerging consensus among economists that emerging markets should be particularly wary about full capital account liberalization. It makes little sense for our trade agreements to be pushing on our trading partners restrictions which fly in the face of sound economics."

Let me just reiterate, it is clear we in this case imposed on both Chile and Singapore over their initial objections and their con-

tinuing objections this particular addition to free trade. I think that it is very important to understand, I would hope that we would move toward a consensus on freer trade, globalization, taking into account other values. This inclusion of a very rigid particular ideological view using America's power to impose these in individual free trade agreements goes exactly in the opposite direction.

Chairman KING. Thank you, Mr. Frank. I would ask if any other members have an opening statements, that they submit them in writing so we can get to the statements of our witnesses.

Mr. Sanders?

Mr. SANDERS. Thank you very much, Mr. Chairman.

This is an important hearing. It is an important hearing because it raises discussion about our trade policy. It is important to begin to talk truth about our trade policy and recognize that from beginning to end our trade policy has been an outrageous failure. And it is incomprehensible to me that people keep coming forward—we had Alan Greenspan in front of the full committee a couple of months ago talking about the ongoing success of our trade policy. I wonder. I scratch my head and I say, what world are these people living in?

If our trade policy is such a success, Mr. Chairman, why do we have a $400 billion trade deficit? Why in the last two years, and let me reiterate this, because it is not talked about too often by all the editorial writers who support free trade, how come in the last two years on our ongoing success of free trade, we have lost close to two million manufacturing jobs—10 percent of our manufacturing workforce? How come 20 or 30 years ago, General Motors used to be the largest employer in America where workers earned a decent wage?

And Mr. Chairman, you know who the largest employer in America today is? It is Wal-Mart, where large numbers of people are on food stamps. How come any concrete examination of NAFTA will tell us that it has been a disaster for the people of Mexico, for the middle class, the poor people of Mexico, as it has been a disaster for working people in this country?

I returned from China a month ago. It is not just that we have a $100 billion trade deficit with China. If anybody thinks that all the Chinese are going to be doing is stuffing teddy bears and making sneakers, you are absolutely mistaken. All of the evidence is there. It is not just blue collar jobs that are going to be replaced. It is white collar jobs and that is taking place right now. All of the evidence is there.

Mr. Chairman, I have a long statement which I would like to submit for the record. But I think that extending our trade policy should be laughed out of the Congress. We should be saying, are you serious? Obviously, you are joking, aren't you, coming here asking us to extend a disastrous trade policy. You are not really serious? We all have a good sense of humor. But to tell us to extend a disastrous trade policy which is causing havoc not only for the middle class, the working class of this country, but for poor people all over the world. Tell us about what is going on in Latin America—Venezuela, Argentina, the huge uprisings, mass demonstrations against the IMF, against these trade policies.

Now, obviously we understand what goes on in American politics. Large corporations flood this building with huge contributions. Yes, I admit it. Trade policy works well for those companies that want to throw American workers out on the street and hire poor people for pennies an hour. Yes, I grant you. It works well for those CEOs that make a few hundred million dollars when they retire. But for the poor people of the developing world and for the middle class of this country, it is a failure, and the idea that we are thinking of extending our trade policies should be laughed out of this office.

I would ask unanimous consent to allow my statement to be submitted for the record.

Chairman KING. The gentleman's time has expired. Without objection, his full statement will be made part of the record.

[The prepared statement of Hon. Bernard Sanders can be found on page 49 in the appendix.]

With that, we will go to our first panel today—the Honorable John B. Taylor, Under Secretary of Treasury for International Affairs, and Mr. James Mendenhall, Assistant U.S. Trade Representative for Services for Investment and Intellectual Property. We will begin with Mr. Taylor.

STATEMENT OF HON. JOHN B. TAYLOR, UNDER SECRETARY OF TREASURY FOR INTERNATIONAL AFFAIRS

Mr. TAYLOR. Thank you very much, Mr. Chairman, and Ranking Member Maloney for calling this hearing and inviting us to testify. I would like my oral remarks to just summarize briefly the written testimony and submit the written testimony to the record.

Chairman KING. Without objection, your full statement will be made part of the record.

Mr. TAYLOR. I would like to focus in my oral remarks on provisions related to trade in financial services and to investment in capital transfers in the free trade agreements with Chile and Singapore. Let me focus first on trade in financial services.

We believe that reducing barriers to trade in financial services is an essential part of a good trade policy which aims to reduce barriers of all kinds to trade. Open financial sectors lead to more growth. They lead to a better allocation of savings. They lead to better services for people who take advantage of the better financial services. There is a reduction in the barriers to trade in financial services that is part of the two free trade agreements that we are discussing today. For example with respect to Singapore, Singapore has agreed as a matter of opening its market to financial services, to lift the ban it has had on new licenses for banks to operate in Singapore. It has also allowed for banks to get access to additional ATMs that are run by local banks. And it has reduced the limits to the number of ATMs that banks can have. So you can just see by these examples that these are the kind of things that improve the financial services that are available to people in Singapore, and at the same time bring business opportunities to U.S. firms.

With respect to Chile, Chile has agreed that it would make prior notice to any regulatory changes that might have bearing and implications for financial service firms. It is also providing more access to financial advisers and financial management firms who

want to take a role in the management of the Social Security accounts in Chile. These are just some examples of the specific things that U.S. firms and consumers in Singapore and Chile can benefit from from reducing the barriers in financial services. On top of all those, as a chapeau, is an agreement that there would be a lock-in, a commitment not to remove these commitments, not to increase the barriers their current levels, so that there is no going back from the position where the countries are with respect to financial services.

Let me now briefly talk about the investment in capital transfers part of the agreements. Reducing barriers to the flow of foreign investment is also an essential for raising economic growth and reducing poverty in countries around the world. More capital means there is more capital for workers to use to produce, to raise their productivity. Access to capital is an essential way to reduce poverty by raising productivity. One of our major objectives in this administration is to reduce barriers to the flow of capital to emerging markets in developing countries in general, and thereby having greater productivity and lower interest rates as well. I just might mentioned as an aside that the president's proposal for Millennium Challenge Accounts, which is aimed at the very poorest countries in the world, has as a feature a way that their policies will be ones that attract foreign investment and attract capital so that again productivity can increase and poverty can be reduced.

Another example of how our policy is aimed to improve foreign investment around the world is our long-term BIT policies, the bilateral investment treaties, which have been underway for the last 20 years. These bilateral investment treaties are an effort to make the policies in the countries more welcoming to foreign investment so that the countries themselves can benefit from it, as well as the foreign investors.

Now, our FTAs with Singapore and with Chile have endeavored to stick with this policy of free transfers that exists in our bilateral investment treaties. I would say that all sides to these agreements with respect to the Chile, the Chileans and the Americans, with respect to Singapore, the Singaporeans and the Americans—they have agreed that there is an importance to have this free transfer of capital. They agree that restrictions on transfers would clearly not be consistent with the goal of encouraging investment to raise productivity and reduce poverty.

As with the rest of the free trade agreement, there is a dispute settlement mechanism that we put in place. It comes into play when there is a restriction placed on goods trade, service trade, or on capital transfers. The dispute settlement mechanism that we negotiated with respect to capital transfers we think makes a lot of sense and it is one that both the Chileans and the Singaporeans are happy with, as we are. In the case of restrictions on capital, there is a cooling off period before a dispute settlement mechanism comes into place. For foreign direct investment type of investment, the cooling off period is for six months before action can be taken. For other types of restrictions, the cooling off period is for 12 months—other types of restrictions on shorter-term capital movements—direct loans. So there is a longer cooling off period for the

types of capital transactions and capital flows, capital transfers that several of you have already raised in your opening remarks.

We think this dispute settlement mechanism builds on current practice, but allows for a compromise for different views about how capital markets work. We think it is a good place to have the subject of transfers dealt with in agreements. It is a novel approach and we think it works quite well.

Let me just summarize after giving these specifics. We think that the approach undertaken in these FTAs is consistent with a shared economic philosophy and policy perspective of all three countries that we are talking about—the United States, Chile and Singapore. The inclusion of these free transfer provisions, as I have just described it, in the Chilean and Singaporean FTAs with the United States we think sends a strong signal to the markets that all these countries support the free flow of capital and they recognize its importance to the development and growth of economies. Without a doubt, these agreements represent a win-win situation for all the countries involved.

I would like to thank you very much, Mr. Chairman, and to your colleagues, for the opportunity to testify here and look forward to a discussion of these issues.

Thank you.

[The prepared statement of Hon. John B. Taylor can be found on page 193 in the appendix.]

Chairman KING. Thank you, Secretary Taylor.

Mr. Mendenhall?

STATEMENT OF JAMES E. MENDENHALL, ASSISTANT U.S. TRADE REPRESENTATIVE FOR SERVICES, INVESTMENT AND INTELLECTUAL PROPERTY

Mr. MENDENHALL. Good morning, Mr. Chairman, Ranking Member Maloney and Mr. Frank and other members of the committee. I appreciate this opportunity to come before you today to testify on the financial services chapters in the Chile and Singapore free trade agreements. I particularly look forward to this discussion because I am newly appointed in my current position as assistant U.S. Trade Representative and this is my first opportunity to discuss these issues with you.

Since the passage of the Trade Act of 2002, we have pursued an aggressive trade agenda. As stated by Ambassador Zoellick, we are proceeding with trade initiatives globally, regionally and with individual nations. This strategy creates a competition in liberalization, with the United States at the center of a network of initiatives. The recently completed agreements with Singapore and Chile represent the first of the next generation of trade agreements. We have also launched FTA negotiations with five other countries or regions, and at the same time the free trade are of the Americas negotiations are ongoing and are set for completion by January of 2005. On the multilateral front, just yesterday the United States submitted its initial offer in the current round of services negotiations in the WTO.

For several reasons, Chile and Singapore provided a good point of departure. First, the United States has a growing and significant economic interest in trade with these countries. Second, specifically

with respect to financial services, Singapore and Chile have taken steps to open their financial sectors. Both countries respect the concept of the rule of law and were in a good position to explore market access-enhancing concepts relating to transparency of regulatory structures. They have already committed to moving in the right direction for many sectors and our FTAs will reinforce these trends.

Finally, the Chile and Singapore FTAs provide good toe-holds for expanding liberalization in South America and Asia respectively. The liberalization of financial services was one of our main objectives in negotiating the Chile and Singapore FTAs. In the final texts, we achieved the objective set forth in TPA to eliminate discriminatory and other types of restrictive measures on the supply of services. The United States already enjoys a significant competitive advantage in financial services in international markets, and the market-opening initiatives in the Chile and Singapore FTA and in other for a should create additional opportunities for our financial services suppliers. Opening foreign markets for exports of U.S. financial services has two added advantages. First, it creates jobs and expands economic opportunities. For example, states like New York, California, Florida, Illinois, Massachusetts and Pennsylvania depend on financial service activity to contribute to their economic growth and tax base. Also by expanding access to financial services, it enhances prospects for economic growth at home and abroad.

Second, the opening of foreign markets for financial services creates export opportunities for other sectors. For example, financial services companies rely heavily on specialized software and data processing, thereby creating increased demand for computer-related services which is another strong point of the U.S. export picture. And as countries develop their economies with the help of foreign financial services, those countries consume a wider range of goods and services, which benefits U.S. exporters more generally.

The financial services chapters in the Chile and Singapore FTAs cover all means of supply that are relevant for financial services trade, and include a set of important core protections. The agreements require national and most-favored-nation treatment, which ensures that U.S. financial service suppliers are treated on equal terms with their foreign competitors. They also include a market access obligation to ensure that measures such as quantitative restrictions and requirements regarding forms of legal entities do not undermine general market access rights. Lack of transparency is also a major problem facing our financial service suppliers, and we have included provisions that directly address this more subtle, but equally insidious market access barrier. In addition, we have provided rights for foreign-owned institutions to introduce new financial services when certain conditions are met.

Finally, I would like to say a word on the issue of capital controls. The issue of capital controls is clearly complex, yet we have to recognize the potentially serious negative impact capital controls could have on U.S. investors. Our FTAs contain safeguards to allow American investors to have access to their funds, while at the same time they grant Chile and Singapore the flexibility to manage capital flows.

The Chile and Singapore FTAs mark a significant advance over commitments in other fora. For example, unlike in some other agreements, our Chile and Singapore FTAs adopt a presumption that national treatment will apply unless a specific sector is carved out. Chile and Singapore have agreed to commitments across a wide array of financial services that exceed the level of the current GATT's commitments. In some cases, they have undertaken commitments to preserve existing levels of openness that go beyond their GATT commitments, while in other cases they have agreed to commitments that go beyond the current practice. We would be pleased to discuss specific commitments with you here today or to meet separately with you and your staff to discuss in further detail.

While we have moved aggressively to open foreign markets, we are sensitive to the careful balance struck through our own political and legal processes between regulatory and commercial interests. In fact, while the United States agreed to a high level of access under the Singapore and Chile FTAs, implementation of the financial services chapters in the FTAs will not require any changes to U.S. law or practice.

We can expect real benefits to accrue to the U.S. economy as a result of the Chile and Singapore agreements. As we advance a strong trade promotion agenda, we remain ever-mindful of the objectives Congress asked us to achieve when it granted trade promotion authority. I look forward to working with you and your staffs in the future as we strive to continue opening markets around the world. I thank you for the opportunity to testify here today.

[The prepared statement of James E. Mendenhall can be found on page 172 in the appendix.]

Chairman KING. Thank you, Mr. Mendenhall.

As you can determine from some of the opening statements, there is a concern, I believe, by certain members of the committee and certain members in the Congress that in certain elements of the negotiations the United States may have used coercion or improper pressure to cause Singapore and Chile to agree to, or to make certain concessions they would not have made otherwise, specifically in the area of capital controls. If you could address that to the extent you can, how the give and take went, and why you feel that this is essential as far as capital controls.

Mr. TAYLOR. I would say the give and take was healthy and candid, like any other negotiation that I have been involved with. The issues are very complex, as Mr. Mendenhall indicated. There are different points of views. But I think what was most often emphasized to us is that the free transfers of capital is important by Singapore and by Chile. They have those policies in place right now. Neither country has capital controls in place. We were working with them. In fact, many of the ideas that are in this were mutually reached in the discussions. So I would say that they were good. They were healthy. Some of them took place in Singapore. Some of them took place in the United States. They were part of a larger trade agreement, to be sure, in which there were many issues being discussed. Financial services and some of the others we discussed here, but there is trade in goods as well.

Chairman KING. Mr. Mendenhall, do you have anything to add to that?

Mr. MENDENHALL. I agree with everything that Under Secretary Taylor just said. I think in the give and take of these negotiations, it is just that—a give and take. However much we may like to lay down the law on a particular point and force our trading partners to accept it, it is a negotiation. In fact, I believe where we ended up with on capital controls was the result of a negotiation. It was not the result of the United States imposing its will in any way, although Under Secretary Taylor would know this more than I would on that particular issue. I believe that was the case here.

Chairman KING. Secretary Taylor, in your testimony you discuss the president's MCA initiative. Can you go into more detail on that as to how you believe the requirements of the MCA will make this country more attractive to investors?

Mr. TAYLOR. Mr. Chairman, the Millennium Challenge Account is a program which is designed for which funds will go to countries that are following policies that are conducive to economic growth. Many of those same policies are conducive to foreign investment. So for example, there are the three categories of policies—ruling justly, investing in people, and encouraging economic freedom. In the ruling justly part of the policies, there is an emphasis on the rule of law so for example, foreign investors know the rules of the game before coming into a country. It is a very important part of the Millennium Challenge Account—the rule of law. In the encouraging economic freedom section, there is a commitment to have a low inflation rate, a stable macroeconomic environment, which is also conducive to foreign investment. It creates greater certainty. In the investing in people part of the Millennium Challenge Account, it is a commitment for countries to invest in their people, in education and health. So obviously, a good well-educated workforce is one of the best ways that foreign investment can be productive in a country.

So just for example, as you know, some foreign investment in Africa has taken advantage of countries where the skill level is rising. In Ghana for example, education is improving and we see U.S. firms and other firms going in to take advantage of that for computer work, for call centers. Those are the kind of foreign investments that can actually improve well-being in the country directly. The Millennium Challenge Account encourages that through the policies that I indicated.

Chairman KING. Mr. Mendenhall, do you have anything to add to that?

Mr. MENDENHALL. No, I agree.

Chairman KING. Mrs. Maloney?

Mrs. MALONEY. Thank you for your testimony. Secretary Taylor and Mr. Mendenhall, in future trade agreements and negotiations, what will be the position on capital controls? Is the language in the Chile and Singapore agreements an example for future negotiations? Is this something we are going to continue or is this just for these two very strong economies, Chile and Singapore?

Mr. TAYLOR. I think the strategy of focusing on dispute resolution is one that we have found attractive in dealing with these ne-

gotiations, and we would like to see how that works with respect to other countries.

Mrs. MALONEY. So do you plan to use this in other trade agreements? That is what I want to know.

Mr. TAYLOR. Yes, I think the dispute resolution mechanism is a good way to handle this. It is very attractive to both Chile and Singapore, but the specifics will differ by country. I gave the example of the six-month and twelve-month—maybe those numbers would change. I gave examples of what kind of foreign direct investment type of investments at the six-month. Maybe that would change. But I would say it would depend on what the country wants to do. The country is negotiating with us. They have their own interests and their own desires. We think this general approach works well, and would like to try it out as we go, but it is flexible. It is one of the good advantages of it, it is flexible. And it does have this constant ability for us to emphasize the importance of foreign investment and free transfers and not putting restrictions on capital, at least trying to stay away from that as much as possible. That is a philosophy that is embedded in the approach.

Mrs. MALONEY. Secretary Taylor, your testimony reads, and I quote, "our position is to seek greater protection for U.S. investors than the IMF articles of agreement and the GATTs afford," end quote. If this language is included in trade agreements with countries that are more prone to economic collapse than Chile and Singapore, are you concerned about the international fall-out in a situation where U.S. investors win compensation, while all other foreign investors face losses and while a suffering country's own people are experiencing an economic collapse?

Mr. TAYLOR. The comparison with the GATTs is important. The way I think about it, an FTA, a free trade agreement, is an effort to get a reduction in barriers compared to what you would have if you did not have a free trade agreement. It is an opportunity for both countries to reduce barriers compared to what would exist out there under the GATTs or under other multilateral trade agreements. So it is natural that the barriers are less in a free trade agreement and that is what you are seeing here. With respect to other countries, as we go forward, I just go back to my previous answer that it will depend on the country's situations and what they really would like. We have noted in just going over our BITs and reviewing all the BITs we have had, that there are many very poor countries who welcome the opportunity to pledge to make it clear in an agreement that they were very welcome to foreign investment and very open. My best guess is other countries are going to do that as we do more BITs and as we do more FTAs, but it very much depends on the countries and the negotiations.

Mrs. MALONEY. I want to follow up on if we go into these trade agreements and U.S. investors are able to recover for losses caused by imposing the capital controls, won't foreign investors learn to channel their own investments through U.S. investment banks, so that they would get the protection of the U.S. trade agreements? It is not going to be long that they are going to see if I put my money in, I cannot get it out; if I go through the U.S., I will be able to get my money out. Does that increase efficiency? What would the impact of that be? If I were a foreign investor, I would

immediately start going through U.S. banks to make sure I could have the same treatment that U.S. investors have.

Mr. TAYLOR. I think that is an observation which is important. I think that if you recognize the dispute settlement mechanism that we are using here in the free transfers is similar to dispute resolutions that occur in other places. For example, it is called investor state, and investor-state gives the opportunity for individuals to take action in an agreement like this.

Mrs. MALONEY. I was not aware other countries had the same language. I thought we were unique in that respect.

Mr. TAYLOR. What I was going to say is it occurs in other trade agreements. I have not observed any particular phenomenon that you are mentioning in our other agreements. In a way what we have done in the capital area here is lengthen the cooling off period from what it was otherwise, because the six-month cooling off period in other agreements I do not know exactly the time in the BITs, but there is always a cooling off period of some kind; there is always and investor-state dispute resolution mechanism in all of our bilateral investment treaties, and in NAFTA.

Mrs. MALONEY. But Mr. Secretary, even after a year couldn't they face the same problems with the economic collapse of their own people, other investors not being able to get their money out? Even after a year, you would still have the same elements that could be problematic, wouldn't you?

Mr. TAYLOR. The year gives it more time to sort things out, and it is a substantial period with respect to any of the desires or any of the requests that I have ever seen that the countries would like to put on controls like this. So that leeway seemed very acceptable to both Chile and Singapore, and I believe to other countries as well. Remember, neither Singapore nor Chile are using these controls right now.

Mrs. MALONEY. My time is up. Thank you for your testimony.

Chairman KING. Mrs. Biggert, the vice-chair of the subcommittee.

Mrs. BIGGERT. Thank you, Mr. Chairman.

The Asian financial crisis has been cited here and it is often cited by proponents of capital restrictions as a reason why developing countries should be able to limit the movement of capital within their borders. But wasn't the Asian crisis the result of a weak banking system and cronyism and ineffectual regulation? With increased trade in financial services and greater regulatory transparency, will countries that were once vulnerable to currency crises be stronger and be able to withstand economic downturns?

Mr. TAYLOR. Yes, I agree with that very much. What we have seen when investment is open to foreign companies or financial services firms, it frequently brings in better prudential regulations. With respect to the first part of your question, yes I very much agree that a lot of the crisis had to do with currency mismatches, where liabilities and assets did not match by currency, and that was because of defective regulations in many cases. So that can be improved and I think the foreign investment and the experience of financial service firms in the United States and other developed economies can be very helpful.

Mrs. BIGGERT. And then going back to the short-term restriction on the transfer of capital which was put in for Chile and Singapore, can you give the committee any examples of where capital restrictions were responsible for preventing a crisis or promoting growth?

Mr. TAYLOR. No, I cannot personally give you examples, but looking at the many examples where capital controls have been applied, sometimes they change the maturity structure of debt, maybe more longer term, less short term. There is evidence for that in Chile. That has not, in my view, had an impact on crises. But it has also had disadvantages. There are some recent studies that show that those same controls made it more difficult for small firms to get credit, to get access to markets. So it had a bias against small firms in the country. So often these kinds of controls have impacts that you do not even know about when you are putting them on. There are always disadvantages, even studies that try to find and look for the benefits of a capital control, that it really was effective in stemming a crisis or in remedying a crisis. As I read the data, I do not see them used effectively that way. But even when they are used, you see the other harmful effects that come from them.

Mrs. BIGGERT. Our U.S. financial service products are some of the most effective and most sophisticated in the world. How will increases in trade in financial services result in greater economic stability in these countries and what impact will greater access to capital have on Chile and Singapore? Maybe Mr. Mendenhall can answer that.

Mr. MENDENHALL. I will have to leave it to Under Secretary Taylor to talk about the specific economics of it. But I think there are several studies out there available, the most recent on coming out of the University of Michigan talking generally about the liberalization of trade in goods and the benefits for developing and developed countries alike. I apologize I do not have specifics for Chile and Singapore, but this particular study for example said that just for the United States that for services alone, a one-third cut in services restrictions would result in a gain for the United States of $150 billion. I think there are studies out there supporting, maybe not of the same magnitude, but supporting benefits for the average Chilean and Singaporean citizens as well.

Mr. TAYLOR. If I could just add briefly, I think the Chilean economy is a real success story in Latin America. They have withstood lots of crises. A lot of that is because of the openness of the economy. In the financial services area, they are relatively open already, so the examples of the increased openness are smaller than in the case of Singapore. But the economic stability is improved when banks run more efficiently, when there is more prudential investments and better regulations. What we have found in Mexico and other countries, that the foreign investment, again whether it comes from the U.S. or other countries, improves the efficiency and the regulatory oversight in ways that are beneficial for economic stability.

Mrs. BIGGERT. It has been about the last 10 years that Chile has had much more stability, isn't it? It seems to me that before that there was pretty wild fluctuation in their currency and the financial markets. Why is that?

Mr. TAYLOR. The Chileans have chosen a number of good policies—the openness which is now even better with the FTA that is coming, but the also the policy with respect to keeping inflation down. They basically, it used to be they had hyper-inflation for many, many years, big ups and downs, triple-digit inflation numbers. In the early 1990s, they went to a policy that focused on getting inflation down. It has been very successful, but it is just one example of the improvement in policies that they have had.

Chairman KING. The gentlelady's time has expired. The gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. I want to reemphasize we are not talking here—no one is arguing, I believe, that capital controls are always a good thing or they ought to be mandatory. We are talking about a very extreme argument on the other side that says they are never a good thing and they ought to be prohibited, and that no government democratically elected might be even allowed to experiment with them.

Mr. Taylor, you keep talking about the cooling off period, but I am afraid the ice is in the eyes of the beholder here. It is not as cooling off as you say, because while you have to wait six months in the case of foreign direct investment and 12 months in the case of foreign direct investment and 12 months in the case of portfolio investment to bring a complaint if you are an aggrieved private investor, in either case if you decide to bring it, in the first place that is the decision of the private investor—no government intervention can dissuade you; and secondly, your damages go back from the day it happened. In other words, the six and twelve month cooling off periods are cooling off periods when you can file your claim, but you do not delay the effective of this. So that a country that decides to impose controls on short-term capital, yes, someone might have to wait 12 months, has to wait 12 months before claiming damages, but if that private individual decides to claim damages, it is the absolute right of that private individual to go to the arbitration panel—there is no government role in this on either side—and the damages accrue from the first day. Isn't that accurate?

Mr. TAYLOR. That is accurate if the controls on these particular types of capital last for longer than year and if they substantially impeded transfers, yes.

Mr. FRANK. Right. And of course, the definition of "substantially impede" is nowhere in the agreement. We have not been able to get anybody to tell us what that means, and it will be left to them. We ought to be very clear about this, because these are very important policy issues, as all the questions are made clear. But the ultimate determination is left to these private arbitration panels which can be triggered by private aggrieved individuals. So what is a substantial impediment would be left to that group.

Now, you make a distinction here, which I am struck by, because I do not think you carried through, frankly, with it in policy terms, between foreign direct investment and portfolio investment. I think if we were talking about foreign direct investment, there would be much less objection here. You talked about providing funds for workers. Short-term capital flows—does our government really think that there are never times when a country, particularly one that might not have a well developed banking system—the gen-

tleman from Illinois said, well, the problem was not liberalized capital flows; it was a poor banking system. But our problem is enforcing these capital flows when people have weak banking system, and it seems to me that is what—I see no indication you do not plan to do that in any case. But are there no cases where controls on the short-term capital flow in countries that do not have fully developed regulatory systems would be a good idea?

Mr. TAYLOR. I think the important thing is they get the prudential regulations in place so that the chances of financial——

Mr. FRANK. Okay. Let me ask you this question. I accept that answer, but then the question is, does that mean that you will not be including these provisions in any free trade agreement with a country that does not have a well developed regulatory system financially?

Mr. TAYLOR. I was indicating to Ranking Member Maloney, as we go through and consider future free trade agreements, we are going to have to consider what the countries want. As you say, these are democracies.

Mr. FRANK. Oh, let us leave aside what they want, because the question is whether you will be pressing, the United States will be pressing—is it a prerequisite for your insisting on these kind of provisions that the trading partner in this case have a well developed regulatory system? That would be particularly a problem, say, with the free trade area of the Americas. Let me ask you this specifically, does every country that would be encompassed in the FTAA have a well developed financial regulatory system, in your judgment?

Mr. TAYLOR. I think, as you know, the FTA agreements that we are considering are with countries that we want to be doing all the things with respect to their policies.

Mr. FRANK. So there is no country that would be included in the FTAA that does not have a good financial——

Mr. TAYLOR. Well, I hope that they can all improve and get better. But your question about whether we insist on this imposition, it is really not the way to think about it. We negotiate with a point of view which we think is a good point of view, a good philosophy. We have listened. We negotiated.

Mr. FRANK. Mr. Taylor, I am sorry to have to say this, but that is not true, and I know that first-hand. I have been in conversations with the Ambassador of Singapore. The United States market is the eighth wonder of the world. We have developed fortunately for us an economy that is extraordinary. Access to the American market, access to American capital is obviously enormously important, particularly when you were talking about bilateral agreements. The ability of an individual country to refuse to deal with America is quite minimal. I know as a fact that the Singaporeans would have much preferred not to have had this. They were for free trade. They did not want to give in to this, and I know this from the ambassador from Singapore, who sought me out when my colleagues and I objected in a letter that we sent to the Treasury, saying do not push for this.

So I have to say I am disappointed by what I think is an inaccurate characterization you give of these negotiations. I think it is clearly a case where the enormous economic power of the United

States was put in the service of an ideology and some economic interests, but I believe it was primarily the ideology, and that the Singaporeans assented. I will tell you this, and my time is up, but I think that probably also accounts for the fact that your testifying partner has been significantly less enthusiastic in this testimony than you have been. I think it is clear that in fact this is the Treasury Department imposing not just on Singapore, but on the U.S. Trade Representative.

Thank you, Mr. Chairman.

Mr. TAYLOR. If I could just answer briefly, these are negotiations. They are give and take. Different parties have different interests. That must be clear in every single negotiation that takes place, whether it is on a reduction for trade in a particular good or a particular commodity or whether it is trade in financial services or whether it is these issues. We had a lot of discussion in our government on these, and this agreement represents a compromise which was negotiated.

Mr. FRANK. I agree, but you have just acknowledged, I think, the United States and Singapore saw themselves as having different interests. I understand why the Singapore government felt they had to give in to you on this important point, although very reluctantly.

Chairman KING. Mr. Mendenhall, do you want to comment on the gentleman's observation on your level of enthusiasm?

Mr. FRANK. I would note, Mr. Chairman, that was not a volunteered intervention. I appreciate that.

[Laughter.]

Mr. MENDENHALL. I generally have a penchant for understatement. I am quite enthusiastic about these particular agreements.

Mr. FRANK. I would hate to see you when you were bored, Mr. Mendenhall.

[Laughter.]

Mr. MENDENHALL. Part of my silence on this issue is because I was not at the table for most of this. I am newly appointed to this position, and I observed much of it from afar. But I think the points that Under Secretary Taylor has made are correct. In fact, I know we fully endorse them. In our view, the particular provisions that we negotiated on, or that my colleagues have negotiated on capital controls strike an appropriate balance between the regulatory interests and the commercial interests. I think the points that Under Secretary Taylor has made on those points are quite powerful. Again, just a general comment on whether or not the United States was unilaterally dictating the terms of these agreements, I think that is—in fact, I know that is not the case. This was the result of a compromise, as were many other provisions in the FTAs. There were many things that we wanted to get at the end of the day.

Mr. FRANK. A compromise between our wanting it and their not wanting it on this one issue. That is all I would agree.

Mr. MENDENHALL. Again, to the extent that we wanted it and they did not want it, I defer to Under Secretary Taylor. But again, there are points of convergence and that is what the compromise is about. That is what the negotiation was about and that is where we ended up at the end of the day. Did both sides get everything

they wanted in every aspect of these FTAs? No, probably not. This was a negotiated compromise. That is the nature of what a negotiation is for a free trade agreement and any other area.

Chairman KING. I would advise the gentleman from Massachusetts that is really an unfair standard to apply to witnesses to expect them to match your level of exuberance.

[Laughter.]

That is a very unique level, and witnesses can have other talents besides being as exuberant at the gentleman from Massachusetts.

Mr. FRANK. Well, if the majority would let me pick more of the witnesses, we might have a little more energy here.

[Laughter.]

Chairman KING. The gentleman from Florida, Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman, and thank you, gentlemen.

Earlier, one of my colleagues suggested that the restriction on capital controls might tend to favor U.S. banks and that investors would seek the protection provided by these agreements. Granted that that is certainly a possibility, isn't there also a corollary benefit that it will discourage countries that otherwise might be in a haste to exercise those capital controls on their own banks? And isn't there also the possibility that those countries will focus increasingly on sound monetary policy, good regulatory practices with respect to their own financial institutions? And isn't there a potential net positive effect on their internal mechanisms coming from doing the right thing with respect to U.S. investors and banks?

Mr. TAYLOR. Yes, I agree with that very much. The controls and restrictions have benefits that sometimes go to particular individuals, but they have harms that are broad. You are pointing out some of the harms that can actually occur in the country themselves. We are focusing on rights for foreign investors, but the harms actually I think are more pervasive in the country itself. Just for example, short-term capital flows sometimes are bank loans, short-term bank loans. A lot of businesses need bank loans for various purposes. So if there are restrictions on those of any kind, it is harmful to the businesses that are trying to get the loans. That is just an example. So every time one of these restrictions is put in place, it has harmful effects. In fact, I think people would prefer not to use the restrictions and that is what we have found in the case of Singapore and Chile. They would prefer not to use them, and we gave them in this agreement an opportunity for flexibility in case they really had to in the future, but they were very reluctant to do it.

Mr. FEENEY. Mr. Mendenhall, I do not know how enthusiastic you can get about helping countries reform their banking regulation and fiscal policy and monetary policy, but maybe you can add to that.

Mr. MENDENHALL. I think in large part, it would be our policy that the countries should reform independently, even if what we do in the free trade agreements. The free trade agreements are a useful tool to prod them along, to lock in the commitments that they have already made.

Mr. FEENEY. And just so competition helps improve goods and services in countries, so it may improve regulatory practices with respect to financial institutions.

Mr. MENDENHALL. I think that is correct, and I think that has been our approach on our whole trade agenda. That is one of the reasons we are being so aggressive on our free trade agreements is we expect this competition for liberalization, which is why we are pursuing liberalization of financial services, both in the WTO and on the free trade agreement side. We might be able to get more or less in some areas, and make up for it or complement it in other areas. So I think that is right.

Mr. FEENEY. If I can, several of my colleagues here, and I think at least one of the professors is going to address this, has suggested that there is some huge difference between free trade practices and free capital flow regulatory issues. They have actually suggested that some of us free traders are not so free when it comes to letting countries regulate their own capital flow. But indeed, isn't there another way to look through the prism at this, and that is that to protect a country's ability to essentially confiscate or freeze the flow of capital actually encourages protectionism in those countries. What you are protecting is faulty monetary policy and bank regulations. Can't you look at it through the free trade prism?

And finally, because I see my time is almost up, you will not get to respond if we wait to the suggestion that bilateral agreements somehow will ultimately interfere with the ability to deal with multinational approaches to free trade, so if I could have the gentleman weigh in on the first question with respect to aren't we really suggesting, some of my colleagues, that what we want to do is to protect bad regulatory behavior, (A); and (B) is it true that promoting bilateral agreements with friends is somehow going to undermine the ability to deal with multinational free trade throughout the globe?

Mr. MENDENHALL. Sure, I will address those comments in turn. I think the dichotomy between free trade and free movement of capital is a bit false. What we are really talking about is free markets, opening free markets. So that principle I think would apply equally to both free movement of trade and free movement of capital. The nature of those problems may differ. The free movement of capital and the regulatory issues related to financial services are complicated, in many cases more complicated that dealing with reductions of tariff barriers and that type of thing. But I do not think that changes the underlying fact that the free market principles is what we are trying to enshrine and promote in these trade agreements.

On the point about whether, if I understood the question, is whether bilateral agreements, the pursuing of a bilateral trade agreement agenda undermines or undercuts the multilateral initiative—did I understand that question correctly? Okay. We do not believe that. In fact, we believe that they complement each other. One of the points I wanted to raise in my testimony was that this is certainly Ambassador Zoellick's philosophy and it is the philosophy that we are pursuing, that we are pursuing bilateral, regional and multilateral initiatives at the same time, precisely to encourage competition and liberalization. In fact, we are even doing it

within the same region. We are pursuing free trade agreements with Central American countries. We just concluded the trade agreement with Chile. At the same time, we are pursuing the FTAA. We are engaging in these bilateral discussions because you can frequently make much more progress in a bilateral context than when you are negotiating in a multilateral context. But they all have value and they all complement each other in many ways. The advantage of the bilateral context is, one, you can make progress; two, you can tailor the specific provisions if you need to to specific problems that are in a country. You do not always get reduced to the lowest common denominator.

Chairman KING. The gentleman's time has expired. The gentleman from Vermont.

Mr. SANDERS. Thank you very much, Mr. Chairman.

What I would like our guests to do, and thank you very much for being with us today, is, I am going to make some what I believe to be statements of fact. When you disagree with me with exuberance or not, just tell me where I am wrong.

The United States believes, this administration, previous administrations believe very strongly in pushing free trade and globalized liberalization. This country today has a $400 billion trade deficit, the largest in our history. We have $100 billion trade deficit with China. In the last two years, we have lost 1.7 million manufacturing jobs, and at 16.5 million jobs, we now have the lowest number of manufacturing jobs in the United States in the last 40 years. Anything I have said that you disagree with? I do not see any disagreement, Mr. Chairman.

Mr. TAYLOR. Just on the facts, of course.

Mr. SANDERS. Yes.

Mr. TAYLOR. There is a causality that is implicit, but we can come back.

Mr. SANDERS. If you disagree with the facts, please, but you are not disagreeing with what I have said.

You will not disagree with the fact that over the last number of years there has been a transition in our economy from manufacturing to service industry jobs, and that most service industry jobs pay workers less than manufacturing jobs. That is what is happening in the United States, which indicates to me a failure of so-called free trade. Let me quote from the New York Times of September 4, 2002. I think we can all agree that the flagship of free trade, the model that we looked at, is NAFTA. The New York Times, by the way, strongly supported NAFTA when it was passed; article, September 4, 2002—you will forgive me. I am, needless to say, excerpting. "It has been two decades since Mexico committed itself to free trade reforms aimed at propelling this country into the developed world. But government statistics show that economic liberalization has done little to close the huge divide between the privileged few and the poor and left the middle class worse off than before. According to a recent government report, in the year 2000 half the Mexican population lived on about $4 a day, with scarcity shifting along with the population from rural regions to cities. Some 10 percent of Mexicans at the top of the economic period controlled close to 40 percent of the nation's wealth. Meanwhile, the 35 percent of Mexico's population that lives in the middle, with av-

erage earnings of about $1,000 a month, spirals slowly downward. The economist Rogelio Ramirez de la Oze, said that in the 1970s, when Mexico's population was 50 million and the country had begun to enjoy the benefits of an oil boom, some 60 percent of Mexicans were middle and working class. Their numbers and buying power have declined dramatically since then," Mr. Ramirez said.

In other words, free trade and NAFTA has failed for Mexico. It has failed for the United States' workers in the United States. I believe that if you look at what is going on in Argentina, what is going on in Venezuela, what is going on in Brazil and other countries throughout Latin America, you will find the same story.

So my first question, starting off, and there are two questions I would like to ask, Mr. Mendenhall, is why are you here telling us that we should defend a policy which has failed American workers and failed the poor people and the middle class of developing countries? My second questions—of course, we are here dealing with financial services—let me quote from Business Week, February 3, 2003, quote, "In the past year, Bank of America has slashed 3,700 of its 25,000 tech and back-office jobs, an additional 1,000 will go by March. Ex-Bank of America managers and contractors say one-third of those jobs are headed to India, where work that cost $100 an hour in the U.S. gets done for $20. Bank of America acknowledges it will outsource up to 1,100 jobs to Indian companies this year. My second question is, in terms of free trade in financial services, how many decent-paying, middle class jobs do you expect will be lost?

Two questions, why are you telling us to expand free trade when it has been by and large a disaster for working people in this country and for poor people abroad? Number two, in terms of financial services, how many jobs will American workers lose? Mr. Mendenhall, could you start it please?

Mr. MENDENHALL. Sure. I do not know all the numbers that you cited in the beginning. I cannot take issue as to whether they are right or wrong. I will assume they are. I do not know the sources. I think there is, as Under Secretary Taylor started to explain earlier, there is a tendency, I think, to load too much onto trade, perhaps for the bad and for the good. Trade is often blamed for the world's evils and on the other hand, trade is often viewed by some as the panacea for all the world's ills. The true answer is probably somewhere in the middle. So when you talk about loss of manufacturing jobs or the other factors that you cited, Under Secretary Taylor is entirely correct that we have to look at the cause of those particular losses. So I do not know for sure what the causative factors are for those losses.

Mr. SANDERS. If I may, sir, thank you—but when the evidence is overwhelming that companies are laying off American workers and going to China and to Mexico, can you doubt that trade and this policy plays a significant role in limiting manufacturing jobs, cutting back on manufacturing jobs in America?

Mr. MENDENHALL. I can tell you that the United States——

Mr. FEENEY. [Presiding.] The gentleman's time has expired. Without objection, he is yielded another 30 seconds.

Mr. SANDERS. I thank the gentleman, but I would ask for roughly the same amount of time as some of my colleagues had. I am not going to go on indefinitely. Do we have a vote, by the way? Did I hear bells go off? Did anyone hear that? No.

Mr. FEENEY. We will try to let you know, but if we can, to answer that question, we will try to go on and stick to the five-minute rule. We do have another panel of witnesses.

Mr. SANDERS. Okay. Yes, I understand.

I understand your point that trade is not the end all. There are other factors, but I find it very difficult to hear people keep coming forward when the evidence is overwhelming that for the middle class, working class in this country, and for poor people abroad, this policy has largely failed. Mr. Taylor, did you want to comment on that?

Mr. TAYLOR. I do not think it has failed at all. I think you are pointing to some trends about manufacturing and services that have been going on for many, many years. Our productivity in manufacturing is increasing at leaps and bounds, so to provide the same number of products, workers are going into services, which the United States has a great comparative advantage; and some very sophisticated services, some very high-paying services. So I think that is something that is going on, and as long as it is being done in a way that is beneficial to workers and firms, it is fine.

Mr. SANDERS. It does not concern you that millions of American jobs are now in China, where people do jobs at 30 cents an hour.

Mr. TAYLOR. I do not think millions of American jobs are in China.

Mr. SANDERS. You do not believe that?

Mr. FEENEY. The gentleman's time has expired. The gentleman from Texas is recognized for five minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Secretary, when the Administration sits down to negotiate a trade agreement with Singapore, is the Administration there to advocate, negotiate on behalf of Singapore's interests or the U.S.'s interests?

Mr. TAYLOR. No, it is on behalf of the U.S. interest.

Mr. HENSARLING. For those who wish to invest in Singapore, for those who wish to trade in Singapore, have you heard, have you seen any evidence, have you heard any evidence, or testimony that they prefer capital controls, or that they want to increase the risk of the loss of their capital?

Mr. FEENEY. Mr. Taylor and Mr. Mendenhall, if you would pull those mikes a little closer to you we could hear better and the recording secretary could hear you better.

Mr. TAYLOR. No, I have not heard requests for capital controls from U.S. financial representatives.

Mr. HENSARLING. Mr. Mendenhall, in your testimony, you indicate that the U.S. provides a substantial portion of the world's financial services, which I think many members of this panel are aware of. You point to several statistics that show we run a trade surplus in certain aspects of financial services. I must admit I am not one who is concerned about trade deficits. For example, I run a trade deficit with my barber every month. I run a trade deficit with my grocer every month. I am more concerned about whether

or not my income is increasing and whether I have enough income to pay my bills. For those who are concerned about the trade deficit figure, if we are running a surplus in many aspects of financial services, a trade surplus, can you speak to the impact of capital controls on the further export of U.S. financial services?

Mr. MENDENHALL. I can speak to it briefly. On the surplus issue, I think on the services side, not just financial services, but services as a whole, the United States is essentially running a trade surplus overall, as opposed to the trading goods sector. On the impact of capital controls, I can speculate what that would be. I would imagine the riskier that the investment would be in foreign markets, whether they be Singapore, Chile or elsewhere, if there is a high risk of capital controls being imposed that it would lessen the degree of investment and lessen the degree of cross-border transactions, and therefore reduce the surplus, would be my speculation.

Mr. HENSARLING. Mr. Secretary, can you speak, give us a little bit more detail about the regulatory transparency that has been negotiated in these two trade agreements?

Mr. TAYLOR. The regulatory transparency in the case of Chile is one in which they have agreed to, for example, make formal notification if there is a change in regulation, so that becomes very clear and is not a surprise. In the case of Singapore, there is just more information put out about the regulations, more transparent in the sense of more public notice in general.

Mr. HENSARLING. Thank you.

Mr. MENDENHALL. If I could just say a word about that as well, the transparency provisions I think are fairly central to the financial services chapter. I know it is of critical importance to our own financial services industries. In many ways, it parrots what we do in the United States. We have a publication and comment period. We have time frames for issuing or responding to applications for permits for financial services and so on. The reason I wanted to come back to the point is because I got an earlier question dealing with how these agreements might promote stability in some of these countries. I think the transparency provisions by making the markets more open, promoting information sharing, promoting the formulation of good regulations—all of that I think contributes to the rule of law and the stability of these financial regimes. Thank you.

Mr. HENSARLING. Thank you, Mr. Mendenhall. In the few seconds I have left, Mr. Chairman, if I could simply state for the record, coming from Texas, which is a lot closer to the nation of Mexico than the state of Vermont, I can tell you that NAFTA has been an incredible success on both sides of the border. Approximately one out of six jobs in Texas results from export and trade, principally with Mexico. If you have traveled south of the border, you see how many people have been liberated from poverty because of the American investment along the border, particularly in the maquiladors.

Thank you, and I yield the balance of my time.

Mr. FRANK. Would the gentleman yield for one second?

Mr. FEENEY. This is not the geography committee.

The gentleman from New York, you are recognized for five minutes.

Mr. MANZULLO. Illinois is a long way from New York.

Mr. FEENEY. I am sorry. Mr. Manzullo, you are recognized.

Mr. MANZULLO. I appreciate it. Thank you very much.

What was that, Barney?

[Laughter.]

It is good to see you here. I would like to see everybody here on one panel, because I would—it would be delicious if Professor Bhagwati were there and able to point for point meet with Ambassador Zoellick on the efficacy of these regional free trade agreements, as opposed to world free trade agreements as a whole. I do not know if I agree with his calling it a Leninist approach, but that certainly would make things pretty interesting.

I have this question. I am the Chairman of the U.S.-China Interparliamentary Exchange. We have met with the members of the National People's Congress on five different exchanges now. We just came back from China in January. Mrs. Biggert and Mr. Saunders were with us. One of the problems in the U.S.-China WTO accords is the fact that even with the liberalization or the ability of the United States' financial institutions to establish a presence in China, there has been this incredible standard that the Chinese have been setting. I do not want to call it deposit reserves, but in terms of almost a separate licensing requirement. It is obviously a non-tariff barrier, but it is just not working to get our people in there.

I know it is not related to the issue of capital flight or anything like that, but what have we learned from the fact that there perhaps is a lack of specific language in the U.S.-China WTO accord, and to take that lesson and put it in future agreements so that we do not have the continuous problem of fighting with the foreign government as to exactly what the reserve requirement is.

Mr. MENDENHALL. I think I am going to have to defer on that question myself. I would be happy to meet with you afterwards to talk about the specifics. I do not know the specifics of that.

Mr. TAYLOR. Just briefly, the WTO agreements are of course much different than these FTAs we are talking about, which are regional.

Mr. MANZULLO. Regional.

Mr. TAYLOR. Yes, but not only that, they get better agreements in some sense; more substantial tariff reductions. Perhaps that is the issue that Professor Bhagwati is concerned about. But the nature of the FTAs is they do get more specific about these kinds of things. In fact, these capital control issues we were talking about are just exactly the kind of deposit regulations you are referring to. In this free trade agreement with Chile, we have endeavored to reduce the likelihood that those would take place. It was very specific. That is one of the advantages of free trade agreements, or more general trade agreements. The WTO is not as substantial as these free trade agreements.

Mr. MANZULLO. But it could have been. I know, Mr. Mendenhall, you are the new guy on the block. I would love you to stop by the office and discuss this in depth, obviously at a later time. But there is considerable frustration going on. Why, when we entered into the China-WTO accession accord, and I know that is before you came on board, why can't you have just in the matter of—Mr. Tay-

lor, if you want to answer this—why can't you have strict provisions with regard to that problem in banking reserves, as you would in a regional agreement?

Mr. MENDENHALL. I can answer the question at a certain level of generality.

Mr. MANZULLO. That is Okay. Could you pull the mike closer, Mr. Mendenhall?

Mr. MENDENHALL. Sure.

Mr. MANZULLO. Thank you.

Mr. MENDENHALL. I can answer the question at a certain level of generality because I do not know the specifics of the issue you are referring to. But I think the tendency in a multilateral setting is that everything tends to get sort of reduced, if you will, to the least common denominator. In a bilateral or regional setting, the trade-offs are a lot clearer. The wants on both sides are a lot clearer, and it is easier to just trade one for the other as a single undertaking, if you will. The WTO has a great advantage, of course, that the global trading community is there, but it has the disadvantage of making the trade-offs and the gamin of the system, if you will, must be more complicated, and it is just easier to get higher standards agreements, if you will, in a bilateral or regional setting.

Mr. MANZULLO. Okay. I appreciate that. That really goes to the guts of Professor Bhagwati's statement in there. Thank you very much. I look forward to meeting with you sometime later.

Mr. FEENEY. And thank you, Mr. Taylor and Mr. Mendenhall. I assume that if members of the committee have additional questions and would submit them in writing, that you will do your best to reply.

Mr. MENDENHALL. Thank you. I appreciate the opportunity of testifying today.

Mr. FEENEY. Thank you very much.

We have another distinguished panel. While you are on your way up, I will try to introduce you briefly so we can get straight into your testimony and introductions: Dr. Bhagwati, Andre Meyer Senior Fellow in International Economics, Council on Foreign Relations; Dr. DeRosa, President of DeRosa Research and Trading, Incorporated; Dr. Henry, Associate Professor of Economics at Stanford University Graduate School of Business; Dr. Lackritz, President, Securities Industry Association; Mr. Tarullo, Professor of Law at Georgetown University Law School; and Mr. Vastine, President of the Coalition of Services Industries.

Welcome. I think we have got your name tags set up in order. As soon as you get seated, we will invite Dr. Bhagwati to start his testimony.

STATEMENT OF JAGDISH BHAGWATI, ANDRE MEYER SENIOR FELLOW IN INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS

Mr. BHAGWATI. Thank you, Mr. Chairman.

I think a lot of what I am going to say has been partly covered by the morning's discussion, but I will still indicate some principal points to recap and bring my own emphasis to bear. I think there are three questions before this committee. One is should we seek to impose serious restraints on the developing countries' ability to

use capital controls, just a general question. Two, should we do this as part of our trade agreements. And three, what can we even say about the wisdom of the specific provisions which we have in the two agreements before us? I will take up these issues in that order.

First, on the general wisdom of putting restraints on the use of capital controls, I am not encouraging people——

Mr. FRANK. Professor Bhagwati, could you pull the mike a little closer to you please? Thank you.

Mr. BHAGWATI. On whether we should impose constraints, as against encouraging people to use these, we have to be very clear whether we want to restrain countries from using these kinds of capital controls. I think after the Asian financial crisis of 1997 and 1998, nearly all economists in my judgment and information, and the International Monetary Fund, publicly now, have become much more cautious about the freedom of capital flows unregulated, you know, total freedom like total free trade. I would distinguish between three different contexts to understand this. First, should we pressure countries that are not on capital convertibility at all, to hasten their progress to doing so? IMF and U.S. Treasury were in fact doing this prior to the Asian crisis.

But both the crisis and the fact that India and China escaped it, I think as Under Secretary Taylor was somehow forgetful when one of you asked as to whether there were examples of people who did well by not going in for capital convertibility, and these are two gigantic countries, which have been outward-oriented on trade, on foreign investment coming into them—China more so than India, but India has caught up. They escaped the crisis, the contagion altogether and they survived. So we do have examples where countries were prudent, maybe excessively prudent, probably too closed—one can discuss that—but they really escaped it. So I think IMF certainly, and economists have become much more cautious and prudential compared to the pre-Asian crisis situation. Second, when you are more or less open—this is a different problem—when you are more or less open financially anyway, should you also not be prudent at the same time? The Chilean example with the Chilean tax, which might be looked upon as a token tax at a country level, was designed to moderate in-flows. So flows coming in, when they seemed too large relative to the reserves and to the fundamentals at hand—your export capabilities and so on—and there I would say, again, people concede everywhere that such a tax, as against a permanent capital control, is actually a good weapon to have. Not that you want to rush and in use it all the time, but it is something you want to be able to have as a weapon under your command.

The third is a more difficult one, namely that when you actually have panicky out-flows happening, as part of crisis management, do you then resort to capital controls? That is a different problem, again. Now, the Malaysians, of course, used them during the Asian crisis, and there was more controversy on this one. Again, my own judgment from whatever I have studied on this problem, is I am inclined to agree with those who have actually argued that Malaysians did rather well out of it, compared to the countries which took the then-prescription of the IMF.

In conclusion, I would say on the first question, we are far more conscious today about the wisdom of not taking an ideological or a financial lobby-driven position against the use of capital controls. I think today we certainly would be emphasizing in the classroom and in every course we will teach that, look, this is not on a par with free trade. I think one of the Congressman asked me, you know, why is this different? The reason it is different is that with trade, which I am a great proponent of, as the Congressman from Illinois pointed out, that is a very different kind of proposition. I say that if I exchange my surplus toothbrush with some of your surplus tooth paste, and we remember to brush our teeth before we go to bed, we are both going to get white teeth. And the possibility of our teeth being knocked out in the process is very negligible. But when it comes to the analogy on capital flows, it is obvious that really the analogy is like fire. You can use, as I have pointed out in my written testimony, Tarzan can roast his kill, but if he goes back as the Earl of Greystoke and he plays around with fire, he can bring his ancestral home down. So you have to be prudent. It is a very elementary point, and only ideologically one could be against it today. So I think that is number one.

Now, two, putting any such restrictions——

Mr. FEENEY. Doctor, if I can, we have your written testimony, and unfortunately as have a number of distinguished witnesses.

Mr. BHAGWATI. Okay. Let me just make one point quickly.

Mr. FEENEY. Yes, sir. Wrap up.

Mr. BHAGWATI. On putting any such restrictions down in a trade agreement, I think the Under Secretary was right, that trade liberalization should include services. We have a general agreement on trade in services. But that is not the issue we are discussing. We are discussing whether we should have capital controls ruled out, and there it seems to me that there is a real problem about bringing this into trade agreements. It is not just Congressman Frank or me and others who are worried about this. Today, we have had problems, as you know, with Chapter 11 and NAFTA, if this is where overly liberal ideological views seem to have been taken on takings. And that got us into a lot of trouble.

Today, all the NGOs are anti-globalizers. They are very concerned about post-financial crisis about what we are doing on the financial issue. If we put something like this into a trade agreement, no matter which trade agreement, that is immediately going to attract flack. So I think it is politically imprudent to mix up trade treaties with capital account controls. If you want to shove it into an investment agreement, fine, then more of the objections will go there, but trade is bad enough—Congressman Sanders was exaggeratedly pointing to its perils, in fact erroneously so in my view—but you have positions like that. You do not want to mix it up and make and over-burden your case.

[The prepared statement of Jagdish Bhagwati can be found on page 51 in the appendix.]

Mr. FEENEY. Thank you, Dr. Bhagwati.

Mr. DeRosa?

STATEMENT OF DAVID F. DEROSA, PRESIDENT OF DEROSA RESEARCH AND TRADING, FREDERICK FRANK ADJUNCT PROFESSOR OF FINANCE, YALE SCHOOL OF MANAGEMENT

Mr. DEROSA. Good afternoon, Mr. Chairman and members of the subcommittee. I am David DeRosa. I am president of DeRosa Research and Trading, and I am an Adjunct Professor of Finance at the Yale School of Management, where I have taught international finance for the last six years.

My testimony is going to be on my position on capital controls. In the middle 1990s and continuing up to the present time, a great many emerging market nations experienced cataclysmic financial crises. Many of these same nations had previously been identified as growth miracle economies. Examples are Mexico in 1994; Thailand, Indonesia, Malaysia in 1997; South Korea, 1997, 1998; Russia, 1998; Brazil, 1998; Turkey, 2001; Argentina, 2002. These were devastating crises, much economic suffering ensued; inflation, unemployment, bankruptcies were widespread.

Now, stock and bond markets plunged and in all of these cases, the national currencies depreciated greatly and the foreign exchange regime that governed those currencies were abandoned. The reaction to the crisis has been largely to blame—the international capital markets and in particular the foreign exchange market. Some say the afflicted countries were victims of capricious international capital flows. Hence, we are here today to discuss capital controls in the context of some trade legislation.

I studied economics at the University of Chicago for 10 years. I have a bachelor's and a Ph.D from the school in economics and finance. I have been a currency trader at a major bank. I have been an investment manager and I have been a hedge fund manager. At present, I am a member of the board of directors of two of the most successful hedge funds. That does not affect my opinion on capital controls. It just explains my experience.

Now, I want to call your attention to this, because it is my sincere belief that much of what happened in the 1990s and the last three years has been totally misunderstood. Take this, for example: All of the above-mentioned crises that seems to have shaped our thinking, all except one, Malaysia, which I will come to, took place in economies that had some form of fixed exchange rate regimes. In fact, the climax of all of these crises were when the fixed exchange rate regime exploded or was terminated. Each crisis was marked by a sharp out-flow of capital prior to the moment when the fixed exchange rate regime was scrapped. Once it was scrapped, there was sharp depreciation in the currencies, sometimes as much as 70 percent.

In each case, the government replaced the fixed exchange rate regime with a floating exchange rate regime. And you know what? No more crises. No more crises. Once a floating exchange rate, no more currency crises. All of these countries had accumulated massive amounts of private and public debt denominated in U.S. dollars. So when the exchange rate depreciated, the local value of those debts magnified up, sometimes two or three times. Preceding the crises, an enormous amount of foreign capital flooded into these countries, sometimes buying local securities, sometimes as direct investment, sometimes as leveraged transactions. But most impor-

tant, all of these trades, which are called carry trades, were really not investments per se in the country, they were investments in the fixed exchange rate regime. Under the umbrella of safety that they thought they had, people invested in these countries to get superior interest rates, hoping that the fixed exchange rates would preserve the value of their capital.

History has shown that fixed exchange rate regimes are crisis-prone. Almost all of them have blown up. It is an endemic problem, and it is not just emerging markets, it is major countries as well—witness Bretton Woods and the exchange rate mechanism. The reason why currencies depreciate so violently when fixed exchange rate regimes are abandoned is that domestic dollar borrowers and foreign investors all rush to hedge their positions. So it is the case of a crowded theater, 200 fat men, somebody yelled "fire," and it is a narrow doorway. Governments in crises almost always make these crises worse, if not considerably worse, by enacting bad responses that exacerbate the situation. Thailand, Indonesia, Russia, Brazil and Argentina stand out as especially poor examples of how to respond to financial crises.

Now, we have this myth that Malaysia found a kinder and gentler way by imposing capital controls. The fact is, Malaysia imposed them 14 months after the crisis started. This was a spectacular case of locking the barn door after the horse was out. In fact, Malaysia also simultaneously pegged the ringgit at 3.8 to the dollar and that is where it is today. And subsequently, all of the other Asian currencies have rebounded substantially. What relief Malaysia got was——

Mr. FEENEY. Dr. DeRosa, if you can wrap up. Thank you.

Mr. DEROSA. Right. It was simply because it pulled a fast one. It devalued the ringgit relative to its neighbors.

So the point is that you do not really have to worry about these crises or capital flows. They are a function of fixed exchange rate regimes. You do not need the capital controls. They are a bad idea.

Thank you very much.

[The prepared statement of David F. DeRosa can be found on page 64 in the appendix.]

Mr. FEENEY. Thank you.

Mr. Lackritz? I am sorry. Dr. Henry?

STATEMENT OF PETER BLAIR HENRY, ASSOCIATE PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY GRADUATE SCHOOL OF BUSINESS

Mr. HENRY. Mr. Chairman, members of the committee, my name is Peter Henry. I am Associate Professor of Economics at the Stanford University Graduate School of Business. I am also Faculty Research Fellow at the National Bureau of Economic Research. My research is funded by the National Science Foundation's Early Career Development Program. I have written extensively on the economic effects of capital account liberalization.

Thank you for the opportunity to discuss the implications of my research for the financial services component of the recent U.S. trade agreements with Chile and Singapore. My testimony consists of three brief general points. Point number one, what is my position on the importance of free trade? Free trade in goods, also

known as trade liberalization, is the linchpin of globalization. All countries can benefit from free trade because free trade allows countries to export those goods for which they are low-cost producers, and import those goods for which they are high-cost producers. This kind of specialization brings two specific benefits. First, countries get to consume goods at a lower price than would be possible if instead of importing the goods, the countries produced them at home. Second, specializing in the production of goods at which they are more efficient raises countries' gross domestic product.

Trade liberalization is not costless, however. Liberalizing trade may cause unemployment by driving inefficient producers out of business. In principle, however, the overall gain in gross domestic product that result from free trade are sufficiently large to pay for the cost of retraining workers in redundant industries. In other words, all members of society can be made better off from trade liberalization when it is judiciously applied. Therefore, we should take the lead in promoting worldwide free trade by continuing to open our borders to foreign goods and encouraging other countries to follow suit. The recent trade agreements with Chile and Singapore provide a small step in the right direction.

Point number two, what is my position on the importance of capital controls? A heated debate over capital account liberalization has followed in the wake of financial crises in Asia, Russia and Latin America. Opponents of the process argue that capital account liberalization invites speculative hot money flows, increases the likelihood of financial crises, and brings no discernible economic benefits. Some economists have gone so far as to assert that open capital markets may actually be detrimental to economic development. I believe that there is a serious flaw with such reasoning. This flaw stems from the fact that those who oppose capital account liberalization have failed to define exactly what they mean. Why is it important to define precisely what one means by the term capital account liberalization? The reason is that there are many different types of capital account liberalization. At a minimum, we need to distinguish between two categories: those that involve equity and those that involve debt.

Consider first equity market liberalization—opening the stock market to foreign investors. My research demonstrates that three things happen when economies open their stock markets to foreign investors. First, the cost of capital falls for companies that are listed on the stock market. Second, in response to the reduction in their cost of capital, the companies that are listed on the stock market increase their investment in physical assets. And third, as a result of the increase in investment, productivity rises and the country's growth rate increases by more than 1 percentage point per annum. Since the cost of capital falls, investment booms and economic growth increases when countries liberalize the stock market. The view that capital account liberalization brings no real benefits seems untenable.

Liberalization of debt markets, on the other hand, has often led to great difficulty. For example, excessive short-term borrowing in dollars by banks, companies and governments have played a central role in the onset of almost every emerging market financial cri-

sis during the 1990s. In essence, the mismatch between the term structure of borrowers' assets, which were typically long-term and denominated in local currency, and their liabilities, which were short-term and denominated in dollars, placed these countries in an extremely vulnerable position. Any bad news that made the lenders reluctant to extend new loans was bound to create an immediate liquidity problem. So we have to distinguish between debt and equity. Equity market liberalizations bring about good results; debt market liberalizations are much more problematic.

Point number three, and last point—the lessons for this and future agreements on capital controls. The evidence I have outlined in this report can be distilled in a few key lessons for the capital controls portion of the Chile and Singapore free trade agreements. First, the liberalization of dollar-denominated debt flows should proceed slowly and cautiously. This agreement, as well as all future agreements, should refrain from any language that inadvertently pushes countries into prematurely liberalizing dollar-denominated foreign borrowing. The second lesson is that all the evidence we have indicates that countries derive substantial economic benefits from opening their stock markets to foreign investors. There is no reason to think that Chile and Singapore will be any different in this regard.

Thank you.

[The prepared statement of Peter Blair Henry can be found on page 151 in the appendix.]

Mr. FEENEY. Thank you, Dr. Henry.

Mr. Lackritz, welcome and thanks for being here.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman. It is a pleasure to be here. Thank you for the opportunity to testify. I am Mark Lackritz, president of the Securities Industry Association. I want to testify in very strong support of these bilateral free trade agreements with both Chile and Singapore.

These agreements will result in increased commerce between our respective countries, and in both cases the already close economic relationships will be further strengthened, providing new opportunities for U.S. securities firms and additional jobs in the United States. Importantly, we believe these agreements are excellent precedents upon which to build and negotiate ongoing and future bilateral and regional trade discussions. Both agreements successfully achieve many of the securities industry's specific objectives, including, first, permitting 100 percent ownership and market access. Both of these countries are open market and provide U.S. securities firms with full market access by the establishment of a subsidiary or the acquisition of a local firm. Since the conclusion of the 1997 WTO financial services agreement, both countries have undertaken extensive liberalization of their financial services markets. These agreements not only lock in current levels of access, but also produce commitments by both countries to eliminate and reduce some of the remaining establishment barriers.

In terms of specific commitments, the FTA would for the first time afford legal certainty to U.S. firms to establish a wholly

owned affiliate in Chile to provide asset management services on a national treatment basis. Singapore also made commitment guaranteeing U.S. membership on the Singapore stock exchange, as well as for the acquisition of equity interests in local securities firms.

Increasingly, services must be delivered through a business presence in the host country. As a result, the ability to operate competitively through a wholly owned commercial presence or other form of business ownership must be a fundamental element of any agreement. These agreements guarantee the ability of U.S. securities firms to enter into these markets through the establishment of a subsidiary or the acquisition of a local firm. Once established, U.S. securities firms will receive the same treatment as domestic companies. For example, the free trade agreement with Chile provides national treatment to U.S. asset management firms in managing the voluntary portion of Chile's national pension system, and the ability to manage the mandatory portion of the pension system without arbitrary differences between the treatment of providers. In Singapore, U.S. firms will now be able to compete for asset management mandates from the government of Singapore investment corporation.

In addition, obtaining commitments on regulatory transparency was our industry's major goal in the agreements with Chile and Singapore. We view the provisions contained in these agreements as excellent, and view the FTAs as important precedents for transparency of future efforts. The specific financial service transparency commitments in the FTAs will require that rules cannot be adopted without appropriate public notice and opportunity to comment; that requirements and documentation for applications be clear; and that decisions on applications be made in a specified or reasonable time. The ability to freely transfer and process information is essential to the business of modern financial services firms. Indeed, many products such as instruments built around market indices that are vital to smoothing out risk, could not function without timely data flows. Nevertheless, too few countries have committed to this key link in the financial services infrastructure. In this regard, commitments by both Chile and Singapore mark a major step forward. Chile made no commitments in financial information in the 1997 GATT agreement, while Singapore made a limited commitment. The FTAs will now give U.S. firms the legal certainty to process and disseminate financial information both domestically and cross-border.

As a general matter with respect to capital transfers, our members believe that restrictions on capital flows deprive both parties of the benefit of cross-border investment. This is of particular concern to financial services companies and others engaged in portfolio investment. We welcome the general commitment in both agreements to permit the free and immediate transfer of capital related to an investment. However, we regret that both agreements contain exceptions to this general commitment. Our members fervently hope that these exceptions to free capital movements will not form a template for future agreements.

In conclusion, Mr. Chairman, we believe these agreements offer Congress another opportunity to secure open and fair access to for-

eign markets for U.S. firms and our clients. This pact will result in benefits to consumers and businesses in both countries, as well as globally. We look forward to continue to work with both this committee and the Administration in developing a fair, rules-based trading system that enhances U.S. economic competitiveness.

Thank you very much.

[The prepared statement of Marc E. Lackritz can be found on page 161 in the appendix.]

Mr. FEENEY. Thank you.

Mr. Tarullo, please pull that mike close to you so we can hear you.

STATEMENT OF DANIEL K. TARULLO, PROFESSOR, GEORGETOWN UNIVERSITY LAW CENTER

Mr. TARULLO. Thank you, Mr. Chairman.

Mr. Chairman, I am struck by the fact that it is Chile and Singapore we are talking about here. Chile and Singapore have been among the most exemplary developing countries in terms of their economic policies, their financial policies, and the orthodoxy of those policies. The fact that both of those countries, neither of which have imposed capital controls on out-flows in recent decades, asked that they be allowed to retain some capacity to impose capital controls in exigent circumstances seems to me a reason why this committee and the Congress ought to take a moment and reflect upon the import of these capital control provisions as a template for future agreements.

Now, why would Chile and Singapore, as I say, two orthodox exemplary sets of macroeconomic policymakers ask for an exception? I think it is because of the cumulative effect of not just the Asia crisis, but the Mexico crisis, and what they have observed over the last decade in an increasingly globalized and sometimes turbulent financial system. They want to retain the capacity, in an emergency, to do something that they otherwise have no intention of doing. The International Monetary Fund, which was certainly a proponent of full capital account liberalization as recently as seven or eight years ago, has just released a very careful study which shows how nuanced one has to be in determining when and how capital flows are going to be efficient and effective in developing economies.

Why is it that capital flows do not have the effect in a developing economy that they do in the United States, where more or less untrammeled capital flows are indeed productive? I think it is because we are in that murky realm which economists call the world of second-best. Developing countries do not have deep and liquid capital markets, by and large. They do not have well regulated securities markets. They do not, by and large, have sophisticated supervision for their banking systems. For all of these reasons, the countries are not able to absorb capital flows, particularly shorter term debt flows, in the way that the United States or the United Kingdom could. That is the reason why Chile and Singapore want this insurance policy, and that is the reason why I think we need to pay heed to their policymakers, speaking for themselves and on behalf of other developing countries.

What troubles me about the present template is that it is really quite absolutist. It really does not distinguish, as Dr. Henry is trying to do, among different kinds of capital flows. Indeed, I note that the investment chapter of the Singapore agreement mentions and includes as an "investment" bonds, debentures, other debt instruments and loans. Unlike the NAFTA, for example, it does not say such bonds, debentures, debt instruments and loans of longer than three years duration. It is any such bond, debenture, debt instrument or loan. That kind of painting with a broad brush seems to me not to incorporate the appropriate modesty that we all must have in assessing the operation of global financial systems in developing countries in the wake of all we have seen in the last decade.

I am concerned that what we are witnessing here is a bit of a triumph of economic creed over economic evidence. What I would like to see is more of what Dr. Henry and others are doing, of trying to draw distinctions, to see how much we can learn, and then through appropriate channels such as the IMF and discussions in the G-7, to see if we can come up with a set of sensible nuanced standards—standards that are not just based upon the textbook finance that apply in the United States, but that are based on the real operation of capital markets in the murky second-best world of developing countries.

I do absolutely believe that when the United States enters into trade agreements, it ought to be doing so with its self-interest in mind. But that self-interest needs to be an enlightened self-interest. By "enlightened" I mean that we promote rules which are going to redound to the benefit of all of our trading partners, which will produce a more growth-oriented, stable international economy in which the exports of the members of the coalitions represented by the gentlemen on my flanks today will be able to prosper. I do not think we have an interest in some sort of short-term asset grab, if it is at the cost of our ability to promote such sensible rules.

Thank you very much, Mr. Chairman.

[The prepared statement of Daniel K. Tarullo can be found on page 177 in the appendix.]

Mr. FEENEY. Thank you.

Mr. Vastine?

STATEMENT OF J. ROBERT VASTINE, PRESIDENT, COALITION OF SERVICE INDUSTRIES

Mr. VASTINE. Thank you very much, Mr. Chairman. I am here to testify on the commercial advantages of the Singapore and Chile agreements, and explain why they should be approved by the Congress.

U.S. financial services companies are committed to trade negotiations to remove barriers to trade and investment. In any form, these barriers are very extensive. We would be glad to supply lists by countries of the kinds of barriers our companies face. The industry's $6.3 billion trade balance in cross-border trade in financial services last year would grow if we could remove these barriers. Indeed, reducing barriers to U.S. services trade is our best hope to reduce the chronic goods trade deficit that Congressman Sanders has referred to.

Indeed, in order to try to add some light to the statistics raised earlier by Mr. Saunders, there were 20 million new services jobs created in our economy between 1992 and 2002. That more than offset the loss of manufacturing jobs. It is not correct to think that those jobs are low-paid, poor jobs. In fact, there are some, of course, as there are in manufacturing, low-paid jobs in services. But the average annual earnings in services in 1999, which is the last year for which we have data, were $32,800 compared to $32,400 in manufacturing. So it is not true that services jobs in general on the whole are low-paying jobs. Just to add one more statistic, between 1990 and 2001, U.S. total employment increased from 92 million to 115 million in the private sector. That is not the evidence of a country that is being laid waste by its foreign trade policies.

Singapore and the Chile agreements, to go back to the subject, deal with the trade agenda of financial services companies more thoroughly than any other trade agreement to date. The Singapore and Chile markets are small, but the agreements are important precedents. They should be approved by Congress because, first, they fulfill the negotiating objectives of the TPA Act. Secondly, they bind liberalization already adopted by the two countries. Thirdly, they make commitments to new liberalization. For example, the provisions in the Singapore agreement on banking give U.S. banks significant new rights to operate as qualified full banks in Singapore, and to create and join ATM networks. They include commitments to cross-border services trade in insurance. Both agreements allow U.S. companies to offer many more products such as reinsurance auxiliary services, including actuarial and other consulting services, marine aviation and transport cross-border, and brokerage services.

They provide for freedom of financial information flows for firms like Reuters. They contain important commitments to freedom of establishment, that is to say direct investment. You cannot sell a life insurance policy to a Singaporean from an office in New York. You have to establish. As Mr. Lackritz said earlier, services trade is characterized by this need to establish, to enter a market, to set up your business, and to sell a product. This creates, as in the case of New York Life in India, a lot of new jobs in New York and elsewhere in our country. It supports the home offices of our companies.

Next, the agreements contain extensive commitments to transparency, which are very, very helpful—indeed, a breakthrough. They contain new provisions for improved regulatory quality. They provide modest provisions, but important ones, for the movement of people for temporary foreign assignments, which is a very important way in which financial services are traded. Finally, the agreements have sound investment chapters, which include of course commitments to freedom of capital transfers. We join the Securities Industry Association in noting that the agreements have measures to compensate private investors in case a country controls capital movements. I would just like to point out that these measures can backfire against the country that wants them. Countries that reserve the right to use controls may risk chilling the investment climate to their own disadvantage. It is like putting up a sign on the

highway into town, "investors are welcome, but we reserve the right to keep your cash."

Finally, Mr. Chairman, we believe these agreements are in our national interest and the Congress should approve them. They fulfill the TPA negotiating objectives. They are the result of substantial industry consultation. They contain some real breakthroughs, like in transparency. They are good precedents for FTAs with larger economies. They can seriously increase our financial services trade, especially if broadened among other countries, and increase U.S. jobs and prosperity. Finally, they can help reduce the goods trade deficit.

Thank you very much.

[The prepared statement of J. Robert Vastine can be found on page 198 in the appendix.]

Mr. FEENEY. And thank you.

Congressman Frank, if it is all right with you, why don't you take about 10 minutes and then I will defer to you, and then I will conclude if we still have some time and interest.

Mr. FRANK. Thank you, Mr. Chairman. I appreciate this.

Let me say, I was pleased to hear Mr. Vastine say that this goes much further in terms of accommodating the prudential interests than any previous treaty. I think that is a far more accurate description than Mr. Taylor saying, oh, it is just what we have always been doing. I think Mr. Taylor significantly understates the difference.

I was particularly interested in Professor Henry's distinction. I welcomed it, with regard to debt versus equity. To some extent, I think that they are overlapping categories. There are short-term, long-term. There is foreign direct investment in portfolio and there is debt and equity. They have substantial overlap. What strikes me, Professor Henry, is that the interesting thing about these provisions is they do not make that distinction that you so carefully made. I wonder if you would care to comment on whether or not when we do this, we ought to take those fundamental differences into account.

Mr. HENRY. One of the reasons that I wanted to point that out was actually when I read through the agreement myself, the chapter on investment, it struck me that there were two separate issues. One issue is to what extent do you actually require a country to open up to various kinds of investment, and that issue does not seem to be addressed at all in the current investment agreement. What the current investment agreement addresses is really the second issue, which is given the decision to open up to certain kinds of investment, how do you treat foreign versus domestic holders of a given asset? The point that I just wanted to make, just so it would be on the record and people can think about it, is that I think the first point, the extent to which we actually require or possibly inadvertently push countries to open up to certain kinds of investment prematurely, is something that we should move away from.

Mr. FRANK. And again, the problem I think many of us have with these sets of treaties is that they do not make those distinctions. There were things—nondiscrimination, national treatment—a number of these things—access to ATMS—which are very good things.

The point that Professor Bhagwati made, who has been a very strong support of free trade, is that the danger here is that this will undercut precisely the kind of support for trade that we wanted.

Mr. Tarullo, one other point you noted, because again Mr. Taylor keeps saying this is just more of the same, you noted that with regard to NAFTA I think it was, there was a three-year requirement that is not here in this treaty. Is that correct, with regard to bonds, et cetera?

Mr. TARULLO. Congressman Frank, there are a number of differences between the NAFTA provisions covering investments and those in the Singapore agreement. I am not able to get a copy of the Chile agreement. Apparently the Administration has not formally released it, but I gather it is pretty much the same. The one difference I mentioned in my testimony, which is that the definition of investment in NAFTA covers debentures, bonds, other debt instruments which are of longer than three years duration. Obviously, that was distinguishing between shorter and longer term. Another point of difference is——

Mr. FRANK. And here there is no such distinction.

Mr. TARULLO. Not that I am able to find, sir. No.

Mr. FRANK. I was told there is not, that there is no short term, long term, or any other kind of distinction.

Mr. TARULLO. The second point—there are a number of distinctions; we do not want to go through all of them here—but a second distinction is that the NAFTA explicitly incorporates IMF standards. Whereas, this agreement, at least with respect to the investor-state dispute settlement, seems——

Mr. FRANK. And the IMF does allow for certain kinds of exceptions.

Professor Bhagwati, I want to go back again to the experiences that we have had, because again I know no one is arguing for a regular reliance on capital controls. But would you talk some more? We have had some dispute about the East Asia experience in particular. Would you just talk a little bit more about what we learned from East Asia about particularly short term, hot money, portfolio investment, and how it is covered in this treaty?

Mr. BHAGWATI. Just to keep matters short, I think there is a diversity of experience there. South Korea was sort of caught up by the flu that came from Indonesia and Thailand. Thailand was a little weaker than Indonesia was, but essentially I think what happened was that despite relatively strong fundamentals compared to, say, Mexico or South American countries, these countries suddenly experienced massive out-flows. So it was in fact panic. Now, in economic theory, we do recognize that even when you are strong, you can have panic withdrawals simply because of things like what we economists call in jargon asymmetric information and so on. There are lots and lots of reasons why one could have this. DeRosa would have probably learned this as destabilizing speculation at Chicago, but it does occur. This is certainly did occur.

So it had nothing to do with mismanagement or something like you had, you know, tremendous excess spending, the kind of thing which broke out in Mexico in 1994. So in that sense, it was really I think a classic case where you really learned that systems could

in fact collapse under this kind of regime. So I think that is one lesson that we have learned. So we should no be too complacent, Congressman.

Mr. FRANK. Thank you. I would just note, I understand there are legitimate differences here. But to impose one particular view of what is at best a very hotly disputed thing, and to tell other governments that the price of dealing with the American market on these terms is to acquiesce to it seems to me a mistake.

I have one final question for Mr. Lackritz and Mr. Vastine. We tend to get involved in two ways here. One, we negotiate treaties as to what kind of investments go, but when countries get into trouble and are not able to pay off either through sovereign debt or through other kinds of debt, our government also gets involved. Does this preference for a complete laissez faire, free trade, pure let the market work approach apply to when the trouble starts? Should we be equally saying, okay, the United States will run interference for you, and we will create for you absolutely open areas to invest in any of these countries. However, if having done that, you get into any kind of trouble and there are not payments et cetera, you are on your own. Should that be part of the deal, Mr. Lackritz?

Mr. LACKRITZ. Well, I think you are referring to sort of sovereign debt restructuring.

Mr. FRANK. No, I am referring to—no, there are other things. There is sovereign debt restructuring. There is the United States lending money. There is pressure on the IMF. You know, there are a whole range of things, not sovereign debt restructuring only. I am talking about whether or not the United States Treasury, whether it is Argentina or Mexico or any other country, ought to get involved and say, alright, let's get involved and let's try and increase the flow of funds, partly so that the American investors can get their money back out.

Mr. LACKRITZ. First of all, I think that what you are talking about, first of all, we favor having private contractual mechanisms to work out these kinds of situations.

Mr. FRANK. So you do not want any United States government involvement?

Mr. LACKRITZ. And the involvement of the government obviously is helpful in those circumstances, but——

Mr. FRANK. But you would be opposed to it as an interference with the free market?

Mr. LACKRITZ. I was not saying——

Mr. FRANK. You want the right to go in unimpeded. If you want to go in on your own, shouldn't you stay on your own once you are in there?

[Laughter.]

Mr. LACKRITZ. Well, conditions change, as you know.

Mr. FRANK. Oh, yes, once you have your money in there, they change.

[Laughter.]

Mr. LACKRITZ. I think you have to look at this from a longer-term perspective, from the standpoint of, how do we improve the flows of capital.

Mr. FRANK. No, that is a separate issue. I understand that. But I really will be honest, you know, Mr. Tarullo said there is a question of a creed intervening here. Let's put it on the table, there is also a question of whether greed is intervening. Obviously, people have a right to pursue their own interest, but I do not think it is in America's interest, by the way, to gain every short-term advantage for every commercial interest. We have an interest in stability. We have an interest in democracy. And the question is, frankly, are you not being inconsistent in being free-marketers when it comes to put the money in, but somewhat more mercantilist when it comes to you getting it out? Mr. Vastine?

Mr. VASTINE. I do want to respond to something you said earlier, characterizing my statement that these agreements gave more attention to financial services and other services, all other tradable services than previous agreements. Listen, the capital transfers provision of these agreements is a very small element.

Mr. FRANK. Could you get back to the question? I was just trying to say that you and I agreed that this is more different than previous ones than Mr. Taylor says. But what about the differential standards on the money going in and the money coming out?

Mr. VASTINE. Well, the market should be encouraged to work. Countries should be encouraged to take fundamental steps, not surface, not arbitrary, not administrative steps, to try to cure their international payments problems. Those are the real cures.

Mr. FRANK. I understand that, and that is a good answer if somebody asked you that question. But the question I had was, when you have taken advantage of these treaties and freely invested short-term, long-term, and trouble comes up, should I not just say, well, I will be interested to watch that because, you know, you took advantage of the market and the market has its bumps and its ups and its downs.

Mr. VASTINE. And some Treasuries take that point of view.

Mr. FRANK. What do you want them to take? I understand that, but what would your position be? Would you say to the Treasury, please, let's not be inconsistent here; the free market should work and we went in eyes open and we knew what we were getting into; let's not hear any talk of bailouts or federal government pressures for restructuring.

Mr. VASTINE. That is why this agreement provides a mechanism. If flows are stopped, the agreement does indeed provide a mechanism, a rather complex one and somewhat delayed one, to make investors whole. So in theory, there would not be any need for the government to involve itself.

Mr. FRANK. Unfortunately, the way to make investors whole would be, and I think this is a point that others have made—Mr. Tarullo and others—it would make investors whole by taking from a fairly poor country money that would otherwise be available for some basic services.

Mr. LACKRITZ. Could I just respond to that?

Mr. FEENEY. Why don't we let Mr. Lackritz and Mr. Vastine, and then we are going to go the gentleman from Illinois.

Mr. LACKRITZ. Thank you, Mr. Chairman.

Mr. FEENEY. Mr. Lackritz?

Mr. LACKRITZ. I think the point that you are raising, Congressman, is an excellent point, but I would only refer you back to Emerson's notion that a foolish consistency is the hobgoblin of small minds. That is why we are trying to be pragmatic and practical here as well.

Mr. VASTINE. I guess my last point, Congressman, is that I cannot quote Emerson. I could give you a little Mark Twain on "lies, damned lives, and statistics," but I will not do that. I would just like to caution that we should not be cavalier or presumptuous in thinking that the Chileans and the Singaporeans have weak regulation, and are not sophisticated negotiators. They are very sophisticated.

Mr. FRANK. I agree. One second here, I just want to say to Mr. Lackritz, to modify another quote, reference to Emerson in that sort of a situation is the last refuge of people who do not have a logical answer for an inconsistency.

Mr. FEENEY. Well, I thought we were talking to economists. We expect some inconsistencies, don't we?

The gentleman from Illinois.

Mr. MANZULLO. I have a son studying English and poetry and Grove City, and he fell in with the libertarians and now he wants to double major in economics, so he can quote Emerson along with the economists.

First of all, I am sorry I could not listen to the testimony of everybody, but it really ties into the constituents I have back there. There is a very skeptical mood in Congress with regard to any new free trade agreements, based upon the fact that there are not empirical studies that can justify economic theories. Members of Congress are elected by real constituencies, and not theorists.

Let me give you an example. We have got a huge war going on with massive waivers of the Berry amendment by the Secretary of the Air Force, that is allowing Russian titanium to go into engines on our military aircraft. The waivers are granted ex parte. There is no notice. These are strategic metals, and therefore in the area of procurement. As a person who calls himself a free trader, we have looked upon the $300 billion in procurement in this country as a way of leveling the playing field. In other words, if the local manufacturers can get contracts for U.S. consumption, paid for by U.S. taxpayers' dollars, then that is the way to get a good share and to maintain a base, especially in the area of strategic metals.

In examining these free trade agreements of America, the new FTAA, the Singapore and the Chilean agreements, our U.S. procurement is opened to these countries, and they can manufacture goods obviously a lot cheaper than our people, by providing nondiscriminatory treatment. In other words, if somebody from Chile wants to make a tank tread or tank turret, they can come in, bypass the Berry amendment, and again add to the hollowing out of manufacturing that is going on. I asked one of the assistant USTRs, and I have tremendous respect for Bob Zoellick. I do not think he is a Leninist, Dr. Bhagwati, even though the theory may have been Leninist. I am just teasing you, you know that.

But I said, do you have any quantitative evidence as to who wins and who loses when we open U.S. procurement to foreign countries? In other words, are there any documents out there that show

how much U.S. companies are buying of procurement from other countries, and how much other countries are buying of procurement from the United States. I was told the statistics do not exist. If the statistics do not exist, then why do we proceed with going ahead with these new agreements that leave the procurement open and further hollow away at our manufacturing base in the United States? I know this is on services and services are extremely important because the more liberalization of services you have, the merchandise follows after that. That is after the Vastinian theory put forth in a Cato article that Mr. Vastine published about three years ago, and that is when we first got involved in this. Does anybody want to tackle that question, take a look at it? Professor, I know you would like to.

Mr. BHAGWATI. I do not know of any empirical studies because procurement has usually been for one's own people, so that you would have to have an anticipatory study—you know, what would happen if, which would be very problematic. But I think I would just sort of make one response to this. This is a matter of opening up your system to more trade, just like the rest of the system. Procurement has been usually, even in the Uruguay Round agreement, I mean, that was kind of optional for most countries, I think, who signed onto it. But it is not in the regular agreement. It is on the annex.

I would simply say that as more countries do that—I mean, obviously we are not going to get much out of these two partner countries in an FTA, but as we open it up and make procurement open to everybody around the world, and in the major countries, we will gain as much as we give, even looking at it on the terms in which you specify.

Mr. MANZULLO. But that is theoretical. You do not have any——

Mr. BHAGWATI. Well, we are pretty competitive, Congressman, so I would say we would expect to win a fair amount.

Mr. MANZULLO. But if that is the case, then the Chinese could come in and make all of our aircraft. They could make everything for us at a cheaper cost. Currently, if a document is shipped from the United States, with the exception of something that is bonded going to Mexico, because we know it is coming back, and with the exception of the 62.5 percent, NAFTA content in automobiles, we have no way of knowing how much foreign content exists is in an item that is shipped as a U.S. export. We have to study that because, you know, I lost 10,000 manufacturing jobs in the congressional district that I represent in the past two years. So has the Speaker. His district is the mirror image of mine. Rockford, Illinois, which is in the center of the congressional district I represent, led the nation in unemployment in 1981 at 24.9 percent. And now, it is pushing 11 percent and we are losing more and more manufacturing jobs. These jobs are not coming back. So we are taking a look again at free trade being fair trade, and we are trying to make sure that what is touted as something that is made in America actually has American parts.

If I may indulge the chair for a minute or so.

Mr. FEENEY. How about you take another two minutes?

Mr. MANZULLO. Okay. Thank you very much.

In October of 2002, the Congress passed a bill that would authorize Boeing aircraft to lease to the United States 100 767s, retrofitted as KC-135s, which are the fuelers that haul the fuel. Included in that legislative language, was a Berry waiver. I have scheduled an April 30th hearing on this before the Small Business Committee. I have held a meeting with the principals of this hearing this past week, along with Duncan Hunter from the Armed Services Committee. The question became, this is a noncompetitive contract; it is done by the grace of the U.S. Congress to help out Boeing aircraft. At the same time, with all the Berry waivers in there, we do not even know how much of that aircraft would be U.S.-content. In fact, Pratt and Whitney were at that meeting, and on the military aircraft they are selling, not only is there Russian titanium, but the drive shafts are made of nickel coming from Japan. Nickel is also a strategic metal that is covered under the Berry amendment.

The reason I bring this up is the fact that, and I know you are testifying on services, and services are critical, and those who are not free traders in service do not understand that unless the service industry gets way out front, it is the service industry that pulls the manufacturing component behind it—so I know that you all have different views on this, but I accept that basic theory. Bob Vastine, you have been a real mentor to me on that, and Professor, I have read your stuff. I will read the testimony of each of you. But if anybody has anything they want to send me with regard to that, please do not send it through the mail. Call our office, and we will give you the fax number.

Mr. BHAGWATI. I would be glad to do that.

Mr. MANZULLO. And thank you very much for giving me the additional time.

Mr. FEENEY. Thank you. Obviously, this is a very important issue to Mr. Manzullo and his constituents. If any of our distinguished panel has anything that they can assist him with, I am sure he would be grateful and so would the committee.

I just have one or two questions before we wrap up and let everybody go for lunch. First of all, I want to make sure that there are six other people that are engaged in the same premise I am, and that is that in general, with some exceptions, Adam Smith was right and free trade is best for both parties involved. Does anybody want to raise their hand?

Mr. DEROSA. Absolutely.

Mr. FEENEY. Mr. DeRosa, maybe you can start, then, if we all start with the same basic premise, it seems to me that the history of both undeveloped, developing and highly developed countries is based on a couple of things—certainly being at peace is helpful—but in terms of things that you can help internally with respect to domestic policy. They are prudent monetary policy; respect for the rule of law; respect for property rights, both real and intellectual; relatively low marginal tax rates; and transparency in terms of the way the country does business. These help generate prosperity within a country, but is it also true to say that those policies attract capital? That is part one.

And then number two, and then I will open it up for some other folks to respond, with respect to this question about basically re-

stricting or freezing capital. This is part two of the question. Surely, regardless of whether you come down as an absolutist, that it should never be done or allowed in these particular trade permits, or whether we should always allow countries free rein, surely most of the panel will agree that there is going to be a risk associated with investment in nations that can essentially restrict, or at least temporarily nationalize capital.

And so going to Dr. Henry's distinction, which is sort of the moderate position as I review the testimony, can you attack the problem based on Dr. Henry's testimony? If I want to create a widget manufacturing plant and invest $100 million, am I more or less likely to invest in a country that is prone or able under a trade agreement to nationalize the $100 million investment in my manufacturing plant? And if I am less likely, and I assume we all agree that I am less likely to make that investment, why would we in terms of incentives for investors, because after all capital is the most liquid and the most morally neutral thing I know of, why would we be more likely to disincentivize investors on the debt area, as opposed to the equity area? Maybe Dr. DeRosa, you can start.

Mr. DEROSA. Thank you. The reason that these countries that we speak of got in trouble was not necessarily a distinction between debt and equity, but the denomination of the financing. But they did get in further trouble by using excessive amounts of short-term debt, so when the crunch hit, they could not find investors to roll the debt. The reason why this enthusiasm for short-term debt—it is an interesting question, because I indicated earlier that in every one of these cases, you can trace back almost signature errors that governments did in responding. In the case of at least Thailand and South Korea, and I think other ones as well, but I know in those cases, there were government policies before the crisis to force or greatly encourage local companies to borrow short term and never long term. The title for this, the name for this is called window guidance. Thailand had effectively had a government institution set up to encourage companies that borrow internationally only to borrow short term. The same was for Korea.

So it is a combination of a squeeze on the currency and also a squeeze on the denomination. But your characterization of what it takes for growth is something that I have great sympathy for. These are things that actually are in Adam Smith's Wealth of Nations, about what is the proper role of the government in terms of the rule of law, property rights, things like that. Essentially, that is what went wrong in the early stages after the Soviet Union disintegrated. Why didn't growth come earlier? But I come back to this basic premise that capital really is not as fickle——

Mr. FEENEY. Well, and in Latin America, agrarian reforms do not help if every new regime every three years nationalizes property and institutes a new set of reforms.

Mr. DEROSA. Absolutely. And this is what is going on wholesale in Venezuela right now. This is why a country that ought to be prosperous is in a tailspin thanks to the leader of Venezuela. But you know, it all comes back to this. There is this central thing that I keep saying to people. Capital really is not as flighty as people think. The hot money that people describe, thinking that it is going

to rush in and rush out, every case that I know of, and I have studied all of these crises in detail; I wrote a book on this; I write columns about this. It is all associated with the nature of the foreign exchange regime. It is always traceable back to a fixed or a creeping fixed exchange rate regime. People are trying to game the system. The locals are borrowing in dollars because dollar interest rates are lower by definition because of country risk. Foreigners are investing in the local currency, and sometimes on a leverage basis.

When the situation becomes untenable, then when the exchange rate regime goes to break, that is when you get this massive outflow of capital. Once the exchange rate starts to float again, this phenomenon does not—I do not know of a single case; I have studied a lot of economic history, have written a lot about economic history—all of these things are coming out of the exchange rate regime. That is why the crises occur. No country that I know of has gone from a fixed exchange rate regime to a floating regime in the last 20 years and suffered a second crisis. So all this talk about putting in capital controls is irrelevant and damaging, because it is unnecessary. It is unnecessary. Countries do not just fall over dead in their tracks. They do not just roll over and collapse. That is not the nature of modern economics as we know it. You can always dissect it. You can always do a post-mortem and in all of these cases that we are talking about, where capital flight is a problem, go back and look at it carefully and you will see it is coming out of the disintegration of a pegged or fixed exchange rate regime.

Mr. FEENEY. Thank you, because it would be a waste of some superior intellect and talent to speak at length to a freshman Congressman from Florida, if each of you will take two minutes—Dr. Bhagwati, and then maybe we will skip Dr. DeRosa—thank you for your lengthy—and maybe we will just conclude and thank you for your participation.

Dr. Bhagwati?

Mr. BHAGWATI. Thank you, Congressman. Just to respond to your last question very briefly, what we are dealing with is the ability to use capital controls in a crisis and what the consequences would be. I think to treat that as something like confiscation. I do not think that is what the gentlemen who are going to invest are going to look at it that way. I think the probabilities are on the low side. What we are saying is you have to allow for it and let these countries really be able to exercise this option. I do not think anybody is going to be affected by that in terms of investing in one country rather than another. So I think it is, my answer to you is, well, the threat of nationalization, et cetera, of course it is something we would all react to. We would not want to put money there. That is not what we are dealing with. So I would say relax on that one and take this out if you can.

Mr. FEENEY. Thank you.

Dr. Henry?

Mr. HENRY. Let me start by saying that free trade is one of the best means we have for actually increasing global welfare, so we should almost always in all circumstances continue to push for free trade on a fair basis. With respect to free trade in capital, by and

large free trade in capital also has the potential for the same kinds of effects. Where we need to be careful is when we are dealing with systems in which there are other distortions, for example a fixed exchange rate regime, as Dr. DeRosa mentioned. In those circumstances, we want to be careful about inadvertently pushing countries into undertaking policies which, given those other distortions in the system, could prove very damaging in certain kinds of situations.

So for example, if you have a fixed exchange rate system and people are tempted to borrow in dollars because interest rates are low, what we have seen time and time again is that the people who actually borrow in dollars are people who are not actually earning dollar revenues, and that creates a real, very explosive situation when in fact the exchange rate regime comes to an end. So what we should do in those situations is really force people to internalize those risks and recognize that in certain situations where there are obviously other distortions, the first best policy—complete free trade in capital—might not be the best answer. In particular, since history has shown us empirically that these debt market liberalizations seem to get countries in trouble, we should just be very wary of that.

In general, I agree with your point. Anything which creates a disincentive to capital to go into a country is going to lead to less investment. But we should remember that what we want is efficient investment, not just investment.

Mr. FEENEY. Or higher interest rates or expectations of return on capital.

Mr. HENRY. That is right, but sometimes higher interest rates or implicit interest rates are in fact warranted because there are risks involved. We should in general move to a situation that is efficient, to use an economist's term, ex ante—before things happen—where we get people to actually internalize those risks and generate efficient investment.

Mr. FEENEY. Thank you, doctor.

Dr. Lackritz?

Mr. LACKRITZ. Thank you. I appreciate the upgrade in my degree.

I think going to your point, Congressman, that obviously capital flows to countries which have institutions where there is the rule of law, where there is an openness and a transparency, and where there is a culture and a tradition of where there is an expectation of returns. At the same time, the market is fairly efficient, and where these institutions do not exist, obviously the rate of return has to be higher to attract the capital to reflect the added risk that is involved. I think one of the benefits of these kinds of free trade agreements is that they open up markets more to promote more capital flows back and forth from country to country, and more flows of goods and services, which of course the financing is accompanying. That is why the capital flows are going back and forth as well.

So these agreements actually are a good start, which help other countries to see what they need to do to attract capital. They see the results from the standpoint of the marketplace and the rate of

their own development, which is a very powerful incentive for them to open up and to create these institutions.

Mr. FEENEY. Thank you.

Mr. Tarullo?

Mr. TARULLO. Thank you, Mr. Chairman.

Mr. Chairman, I will end where I began, which is urging some sense of modesty in this area. We are all experts in retrospect. We look back at the Asia financial crisis, and we say, aha, that is what happened. But if we are honest with ourselves and go back eight or ten years, so far as I am aware the people at this table and the people elsewhere were not identifying some of the problems which we now in retrospect see were very important. I have no doubt but that the next financial crisis, when it comes, will contain elements of traditional financial vulnerabilities and will contain something new, that will be a surprise, and that will give more fodder for scholarly and policy work thereafter.

I think the reason why some of us are concerned with the capital controls provisions is not because we want to go proselytizing for capital controls. I think Dr. Bhagwati and I have tried to make that clear in our own approaches to this issue. We believe we need to understand this more, we need to understand where and how problems may arise, and we need to have a system prepared that will allow countries to respond if the worst happens. My own sense is that if Singapore and Chile are concerned about not having this fallback position, then other countries with even less well-developed capital markets and regulatory systems are even less well developed, will be more concerned. I do not think we want to push them down that road. I think what we want to help them to do is to build the institutions that will make for strong securities markets and strong bank regulatory systems, and then see what benefits the free flows of capital can bring.

Thank you very much.

Mr. FEENEY. Thank you.

And finally, Mr. Vastine, you can sum up.

Mr. VASTINE. Thank you very much, Mr. Chairman.

First of all, these are good agreements. They contain a great deal more than the capital issues. Congress should adopt these agreements. Chile and Singapore freely agreed to these provisions. I was familiar with these negotiations. No one held a gun to their heads. They are very sophisticated negotiators. They are very good regulators.

Finally, I do not think the objections raised today give grounds to the committee or to other members of Congress not to vote for these agreements.

Thank you.

Mr. FEENEY. I want to thank all of you. We will get you out for a late lunch. The chair would like to thank all of you for traveling and being here with us today. Without objection, the record of today's hearing will remain open for 30 days to receive additional material from members and supplementary written responses from witnesses to any question posed by a member on the panel.

The hearing of the Domestic and International Monetary Policy Subcommittee is hereby adjourned.

[Whereupon, at 12:35 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 1, 2003

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Domestic and International Monetary Policy, Trade and Technology
April 1, 2003

"Opening Trade in Financial Services- The Chile Singapore Example"

Good morning, I would like to thank Chairman King for holding this important hearing on the financial services provisions in the recent Chile and Singapore free trade agreements. Chile and Singapore have long been close allies of the United States and I applaud the Administration for negotiating what I see to be two strong agreements that will bring our countries together and help spur economic growth.

Free trade is critical to the development of the global economy and the future of the United States. Last year we successfully passed the Trade Promotion Authority Act which empowered the President to negotiate trade agreements without changes from Congress that would effectively kill the agreed-upon terms. The large number of countries that have lined up seeking to enter into free trade negotiations with our country demonstrates the success of Trade Promotion Authority.

Trade in financial services is an essential part of the agreements we will be discussing today. These agreements set a high standard for other countries to open their markets and grant U.S. financial service providers the ability to operate on a level playing field. Also, by granting their citizens access to U.S. financial service products, these countries will see an increase in growth and an improvement in the operation of their domestic markets. These agreements include important improvements in transparency of regulation, increased access to banking, securities and insurance markets and important cross-border trade provisions.

I am looking forward to an interesting discussion from our witnesses on the issue of the free flow of capital. This issue was discussed at length by the negotiators and, in the end, the U.S. reached a compromise that all sides assented to. In essence, Chile and Singapore are permitted to institute measures that restrict capital for short periods of time, as long as these restrictions do not substantially impede transfers. In my opinion, this is reasonable and will give U.S. investors confidence that they will have access to their capital in these countries.

The free flow of capital is vital to economic growth, fostering development, and increasing investor confidence. These provisions signal to the markets that Chile and Singapore are sound markets in which to invest in, and that they are committed to free market principles. I would like to acknowledge Treasury and USTR officials for their hard work in negotiating these agreements and also want to welcome our distinguished panel to the Committee. I look forward to your testimony. Thank you.

STATEMENT BY REP. BERNARD SANDERS ON SINGAPORE AND CHILE FREE TRADE AGREEMENTS

Mr. Chairman, thank you for holding this important hearing.

In my view, the free trade agreements with Chile and Singapore that were recently signed by the Bush Administration largely replicate the disastrous North American Free Trade Agreement which has cost the U.S. hundreds of thousands of decent-paying jobs, and must be rejected by the Congress. Adding insult to injury, the Singapore and Chile free trade agreements create entire new visa categories for the temporary entry of workers for any job in the United States that requires a bachelor's degree, allowing thousands of foreign workers to compete against American workers at home during a time when millions of U.S. citizens are desperately looking for employment. In addition, the provisions contained in these free trade agreements on capital controls that our distinguished Ranking Member Mr. Frank has already talked about will reward wealthy investors at the expense of the poor.

Mr. Chairman, our trade policy has been a complete failure. We now have a record-breaking trade deficit of $435.2 billion, including a $103.1 billion trade deficit with China. According to the Economic Policy Institute, 99% of this deficit is due to the goods we must increasingly buy from overseas because we no longer make them at home. From 1994-2000 we have lost 3 million manufacturing jobs due to NAFTA and the WTO trade agreements. During the last 2 years alone, under the Bush Administration, we have lost 1.7 million more manufacturing jobs, representing 10 percent of the total industrial sector. At 16.5 million, we now have the lowest number of factory jobs in 40 years.

Here are just some of the jobs that have been lost due to U.S. trade policy:

** Over 180,000 jobs have been eliminated in the textile industry since 1996, including 59,000 from North Carolina alone.

** Over 46,000 steelworker jobs have been eliminated in the U.S. since 1998, including 18,000 in Cleveland, Ohio.

** Since April of 1998, the apparel industry has lost one in three jobs, including over 40,000 in California.

** One in five jobs among companies producing aircraft is gone.

** We have lost over 360,000 jobs in industrial machinery, 290,000 jobs in electronic and electrical equipment, a quarter million jobs in transportation equipment, and 116,000 jobs in motor vehicles.

Mr. Chairman, some of the supporters of unfettered free trade have argued that we might lose some manufacturing jobs through these trade agreements, but we would also gain many more high-paying white collar jobs. Well, they have been proven wrong.

According to Forrester Research, "Over the next 15 years, 3.3 million U.S. service industry jobs and $136 billion in wages will move offshore to countries like India, Russia, China and the Philippines. The IT industry will lead the initial overseas exodus."

How many of those jobs will wind up in Singapore and Chile? How many workers from Singapore and Chile will be able to walk right into this country and take jobs away from American workers through this trade agreement? That is what I would like to find out today.

I was told that this hearing would focus on the financial services aspect of

our free trade agreements.

Well, let's focus a little bit on the Financial Services sector.

According to a cover story that appeared in *Businessweek* on February 3, 2003, "In the past year, Bank of America has slashed 3,700 of its 25,000 tech and back-office jobs. An additional 1,000 will go by March. Ex-Bank of America managers and contractors say one-third of those jobs are headed to India, where work that costs $100 an hour in the U.S. gets done for $20. Bank of America acknowledges it will outsource up to 1,100 jobs to Indian companies this year."

Businessweek goes on, "Even Wall Street jobs paying $80,000 and up are getting easier to transfer overseas. Brokerages like Lehman Brothers Inc. and Bear, Stearns & Co., for example, are starting to use Indian financial analysts for number-crunching work. Processing insurance claims, selling stocks, and analyzing companies can all be done in Asia for one-third to half of the cost in the U.S. or Europe."

And, finally, listen to this quote from Microsoft's Vice President for Windows Engineering, "It's definitely a cultural change to use foreign workers, but if I can save a dollar, hallelujah."

Mr. Chairman, I hope that Congress will reject the Singapore and Chile free trade agreements, and work together to make U.S. companies invest in our own country instead of exporting our jobs overseas in a destructive race to the bottom.

U.S. House of Representatives
Committee on Financial Services

Testimony
Subcommittee on Domestic and International Monetary
Policy, Trade and Technology
Tuesday, April 1, 2003

By

Jagdish Bhagwati

University Professor (Economics)
Columbia University
&
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The proposed FTAs with Chile and Singapore, which are discriminatory trade agreements and hence fall into the class of what are now universally called Preferential Trade Agreements (PTAs) so that public discourse is not contaminated by confusing them with (multilateral) Free Trade, raise several questions for both scholars and policymakers. I will concentrate however on the few that the Chairman, Congressman Peter T. King, has asked me to focus on.

I: **Importance of Free Trade and the Role of FTAs**

The Case for Free Trade: Despite recurrent recent attacks on free trade, both by anti-globalizers and in a less vociferous but still populist mode by a few, indeed very few, economists (chief among them Dani Rodrik of Kennedy School at Harvard and my new colleague Joseph Stiglitz), the case for freeing trade remains overwhelming.

The relationship of outward orientation in trade policy to economic prosperity has been demonstrated in several projects, one of which I co-directed for the National Bureau of Economic Research in the late 1960s, and by several in-depth research projects since. The objections are not serious.

Take just three criticisms. First, that the gains from outward trade orientation are exaggerated and come instead from sound macroeconomic policies. But if you are going to have sustained outward trade orientation, you better have sound macroeconomic policies! The commitment to sound macroeconomics is a precondition for a successful outward trade strategy; the gains from the former are therefore to be attributed to the latter.

Second, we are told that trade might be good for prosperity but misses out on eradicating poverty; that "trickle down" does not work. But the experience of China and India, two countries with massive poverty, shows that the growth strategy is more aptly described as a "pull up" strategy: growth pulls the poor up into gainful employment. It also affects poverty indirectly by generating tax revenues without which health and education cannot be financed adequately to help the poor. Upto early 1980s, when both countries grew in a lackluster fashion, with India exhibiting over a quarter of a century an abysmal growth rate of 3.5%, there was predictably little impact on poverty. After both countries began so-called "neo-liberal" reforms, including outward orientation, growth rates picked up dramatically and poverty has declined significantly in the last 15 years, if not more.

Third, even the effect on social agendas such as reduction of child labor and the advancement of gender pay equality has been shown to be favorable, rather than harmful as often alleged by the anti-globalizers. Econometric studies find that child labor declines as incomes grow with removal of export restraints, for example. Again, in the United States, gender wage gap has declined faster in globally competitive industries because these industries cannot afford the luxury of paying men more than women, even when equally qualified, because every penny now counts!

Adjustment Assistance Programs in Poor Countries: Freer trade therefore is a virtuous policy, whether you are focusede on economic gains or on social agendas. It truly deserves bipartisan support. Yet, when it comes to the poor countries, while they have come to appreciate market access for their exports, they remain fearful of imports -- - a phenomenon not entirely unfamiliar to our Congress where steel protection, textile

quotas and tariffs, farm subsidies, the Byrd Amendment which makes a yet further mockery of anti-dumping actions, and much else still mars our profession of free trade.

But where we have managed to ease the potential adjustment costs, for political and economic reasons, by building into virtually every trade legislation some provision for adjustment assistance --- this is true of the NAFTA legislation and also of the latest fast-track legislation ---, I am afraid that the poor countries which are opening up to trade more ambitiously do not have such programs. They simply do not have the funds to dod so. For some years now, therefore, I have been suggesting that the World Bank be asked by the major donors, such as the United States, to do exactly this, instead of spending its limited resources on all kinds of programs that spread its resources thin, in an unfocused way. It is not for nothing that Mr.Wolfensohn has been compared to Evita Peron: spreading money around, buying popularity with each throw of funds, but doing little to support in a robust and creative way the economic globalization that is the most important driver of prosperity and the most lethal scourge of poverty.

Bilaterals: Why USTR Ambassador Zoellick is Wrong: Today, there is a remarkable divide between politicians who for the most part like bilateral FTAs and economists who by a vast majority consider them to be a plague on the world trading system. Mr. Pascal Lamy, the articulate and intellectually exciting Frenchman who is the EU Trade Commissioner, recently wrote with British understatement that "half the world's" trade economists are hostile to bilateral FTAs!

Ironically, bilaterals are known as the "European disease": they went well beyond the European core to sign all kinds of bilaterals around the world. We have only followed the Europeans, having renounced our firm embrace of multilateralism in trade and

implacable hostility to bilateralism beginning with almost negligible success with Secretary Baker and Mr. Zoellick in tandem as his deputy. Now that Mr. Zoellick is the USTR, he wants to make up for lost time!

Today, these bilaterals have created a massive "**systemic problem**", with preferences multiplying worldwide through varying tariff schedules based on origin and also with varying rules of origin. This phenomenon, and problem, is now called the "**spaghetti bowl**" problem, with preferences like noodles criss-crossing all over the place. With over 200 such bilaterals in place, and growing by the week as Asia follows in out footsteps now, we can confidently expect that they will grow to well over 400 by the end of the year. The great economists who warned us against preferences during the 1930s when competitive tariff-raising was creating fragmented markets worldwide would have been horrified to see that, in the name of free trade, we are now re-enacting such fragmented markets on a parallel scale, and feeling virtuous about it!

Ambassador Zoellick is nonetheless passionately behind these bilaterals, arguing that they lead to competitive liberalization" which will benefit multilateral liberalization over time. But this is a scenario that is shared by hardly any serious international economist. As the bilaterals multiply, especially when one's main markets are taken care of and preferences granted to oneself, the willingness to invest more lobbying effort into pushing the multilateral envelope begins to weaken. Again, from the viewpoint of the smaller countries that sign on to a bilateral FTA with us, a superpower, there are reciprocal obligations and preferences they must grant us in exchange for the preferential access to our market. Thus, the Singapore and Chile FTAs repeat the requirement that their garments ands textiles must use our fabric if they are to qualify for the preferential

entry to our market! This cuts into the benefits they enjoy, compared to an MFN reduction of barriers to our market at Geneva/Doha! The preferences also erode as the MFN tariff is reduced; so, to maintain the preference, these small countries become opponents of MFN tariff reductions: a phenomenon we have witnessed time and again in textiles and in agriculture.

Then again, bureaucratic and political attention is diverted to these bilaterals rather than to Doha since it has become customary to equate every trade agreement with every other, regardless of its scope and merit. Ambassador Zoellick typically writes in this vein, equating the Uruguay Round Agreement at Marrakesh with piffling bilaterals when he argues that we have done only two agreements --- these being the huge NAFTA and the Uruguay Round --- whereas Mexico has done several more: the comparison is ludicrous on the dimension that he is comparing the United States with Mexico, having the tail wag the dog! At the Waco Presidential Summit that I attended, the President actually said to Mr.Zoellick: I have gotten you the fast track; now go out and get me some trade agreements!

But the chief argument against bilaterals is something that is relevant to the question of capital controls that is at the heart of the Hearing today. The bilaterals, between us and small countries like Jordan, Singapore, Chile and Morocco cannot be judged on the basis of trade alone. They are increasingly used to establish "templates" by different lobbies which then proceed to argue, both to Congress and then at the multilateral negotiations, that this template must logically be extended to the multilateral trade negotiations and agreements. Since, in many cases, it is the developing countries who hesitate ands oppose these lobbying demands at the multilateral talks, and since

bilaterals with the developing countries are used to create the templates, the process has also been described realistically, perhaps cynically, as an application of the Leninist policy of "divide and rule": the lobbies use the strategy to break up the coalitions of the developing countries against their lobbying demands. This (along with punishments threatened or carried out by use of Special 301 provisions of the 1988 trade legislation), was the strategy used with Mexico over NAFTA: intellectual property protection, as we wanted it, was built into NAFTA and Mexico basically deserted the ranks of the developing countries which saw this as an extraneous, non-trade issue, as a royalty-collection rather than as a trade question.[1] With Jordan, which had literally no bargaining power vis-à-vis us, the Clinton administration, responding to its core constituencies in the labor and environmental communities, used this FTA to move the labour standards and environmental requirements into the text of the agreement as distinct from their being Annexes in the NAFTA agreement. That in turn led to the fast track legislation where the Jordan template was used to put similar requirements into <u>any</u> trade agreement, including multilateral. And now, the same game was being played in the case of Chile and Singapore, evidently by the Wall Street lobbies, to set up a template that says: you cannot use capital controls.

This strategy may work. If it does, the only question is whether we are not turning the WTO, a trade institution, into an institution where our lobbies, whether good or bad, park their agendas and capture, and distort, the working of that important institution to

[1] To argue that intellectual property protection (TRIPs) does not belong to the WTO is <u>not</u> to say that it should not be granted or that trade sanctions should not be applied as a remedy. A self-standing treaty like Kyoto or CITES could have been negotiated for TRIPs instead of its being pushed into the WTO. As it happens, when the AIDs crisis broke out, and the poor countries and the rich-country NGOs began to attack TRIPs agreement, it was the WTO that became the focus of worldwide opprobrium when in fact the complaints would have been properly directed to Washington if the matter had not been worked in a draconian fashion into the WTO.

the detriment of the institution and even to harm the developing countries and disillusion them at a time when they have finally turned to it as interested members.

And, if the strategy does not work, and the developing countries continue to raise spirited objections as they have regarding labor standards inclusion, for instance. At the multilateral level, we will then hold up multilateral trade liberalization, while the bilaterals where we intimidate or seduce them one-on-one will multiply. And so we must caution Mr. Zoellick on his excessive enthusiasm for bilaterals, even though he dismisses all these widely shared objections as coming from "purists"!

II. **Capital Controls and Trade Restrictions: Asymmetries**

Now, free capital flows and free trade have similarities: capital controls and trade restrictions will both segment markets and therefore incur efficiency, what economists call "deadweight" losses; they will also reduce "economic freedom". But the asymmetries are more important; and they are regularly conceded, indeed taught, in the classroom.

The problem is illustrated by an analogy. If I exchange some of my toothbrushes for some of your toothpaste, and we remember to brush our teeth, both of us will have whiter teeth; and the chance of our teeth being smashed in the process is negligible. But capital flows are like fire. If Tarzan uses it to roast his kill, he is ahead. But when, as the Earl of Basingstoke, he returns to his ancestral home in England, the fire can burn it down if he is not careful.

And that is exactly the problem. It is easy to say: follow sound macroeconomic policies, adjust your exchange rates, improve your banks, eliminate cronies; etc. There has been no dearth of such advice. But can anyone seriously maintain that these

conditions can be fulfilled or that, even if they are, panic-fed outflows of huge quantities of capital in the absence of controls will not materialize? Both empirical evidence and theoretical models strongly indicate that we have to be less gung-ho and more prudent than was the case in the years prior to the Asian financial crisis and its spread through contagion. Three different situations need to be distinguished.

First, consider the case where a developing country has never been on capital account convertibility. The question is: should it be pressured to go to such convertibility? The answer is that we have to be prudential about this. Developing countries can experience panicky outflows of capital, which can be swift if all spigots are open in the absence of capital controls. Such panic can arise because these economies may be perceived to be fragile; or their politics may be considered to be knife-edge. It is noteworthy that both India and China escaped the Asian financial crisis; they did not have capital account convertibility. So, the not-so-gentle pressure from the IMF and the Treasury to have developing countries open up fast on capital account was an error of judgment.

It is often claimed that the East Asian crisis was because of internal problems: crony capitalism and inefficient banks. But one may well ask: what do we pay the IMF and the bureaucrats at the Treasury for? Was it not <u>their</u> job to alert themselves to these drawbacks before they put the pressure on these countries? It seems evident that when countries are economically and politically fragile, letting capital move in and out freely is to bet the company. The consequences of large-scale outflows can be disastrous.

A different, second question is whether, if you have basically opened your system to capital flows, should you then not be using taxes on capital <u>inflows</u> to moderate their

amount if the inflows seem to be getting uncomfortably large and the probability of a panic occurring rises? Chile did this to advantage, though there are questions as to how effective this was. Such taxes are applicable only as used; they differ from quantitative controls which would normally be in place continuously. Most economists agree that such taxes are a useful tool. Remember that their use does amount to the use of differential exchange rates for capital ands current transactions: and this seems to be ruled out in the draft FTAs before us!

But consider a yet different, third question: you have gone to capital account convertibility, like Malaysia had and capital starts leaving in huge amounts due to panic. Do you then clamp down capital controls? So, we are then considering using capital controls when capital is leaving, not to moderate its size when it is entering. Here, again, there seems to be a sound body of opinion that Malaysia did well to use capital controls. The reason is that, by segmenting the capital markets (as noted by many economists at the time, including Paul Krugman and Dani Rodrik), Malaysia managed to lower interest rates compared to what would have been necessary otherwise because of rising interest rates elsewhere, and thus Malaysia managed to follow an expansionary policy that enabled it to escape the deflation that followed rising rates in other afflicted countries which followed the wrongheaded deflationary conditionality imposed by the IMF in the first year of the Asian crisis. Again, for Russia, the Russian scholar Padma Desai of Columbia University has argued that Russia would have done better in the aftermath of the Asian crisis if de facto capital account convertibility had been immediately suspended temporarily.

In all three types of situations, it is clear that good policymaking requires that the developing countries in question must be allowed the freedom to exercise their discretion and use capital controls (or taxes). In the latter two cases, clearly the use of capital controls/taxes would be temporary. In the first case, the country has a longstanding lack of capital account convertibility and the transition to more openness is slow simply because such a transition requires prior transition to economic and political stability in a manner which is credible.

A final thought: is it true that capital controls must be eliminated to attract direct foreign investment into the developing countries? I.e. is the United States doing Chile and Singapore a favor by getting them to use capital controls only with the greatest difficulty? Not a chance, I am afraid. I have seen no persuasive evidence that full capital account convertibility is necessary to bring in direct foreign investment. A very limited guarantee of convertibility for profits and repatriation of principal is often offered for Greenfield investments: and that seems to be enough. I am afraid that many such assertions are made by interested lobbies: the pharmaceutical firms made this argument for TRIPs even as they were investing in countries such as China where no intellectual property protection was being offered. All that happens is that the latest technology, which might diffuse in the absence of such protection, is not used; but investment with less-than-the-latest-vintage technology does not seem to be deterred.

The Capital Control Provisions in the Singapore and Chile FTAs

The inclusion of capital control provisions in the Chile and Singapore FTAs is therefore difficult to understand in terms of economics. Even the IMF, including in its

latest report from its Chief Economist Ken Rogoff and associates, concedes the case for prudence rather than haste in dismantling capital controls and in occasional but cautious use of them when necessary in otherwise capital-wise open economies. The inclusion of provisions in this regard in these FTAs seems therefore to be ideological and/or a result of narrow lobbying interests hiding behind the assertion of social purpose. I see, in particular, the following problems with these FTAs as a template:

1.The provisions are overly ambitious in extending to all kinds of "investments", including "futures, options and derivatives", instead of being confined to direct foreign investment. I see this as a potential problem with the NGO community which has become properly sensitive to financial flows and crises, and to the havoc they cause, especially on the poor in the afflicted countries. It will simply play into the hands of the many anti-globalization critics who see trade treaties as being captive to financial and corporate interests. At a timed when trade liberalization itself has become difficult to manage, the inclusion of such provisions into a trade agreement is to invite gratuitous criticism.

2. The limitations put on what can be demanded by way of compensation for use of capital controls and their effects on the value of investments by foreign entitities go some way towards assuaging the early concerns. But they still amount to roadblocks. I do not see how it can lead to anything but political objections when invoked, just as the ultra-conservative view of "takings" that was slipped into Chapter 11 provisions of NAFTA has led to fierce political objections.

3. As I read the text of the agreements, it appears that the traditional protections built in for "balance of payments" situations, which would have been invoked automatically to suspend "free transfers", have been removed and been replaced by a

separate Dispute Settlement mechanism when capital controls are invoked. This is more restrictive for Chile and Singapore; it also constitutes a tightening of the restrictions being imposed on these countries' ability to use capital controls as they see fit.

None of this is good news. It also seems to me that few other countries will be prepared to accept such a template. Such restrictions, which are to be deplored in any event, are best left to be handled through investment agreements, rather than fastened on to trade agreements where they will bring trade liberalization, a policy which is far less controversial, into disrepute.

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Testimony of David F. DeRosa, Ph.D
Before the House Subcommittee on
Domestic and International Monetary Policy,
Trade and Technology.

Opening Trade in Financial Services—
as well as The Chile and Singapore Example

Tuesday, April 1, 2003

Good afternoon, Mr. Chairman and members of the Subcommittee. I am David DeRosa, President of DeRosa Research and Trading, Inc. and the Frederick Frank Adjunct Professor of Finance at the Yale School of Management. My testimony will concern my position on capital controls.

In the middle 1990s and continuing up to the present time a great many emerging markets nations experienced cataclysmic financial crises. Many of these same nations had previously been identified as "miracle" growth economies. Examples of such crises include but are not limited to Mexico (1994), Thailand, Indonesia, and Malaysia (1997), South Korea (1997-1998), Russia (1998), Brazil (1998), Turkey (2001) and Argentina (2002).

The aforementioned crises devastated these counties. Much economic suffering ensued - inflation, unemployment, and business bankruptcies were widespread. stock and bond markets plunged, and in all cases national currencies depreciated severely and the foreign exchange regimes that governed exchange rates were abandoned.

The reaction to this series of crises has been largely to blame the international capital markets and the foreign exchange market. Some say that the afflicted countries were victims of capricious international capital flows. Hence we are here today to discuss whether the trade agreements that

our nation is contemplating ought to contain provisions allowing our trading partners to invoke capital controls.

I studied economics and finance at the University of Chicago where I received both a bachelor's and a doctorate. In the subsequent years I have never found a contradiction to the fundamental doctrine of the "Chicago School of Economics" that free markets make for the best markets. Capital markets are no exception.

Over the two dozen years since I left Chicago I have held a wide variety of markets-related positions. For a good part of the 1990s I was a currency trader at a major money-center bank and later at a hedge fund. At the present time I am a member of the board of directors of two large and successful hedge funds.

When I combine my academic training in economics with my "real world" experience in markets I arrive at a very different understanding of why the above-mentioned emerging markets crises occurred. I don't believe the fault comes from the markets, or, as it is fashionable to say, the "international financial architecture." The following conclusions are supported in my recent book entitled In Defense of Free Capital Markets: The Case Against A New International Financial Architecture (2001, Bloomberg Press):

- All of the above-mentioned crises, except one (Malaysia), took place in economies that had some form of fixed exchange rates. In fact the climax of each of these crises was when the disintegration of the fixed exchange rate regimes transpired.

- Each crisis was marked by a sharp outflow of capital prior to the moment the fixed exchange rate regime was scrapped. Once the peg was abandoned the local currency depreciated massively, in some cases by more than 70 percent.

- In each case the government of the afflicted country replaced the fixed exchange rate regime with a floating exchange rate regime. Importantly, no further currency crises occurred after adopting floating exchange rates.

- That all of these countries had accumulated massive amounts of private and public debt denominated in dollars aggravated the crises. As the exchange rates depreciated the local currency values of these debts were magnified greatly.

- Preceding the crises, an enormous amount of foreign capital flooded into the countries, sometimes buying local securities, sometimes as direct investment. Interestingly it also came in the form of leveraged transactions that sought to capitalize on higher interest rates in the local currency under the security of the fixed exchange rate regimes.

- These trades, known as "carry trades," would never have been created had it not been for the fixed exchange rate regimes. In fact, a great deal of the investment inflows in these countries was nothing more than an attempt to capture high local interest rates in the "safe" environment of fixed exchange rates. Investors were not investing in these countries so much as they were investing in the fixed exchange rate regime.

- History shows they are crises-prone. The problems in emerging markets are not caused by capital of a capricious nature but rather by the inherent instability of fixed exchange rate regimes.

- The reason why currencies depreciate so violently when fixed exchange rate regimes are abandoned is that domestic dollar borrowers, as well as foreign investors, rush to hedge their exposure to the doomed local currency.

- Governments in crisis countries often make things worse - sometimes considerably worse - by enacting bad policy responses. Thailand, Indonesia, Russia, Brazil, and Argentina stand out as especially poor examples in responding to their crises.

- Emerging markets nations can avoid these crises in the first place by not using unsustainable fixed exchange rates.

- Capital controls are neither desirable nor effective in avoiding crises or responding to crises.

  - A popular myth is that Malaysia found a "kinder and gentler way" to deal with its crises by imposing capital controls. This is bogus. Malaysia imposed its capital controls a full 14 months after the crisis erupted - a classic case of locking the barn door after the horse had bolted.

  - Moreover, Malaysia imposed the controls concurrently with fixing its currency, the ringgit, at 3.8 to the dollar, where it remains today. Malaysia then sat back and enjoyed what amounted to a regional devaluation of its currency because all of the other Asian nations, including Japan, saw large revaluations of their currencies. Malaysia pulled a "fast one."

  - Parenthetically, Malaysia had a floating exchange rate, more or less, before the crisis. It also was notorious for imposing capital controls. Fear of new capital controls explains why Malaysians and foreigners rushed to cover exposures to the ringgit when the Thai baht exploded on July 2, 1997.

My conclusion based on my observations and analysis is that financial crises never appear as random visitors - they never show up uninvited. Crises are manufactured from bad and unsustainable policies, fixed exchange regimes being at the top of the list, and aggravated by local policy response blunders. Careful analysis shows capital controls are neither effective nor desirable.

Thank you Mr. Chairman and thank you members of the Subcommittee.

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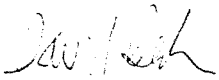
Testimony of David F. DeRosa, Ph.D
Before the House Subcommittee on
Domestic and International Monetary Policy,
Trade and Technology.

Opening Trade in Financial Services—
as well as The Chile and Singapore Example

Tuesday, April 1, 2003

Enclosed Please find the preface and chapters 1, 3, and 4 of my In Defense of Free Capital Markets: The Case Against A New International Financial Architecture which are parts of my written testimony

Sincerely



David DeRosa

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In Defense *of* Free Capital Markets

The Case Against a New International Financial Architecture

DAVID F. DEROSA

BLOOMBERG PRESS
PRINCETON

Preface

BROAD-SPECTRUM REFORM of the international financial system has been recommended following the remarkable financial crisis in the 1990s, especially since the collapse of the Asian developing countries and so many other emerging market nations. This book argues the opposite, that reforms, meaning more regulations, are not needed. As its title suggests, the book is a straightforward defense of free-market economics, with the focus on the international financial system. It makes the case for allowing the international financial markets to remain largely unregulated.

When people advocate that the international financial system needs to be totally redesigned, one would hope that they are in possession of a solid understanding of what actually causes financial crisis. Usually that is not the case. Indeed, even commentary about international financial economics made by heads of state, ministers of finance, and central bankers often betrays a basic ignorance about the international capital market, down to the level of what it is and how it works. One has to wonder, on occasion, what influences shape their sense of recent economic history. And when confronted with a financial crisis, many leaders, but not all leaders, prefer to hunt for villains and indict the international financial system rather than admit to policy blunders of their own making. The first blame usually goes to the foreign exchange market and to the system that affords mobility to international capital.

The methodology of this book is one of examination of the historical economic conditions that produced financial crises in the 1990s and in some preceding periods. Also examined are the responses to crisis. Did government policies directed at these episodes of turmoil made matters better or worse? In many cases, at least in the history of the '90s, policy can be shown to have exac-

erbated the upheavals. What comes from this exercise is an understanding that financial crisis largely can be explained by looking at the domestic policies that ministries of finance and central banks have laid out for their own countries. In other words, the predisposing conditions for crisis are local in nature; crisis comes from within, not from the outside, and not because capital is permitted to move freely across borders or because of market-determined exchange rates.

Another revelation is that the concept of financial contagion, a notion that permeates speeches and press interviews given by the authorities, is dubious at best as a cause of financial turmoil. Financial crisis does not come right out of thin air to strike economically healthy nations and then spread like a communicable disease from one country to the next.

One lesson rings loud and clear, that a country's choice of a foreign exchange regime is one of the most important decisions that it makes. For example, fixed foreign exchange rate systems, but not floating systems, are in fact the breeding grounds for great financial crises, as will be demonstrated repeatedly in the cases that this book examines.

For this reason the dynamics of how a fixed exchange rate regime collapses are studied closely in this book. It will be shown that practically all of the episodes of financial crisis in the '90s occurred in countries that had fixed exchange rate systems, and that this is more than coincidence. This should become apparent as the book goes through the history of Mexico in 1994–1995, Southeast Asia in 1997–1998, South Korea in 1998, Hong Kong in 1998, Russia in 1998, Brazil in 1998, and several other countries as well.

Chapter 2 is spent entirely on Japan to answer the question of how the world's second-largest country managed to reverse its pattern of decades of phenomenal growth to end the century in a state of economic torpor. Though Japan does not have a fixed exchange rate regime, it will be shown that its economic disappointments are traceable in part to errors in the formulation of monetary policy. Other factors, ones deeply embedded in the Japanese economic and political system, also are to blame for that country's problems.

The later chapters of the book are concerned with alternative

foreign exchange regimes, including currency boards and dollarization, and rebuttal of various suggestions for reform of the international financial architecture. Chapter 8 delves into the question of what should be the future of the International Monetary Fund and comes down on the side of those who want to greatly limit its activities, especially those pertaining to its financial crisis and rescue work.

Finally, I should say that this book is not intended to be a defense of hedge funds, foreign exchange trading, and speculation. There are no ulterior motives; the book is nothing more than what its title suggests.

Chapter One

Financial Policy and the Cycle of Regulation

THE FINANCIALLY TURBULENT decade of the 1990s is a challenge for market-oriented economists to explain. Conservative economists, starting with Adam Smith, have professed for more than two centuries that a free-market economy, devoid of central economic planning and light on government regulation of the forces of supply and demand, is the most efficient and reliable economic system.

Yet in the 1990s, exchange rate crises, stock market crashes, and severe economic contractions plagued countries around the world. Eisuke Sakakibara, Japan's outspoken former Vice Finance Minister for International Affairs, captured the desperation of the time when he declared the existence of a "crisis of global capitalism."[1] It is no wonder that the free-market model has begun to be seen as an unworkable paradigm, in some people's minds.

In Asia, things began to go wrong precisely at the start of the decade. Only a few years earlier it had been heard that the next century, meaning the twenty-first, would be the "Asian century." Normally skeptical observers were confounded by Asia's economic reversal; seasoned professional investors were caught flat-footed in Asia's meltdown, first with Japan, then with Southeast Asia, and later with South Korea.

Japan, by the end of the 1980s, had been the world's pre-eminent economic growth model for more than thirty years. Trouble

arose in January 1990, with a sudden decline in the Japanese stock market. Soon after, the Japanese real estate and banking sectors headed toward a state of near insolvency. Japan spent the entire decade of the 1990s in varying degrees of economic stagnation. It also experienced an uncharacteristic political instability; prime ministers came and went from the national stage faster than actors at a music hall variety show. As the economic predicament became progressively more severe, embittered and frustrated politicians began to put blame on exogenous foreign factors.

Financial chaos paid a visit to central Europe in the first three years of the same decade in the form of two currency crises. In 1979 members of the European Monetary Union decided to enter into a system of semifixed exchange rates called the Exchange Rate Mechanism. The ERM was to engender stability among the intra-European exchange rates and pave the way toward the long-cherished single European currency project. Instead, it spawned two spectacular currency crises (September 1992 and August 1993) and several dozen exchange rate revaluations.

In December 1994 Mexico experienced a stunning currency crisis only twenty days into the administration of its newly inaugurated President, Ernesto Zedillo. Previously Mexico had had a fixed exchange rate regime for the peso that allowed for a gradual, controlled devaluation. The peso crisis, which did tremendous damage to the Mexican economy, turns out to have been a near perfect blueprint for what happened two and one-half years later in Southeast Asia. The Southeast Asian crisis was nearly identical in its financial mechanics to what happened to the Mexican peso. Also, Mexico, in receiving emergency financial assistance from the United States in 1995, set the conceptual stage for the International Monetary Fund (IMF) to bail out Thailand, Indonesia, and South Korea later in the decade.

The Asian investment outlook that investors accepted as correct for most of the '90s was disarmingly simple. Japan's own decades of impressive economic growth would be Asia's lamp, lighting the way to prosperity for the so-called tiger countries, Thailand, Indonesia, Malaysia, and South Korea. Investors saw these countries as their chance to get rich by participating in a

replay of Japan's postwar economic history, about to be repeated in Southeast Asia and South Korea. Putting money in these so-called tiger countries was seen as the next best thing to having had the foresight to have invested in Japan in the 1960s.

Economist Paul Krugman challenged this rose-tinted view of Asia in 1994 in a widely read article entitled "The Myth of the Asian Miracle."[2] Krugman, as he himself has pointed out, merely predicted a gradual slowing of Asian growth. Neither Krugman, nor anyone else to the best of the author's knowledge, foresaw that Asia would suffer a series of violent economic implosions. But he did make his point. In 1994, Asia's growth was about to become a story that would have to be told in the past tense.

In the summer of 1997, the Southeast Asian currency crisis ignited. Asian emerging market nations tumbled into economic chaos like dominos. The chain of events commenced when Thailand was forced to float the baht on July 2, 1997. Observers at the time remarked that some sort of previously unknown and highly contagious economic plague was loose in the Asian continent. It quickly spread throughout the region, with devastating consequences to the Philippines, Malaysia, and Indonesia. Thailand and Indonesia requested and received massive financial aid from the IMF.

The second round of the Asian crisis occurred in October 1997 when the stock market in Hong Kong experienced a steep drop. Rumors began to circulate that Hong Kong would soon be forced to abandon its fixed exchange rate regime for the Hong Kong dollar. Within two months, South Korea became the next casualty to experience a foreign exchange crisis complete with a stock market meltdown and a bank panic. South Korea requested and received billions of dollars in financial relief from the IMF that allowed it to narrowly avoid national bankruptcy.

Major changes in the political landscape followed quickly. New governments were elected in Thailand and South Korea. The crises also claimed the presidency of Indonesia's Suharto, who was forced from power after three decades of ironfisted rule. In Malaysia, Prime Minister Mahathir bin Mohamad managed to remain in power despite the near total collapse of his country's

BOX 1.1

Spot and Forward Foreign Exchange

THE FOREIGN EXCHANGE market is comprised of money-center banks, investment banks, and specialized brokerage firms. It is a wholesale market where an estimated one trillion dollars per day moves around the world. Most of the trading, some 90 percent, involves transactions for which the U.S. dollar is one side.

A spot foreign exchange transaction is a deal between two counterparties, usually banks, that requires the exchange of sums of foreign currency in two bank business days (referred to as the spot value date). For example, if one party buys ten million dollars against yen at the exchange rate of 125.00, it will receive $10,000,000 (in New York) and must deliver 1,250,000,000 yen (in Tokyo) in two days' time. The bulk of the trading in the foreign exchange market consists of spot dealing.

Many currencies are quoted against the dollar in terms of the number of units of foreign currency equal to one dollar. For example, $/¥ might be quoted as 120.00, meaning 120 yen are equivalent to one U.S. dollar. The euro, the pound, the Australian dollar, and the New Zealand dollar are prominent exceptions. Those currencies are quoted in dollars. For example, the value of the euro could be quoted as .9000, indicating that one euro costs ninety U.S. cents.

A second variety of foreign exchange trade is the forward transaction. This is the same as spot except that the value date falls after the spot value date. Forward transactions are routinely quoted for value in 1 week, 1 month, 3 months, 6 months, 9 months, and 1 year. The forward exchange rate for a particular value date is called the *outright*.

The difference between the outright for a particular date and the spot exchange rate is called the forward points. The forward points are linked by arbitrage to the difference between the interest rates in the two currencies. This relationship is called the cov-

ered interest parity theorem (see DeRosa 1996, 2000, and Keynes). Keeping all other things constant, the higher the foreign currency interest rate, the lower the forward dollar value of a foreign currency.

Forward foreign exchange is essential to hedgers. Consider the case of American investors who have decided to buy Japanese government bonds (JGBs). In the first instance the investors must exchange dollars to buy yen to pay for the bonds. As soon as they own the yen, they are exposed in the dimension of foreign exchange to movements in the yen. If the yen weakens, the investors will have a loss on the bonds; if the yen strengthens they will have a gain on the bonds—both deriving purely from the movements in exchange rates without any consideration of changes of the value of the bonds in yen terms.

So the investors might decide to *hedge* their foreign exchange exposure using forward foreign exchange contracts. The typical way that investors hedge is with short- and medium-term forward foreign exchange contracts, 3 or 6 months in term. (If the hedge is to be kept for longer periods of time, the investors can simply roll to a new forward contract as the existing contract matures.) In the example of the American investors with the JGB position, the hedge would consist of a forward contract to buy dollars and sell yen. No cash moves until the value date of the forward contract. If the yen rises in value, the hedge will produce a loss, but that will be balanced by the foreign-exchange-related capital gain on the Japanese bonds. Likewise, if the yen falls, the hedge will show a profit and the bonds will have a corresponding capital loss—all because of changes in the exchange rate. In practice there are many levels of complexity beyond this; interested readers may refer to DeRosa "Managing Foreign Exchange Risk." In its simplest form, however, this is how a forward hedge takes currency risk out of the investment equation.

economy, but he felt he needed to resort to extraordinary measures to hold on, including making wild accusations about an international conspiracy against his country.

In August 1998, Russia simultaneously defaulted on its maturing treasury debt and devalued the ruble. When the ruble was allowed to float, it plunged to near worthlessness. Many international investors who participated in the Russian debt market had hedged their exposure to the ruble with forward foreign exchange contracts that had Russian banks as counterparties (Box 1.1).

Unfortunately for the investors, Russian banks refused to perform on their forward ruble contracts when the government defaulted on its debt. The shock waves from the Russian default set off financial events felt as far away as Latin America. Violent movements in North American stock and bond markets ensued, climaxing with the dramatic collapse of Long-Term Capital Management (LTCM), a well-known American investment firm.

In September 1998 Malaysia's mercurial prime minister Mahathir declared with flourish that he had put an end to foreign exchange trading in the ringgit and imposed capital controls on international money flows trying to exit his country. Mahathir put the blame for the entire Southeast Asian crisis on currency speculators, and in particular, on the person of famed hedge fund manager, George Soros.

In January 1999, Brazil suffered a huge depreciation in its currency, and its financial markets nosedived after one of its states refused to make scheduled payments that it owed to the national government. Ecuador next was hit with a currency crisis of its own. Ecuador secured its place in history when it became the first nation to default on a Brady bond issue. Brady bonds are named after former U.S. Treasury Secretary Nicholas Brady who introduced them in the 1980s to reduce the debt burden facing developing nations.

These are the highlights of the low points of the '90s. The big picture for this troubled decade can be summarized as this: Parts of Europe, Asia, Russia, and Latin America experienced currency crises, stock market crashes, deflation, recession, sovereign insolvency, and political instability all rooted in economic dislocations.

Understandably, the stability of the global market economy has been called into question. However, the questions being asked are often the wrong ones.

The Analysis of Financial Policy

THIS BOOK IS LARGELY concerned with the analysis of financial policy, a term which the author narrowly defines to be the class of macroeconomic initiatives directed by heads of state, central bankers, and ministers of finance at foreign exchange and asset markets. The analysis of financial policy first requires consideration of the goals that officials set out to achieve. Some of these goals have been worthwhile. Others have been frivolous if not outright detrimental to the proper workings of economic markets.

The single most important financial policy decision that a country makes is its choice of which exchange rate regime to establish for its currency; as will be discussed at length in this book, many fixed exchange rate regimes have failed in their intended purpose of maintaining stability in the currency market. Quite the opposite of what was intended, fixed exchange rate regimes can cause violent macroeconomic fluctuations. A few fixed exchange rate regimes have been successful, but most have ended in spectacular crises, such as was experienced with the Mexican peso (1994), the Thai baht (1997), the Indonesian rupiah (1997), the Russian ruble (1998), and the Brazilian real (1998).

The unintended or indirect consequences of financial policy are more complex to judge. Financial policy can have far-reaching effects, some salutary, others harmful. In the period 1994–1995, the United States, Germany, and Japan banded together to try to stop the dollar from falling, principally against the Japanese yen but also against the German mark. This group, nicknamed the G3, expended considerable energy and funds to try to turn the dollar around. Eventually, the dollar did bottom out in April 1995. The complication was that while U.S. Treasury Secretary Robert Rubin and his partners in Germany and Japan were telling the world that a "strong dollar" was in everyone's interest, Asia was accumulating massive debts, most of which were denominated in dollars. The

Asian countries had in effect taken a very risky exposure to the potential rise in the dollar. As the dollar began to rise, the severity of the Asian dollar debt was magnified greatly, from the perspective of local currency. Foreign currency denominated debt was a major causal factor in the 1997 Southeast Asian currency selloff. Hence to the extent to which the G3's strong-dollar policy was successful in impacting exchange rates, it could be said to have contributed to the ensuing the bankruptcy of Asia.

Sometimes financial policy goes wrong in execution. Soon after becoming Secretary of the Treasury in 1995, Robert Rubin initiated a coordinated foreign exchange intervention to support the dollar. No sooner had the intervention commenced than did President Bill Clinton begin to deliver televised speeches attacking the Republicans in Congress for wanting to "explode the budget deficit." The dollar first rose against the German mark and Japanese yen but then promptly plunged as the market took in what the president was saying. The market could hardly have been expected to be enthusiastic about the dollar when the president was accusing the Congress of being fiscally irresponsible. Rubin's later interventions showed more of the considerable currency trading skills learned earlier in his career during his Wall Street days.

One of the most egregious technical errors in the execution of financial policy occurred in 1985 when the finance ministers and central bankers from G5 nations, the Group of Five Industrialized Nations that consisted of France, Germany, U.K., Japan, and the United States, hatched the Plaza Accord foreign exchange intervention to lower the value of the dollar against other principal currencies. The "Plaza intervention," as it has come to be known because the ministers met in the famous New York hotel by that name, was the first large-scale coordinated central bank attack on the foreign exchange market since exchange rates were allowed to float against the dollar in 1973. The error was that the G5 delegates failed to obtain, or maybe completely overlooked, a necessary agreement among themselves to coordinate their immediate monetary policy surrounding their planned currency intervention, as will be explained in Chapter 2. Even more serious errors in execution of financial policy occurred in the Asian currency crisis

of 1997, as will be revealed in subsequent chapters.

Financial policy can also be directed at asset markets. Japan has a long-standing interest in preventing a declining trend in prices in its government bond market. At this writing, Japanese government bonds are at record low yields following a decade of economic stagnation. The authorities feel it is their duty to manage any rise in bond yields that they see forthcoming with the potential emergence of Japan from its ten-year slump. To this end, they engage in convoluted tactics to support the bond market, including the counterintuitive practice of having the government and its agencies buy their own bonds in the secondary market.

Another example of financial policy aimed at asset markets is in Hong Kong, where the authorities took the extraordinary step in August 1998 of direct intervention to support the local stock market. This policy initiative stands in direct contradiction to Hong Kong's long-standing legacy as the bastion of free-market economics.

The U.S. Federal Reserve, too, has been known to react to stock market fluctuations. This is not necessarily a bad thing. High praise was heaped on U.S. Federal Reserve Chairman Alan Greenspan for his handling of the threatening situation that surrounded the 1987 stock market plunge. Greenspan offered unlimited funds to the nation's banks to preclude their shutting off credit to the brokerage community. The intention of the Federal Reserve was to stop the stock market panic from spreading; it achieved this objective without crossing the line by directly stabilizing share prices.

The New York Federal Reserve showed less restraint when it decided to introduce itself into the dissolution of Long-Term Capital Management, an insolvent investment company, in 1998. Officials of the Federal Reserve Bank of New York encouraged, and maybe coerced, a group of commercial and investment banks that had lent money to LTCM into taking over the firm. At about the same time, the Federal Open Market Committee delivered a series of cuts to the federal funds target interest rate, totaling 75 basis points, or 0.75 percent. The LTCM crisis faded in a few months. Whether or not the Federal Reserve helped or damaged

the situation is not clear. But what endures is the impression that a privately managed investment fund almost brought the international financial system to ruin but for the swift intervention of the government.

The broad study of financial policy might also involve the analysis of tangential areas of economic decision making, such as fiscal policy, including the implications of changes in a country's tax laws. Japan made a crucial error in judgment in April 1997 when it decided to raise its national sales tax. Critics of then Prime Minister Ryutaro Hashimoto believe his insistence on raising the tax was responsible for materially obstructing a nascent recovery in Japan. It didn't do Hashimoto much good politically either, because the electorate roundly hated his tax hike. His Liberal Democratic Party (LDP) garnered a miserable showing in the July 1998 parliamentary elections. Hashimoto accepted responsibility and promptly resigned as Prime Minister, but the bureaucrats at the Ministry of Finance (MOF) who pushed for the tax increase remained safe at their desks.

The Growth of Antimarket Sentiment

JOHN MAYNARD KEYNES in the 1923 preface to the French-language translation of his *Tract on Monetary Reform* wrote, "Each time the franc loses value, the Minister of Finance is convinced that the fact arises from everything but economic causes. He attributes it to the presence of foreigners in the corridors of the bourse, to unwholesome and malign forces of speculation."[3] These two brief sentences are prescient, for as Keynes surely would have predicted, the blame for the 1990s crises has been ascribed to everything but fundamental economic causes. Many prominent political leaders and economic ministers have ducked any examination of how their domestic policy blunders may have created the nightmarish economic conditions in Europe, Asia, Russia, and Latin America, and have turned instead to making the international monetary system their scapegoat. The fault it is said, is with the free-market system itself (Box 1.2).

Financial crisis has been identified as a natural outcome for an

BOX 1.2

Who Is Blaming the Market?

Here are some examples:

The United Nations report "Toward a New International Architecture" begins with this paragraph, entitled "The International Financial Crisis and the Need for Reform":

> World events since mid-1997, and its precedents in the 1980s and 1990s, have made painfully clear that the current international financial system is unable to safeguard the world economy from financial crises of high intensity and frequency and devastating real effects.[4]

South Korean President Kim Dae-Jung backed the regulation of speculative flows of capital as being necessary:

> To minimize the damage from speculative global capital flow, we should strengthen the financial system of the newly emerging market economies....Given the fact that a foreign currency crisis that began in one country of the region had global repercussions and grave effect on the neighboring countries of East Asia, there is an urgent need for closer cooperation.[5]

The most unexpected of all of the critics of the free market turned out to be none other than George Soros:

> There is an urgent need to recognize that financial markets, far from tending towards equilibrium, are inherently unstable. A boom/bust sequence can easily spiral out of control, knocking over one economy after another. Thus, in finding a remedy, "market discipline" may not be enough. There is also the need to maintain stability in the financial markets.[6]

Soros later amplified his remarks with:

> Financial markets are given to excesses and if a boom/bust sequence progresses beyond a certain point it will never revert to where it came from. . . . Instead of acting more like a wrecking ball, knocking over one economy after another.[7]

economic system that permits the unrestricted flow of capital across borders. In this view, leveraged speculative trading in foreign exchange and fixed income markets is to blame, as are the dearth of regulation of capital markets and the practice of letting exchange rates float freely. Recently, calls for reform have sprung up everywhere demanding the reinvention of what is termed the "international financial architecture." That imposing phrase generally means the foreign exchange market, though it also can refer to international capital movements or by inference to the unregulated trading of large and leveraged investment funds. This crusade for reform has been blessed by at least two heads of major nations. German Chancellor Gerhard Schröder said: "Japan, Europe and the United States agree on this. We are on the eve of a new financial architecture."[8] U.S. president Bill Clinton promised: "[It is now time for the world to] take the next steps [of implementing a] new financial architecture and long-term reform of the global financial system. [This should include] steps to reduce the entire financial system's vulnerability to rapid capital flows and excess leverage." [9]

The common claim of the reformers is that changes must be made to the international monetary system to prevent the arrival of fresh waves of financial devastation. The proposals on the table, to name a few, include the regulation of capital flows, especially to emerging market nations, the imposition of a tax on foreign exchange transactions, the establishment of target zones to limit fluctuations in foreign exchange trading, and the policing of hedge funds and other trading concerns.

Yet a great deal of these claims are built on presumption. To believe what is being said is to give credence to some very dubious propositions. It would require one to embrace the belief that fluctuations in exchange rates serve no economic function in the allocation of economic resources but exist merely for the employment and enrichment of currency traders. One would also have to believe that a ruthless cartel of destructive speculators can hold the world for ransom at will. One would have to accept the premise that market economies are prone to spontaneous and unpredictable implosion simply because they are market economies.

An Alternative View of Crisis and Regulation

THERE IS AN ALTERNATIVE VIEW; the market is getting a bum rap. Financial breakdown is not a nomadic creature with the power to settle into any address of its choosing. On the contrary, crisis never arrives without having first received a hand-delivered invitation from domestic policy makers.

That said, it couldn't be denied that markets in and of themselves do at times go to extremes, sometimes swinging from wild optimism to pessimism and even panic over short periods of time. This idea seems to be readily acceptable even to the general public, as witnessed by the success of economist Robert Shiller's book *Irrational Exuberance*. Shiller's book is primarily directed at explaining the perceived overvaluation of U.S. common stocks at the end of the '90s. One can imagine a similar book about the phenomenon of investors having rushed into and then out of Southeast Asia and Russia in the purest sense of what popular psychology calls the "herd mentality."

It is factually correct that large amounts of capital flowed into every crisis nation in the year or two before its collapse. But for governments to moderate capital flows, even assuming that this is what needs to be done, would require the imposition of a rigid structure of global capital controls.

As we will see in the chapters that follow, better solutions appear once one recognizes that the problems of the 1990s were not caused by the malfunction of the international financial system, or by foreign currency traders, or by hedge funds, or by errant capital flows. The crises came not from the outside but rather from within. Disaster was homegrown and the natural consequence of wholly ruinous domestic policies. The worst of these policies was the decision by Mexico, Thailand, Indonesia, and other countries to adopt forms of fixed exchange rate regimes.

Moreover, a major part of the story is often conveniently overlooked by those seeking to reform the system: A substantial and speedy recovery has already taken place in South Korea and in most of the Southeast Asia countries that went through the crisis period, now that their currencies are floating. Seldom is this men-

tioned in the clamor for new regulations on international financial markets; credit is rarely given to the market forces for their work to repair the damage done by bad domestic financial policy.

A cynical but not wholly inaccurate description of the process by which new market regulation comes into existence runs as follows. First there is a notable financial catastrophe, of which the 1929 U.S. stock market crash is a good example. Next there is a call for market reforms and new regulations. This is what happened in the 1930s when the superstructure of American securities laws and regulation came into existence.

In time, the government's new role becomes cemented into the fabric of the marketplace. A veritable industry can evolve out of the need to monitor and enforce compliance with the new rules, and this furnishes steady employment to an army of lawyers, accountants, and bureaucrats.

The process always includes a concerted search for the guilty parties, because it is presumed that venal, self-interested persons must have been the cause of the calamity and possibly even profited from it. In the 1930s, the investment banks and the stock trading community took the fall. Stock market traders were accused of market manipulation, a term that quickly permeated the language of the new securities laws and regulations.

A second major U.S. stock market crash occurred in October 1987. The blame then was pinned on derivatives trading in stock index futures contracts and on a then-popular hedging strategy called portfolio insurance. Nicholas Brady, the sitting Secretary of the Treasury, reacted to this crash by creating a system of mandatory trading interruptions called "circuit breakers." Brady's trading halts were designed to limit the absolute fluctuation in stock prices in a short span of time. The idea was that if the market were in a free-fall, a break in trading would allow the panicked some time to collect their composure.

Brady's circuit breakers were also designed to obstruct arbitrage linkages between the shares and equity index derivatives markets. No substantive proof was ever given as to why this trading, called index arbitrage, is destabilizing to the market. In an index arbitrage trade, a trader buys or sells stock index futures

contracts and simultaneously goes the other way in the underlying stocks that constitute the index. The motive is to capture any small mispricing in the futures relative to the stock index. However, because the arbitrageur always takes opposite positions in the stock market and in the futures, no net market impact results.

Brady was not the only finance minister to be fooled by index arbitrage. In the early 1990s Tsutomu Hata, Japan's minister of finance (he later became prime minister briefly) conducted a relentless campaign against index arbitrage trading on his country's securities exchanges. Hata, convinced that the derivatives arbitrageurs were responsible for the downturn in the stock market, installed a set of circuit breakers on futures trading on the Osaka Stock Market where Nikkei stock index futures trade. This opportunity wasn't wasted on the Singapore International Monetary Exchange. SIMEX actively promoted and subsequently enjoyed an explosion in trading in its own exchange-listed Nikkei futures contracts, all thanks to Hata's shadowboxing with the arbitrage community.

One question almost never heard when new regulations are proposed is whether the cost of administration and compliance with the new rules exceeds whatever benefits are being touted. It is far more likely to be presumed, as in the case of the U.S. securities industry, that near-absolute purity is worth whatever it costs. No less of an opinion was delivered in sanctimonious tones by Arthur Levitt, chairman of the U.S. Securities and Exchange Commission, in his blistering 1999 attack at online securities trading: "The laws regulating our markets are a product of the New Deal era. To me, their concepts are as indelible as the Constitution. They have weathered challenge after challenge, decade after decade, and are every bit as relevant and effective today as they were the day they were written."[10]

The securities and derivatives markets did get some relief in 1997 when the bandwidth of the Brady circuit breakers was expanded to cut down on the all too frequent disruptions in trading. But this only happened after a consensus was reached throughout the industry that Brady's circuit breakers, in their original design, had materially exacerbated the October 27, 1997 stock market

plunge. There are still circuit breakers for the U.S. equity market but their workings are now linked to percentage moves in the market, not to absolute point fluctuations.

On occasion, hope for reversal of the onerous burden of regulation manages to sparkle through the dark of the night.

Such a rare event occurred in 1999 when the U.S. Congress repealed the depression-era Glass-Steagall Act of 1933 that artificially separated commercial banking from most forms of investment banking activities.

The ideology of the free market also got a sympathetic opinion from the President's Working Group on Financial Markets. The task force is comprised of Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the U.S. Securities and Exchange Commission (SEC), and the Chairman of the Commodities Futures Trading Commission (CFTC). The Group recommended in November 1999 that trading in financial derivatives by eligible swap participants (defined in various ways by the CFTC to include institutional market participants) should be excluded from the Commodities Exchange Act. The latter act is the primary legislation that governs trading in futures contracts.

The Working Group's report is a victory for the market in a subtle and more personal fashion, in that one of its members, Secretary of the Treasury Larry Summers, was a rabid foe of the derivatives markets in the years before he made the transition from Harvard to Washington. Here is what Professor Summers wrote about stock index futures in a guest editorial published in The *New York Times* on October 21, 1987:

> In the longer term, the stock index futures market should be regulated out of existence. The futures market circumvents margin requirements by enabling investors to have effective ownership of more than $150,000 of stock while putting down only $6,500. It makes possible trading strategies like portfolio insurance that increase market volatility by creating huge selling pressure following market declines. At the same time, the futures market offers no new opportunities to stable investors seeking to invest for the long term.[11]

Clearly something must have happened to Summers in Washington to improve his understanding of financial markets. Rarely does such an epiphany occur on the banks of the Potomac River. Supporters of free markets are thankful that the new Larry Summers, the supporter of deregulation, is the Summers who is seated in the Treasury, rather than the old Larry Summers, the man who wanted to bust the index futures market in 1987.

Despite these few triumphs for the free markets thesis, the process that produces new government involvement in the marketplace seldom reverses itself. Once new regulation is in place, it tends to stay in place, even after it has outlived its original reason for existing.

The decade of the 1990s afforded two opportunities for reformers to gain ground. First, as described above, there was the Southeast Asian crisis and the follow-up "contagion" in Hong Kong, Russia, and Brazil. Second, the collapse of Long-Term Capital Management in 1998 practically served up the entire hedge fund industry on a platter to the proponents of market reform. The two, occurring in such close time proximity, prompted renewed calls for reform, this time centered around trading in foreign exchange and interest rate markets and on what have come to be known as "highly leveraged" institutions, presumably because of the aforementioned leverage on the balance sheet of LTCM.

Suppose that the reformers are right and that major changes are needed to the way the financial system functions. Imagine that a sophisticated new team of architects is ushered in. What the reformers would soon find is that the market is not without its natural defenses and camouflage. It is not easy to halter and rein in a capital market. Regulating such things as the issuance of shares, trading in the secondary markets for shares, and arbitrage trading in stock index futures is a relatively simple process when compared to taking on the foreign exchange market. Foreign exchange is inherently an international market. It can make its home wherever it can find a set of good telephone connections. The same can be said of the over-the-counter (OTC) market for interest rate derivatives (e.g., swaps, swaptions, and forward rate agreements) which were the topic of the President's Working Group report.

The Demonization of the Foreign Exchange Market

THE FOREIGN EXCHANGE MARKET, more than any other market, has been cast in a villain's role. Even heads of state have been known to visit invective upon the foreign exchange market; they hate foreign exchange traders even more. President Franklin D. Roosevelt bashed currency traders in his first inaugural address (1933): "Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men."[12]

This kind of animosity may come from the fact that few heads of state study economics. Pursuing a law school education is seen as better preparation for a career in politics. Few chief executives ever attain a fundamental understanding of the functioning of prices in modern economies. Prices, including exchange rates, are the agents that ration scarce resources among competing demands. They are what corrects imbalances between supply and demand in all markets, whether it be the market for food, labor, stock prices, or foreign currency. Prices do their work without anyone's even being conscious of their activity, much like the human body's autonomic nervous system that controls a person's breathing and the functioning of internal organs. This is a difficult lesson that economists like Adam Smith and his followers have struggled to inculcate. Unfortunately, the principles by which a modern market economy functions may never cross the minds of politicians like Roosevelt when they are taking the "high road" by denouncing the currency market.

Consider a famous outburst from French president Jacques Chirac who on the occasion of the June 1995 Halifax summit of the Group of Seven (G7) largest industrialized countries told reporters that foreign exchange "speculation is the AIDS of the world economy." Chirac went on to say that there were "ways and means" for dealing with speculators but did not elaborate on his threat. Of course nobody can top Malaysian Prime Minister Mahathir when it comes to insulting currency traders:

> We do not like currency traders. Do we want to see the wealth of nations built up over years be destroyed because currency traders wanted free trade?[13]

and

> It is said that the value of the currency trade is 20 times that of world trade in goods. But apart from the enrichment of the currency traders, what is there to show for this huge trade? On the other hand we are now witnessing how damaging the trading of money can be to the economies of some countries and their currencies. It can be abused as no other trade can. Whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their rich clients.[14]

Finance ministers and central bankers are supposed to know more about economics than heads of state do. Yet they, too, have an adversarial relationship with the foreign exchange market because exchange rates have a habit of making them look like dolts; the currency market has made a monkey out of many a minister. In much popular thinking the whole foreign exchange market is nothing more than a business centered on speculation. Even Roosevelt's Treasury Secretary, Henry Morgenthau, couldn't resist taking a shot at traders on the occasion of the signing of the Bretton Woods agreement in 1944. Morgenthau said that he hoped the Bretton Woods system would "drive the usurious money lenders from the temple of international finance."[15]

Possibly the worst thing anyone has ever done to the reputation of the foreign exchange market was the announcement by George Soros in September 1992 that his hedge fund had made a profit of over $1 billion by selling short the British pound. Soros—famed hedge fund manager or infamous currency speculator, depending on your perspective—has been tagged forever with the responsibility for driving sterling out of the Exchange Rate Mechanism. In Chapter 3 it will be argued that putting sterling in the ERM in October 1990 was pure folly, and that Soros or no Soros, the pound was set up for a beating. On the other side of the Soros trades was

the Bank of England, which in the course of its ill-fated defense of the pound, squandered a great deal of its government's assets, possibly as much as 5 billion pounds of real taxpayers' money. The choice to defend the pound at a completely unrealistic exchange rate was made by the British government, not by Soros.

However, hostile perceptions of the market were reforged by the incident. Though the Soros trades were legal and by no means underhanded, people remain convinced that speculators can manipulate any currency and run roughshod over any central bank of their choosing. This dovetails with the long-standing presumption that the foreign exchange market is replete with fraud because it is an unregulated market, outside the purview of both the U.S. Securities and Exchange Commission and the Commodities Futures Trading Commission.

One frequently hears another assertion, that foreign exchange rates bear no relation to economic fundamentals. It is said that exchange rates, in that they can get out of whack with the economy, are destabilizing factors, as opposed to being market-clearing prices. This was certainly the opinion of Japan's Eisuke Sakakibara: "In the process of overcoming the crises of 1997–1998, one lesson we all learned was that the free movement of prices, be it exchange rates or interest rates, does not necessarily restore equilibrium."[16]

Such a statement reverberates from the foundations of Sakakibara's view on markets. He is one of the most influential advocates for government management of exchange rates. His last act before retirement from the Ministry of Finance (MOF) in the summer of 1999 was to launch an aggressive program to halt what he called a "premature" rise in the yen. No serious student of economics could give a proper definition of what constitutes a "premature" move in a price. That would take a MOF bureaucrat like Sakakibara to explain. And he is not alone. The foreign exchange market has been routinely branded with the stigma that it "overshoots" and that it displays "excessive" volatility.[17]

What is often missed in the rush to diagnose the foreign exchange market is an important, if not crucial distinction about volatility. In normally functioning markets prices move up and down in a more or less continuous manner. Parenthetically, finan-

cial theoreticians have described this with a class of models called diffusion processes, as was used to develop the celebrated Black-Scholes option model. Large moves are permitted with this class of model, yet one still can expect to find market makers willing to offer two-way buy-sell prices in derivative instruments.

A normal market can be trending down or up, it can even experience large fluctuations from time to time, and there will still be specialized economic agents willing to deal in derivative contracts. The importance of this is that derivatives are the principal tool that investors use to hedge foreign exchange risk. Among these are forward foreign exchange contracts and options on foreign exchange. Hence one can make the important generalization that investors are not put off by the possibility that a national currency will weaken over time—if that is their view, they can hedge, so long as there are dealers offering such instruments at reasonable prices. Where this breaks down is in the case of an exchange rate that is capable of making sharp, discontinuous movements. No dealer can afford to offer hedging contracts in an environment of potentially discontinuous moves in an exchange rate. Such a scenario has been known to occur with fixed exchange rate regimes, especially ones that are suspected of being about to disintegrate.

Chapter Three

Exploding Foreign Exchange Regimes

THE CURRENCY CRISES that were prevalent in the 1990s contributed in no small part to the economic dislocations that plagued the decade. Yet the origins of exchange rate crises are widely misunderstood, with the most popular explanation being that speculators are to blame. And some observers point to international capital flows as being the cause. They claim that money can move "too freely" between markets for the well-being of the international financial system. Neither the speculator hypothesis nor the capital mobility explanation is satisfactory.

Any currency, even one that is freely floating, can experience a sharp depreciation as part of a general macroeconomic reversal. Stock market crashes, political crises, natural disasters, or the economic collapse of an important trading partner country, to name a few examples, all can induce the value of a currency to plummet.

Although all exchange rate regimes, be they fixed or floating, can be brought low as part of a general economic meltdown, only fixed exchange rate regimes can explode essentially of their own accord. This insight is usually lacking in discussions about the currency crises of the 1990s where there needs to be acknowledgment that the common denominator that exists for nearly all of these chaotic episodes is a fixed exchange rate regime.

An *exchange rate regime crisis,* or simply, a *currency crisis,* comes about when market pressure forces a country to devalue its

currency or abandon its fixed exchange rate regime altogether. This phenomenon is always rooted in the distortions that fixed foreign exchange regimes create by giving artificial stability to the currency.

This chapter and the next review the fixed exchange rate crises of the 1990s, meaning the European Exchange Rate Mechanism (ERM) (1992 and 1993), Mexico (1994), and Southeast Asia (1997).

Distortions Arising from Fixed Exchange Rates

AT THE ONSET, WHEN A country decides to fix its exchange rate, it must instruct its central bank to stand ready to buy or sell its currency at an established exchange rate. The object of this exercise is to peg the value of its currency, called the domestic currency, to that of another country's currency, the latter being called the reserve currency. To facilitate this, the central bank must hold foreign reserves, meaning bonds and foreign currency issued by the reserve currency's government.

When the central bank buys the domestic currency to prevent it from falling in value, it must sell some of its foreign reserves. The success of any fixed exchange rate regime requires the central bank to be willing to deplete its stock of foreign reserves in order for it to conduct interventions into the currency market.

If the central bank comes to realize that it cannot preserve the fixed exchange rate, it may decide to try to devalue the domestic currency. *Devaluation* by definition occurs when the central bank lowers the fixed rate for the domestic currency, thereby making it less valuable against the reserve currency; *revaluation* means just the opposite, that the bank raises the fixed rate of its currency. In extreme cases the central bank may be forced to abandon the fixed exchange rate regime altogether and go to a floating exchange rate regime.

In theory, the interest rate associated with a fixed exchange rate currency should exactly equal the interest rate on the reserve currency. In reality, it rarely does. The domestic interest rate usually exceeds that of the reserve currency because there is a risk that the

exchange rate regime might fail. Even in cases in which the market has great confidence that the regime can endure, there can be a risk premium on the domestic currency interest rate, though it might be small. But if the confidence in the regime erodes, the spread between the domestic and reserve currency interest rates can become enormous.

Whatever is the level of the domestic currency interest rate, it is artificial, of course, because it is a function of the reserve currency interest rate and having the exchange rate fixed. The apparent stability in the exchange rate is totally unnatural. These distortions in the interest rate and the exchange rate are the underlying causes of what can turn into an exchange rate explosion.

Consider the case of a foreign investor who is interested in putting money into a country that has a fixed exchange rate system. The investment decision will be determined in part by whether the investor believes that the currency regime is stable. If confidence exists that the system can hold, the investor's preference would be tilted toward investing in assets denominated in the domestic currency and the investor will not consider hedging foreign currency exposure. This is because the domestic currency offers a higher interest rate than the reserve currency. Moreover, as a practical matter, the higher the domestic interest rate relative to the reserve currency interest rate, the greater the cost of doing currency hedging. Hence foreign investors will tend to accumulate positions that are long the local currency (Box 3.1).

There is another group, investment managers, hedge funds, and bank currency traders, who also will be attracted to fixed exchange rate currencies if they believe that the regime will persist. They have no interest in investing in the country, per se. They are solely motivated by a desire to capture the interest rate differential between the two currencies. They express this in a number of trading strategies that go long the domestic currency and short the reserve currency. Though the size of this differential may seem small, the potential profits are enormous when leverage is used. Investment strategies of this nature are generically called *carry trades*. They can be found practically anywhere there is a fixed exchange regime.

BOX 3.1

The Mechanics of Currency Hedging

INVESTING ABROAD CAN involve taking foreign exchange risk. This is readily apparent in the case of buying a foreign government's bond that is denominated in that country's own currency. Real estate and investments in foreign common stocks also have degrees of exposure to foreign exchange risk.

Most institutional currency hedging is done using forward foreign exchange contracts. Forward contracts are used instead of spot contracts to avoid having to make immediate physical delivery of foreign currency.

If an investor has acquired a bond denominated in a foreign currency, then his trade to hedge the currency risk associated with the bond is to sell the foreign currency forward to some value date, such as 3 or 6 months. As the value date approaches, the investor must roll the forward hedge for an additional period of time. Each time the contract is rolled, the profit or loss on the hedge must be settled with the dealer.

Currency hedges constructed with forward contracts can be removed any time the foreign exchange market is open by doing a matching trade in opposite direction. In the example given, such a trade would be to buy the foreign currency in the form of a second forward contract that has the same value date as the outstanding hedging contract. DeRosa *Managing Foreign Exchange Risk* has extensive discussion of hedging foreign exchange risk.

The most famous carry trade in recent history germinated within the European Exchange Rate Mechanism (ERM), the complex program for exchange rate stabilization operated by the European Monetary System from March 1979 until January 1999. Known as the *convergence play*, this carry trade was expressed with long

positions in high-yielding Italian and Spanish debt hedged with short positions in the lower-yielding German mark. The idea was to profit from the high yields on Italian and Spanish paper while using the German mark to hedge the currency risk of the lire and peseta. The German mark, which was the anchor currency in the ERM program, happened to have a relatively low interest rate compared to other European currencies. As long as the ERM held together, meaning no substantial devaluations of the lire or peseta, the trade made money. It was like getting free interest. An IMF report explained this trade as follows:

> For example, a U.S. investor purchasing an Italian Government bond could hedge this exposure with a forward contract in lire. However, if he chose to bet on convergence, without taking an open position in the dollar-deutsche mark exchange rate, he could hedge the latter exposure by selling deutsche mark forward; if the lira stayed within the existing exchange rate bands, this would yield higher returns. Obviously, the proxy hedge actually leaves the investor's position exposed to realignments of the deutsche mark-lire rate.[1]

But the bottom line was that for investors to participate in this trade it meant having to take exposure to the cross-exchange rate between the lire and peseta against the German mark. When the lire and peseta were sharply devalued, as were the ERM currencies during the crises of 1992 and 1993, investors found themselves on the receiving end of some gargantuan exchange-rate induced capital losses. It was only then that the true risk of the convergence trade became widely appreciated.

In the case of Mexico, dollar investors became positively addicted to a carry trade involving peso-denominated short-term government debt issues, known locally as *Cetes*. These instruments offered a nice step-up from U.S. dollar interest rates with no apparent currency risk. During the early '90s, the peso was pegged to the dollar, though a very gradual depreciation was allowed before the December 1994 float.

Thailand's carry trade was the famous "Thai baht basket trade." Prior to July 1997, the Bank of Thailand pegged the baht to a basket of currencies comprised of dollars, marks, and yen. In its most simple incarnation, the baht basket trade consisted of borrowing in dollars, marks, and yen, in the prescribed proportions, to finance investments in Thai baht bonds or baht bank deposits. When the baht was floated, it plunged, and investors took the full hit for the devaluation and were left owing debts in hard currency, dollars, marks, and yen. On a more sophisticated level, the trade consisted of a long position in the Thai baht that was hedged with forward contracts in the basket currencies.

Indonesia managed the rupiah by pegging it to the dollar with an allowance for gradual and controlled depreciation in the currency. This incubated still another Asian carry trade. Investors found ingenious ways go long rupiahs, thinking that they were earning a preferred rate of interest while enjoying the safety of a supposedly bulletproof fixed foreign exchange.

Significant amounts of leverage have been used by aggressive investors who wanted to accumulate enormous positions in carry trades. But carry trades are strange animals indeed. They appear to earn steady profits for long periods of time with little or no exposure to risk. Economists have come to call this phenomenon the *peso problem*. Peso problem trades seem to defy the basic economic principle that there can be no profit without some risk exposure. The IMF described the peso problem in a report on the September 1992 ERM crisis and the convergence play:

> In some way, the convergence play is another version of the "peso problem." In the mid-1970s the Mexican peso had exchanged for the U.S. dollar at the same rate for two decades. The Mexican interest rate was significantly higher than dollar interest rates, year after year. This phenomenon was dubbed the "peso problem."... The interpretation in 1975, which is now commonplace, was that the probability of a large devaluation was low because empirically the event had not occurred in a long run of data. The devaluation, once it occurred, would be large because of the large

> divergence in interest rates. The game for any market participant was to time the conversion of funds back to dollars before the devaluation and obtain higher than the market return on dollars.[2]

History provides many examples of carry trades that have met their days of reckoning. When a fixed exchange rate regime appears to be in trouble, the carry traders see financial disaster staring them in the face. They become desperate to get out of their positions, even if it means having to pay exorbitant prices to eliminate their exposure to the domestic currency. This adds colossal pressure to the already weakened fixed exchange rate regime. The losses on a carry trade can end up being substantial. Ironically, what can be lost in an instant of panicked trading can easily erase all the profits from years of being in the carry trade. The joke among traders after the 1992 ERM crisis was that the convergence trade was like "bending over to pick up pennies while being in the path of an advancing steamroller."

So we have the nonhedged foreign investors and we have the carry traders. And then what of the role of the local residents? Their incentives point the same way as the foreign investors. They are enticed to structure their borrowings in the reserve currency because they want to borrow as cheaply as possible and their own domestic interest rate exceeds the reserve currency rate. Yet this is a bomb in the making because of the risk of the domestic currency experiencing a devaluation. If the domestic currency were to be devalued, the reserve currency indebtedness would be magnified upward in local currency terms. Hence it can be seen that local residents too, when they borrow in reserve currency terms, have a de facto foreign exchange exposure that is long the local currency and short the reserve currency.

The key point is that everyone—the foreign investor and the local investor—is long the domestic currency. Everybody will try to sell the domestic currency or hedge their exposure if they come to suspect that devaluation or an abandonment of the regime is in the cards. The cumulative long position in the domestic currency, which may have taken years to accumulate, will be put up for sale

BOX 3.2

The Nuts and Bolts of Currency Speculation

TO UNDERSTAND THE role of speculators, we must follow the mechanics of going short the domestic currency. Going short means that individuals sell a currency that they do not own. This is done in the hope of being able to buy it back at a cheaper price at a later time. It is similar to selling short shares of common stock. With stocks the short seller must borrow shares to make delivery to the buyer. There is a lending fee that must be paid by the short seller to obtain the loan of the shares. In foreign exchange a short sale is accomplished by selling the currency in a forward transaction. As was explained above, a forward foreign exchange transaction has its value date further out on the settlement calendar than spot, the latter being a trade for nearly immediate settlement. To stay with the analogy of the short sale of stock, the forward sale of a currency involves paying a "lending fee" of sorts that is based on the spread between the interest rate on the currency being sold and the currency being bought. But this "lending rate," rather than being explicitly stated, is folded into the forward exchange rate. The amount by which the forward exchange rate diverges from the spot exchange rate, called the *forward points,* determines the cost of going short the currency.

at once in a block if the fixed exchange rate regime begins to crumble. The magnitude of these positions accounts for the ferocity of fixed exchange rate currency firestorms.

Once a currency crisis begins, a fourth group, who could legitimately be called currency speculators, arrives on the scene trying to get in on the action. They, too, attempt to sell short by taking a forward position (long the reserve currency and short the domestic currency). They hope to be able to close out their positions with vast profits once the currency regime has cracked and the exchange rate for the local currency has plummeted. But their trading is perilous because they are usually too late and because they

Herein lies a basic principle of currency trading: The higher the domestic interest rate, the more expensive it is to maintain a short position in that currency.

One widespread misperception is that the foreign exchange market is rife with situations that are riskless "one-way bets." Practically speaking, these almost never exist. One has to take into account the cost of carrying a speculative position. Seasoned currency traders know to balance the probable gains from devaluation against the cost of maintaining a short position in the currency.

This is why a central bank may choose to hike its short-term interest rate to defend its currency in the face of market pressure. The idea is to try to muscle speculators out of the market by raising the cost of their going short or staying short the domestic currency. But in so doing, the bank must accept that it is damaging its own economy. Higher interest rates may lead to bankruptcies and higher rates of unemployment. That damage can be catastrophic, as has been evident in the history of emerging-market nations where bank loans are typically based on floating interest rates.

have to pay enormous costs to finance their short positions in domestic currency.[3] While it often appears that they have huge sway over the market in a crisis, they actually are never really large position-wise relative to the other groups that have been mentioned. The positions accumulated by the local residents and foreign investors that must be liquidated always dwarf those of the speculators (Box 3.2).

The balance of history in the 1990s is not on the side of the central banks when it comes to managing currency crises. Although there have been successful defenses of fixed exchange rate regimes, a good number of central banks were broken. When

the situation became critical, they faced having to choose between keeping what was left of their foreign reserves and maintaining their exchange rate regimes. Many were forced to devalue their currencies. Others decided in the end to let their currencies float, having abandoned their fixed exchange rate regimes.

Many central banks have compounded their situations by attempting to defend their fixed exchange rate systems with direct intervention in the foreign exchange market. This is the sad record of the Banks of England, France, Germany, Mexico, Thailand, Indonesia, and Malaysia, to name a few. These, and many other central banks, have squandered billions of dollars of reserves trying to defend doomed fixed exchange rate regimes.

The European Exchange Rate Mechanism Crises: 1992 and 1993

THE TREATY OF ROME in 1957 called for the creation of the European Economic Community. This started the process of European economic unification that led to the establishment of the European Economic and Monetary System (EMS) in March 1979 and the most ambitious experiments in fixed exchange rates since Bretton Woods.

At the start, the EMS called for the creation of a new currency, the European currency unit (ECU). The ECU was originally a gross domestic product (GDP)–weighted average of the EMS currencies in 1979. Periodically its composition was supposed to be modified to reflect changes in the relative GDP of member nations. The composition of the ECU did change when new currencies were admitted to the EMS. In November 1994, the composition of the ECU, then comprised of eleven currencies, was permanently fixed. The largest components of the ECU were the German mark (30.1 percent), the French franc (19.0 percent), and the British pound (13.0 percent).[4]

To some extent the ECU did trade for a while as though it were a real currency. Some European governments even issued debt instruments denominated in the ECU, but ECU notes and coins

were never put into circulation. The ECU was replaced by the euro on January 1, 1999, but not before it played an important role in the operation of the Exchange Rate Mechanism (ERM), a complicated exchange rate stabilization program operated by the member EMU countries.

The ERM was supposed to work as follows. Each of the ERM participating currencies was assigned a targeted exchange rate with respect to the ECU called its *ECU central rate.* The ratio of any two ECU central rates was defined as the *bilateral central rate* between two participating currencies. All of the bilateral central rates taken together formed the *ERM parity grid*. Each participating country was responsible for maintaining its currency's position within the grid within a tolerance of a predetermined band. The bandwidth applicable for most participating currencies was equal to plus or minus 2.25 percent, but some currencies were allowed to travel within a wider bandwidth equal to plus or minus 6 percent. To make this work, the member countries were supposed to coordinate monetary and fiscal policy and carry out an orderly implementation of structural economic reforms. They also agreed to make direct intervention into the foreign exchange market to maintain their currencies' ERM positions.

The intended purpose of the ERM was to dampen the volatility of European exchange rates in the period leading up to the launch of the euro. Full interest rate convergence was seen as a necessary precondition to the debut of the single currency. Logically speaking, if exchange rates could be fixed within narrow trading zones, then interest rates in the respective currencies naturally would have to converge on a common level.

But the ERM was anything but a stabilizing influence. The ERM, which was a fine example of financial engineering run amok, actually induced record levels of volatility in European exchange rates. From the time of its inception in March 1979 until the creation of the euro at the start of 1999, the ERM suffered a total of eighteen realignments affecting fifty-six central rates. It also spawned two spectacular currency crises.

September 16, 1992, the day of the sterling ERM crisis, is a day that lives in traders' minds as one of the most chaotic times in

modern foreign exchange history. Not only was the foreign exchange market in chaos, but stock and bond markets in all of Europe were also in a complete uproar. Massive selling of sterling took place as it became apparent that the U.K. had made a massive error in joining the ERM.

This crisis featured the famous episode in which George Soros reportedly earned $1 billion from a short sterling/mark position. The Soros trading in the ERM currency and debt markets, trading that actually netted him about $2 billion, was a singularly brilliant piece of speculation. There never has been anything like it, before or since. Soros quickly became known as "the man who broke the Bank of England."

Soon afterward Soros spoke about his ERM trading in an interview with London *Times* journalist Anatole Kaletsky:

> We did a lot of sterling and we did make a lot of money, because our funds are so large. We must have been the biggest single factor in the market in the days before the ERM fell apart. Our total position on Black Monday had to be worth almost $10 billion. We planned to sell more than that. In fact when [Chancellor of the Exchequer] Norman Lamont said just before the devaluation that he would borrow nearly $15 billion to defend sterling, we were amused because that was about how much we wanted to sell. But things moved faster than we expected, and we didn't manage to build up the full position. So a billion is about right as an estimate of the profit, though dollars, not pounds.[5]

In the same interview, Soros revealed to Kaletsky that he had other positions across the ERM:

> Mr. Soros sold lire and bought German bonds. He took big long positions in British, German and French interest rate futures. And he bought the London stock market, hedging this with sales of German and French shares. The week after the British devaluation, Mr. Soros made further gains

> by siding with the French authorities against speculators who were attacking the franc. In all the funds made about $2 billion.[6]

Soros's astounding trading acumen was revealed in the above passage when he spoke of his having reversed gears to defend the French franc against attacks by other speculators as the crisis subsided. But as was mentioned above, the Soros trading in sterling and related markets forever changed the way that the general public views hedge funds, if not the entire foreign exchange market. Soros made it look to the man on the street, and daresay many politicians and central bankers, as though he or any of his imitators could obliterate any exchange rate regime of their choosing. Is this really true or did the Europeans, particularly the British, set themselves up for a fall?

The most relevant thing about the September 1992 ERM crisis is that it originated from a form of a fixed exchange rate regime. All of the conditions identified above that make for a potentially explosive foreign exchange regime were present. None of them relies on the existence of a superstar currency speculator.

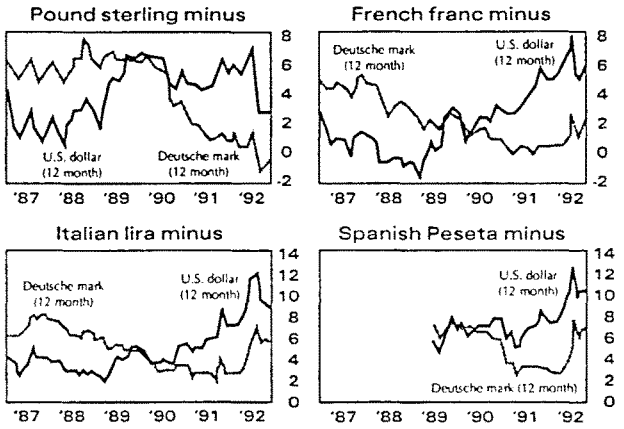
The first factor was the formation in the years leading up to September 1992 of a massive carry trade known as the *convergence play*. The ERM created serious distortions in European capital markets. Despite apparent exchange rate stability, European currencies featured widely disparate interest rates (Figure 3.1).

The IMF wrote of the resultant capital flows into the ERM countries:

> One of the important factors motivating these inflows was the growing perception by international investors that the member countries of the EMS were on a continuous convergence path toward European Monetary Union (EMU), under which interest rate differentials in favor of the high-yielding ERM currencies would increasingly overestimate the actual risk of exchange rate depreciation. As one portfolio manager recalled the prevailing view, "why settle for

FIGURE 3.1

The Convergence Play



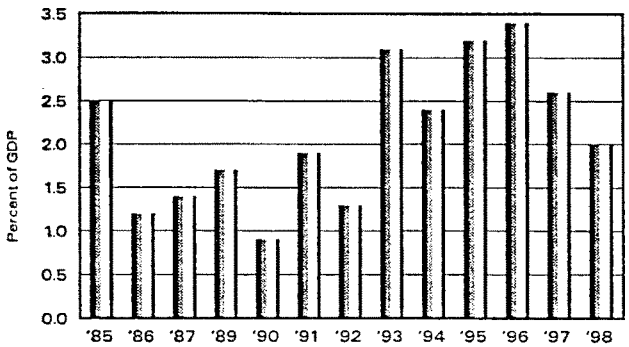
INTEREST RATE DIFFERENTIALS among the ERM participants created the famous "convergence trade." Traders and investment managers were free to invest in the highest-yielding currencies among the ERM countries with no fear of exchange rate risk because currencies were stabilized inside of Europe. These graphs show the size of the interest rate spreads against the German mark and U.S. dollar for the pound sterling, French franc, Italian lire, and Spanish peseta.

Source: Data Resources, Inc. Reprinted by permission of the International Monetary Fund.

the yield on a deutsche mark bond when you can get a higher yield on a peseta or lira bond without a compensating risk?"... In yet another reflection of the fixed exchange rate assumption, the exchange risks of positions against non-ERM currencies was frequently "proxy-hedged," for example, a hedge of a deutsche mark position against the U.S. dollar was emplaced when lira securities were acquired.[7]

FIGURE 3.2

German Budget Deficit (Percent of GDP)



GERMAN MINISTERS WATCHED as their government's budget deficit began to grow as soon as the reunification of East and West Germany was effected in 1990.

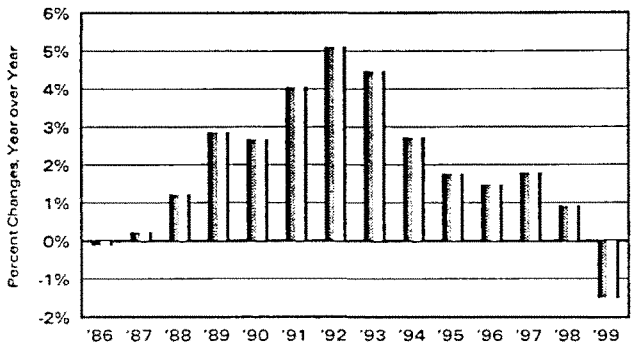
Source: Data from International Monetary Fund, *World Economic Outlook*, May 1993, Table A15 and International Monetary Fund, *World Economic Outlook*, October 1999, Table 1.4.

The attraction to the convergence play was virtually universal. According to one portfolio manager it amounted to having "government-sponsored arbitrage." The ERM was the catalyst for the surprising growth in popularity of a new class of money market mutual funds that specialized in the short-term securities of foreign governments with high interest rates. Morningstar, Inc., estimates that over $20 billion dollars of investor money flowed into these funds between 1989 and 1992. The main engine of portfolio performance for these funds was the convergence play.

As for the overall size of the market's position, the IMF reported that "without pretending too much precision, estimates suggest that the total of such convergence plays could have been as high as $300 billion."[6] Whatever were its true dimensions, the position associated with the convergence play that was unwound in Sep-

FIGURE 3.3

German Consumer Price Inflation, Annual Percentage Changes



EVEN MORE WORRYING to the German officials was that their rate of consumer price inflation began to accelerate after the reunification.

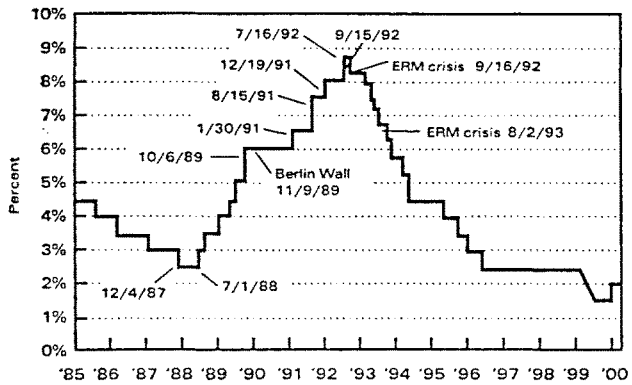
Source: Data from Bloomberg L.P. and OECD.

tember 1992 was larger by multiples than anything either the Bank of England or Soros was attempting to move in the market.

The second factor that caused the September 1992 ERM crisis was the exceptional and deliberate contractionary monetary policy conducted by the German central bank, the Bundesbank, in the period leading up to the events. Certainly, the designers of the ERM could not have foreseen that East Germany would achieve its liberation from the East Bloc amid the chaos surrounding the imminent disintegration of the Soviet Union. This process started with the fall of the Berlin Wall on November 9, 1989. German Chancellor Helmut Kohl, not wanting to miss this historic opportunity, called for a fast vote on reunification by referendum on July 1, 1990. On October 3, 1990, East and West Germany became one country.

FIGURE 3.4

German Discount Rate



THE GERMAN CENTRAL bank reacted to the growing budget deficit and rise in the rate of inflation with a series of hikes in the discount rate.

Source: Bloomberg L.P.

It was not until the tumultuous celebration began to wind down that the immensity of the cost of reunification became apparent to the German government. As government spending soared, the once-proud German Finance Ministry found itself with a large and growing budget deficit, at least by its normal standards (Figure 3.2).

Moreover, the rate of inflation began to pick up immediately (Figure 3.3).

Germany had the most conservative central bank in Europe, if not in the world. Not unexpectedly, the response of the Bundesbank was to hike the short-term interest rate repeatedly. From the time of the fall of the Berlin Wall to July 16, 1992, a period of eighteen months, the Bundesbank raised the discount rate four times, starting from 6 percent and reaching 8.75 percent (Figure 3.4).

The Bundesbank was the anchor central bank of the EMS, yet

it was raising interest rates during the time when the other ERM central banks were hoping to guide their interest rates to common lower levels. The Bundesbank, in so doing, put the interests of the German economy ahead of the European Union.

The third factor that led to the September 1992 crisis was the inclusion of the pound sterling in the ERM twenty-three months earlier. The bilateral central rate for sterling against the German mark was 2.95 when it entered the ERM on October 8, 1990. Economist John Williamson estimates that sterling's Fundamental Equilibrium Exchange Rate (FEER) was 2.24 for the mark.[9] The FEER for a currency is an econometric estimate of its long-run real value, a concept that Williamson introduced.

The first indication that something might be horribly wrong with the ERM structure occurred on June 3, 1992 when a market panic in the currency and European bond market ensued following the defeat of a Danish referendum on the Maastricht treaty. Investors were seriously concerned that the entire single currency project might be doomed. The Danes had called for a vote on the treaty, which twelve member nations had signed on February 7, 1992. The Maastricht treaty contained a set of common provisions that defined the new European Union. The aim of the treaty was to transform the European Common Market into a monetary union, and as such, it set out a timetable for the launch of the new single currency, the euro.

On September 16, 1992, the day that George Soros was referring to in the London *Times* interview as "Black Monday," the full crisis erupted, two months after the final Bundesbank rate hike of July 16, 1992 (Figure 3.4). In the course of the day, the Bank of England would raise short-term interest rates from 10 percent to 12 percent and then announce that it would raise rates again to 15 percent on the next day, all in defense of the pound. The U.K. fought the market tooth and nail, buying large blocks of its own currency against the mark.

It didn't work. The *Financial Times* would later proclaim that "Sterling was being sold like water running out of a tap."[10] Sterling was down and later completely out of the ERM. On the afternoon of September 16, when it became apparent to everyone that the

battle was lost, the Bank of England (BOE) rescinded both interest rate hikes. The crisis forced Great Britain, Italy, and Finland to withdraw from the ERM. Sterling had started the day at the bottom of its ERM band equal to 2.7780 against the mark. Sterling continued to plunge against the mark, reaching as low as 2.32 by February 1993.

Also annihilated that day were practically all of the players who had staked their careers and fortunes in the convergence play.[11] It was likewise the beginning of the end for many of the aforementioned short-term international money market funds, practically all of which disappeared almost as quickly as they had appeared on the investment scene. The full cost to the British Exchequer has never been disclosed to British taxpayers, but one has to imagine that it was many billions of pounds.

Eleven months later, in August 1993, a second ERM crisis occurred, but this time the primary targets were the French franc and the Italian lire. The EMS was compelled to widen the intervention bands to plus or minus 15 percent, an act that nearly converted the ERM to floating exchange rates. Even with these measures, Spain and Portugal, two countries whose currencies were devalued numerous times earlier in the ERM period, were forced to devalue one last time on March 6, 1995.

Eventually the European currencies did stabilize and convergence was achieved. But this happened after the August 2, 1993 widening of the ERM trading bands to plus or minus 15 percent, so the question that the Eurocrats face is whether it was truly in their interest to have created the ERM. The fact is that convergence was achieved not through manipulation of exchange rates but as a natural result of improved economic conditions in their respective economies.

Neither of the ERM crises would have occurred had the EMS not insisted on trying to limit the fluctuations in exchange rates inside Europe. The whole episode should have argued an open-and-shut case for the economic incompetence of the European ministers who designed the ERM. Yet instead, the ERM crises have served to convict the foreign exchange market in the court of public opinion.

BOX 3.3

What Is a Current Account Deficit?

THE TERM *CURRENT ACCOUNT* refers to the net difference between what a country exports and what it imports in the way of goods and services over a given period of time. A country that exports more than it imports, as is the case for Japan, is said to be in a current account surplus position. If a country imports more than it exports, as did most of Southeast Asia before the summer of 1997, then the country is said to be in a current account deficit position.

For the national books of account to balance, a country with a current account deficit must import investment capital. This is the basic identity that underlies the organization of national income accounting.

Current account deficit countries to some extent get by on the good will of their foreign creditors and investors. The position of the United States among current account deficit nations is special because the dollar is the principal reserve currency of the world. Smaller countries, especially emerging market countries, have not been so lucky trying to sustain their current account deficits.

Foreign Exchange Crises in Emerging-Market Economies

MANY FOREIGN EXCHANGE crises in the 1990s occurred in the emerging-market countries previously heralded for stupendous rates of growth. Several had forms of fixed exchange rate regimes, and all ran persistent and large current account deficits right up to the start of their crises (Box 3.3).

Mexico and most of Southeast Asia were running huge current account deficits, exceptional in size by any standard, at the onset

of their crises. But this was generally overlooked at the time, because the argument was made that these fast growing economies required large inflows of foreign capital. Some analysts rationalized away the risk of a currency crisis by concluding that the Bank of Mexico and the central banks of Asia were sufficiently stocked with foreign reserves to hold off an attack on their fixed exchange rate systems. Yet when crisis struck, the size of their reserves proved woefully inadequate, something that could have been deduced from what had happened to the much larger European central banks in the ERM crises of 1992 and 1993.

Analysis quickly exposes the implausibility of an emerging market nation's running a sustained, large current account deficit while trying to maintain a fixed exchange rate regime. The capital that flows in from abroad, which sustains the current account deficit, can stop or even reverse direction in an instant if there is even a whisper that devaluation is being considered.

The most crisis-prone environment of all combines a fixed exchange rate system, a history of current account deficits, and an investment environment where confidence is rapidly decaying. That in fact was the combination of factors, the perfect witch's brew, that brought down Mexico and most of Southeast Asia in the 1990s.

The Mexican Peso Crisis: 1994–1995

THROUGHOUT MOST OF the twentieth century, Mexico was a relatively poor country that happened to be located to the south of the United States, a very rich country. The prospects for Mexico started to improve in the 1970s. By the 1980s, Mexico had transformed its economy into a respectable emerging market success story.

A succession of Mexican presidents—Jose Lopez Portillo, Miguel de la Madrid, and Carlos Salinas, all of the Institutional Revolutionary Party (PRI)—built the image of the "new" Mexico over the period 1976–1994. The favorable outlook was enhanced when the United States, Mexico, and Canada entered into the North American Free Trade Agreement (NAFTA) which became effective on January 1, 1994.

In December 1994, the Mexican peso suddenly was the target of tremendous selling pressure. In a matter of days the peso declined to less than half of its previous value against the dollar. A massive macroeconomic contraction ensued, bankruptcy spread like wildfire, and the Mexican people began to experience great economic suffering.

What went wrong in Mexico? Francisco Gil-Díaz and Agustín Carstens, both economists with the Bank of Mexico, studied the crisis and stated: "We find clear evidence that Mexico experienced a politically triggered speculative attack, not a crisis based on the misalignment of real phenomena."[12]

Basic economic analysis argues differently. The fall of the peso was actually due to real economic forces, as will now be demonstrated. A proper *postmortem* must begin with Mexico's fixed exchange rate regime.

Mexico's "crawling peg" fixed exchange rate regime worked as follows. Starting on November 11, 1991, the Bank of Mexico fixed the value of the peso to the dollar within a formal intervention band. The peso was capped at an upper level equal to 3.0520 to the dollar. The floor was expanded at a rate of 0.0002 pesos per day, meaning that a gradual depreciation in the peso was theoretically allowed. This daily change in the floor was increased to 0.0004 pesos per day on October 21, 1992.[13]

In spite of the peso stabilization program, which required that the government stand ready to buy pesos at the pegged rate, a substantial spread remained between interest rates in Mexico and the United States. In January 1994, the spread between the Cetes interest rate and comparable U.S. dollar rates was 6.22 percent, annualized. Cetes are short-term peso-denominated treasury bills issued by the Mexican government. By July the spread between the Cetes rate and the U.S. dollar rates had risen to 9.94 percent. The spread closed somewhat to around 7 percent in early December before the crisis.[14]

Yet a substantial incentive remained for foreign investors to hold pesos as long as they believed that the fixed exchange rate regime could be preserved. The peso floor was allowed to drop by a mere 0.0004 pesos per day, which equates to a theoretical

maximum annualized rate of depreciation in the currency of 4.8 percent.

Capital literally poured into Mexico in the early 1990s. The IMF estimated $91 billion of foreign capital was absorbed between 1990 and 1993, with $30 billion in 1993 alone. The risk of a forced devaluation seemed remote, given the appearance of massive economic progress. But what was really happening was that Mexico was creating a first-class "peso problem" for itself.

After the fact, it is amazing that foreign investors never realized that there was the possibility that huge blocks of the capital that were stampeding into Mexico might someday turn around and try to leave *en masse*. There was remarkable complacency about the fact that Mexico's current account deficit had steadily risen from $3.8 billion in 1988 to $29.5 billion in 1994.[15] Many sophisticated and professional investors ignored the warning signs of impeding disaster because they were convinced that their commitments to Mexico were nothing short of owning a gold mine.

The authorities reinforced their misjudgment. In a display of boldfaced spin doctoring, Pedro Aspe, the former Minister of Finance, dismissed his country's current account position with the following remarkable logic in 1993:

> Some macroeconomic indicators have changed meaning since I was a student. A large current account deficit signals these days not a profligate government but a strong expansion of private investment financed by capital repatriation or direct flows from foreign investment.[16]

Aspe's remarks amount to a treacherous economic fallacy that was often heard in emerging markets in the 1990s. The fact that capital happens to be flowing into a country does not necessarily mean that the country is growing or even prospering. Rather, as in the case of Mexico, it may be nothing more than a sign that an economic distortion, here being the peso stabilization regime, is pulling in foreign capital. This money could be going right down a rat hole, so to speak, for all the investors care. Their entire incentive for investing in the country rests on the preservation of the

artificially stable exchange rate, rather than on carefully scrutinized real economic opportunities.

Given the importance that investors attached to the apparent stability of the exchange rate, surprisingly little attention was given to the very real possibility that the peso might have been massively overvalued prior to the crisis, as economist Rudiger Dornbusch believes:

> By 1993, Mexican producer prices had risen in dollars by over 45 percent since the late 1980s compared with prices in the United States. An overvaluation of at least 25 percent could be discerned. Growth slowed down (except for election year spending), real interest rates were extremely high when measured by rates on commercial bank loans, and the external balance shifted towards a massive [capital account] surplus. All the symptoms of a troubled financial situation were in place.[17]

One external factor that exacerbated Mexico's problems was a shift in the U.S. Federal Reserve monetary policy toward tightening in early 1994. Practically speaking, this could not have come at a worse time, with Mexico in such a precarious position. It is an example of how a policy of a large country can have disastrous indirect and unintended consequences for a smaller neighbor.

On February 4, 1994, fearing that inflationary pressures were building in the rapidly expanding U.S. economy, the Federal Open Market Committee raised its target for the federal funds rate by 25 basis points. This was Federal Reserve Chairman Alan Greenspan's warning shot, so to speak. Over the next nine months, the Fed raised the Fed Funds target six more times. In the course of the year, the Fed hiked short-term interest rates by a cumulative total of 300 basis points. The final rate hike, of 75 basis points, occurred on November 15.

How much of the peso crisis ought to be assigned to the actions of the Fed?[18] The answer is that the Fed rate hikes were material in that they added yet more pressure on the peso, since the peso was pegged to the dollar. But there were a great number

of other ruinous influences unique to Mexico at work at the time.

Chief among these internal factors was an acute loss of confidence in the political stability of Mexico that began to build in 1994, as Gil-Díaz and Carstens mentioned. Long-standing discontent in the southern province of Chiapas turned into violent disruptions in January 1994. More damaging was the assassination of PRI presidential candidate Donaldo Colosio on March 23, 1994. The political situation stabilized over the course of the summer when Ernesto Zedillo, who received the PRI's nomination after Colosio's death, was elected president. Zedillo was sworn into office on December 1 and trouble arrived at his doorstep immediately. On December 19, violence again erupted in Chiapas.

In an attempt to boost investor confidence, the Salinas administration (that preceded Zedillo's) decided to reconfigure the structure of the government debt by introducing a new form of government bond called *tesobonos* in April 1994. Tesobonos were short-term debt securities that paid in pesos but were indexed to the U.S. dollar. In issuing the tesobonos, the Mexican government effectively issued U.S. dollar denominated debt. Equivalently, the lower the value of the peso relative to the dollar, the more pesos the government would owe to the tesobono holders to preserve the dollar value of the debt. By November, 50 percent of the government debt (or $24 billion) was in the form of tesobonos. By December, tesobonos represented two-thirds of the government debt.

Financial crises often have their unique signature policy initiatives that go wrong with disastrous consequences. With Mexico, it was the decision to issue the tesobonos. These bonds, being dollar-linked, effectively created a financial doomsday machine in the basement of the state treasury. As the crisis progressed, the deterioration in the value of the peso was matched by an upward revaluation of the domestic currency value of the government's debt. The feedback loop was that as the peso weakened, the government's tesobono debt increased, which in turn put more downward pressure on the peso.

When the turmoil struck on December 20, 1994, the government's initial reaction was to try to defend the peso. Froot and McBrady report that the Bank of Mexico lost $4 billion interven-

ing to support the peso between December 20 and 22. On December 22, Mexico announced that the peso would be devalued by 15 percent. It was too little, too late.

Two days later, the selling pressure on the peso was so massive that the government was forced to abandon outright the fixed exchange rate regime and let the peso float. As recounted by the IMF,

> Reflecting continuous pressure during the next two days, and a steep decline in reserves, the peso was allowed to float on December 22, after which Mexican financial markets experienced heavy selling pressures. These pressures were exacerbated by two factors. First, the value of Mexico's dollar-linked tesobono debt increased sharply as the peso depreciated. Second, the depreciation of the peso and the associated rapid rise in domestic interest rates increased the amount of nonperforming loans in the Mexican banking system, in part because most loans in Mexico have floating interest rates that quickly reflect market rates.[19]

The damage done by the peso crisis did not confine itself to Mexico alone. There were some spillover effects, largely confined to Argentina and Brazil. The Argentine stock market fell 14 percent from December 19 to December 27. The Brazilian market fell by 17 percent over the same period.[20] Other countries in the region were less affected and some, like Chile and Colombia, saw their stock markets rally during that week.

Brady bond spreads in the region shot up in response to Mexico, with Argentina's and Brazil's rising 389 basis points and 207 basis points, respectively.[21] But the largest, and most ominous of the so-called spillover effects to hit Argentina and Brazil came in the foreign exchange markets.

Argentina operated a fixed exchange rate regime that will be further discussed in Chapter 5 and Chapter 7. On December 28, one week after the Mexican float, the central banks of Argentina sold $353 million of its reserves. Over the course of the next three months, one-third of the central bank's reserves were expended to

preserve the fixed exchange rate regime.[22]

Brazil had a similar experience with having to expend considerable reserves to keep its currency above the central bank's objective floor of R$0.85 to the dollar. On March 6, 1995, the authorities switched exchange rate regimes to a system of adjustable exchange rate bands.

Another kind of damage resulted from the method by which the developed countries tried to deal with the Mexican crisis. Mexico ushered in the era of the great supranational crisis bailout program.

On January 2, 1995, Robert Rubin, the newly installed Secretary of the Treasury, announced an $18 billion international credit package for Mexico.[23] Later that month, President Clinton announced a multilateral assistance package for Mexico that totaled nearly $50 billion. The funding came from the United States ($20 billion), the IMF ($17.9 billion), the Bank for International Settlements ($10 billion), and various Latin American governments and Canada ($2 billion). At the time this qualified as the largest financial bailout in history,[24] a dubious honor that would soon be conceded to Southeast Asian nations.

A number of serious questions are raised by the Mexican bailout. For starters, who exactly got bailed out? Critics say that the holders of the tesobonos, many being foreign investors and non-Mexican banks, got relief while the ordinary citizens of Mexico were left to suffer economic recession.

A far bigger question surrounds the larger concept of *moral hazard*. This term is thought to have originated from the insurance industry where it refers to cases in which losses are attributable to the moral character or derelict behavior of the insured. Economists use the term to cover instances in which investors participate in high-risk ventures, maybe even ones that are inherently deficient in the economic or social sense, only because of the existence of an actual or implied government guarantee of return of principal.

The case for having free markets rests on the premise that there be a connection between choices and outcomes. Investors need to enjoy the rewards from having taken risks and having

made intelligent, informed decisions. Symmetrically speaking it is also necessary that they suffer disappointment when their choices turn out to be mistakes. Otherwise capital will be allocated to unwise investment projects.

Government-sponsored bailouts of failed projects or even of failed economies represent merely another form of market distortion. When investors come to expect that they can fall back on the U.S. Treasury or the IMF to come to their rescue, they stop trying to make careful judgments.

In this way, the Mexican peso crisis bailout of 1995 only accelerated the flow of international capital into the economies of Southeast Asia.

Chapter Four

The Southeast Asian Currency Crisis of 1997

THAT THAILAND, THE Philippines, Indonesia, and Malaysia, four of the so-called Southeast Asian tiger nations, managed to weather the immediate consequences of the collapse of Japan's bubble economy is remarkable. One might suppose that the sinking of so large a ship would have sucked down in its wake the far smaller tiger economies. But the tigers managed to prosper, at least superficially, for most of the 1990s (Table 4.1).

Southeast Asia met its Waterloo in the summer of 1997. A tremendous currency crisis erupted in Thailand and quickly spread to the Philippines, Malaysia, and Indonesia. The initial manifestation was violent selling of the local currencies. Thereupon stock and real estate prices plunged and widespread financial insolvency followed (Table 4.2).

The cumulative magnitude of the dislocation to these economies can be seen in the dramatic reversals in GDP growth (Table 4.1). The greatest damage occurred in Indonesia, the fourth most populous nation in the world. The IMF estimates that Indonesia will have lost 82 percent of its four-year potential output in the period dating from the summer of 1997. The figures for Korea, Malaysia, and Thailand are 27 percent, 39 percent, and 57 percent, respectively.[1]

The Asian authorities quickly placed the blame on currency and stock market speculators. The most vocal attacks came from

TABLE 4.1

Real GDP Growth, Current Account, and External Debt: Indonesia, Malaysia, Philippines, and Thailand, 1990–1998

		1990	1991
INDONESIA	Real GDP Growth*	9.0%	8.9%
	Current Account Balance (% GDP)**	-2.8%	-3.4%
	Total External Debt % GDP in U.S. Dollars**	63.4%	63.8%
	Percentage of External Debt Denominated in Dollars**	45.0%	46.2%
MALAYSIA	Real GDP Growth*	9.6%	8.6%
	Current Account Balance (% GDP)**	-2.1%	-8.8%
	Total External Debt % GDP in U.S. Dollars**	50.3%	51.7%
	Percentage of External Debt Denominated in Dollars**	62.8%	62.8%
PHILIPPINES	Real GDP Growth*	3.0%	-0.6%
	Current Account Balance (% GDP)**	-6.1%	-2.3%
	Total External Debt % GDP in U.S. Dollars**	72.8%	74.3%
	Percentage of External Debt Denominated in Dollars**	52.7%	46.6%
THAILAND	Real GDP Growth*	11.6%	8.1%
	Current Account Balance (% GDP)**	-8.3%	-7.7%
	Total External Debt % GDP in U.S. Dollars**	34.6%	38.3%
	Percentage of External Debt Denominated in Dollars**	64.1%	65.4%

*Source: Data from International Monetary Fund, *World Economic Outlook*, October 1999, Tables 1.2, 6, and International Monetary Fund, *World Economic Outlook*, December 1997, Table A1.

Malaysian Prime Minister Mahathir who went into ad hominem tirades against George Soros on a number of occasions. He called Soros "criminal" and "an idiot." And Mahathir didn't stop there. He also stated that Soros had conducted his alleged attacks on currencies as part of a "Jewish agenda" against Southeast Asia.

Mahathir found company in denouncing Soros in Martin Peretz of the *New Republic*, who claimed that Soros "...benefited

1992	1993	1994	1995	1996	1997	1998
7.2%	7.3%	7.5%	8.2%	8.0%	4.7%	-13.7%
-2.2%	-1.5%	-1.7%	-3.3%	-3.3%	-1.8%	4.0%
61.1%	58.0%	60.1%	59.6%	58.5%	63.4%	150.9%
45.4%	45.5%	44.5%	45.0%	48.4%	47.8%	45.5%
7.8%	8.3%	9.3%	9.4%	8.6%	7.7%	-6.7%
-3.8%	-4.8%	-7.8%	-10.0%	-4.9%	-5.1%	12.9%
49.8%	59.0%	47.9%	40.7%	39.2%	45.8%	53.2%
62.9%	60.8%	60.5%	60.7%	63.5%	64.6%	64.8%
0.3%	2.1%	4.4%	4.7%	5.8%	5.2%	-0.5%
-1.6%	-5.5%	-4.6%	-4.4%	-4.7%	-5.3%	2.0%
64.3%	68.4%	65.2%	60.4%	60.6%	61.5%	82.5%
55.4%	53.0%	49.4%	52.0%	56.6%	56.5%	54.0%
8.2%	8.5%	8.6%	8.8%	5.5%	-1.3%	-9.4%
-5.6%	-5.0%	-5.6%	-8.0%	-7.9%	-2.0%	12.8%
38.7%	43.1%	47.2%	53.4%	54.9%	62.2%	80.7%
61.7%	66.0%	68.1%	70.2%	71.1%	67.5%	63.1%

**Source: Data from Institute of International Finance, Inc., *Comparative Statistics for Emerging Market Economies*, December 1998 and April 2000, Tables D102, D610.

handsomely by whipping the currencies and markets of poorer counties, then returned to some of those countries to offer his philanthropy."[2]

Indonesian President Suharto also claimed that currency speculators were to blame for his country's crisis: "There are parties trying to engineer the fall of the rupiah to the 20,000-level against the dollar."[3]

TABLE 4.2

Exchange Rate and Stock Market Movements In Southeast Asia, 1996–1998

Peak-to-Trough Percentage Changes*

SOUTHEAST ASIA'S CURRENCIES and stock markets were obliterated in 1997–1998 crises.

CURRENCY		STOCK MARKET	
THAILAND			
Thai baht /U.S. dollar		Thailand Stock Exchange Index	
May 14, 1997	26.15	July 28, 1997	685.69
January 9, 1998	55.68	September 3, 1998	206.73
Change	-53.04%	Change	-69.85%
PHILIPPINES			
Philippine peso/U.S. dollar		Philippines Composite Index	
May 14, 1997	26.5400	July 1, 1997	2,815.54
January 8, 1998	45.0400	September 11, 1998	1,082.18
Change	-41.07%	Change	-61.56%
INDONESIA			
Indonesia rupiah/U.S. dollar		Jakarta Composite Index	
May 14, 1997	2,569.33	July 8, 1997	740.88
January 9, 1998	16,756.94	September 21, 1998	256.83
Change	-84.67%	Change	-65.33%
MALAYSIA			
Malaysian ringgit/U.S. dollar		Kuala Lumpur Composite Index	
May 14, 1997	2.5326	July 2, 1997	1,086.24
January 8, 1998	4.7249	September 1, 1998	262.70
Change	-46.40%	Change	-75.82%

Source: Bloomberg LP

*Foreign exchange depreciation measured from May 14, 1997 when Thailand imposed capital controls; stock market depreciation as percentage change in index measured from a high level in July 1997.

Officials in Thailand also put forward speculation as the explanation for their currency's violent decline. On June 24, Bloomberg News quoted a Thai central banker as saying that the attack on the baht in May was Soros's doing: "Soros was the main guy. When a currency is attacked, it's expected that he be involved."[4]

Yet there is scant evidence for any of these claims, at least as concerns the hedge funds. Hedge funds are thought to be the largest single class of currency speculator along with commercial and investment bank trading operations. Two extensive studies have appeared to address the role of hedge funds in the crisis. One study done by the IMF entitled "The Asian Crisis: Capital Markets Dynamics and Spillover" that appeared in the September 1998 edition of *International Capital Markets* was prepared by a team of economists who scoured the Asian nations in 1997 and 1998, holding discussions with a wide range of market participants. Their findings are of extreme importance to any understanding of what happened in Southeast Asia in 1997:

> The hedge funds have been singled out as having played an important role in the onset of the Southeast Asian currency crises. It would appear, however, that they were only one among the group of investors in the broader dynamic that unfolded and do not appear to have played a critical role, either as leaders or by cornering the markets. While several hedge funds together took positions against the baht, the majority of these positions appear to have been taken when other major investor groups had already begun to get out of the baht, and they did not, therefore, appear to have led the speculative attack on the baht. Moreover, while they together took a quantitatively important position against the baht, the majority of those positions appear to have been taken when the Bank of Thailand began offering large positions against the currency. It would otherwise have been difficult for the hedge funds to build up substantial positions.
>
> The one other simultaneous buildup of hedge fund positions appears to have been on the Indonesian rupiah. These positions were, however, taken after its initial depre-

> ciation and were long positions, reflecting the view that the rupiah had overshot, and the expectation that it would appreciate.
>
> It appears that only a few of the hedge funds took modest positions for short periods, at differing points in time, on the Malaysian ringgit.[5]

These findings were corroborated in an academic paper written by Brown, Goetzmann, and Park (1998) entitled *Hedge Funds and the Asian Currency Crisis of 1997*. The authors test the hypothesis that hedge funds were responsible for the crash of the Asian currencies in late 1997. Their methodology comes from Sharpe (1992) which introduced an econometric technique called "style analysis." This approach infers the composition of an investment portfolio from its historical performance over time. The authors ran their tests using data on the ten largest hedge funds, including Soros's Quantum Fund. Their conclusions were as follows for hedge fund positioning in the Malaysian ringgit:

> The estimated net positions of the major funds were not unusual during the crash period, nor were the profits of the funds during the crisis. In sum we find no empirical evidence to support the hypothesis that George Soros, or any other hedge fund manager was responsible for the crisis.[6]

Brown, Goetzmann, and Park also tested for hedge fund exposure to a basket of Asian currencies over the period of 1993–1997. The basket was comprised of the currencies of the Philippines, Taiwan, Thailand, Japan, Malaysia, Singapore, China, and Indonesia. Their findings were:

> As we observed with monthly data, the bets on Asia are occasionally quite strong—sometimes long and sometimes short. As with the monthly data, however, it appears that the exposures in late 1997 were modest, and unrelated to the steep drop in the currency basket. Again, no evidence that these representative managers were culprits in the crash.[7]

Eisuke Sakakibara, Japan's vice minister of finance for international affairs, would later come to have second thoughts about assertions he once made of hedge fund culpability:

> It was wrong to name them as the sole villains, but there is no question that there were attacks from hedge funds in Thailand, and attacks by copy funds from February 1997.[8]

The copy funds to which Sakakibara refers are supposedly investment funds operated by investment banking firms that try to mimic the investment strategies of hedge funds. He was right; the hedge funds were active in the attack on the baht but what he did not reveal is why it was that Thailand alone became their target.

If hedge fund currency speculation did not break Southeast Asia, what did? One factor working against the tiger countries was the fact that China devalued its currency by 50 percent in 1994 in preparation for its development of export industries. More important in the case of China were the structural reforms that took place in the 1990s that arguably improved that nation's competitive position in Asia.[9] A far bigger external contributing factor was the strong-dollar policy pursued by the United States, Germany, and Japan in the early 1990s.

The Consequences of the Strong-Dollar Doctrine

THE U.S. DOLLAR CAME under significant selling pressure in the first term of the Clinton administration. In part the negative sentiment derived from the new president's entanglement in the Arkansas Whitewater real estate scandal. Geographic association with the Mexican peso's crisis and growing skepticism about Canada's fiscal difficulties further damaged the dollar.

The dollar also got mixed up in the Clinton trade initiative with Japan. A significant element of the Clinton administration's foreign trade policy was directed at reversing the enormous trade disparity with Japan. U.S. Trade Representative Mickey Kantor's ham-

mering of Japan to open its markets to foreign goods produced little in the way of concrete results for the United States. Parenthetically, Kantor's opponent, Ryutaro Hashimoto, made his political career on his efforts to keep Japan safe from America's demands on trade. Hashimoto was seen in Japan as having outmaneuvered the Americans, and a grateful nation elected him Prime Minister in January 1996.

By 1993, the foreign exchange market had come to believe that Clinton's aides wanted the dollar to fall against the yen to redress the aforementioned issue of Japan's massive exports to the United States. That suspicion was confirmed when treasury secretary Lloyd Bentsen replied in the affirmative to a reporter's question about whether the administration was seeking a weaker dollar. Additional confirmation came from Secretary of Commerce Ron Brown who stated unambiguously that the dollar was a legitimate "trade weapon."

But soon the rapid fall of the dollar began to be seen as something that could jeopardize its status as a reserve currency. Bentsen decided that it was in the best interest of the country for him to try to reverse the direction of the dollar. His preferred instrument was coordinated intervention with dozens of central banks participating by buying dollars against yen and marks.

Bentsen put together an intervention as if he were organizing the closing ceremony of the Olympic games. In rapid succession, countries all over the world announced to the news media that their central bank was buying dollars. The idea was to create an impression that central banks everywhere were standing behind a strong dollar. This fooled nobody. Traders knew that the smaller central banks were participating in name only. The failure of the Bentsen interventions to stop the dollar's slide added to the anti–dollar market sentiment.

Bentsen unexpectedly announced his retirement in November 1994. Clinton nominated Robert Rubin, a presidential aide and former cochairman of Goldman, Sachs & Company, to the post. Rubin was sworn in as Treasury Secretary in January 1995. The hallmark of the Rubin foreign exchange policy was a single-sentence mantra that he repeated every time he was in front of the

media: "A strong dollar is in the best interest of the United States."

Rubin avowed that the dollar was artificially undervalued and decided on further central bank intervention. He formed an exclusive partnership with Germany and Japan, correctly reasoning that the size and might of the participants would be what mattered, not their numbers. The trio, dubbed the G3, conducted massive coordinated interventions to try to prop up the dollar.

Japan, of course, loved Rubin's idea of braking the fall in the dollar. Japan has always been on the side of any policy initiative to weaken the yen, a currency that has been in secular strength since the end of the Bretton Woods system in the early 1970s.

Germany's case was more complex. Chancellor Helmut Kohl was finding it difficult to convince his electorate of the wisdom of his pursuing a monetary union with their Mediterranean neighbors. The Rubin dollar plan interested the Germans because they needed to see immediate improvement in their own economy and in those of the other European Union states to meet the Maastricht treaty criteria that they themselves had imposed on the European Union. A surge in European exports did later occur, so it could be said that in some part, Europe had effectively devalued its way to monetary union.

The dollar finally hit rock bottom on April 18, 1995 when dollar/yen traded at 79.70 and dollar/mark at 1.3534. Thereupon, the dollar rose in a spectacular fashion against all currencies.

How much of the dollar's recovery can be credited to the Rubin interventions? Although it is not clear that the G3 managed to brake the fall of the dollar, it is easy to believe that it accelerated its rise in 1995 and 1996.

The significance of the strong dollar doctrine for Southeast Asia was not immediately realized. In the course of the 1990s, Southeast Asia steadily took on large amounts of debt, most denominated in dollars. This reflected a widely held but erroneous belief that the dollar would continue to depreciate against the other major currencies. If one had to borrow, better to borrow in a currency that would lose value, as the dollar was projected to do, than to borrow in a currency that would add value, as the yen and mark were expected to do. Moreover, at least for the fixed

exchange rate regime countries, the dollar offered lower borrowing costs than local debt, via the same mechanisms that were described in the previous chapter.

Thus a gigantic stock of dollar-based indebtedness massed in Thailand, Malaysia, and Indonesia in the years leading up to the crisis of 1997, putting the region in a very dangerous position. Effectively, the balance sheet of the tiger countries was long their domestic currency and short dollars, all based on a wing and prayer that their fixed exchange rate regimes would endure.

The strong dollar policy also damaged the Asian tigers in respect to trade. The rise in the dollar was a de facto depreciation of the yen, which meant that they lost a competitive advantage to the Japanese exporters. The total effect of the strong dollar policy was the foreign exchange equivalent of a pincer movement, in that a stronger dollar and a weaker yen together put the squeeze on Southeast Asia.

Several years later, Eisuke Sakakibara reflected on this aspect of the G3 (United States, Germany, and Japan) dollar policy:

> I don't think that a weak yen provoked the Asian currency crisis (in 1997), although it's true that Asian currencies strengthened (against the dollar in 1997) on the course of the yen's weakening, because Asian currencies had been pegged to the dollar back then. And the weaker yen, by giving Japan's exports a price advantage on world markets, undermined the competitiveness of its Asian competitors.[10]

Thailand Kicks It All Off

THE SOUTHEAST ASIAN currency crisis of 1997 originated in Thailand, but there were ample conditions present in other nations to have had the crisis erupt elsewhere in the region.

In the case of Thailand, the central bank established a fixed exchange rate regime under the auspices of the Exchange Equalization Fund in November 1984.[11] The baht was pegged to a basket of currencies composed of dollars, yen, and marks. Although the Bank of Thailand never announced the exact composition of the

basket, regression analysis using data from February 1997 estimates that the dollar accounted for about 84 percent; the yen, 9 percent; and the mark, 7 percent.

Pressure started to build on the Bank of Thailand in December 1996 to devalue the baht. The bank later described this as a time of "deteriorating fundamentals, looming problems in the financial sector, and widespread rumor of currency devaluation."[12] Substantial capital outflows ensued, but Thailand managed to convince foreign investors to return by promising large budget cuts. The bank dates the baht crisis as having commenced in February 1997 when economic data showed a sharp slowdown in the country's exports. The bank again managed to hold the line, this time by conducting large interventions in the foreign exchange market to support the baht.

On May 7 finance minister Amnuay Viravan announced that Thailand would not be able to achieve a balanced budget for the year as was earlier promised. The market took the news hard. The bank was immediately confronted with ferocious selling of the baht and their stocks.

At the time it was estimated that the total foreign exchange reserves of Thailand were equal to $38 billion. It was known in professional circles that the net reserves might be substantially lower because the bank reported its position on an accrual basis. Some astute individuals put the story together—the Bank of Thailand was not including its forward transactions when it totaled up its foreign reserves.

The Bank of Thailand responded to the pressure on the baht with more intervention, this time in massive size, given the size of the bank's balance sheet. When this failed, it resorted to a form of capital controls on May 14 that the bank itself described thus:

> Toward the end of May 1997, currency defense took on an additional dimension. An informal capital control was imposed to deny the market of baht supply. Foreign exchange transactions with, and lending to, non-residents were limited only to those with genuine underlying commercial or invest-

> ment activities. This measure effectively created a 2-tier foreign market where there was normal supply of baht and the offshore where baht was scarce. So much so that immediately following imposition of the control, offshore Thai baht overnight interest rates rose to over 1,000 percent.[13]

The Bank had effectively choked off the supply of forward swap deals that traders and speculators would need to roll short baht positions. A more colorful way of saying this came from Soros Quantum Fund portfolio manager Stanley Druckenmiller: "They kicked our butts and they've taken a lot of profit we might have had. They did a masterful job of squeezing us out."[14]

The Bank of Thailand had won the battle, but it was soon going to lose the war. After the initial shock about what the Bank had done faded, attention began to turn to whether the new two-tier market was stable. The present author won no friends in Asia but did manage to capture the mood correctly when he was quoted in the *Wall Street Journal* on May 22: "It still may go [the speculator's] way; it is not over.... All these emerging market catastrophe trades are attempts by the market to probe whether there's another Mexico out there."[15]

On June 19, Finance Minister Amnuay resigned. On June 30, Prime Minister Chavalit Yongchaiyudh assured the nation in a televised address that the baht would not be devalued. The Bank of Thailand described what happened next:

> Domestic confidence returned for a while until mid-June when the then Finance Minister resigned under political pressure. The demand from panicked local corporations to buy US dollars to hedge their foreign exchange exposure resulted in a heavy loss of reserves through the EEF [Exchange Equalization Fund] window....The crisis of confidence on the part of domestic residents showed no sign of abating and was beyond the Bank's control. The peg was abandoned on July 2, 1997. The exchange rate was then left to market forces.[16]

In the next six months the baht dropped from its previously pegged rate of about 26 to the dollar to 55, and the Asian crisis showed signs of spreading throughout the region. Thailand circa 1997 indeed had turned into Mexico circa 1994.

All of the same causal factors that had brought down Mexico were in evidence in Thailand now, plus a few special forces unique to Thailand. Like Mexico, Thailand had been in a period of enormous economic growth in the period preceding the crash—growth in real gross domestic product (GDP) exceeding 8 percent in every year from 1990 to 1995 (Table 4.1). This helped Thailand pull in enormous amounts of foreign capital commensurate with its large current account deficits.

Another common factor was the degree to which local Thai companies had indebted themselves to lenders in foreign countries. Because the baht interest rate chronically exceeded the dollar interest rate, Thai companies found borrowing in dollars attractive, as was discussed above.

Making this worse still was the predilection of Thai companies to borrow on a short-term basis. At its peak in 1995 the outstanding short-term Thai debt totaled $45 billion out of the $90 billion of total external debt[17]. The Bank of Thailand reported that this practice could be attributed to there having been an upward sloping U.S. interest rate curve. If true, then Thai companies fell for one of the oldest illusions in finance, the mistaken belief that borrowing for relatively short-term maturities represents bargain financing. Though the cost of borrowing may sometimes be cheap, debtors can end up unable to arrange new financing at a reasonable cost when their loans mature. In the Thai crisis, some borrowers found it impossible to obtain new financing at any price. And this occurred precisely at the time that their revenues were plunging. Financial companies that were in a shaky condition even before the crisis were staggered by the double punch of rising funding costs and collapsing collateral values.

The Bank of Thailand freely admits to the poor state of the Thai financial sector in 1996 but attributes it to the process of financial liberalization that began in the early 1990s. Its report on the crisis which was cited above is rife with accusations that share-

holders pushed banks to make risky loans and that the general investing public had "let its guard down."

What is missing is an admission of responsibility for how badly the bank and the government as a whole had neglected its duties to regulate but not overregulate the financial sector. A prime example is the government's creation of the Bangkok International Bank Facility (known as the BIBF) and Provincial International Banking Facility (PIBF) which institutionalized and subsidized short-term borrowings from abroad.[18]

Also overlooked in the bank's analysis was the role that the baht carry trade played in the buildup to the crisis. Massive baht positions had accumulated solely because of the presumption that the bank's peg for the currency would endure. In February 1997, the spread between Thai baht interest rates and the Bank of Thailand's basket (dollars, yen, and marks) ranged between 500 and 600 basis points. The Thai baht carry trade, in all of its variations, involved being long the baht and short dollars, yen, and marks. Sophisticated carry traders executed directly in the interbank market. But the baht carry trade went very high up the investment food chain, and even to unsophisticated investors, as prime investment banking firms competed to create structured notes, total return swaps, and other derivative transactions whose very existence depended on the carry trade.[19]

But the truly remarkable aspect of the Thai crisis was how poor the response by the Bank of Thailand was. The outcome for Thailand would have been much improved if the bank had simply ignored the crisis and done nothing more than letting the baht float. It also can be argued that the fixed exchange rate for the baht might even have survived had the response from the bank not magnified the severity of the crisis.

In the first two weeks of May 1997, the Bank of Thailand decided to switch its intervention from spot foreign exchange transactions to forward transactions, buying baht against dollars for value in three and six months. Given that these trades were not for immediate settlement, as spot foreign exchange trades would have been, the bank chose to ignore the implications for its balance sheet. Yet there is no mistaking the fact that the BOT was mas-

sively exposed to the fate of its own currency. Moreover, the bank negotiated these forward contracts at off-market forward exchange rates, fearing that its own presence in the foreign exchange market otherwise would drive up Thai baht interest rates. Speculators thereby effectively received a subsidy from the bank to take short positions in the baht. Thanks to its own central bank, the baht turned into a true "one-way" bet for short sellers.[20] According to the IMF:

> Market participants estimated the Bank of Thailand's forward book at $26 billion at the end of June 1997, of which the macro hedge funds accounted for some $7 billion, "other" offshore counterparties for $8 billion, onshore foreign banks for $9 billion, and onshore domestic banks for $2 billion.[21]

From another angle, it would have been practically impossible for the short-sellers to accumulate such an enormous short position in the baht had it not been for the sales that the Bank of Thailand made. The exact parallel here is to the blunder made by the Central Bank of Mexico in issuing the dollar-linked tesobono bonds discussed in Chapter 3. Like the tesobonos, the Thai Bank's forward contracts constituted a financial bomb that the bank itself had planted underneath the state treasury.

In its report on the crisis, the Bank of Thailand was unable, or unwilling, to own up to the enormity of the damage it did, as can be seen by the following defense of its policy:

> Cynics, however, have compared the BOT's swaps to giving speculators the ammunition. This is useless analogy. Since money is fungible and the central bank is the sole issuer of local currency, therefore—by definition—all local currency held or sold by anyone must be supplied ultimately by the central bank. What matters is the monetary policy decision on the appropriate interest rate at which the central bank would supply local currency to the financial system.[22]

The fact that central banks are the issuers of money is irrelevant. Nothing can excuse the Bank of Thailand's having committed the financial blunder of the decade in supplying all comers with massively cheap financing on short baht positions.

The next nation to feel the immediate heat of the Thai baht's meltdown was the Philippines. The Philippine peso seemed to catch a piece of every punch thrown at the baht. Like the baht, the peso was subject to a fixed exchange rate regime, but unlike the baht, the peso was pegged exclusively to the U.S. dollar. The Philippines, like Thailand, had enjoyed substantial economic growth in the earlier part of the decade. Following suit, the Philippines' current account deficits had been on the order of 5 percent of GDP before the crisis.

Pressure began to build against the peso immediately after May 14 when the Thai central bank imposed its ill-fated capital controls. The immediate response of the central bank, Bangko Sentral ng Pilipinas (BSP), was to raise the overnight deposit rate by 1.75 percent to 13 percent and to sell dollars against the peso. Over the course of the next months, the BSP would raise overnight lending rates in steps from 13 percent to 32 percent.

When the Bank of Thailand finally floated the baht on July 2, tremendous selling hit the Philippine peso. The BSP attempted to hold the peg by intervening to sell dollars and buy pesos. Between July 2 and July 10 the BSP is estimated to have lost more than $1.5 billion of its reserves.[23]

On July 11 the BSP raised the white flag of surrender by allowing the peso to move in a wider range to the dollar. Three days later, on July 14, the IMF offered the Philippines $1.1 billion under fast-track regulations that had been drawn up after the Mexican peso crisis in 1994–1995.

Additional patterns of spillover effects, which traders since the Mexican peso crisis of 1994–1995 had started to refer to as *tequila effects*, rippled through emerging market nations as far away as Brazil, where the equity market fell 15 percent during the week of July 11 to 18.

One month later, on August 11, the IMF announced a rescue package for Thailand totaling $16 billion in loans from the fund

and from other nations. The Mexican paradigm, meaning crisis followed by supranational bailout, had begun to play in Southeast Asia. In the words of Thai Prime Minister Chuan Leekpai, "Confidence and optimism are out, and uncertainty and gloom are in."[24]

Indonesia Follows

INDONESIA IS THE FOURTH MOST populous nation in the world. It emerged from Dutch colonial control and Japanese occupation after the Second World War to become subject to the rule of the iron-fisted dictator, General Sukarno, who once declared himself president for life. Sukarno was overthrown in 1966, making way for the next political strongman, General Suharto. Suharto ruled the country for over three decades, and it can easily be argued that he would still be in power were it not for the economic crisis that gripped the country in 1997.

Indonesia in the Suharto years is popularly but not inaccurately viewed today as a kleptocracy that was operated for the private welfare of the family and friends of the president. Suharto promoted his own private label of crony capitalism under the guise of redressing presumed wrongs done to the indigenous Javanese population by the ethnic Chinese business class.

Visitors to Indonesia were quick to note the obvious, that everything valuable was funneled into the president's circle. Suharto and his six children, collectively known "Suharto Incorporated," controlled vast parts of the Indonesian economy:

> The Suharto children are all reputed to have become multimillionaires by trading on their direct line to the presidential palace, involved everything from clove cigarettes to toll roads, from petrochemical plants to automobile manufacturing. So pervasive is the first family's reach into the Indonesian economy that a long-running joke here is that the corruption begins as soon as you arrive at Jakarta's international airport: You can buy a pack of cigarettes, hop in a taxi, take a toll road to the city and check into a hotel, putting money into a Suharto family member's pocket with each step.[25]

Moreover, Suharto's children controlled many of the top banks in the nation, a fact that precluded any notion of independent financial supervision by the central bank. One stunning piece of anecdotal evidence noted by observers at the time was the common practice among upper-class families of purchasing banking licenses as university graduation gifts.

Against these dark realities, it has to be said that wealth did trickle down to the lowest levels of Indonesian society in the Suharto years. But while there is little doubt that Suharto Incorporated managed to siphon off great wealth, the greater damage that it did to Indonesia was from how badly it ran the country. What is important for the immediate purposes is not so much to put out an indictment of the greed of the Suharto regime but rather to lay a foundation for why that nation's financial system could degenerate so quickly into a state of total collapse.

Indonesia for a short while seemed to defy common sense by appearing to have withstood any contagion from Thailand and the Philippines. Forward swap points on the Indonesian rupiah hardly budged until things started to heat up in Indonesia, and this did not occur until the middle of August. It is surprising how many smart people were fooled into believing that Indonesia had somehow escaped the crisis. As stated above, there is evidence (Brown, Goetzmann, and Park, 1998) that some of the large hedge funds were actually long the rupiah, apparently having been convinced that the worst was over for Indonesia.

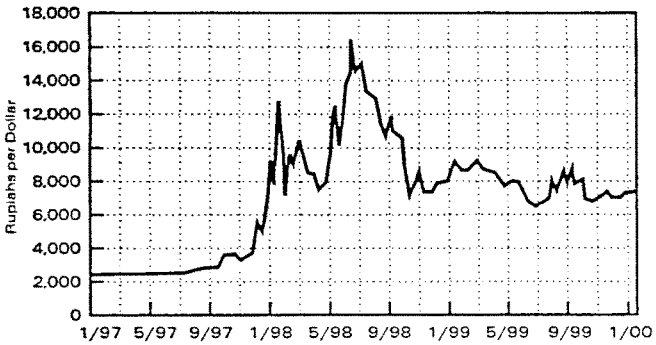
As can be seen from Table 4.1, Indonesia went into the crisis following years of impressive economic growth in the general economy. Indonesia did have a current account deficit, but not nearly as large as the ones in Thailand and Malaysia.

The central bank had kept the rupiah on a crawling pegged regime since 1987, under which the currency was allowed to depreciate within a fixed bandwidth relative to the dollar. As with the baht, the rupiah carried an interest rate premium to the dollar, and a substantial carry traded existed.

Selling pressure began to accumulate on the rupiah in mid-July. On July 11 the Bank of Indonesia decided to widen the band to 12 percent from 8 percent, but that was to no avail. Finally, on August

FIGURE 4.1

Indonesian Rupiah



INDONESIA'S RUPIAH PEGGED to the dollar with slippage allowed at a controlled rate before August 1997. Note that the rupiah did not immediately respond to the floatation of the Thai baht on July 2, 1997. The fireworks came weeks later. The rupiah became a floating currency on August 14, 1997.

Source: Bloomberg L.P.

14, the Bank abolished the managed exchange rate regime and let the rupiah float; it immediately began to plunge. The dollar/rupiah exchange rate rose from its pegged level of about 2,500 to the 13,000 level in four months (Figure 4.1).

At the start of 1998, things began to stabilize and the unit returned to levels below 10,000. Then, in May 1998 the rupiah began to drop again, and by the middle of the summer dollar/rupiah was trading above 16,000—a loss equal to 85 percent from its pegged level.

On October 8, 1997, Indonesia formally requested assistance from the IMF. When the IMF revealed the terms of its $40 billion bailout, Indonesia was horrified. The Fund insisted on commitments to wide-ranging reforms as a precondition of Indonesia's receiving any money.

These included cancellation of the national automobile manufacturing project, reduction of government subsidies, and a drastic restructuring of the banking system over a short period of time. Eisuke Sakakibara, the Japanese vice finance minister for international affairs at the time, gave a first-person account of his dealings with Indonesia:

> He [Suharto] flatly stated that he would agree with the IMF plan, but had no intention of observing the conditions.... The president, his family and cronies began to realize that the structural reform plan initiated by the IMF and technocrats might shake the foundations of the Suharto administration.[26]

Suharto agreed to the IMF's terms, began to receive its money, and then went on his way merrily ignoring, even reversing, the actions that he promised to fulfill. In one instance, banks that were controlled by the Suharto family were supposed to have been closed for reasons of insolvency. The banks were closed, as promised, but only to be immediately reopened under different names. As Sakakibara described:

> On November 2, two days after the IMF and Indonesia agreed on the assistance package, 15 of the large national projects slated to be canceled according to the terms of the IMF agreement were revived. Two electric power generation projects controlled by Suharto's eldest and second daughters were given the go-ahead immediately.[27]

A surrealistic drama was being acted out in which the main plot was Suharto's regime outwitting the Fund by evading the prescribed reforms.

Far worse things were in the works, as Sakakibara described:

> The IMF reform plan has several fatal drawbacks as it was hastily mapped out without taking its economic and social impact into consideration. The plan could have completely

> destroyed Indonesia's financial system as it called for the shutdown of 16 banks without providing a safety net, such as deposit insurance.... A run on banks took place after 16 Indonesian banks were closed, causing a panic on the financial and foreign exchange markets from late November through December. The value of the rupiah plunged as a result.[25]

Sakakibara was correct in his description of the events in Indonesia. Following the run on the banks, the IMF agreed to a second bailout package on January 15, 1998.

A complication arose sometime around the start of 1998, when Professor Steve Hanke, a Johns Hopkins University economist who specializes in exchange rate regimes, was appointed as a special adviser to Suharto. Hanke advised Suharto that the rupiah problem could be immediately cured if the country would adopt a currency board. It appeared to Suharto that Hanke had a painless cure for Indonesia's ailments.

A currency board is an extreme form of a fixed exchange rate regime. The term *board* is antiquated and does not refer to a group of directors, but rather to an agency of the government charged with exclusive control of the country's money supply and its exchange rate policies. The board can function in parallel to the central bank, or it can be operated as part of the central bank. The concept of a currency board goes back in time to the days of the British Empire. Britain gave certain of its colonies permission to issue their own currency, provided that the new currency be pegged to the pound and that the colony agree to exchange its currency for pounds upon demand. An essential further requirement of this arrangement, which became known as a currency board, was that the colony had to have on hand sufficient reserves, in pounds, to cover the entire outstanding amount of the colonial currency. In modern times, a currency board would need to have a large enough quantity of foreign reserves to cover the base money supply (currency in circulation plus commercial bank reserves held at the central bank). Hong Kong and Argentina operate currency board exchange rate systems with a degree of success.

The concept of having a currency board is not without its imperfections, however, principal among which is the fact that the currency board's foreign exchange transactions represent automatic, unsterilized adjustments to the national money supply. From a theoretical point of view, Hanke's plan was not totally objectionable though there are some issues with his concept to be explored in Chapters 5 and 7. Hanke never got to see his ideas for Indonesia put into place.

On February 10, 1998, Dow Jones newswires reported that Hanke, in a working paper prepared for Suharto, had recommended that the targeted exchange rate for the rupiah should be 5,500 to the dollar.[29] That announcement sunk any chance that the Indonesian currency board had. The rupiah was trading well above 10,000 at the time. Market participants and pundits quickly concluded that the Suharto family was planning to loot the central bank's reserves by converting rupiahs for dollars at a massively preferential rate of exchange, meaning that they would have first dibs on the central bank's dwindling foreign reserves.

Hanke objected to this vociferously, stating that no such working paper had ever been written by him and that he had no recommended target for the rupiah. He later wrote "the [*Wall Street*] *Journal* finally fessed up in a belated and muddled correction."[30]

Yet the exact level at which the rupiah would be pegged was never disclosed, and it is not improbable that preference would have been given to Suharto Incorporated. It should be noted that Hanke himself was never acting in anything but good faith. He was an unpaid, and probably unthanked, adviser to Indonesia and was hardly part of a conspiracy to loot the central bank. All things considered, it is hard to imagine that his currency board project, if properly implemented, could have done more damage to Indonesia than what the IMF programs did to the financial sector.

Operatively, it was the IMF, with the support of the World Bank and the Clinton administration, that stopped the currency board project dead in its tracks. In their defense, it could be argued that they had grave concerns over the possibility of monumental fraud in the setting of the exchange rate for the rupiah. But it is more likely that the IMF simply preferred its own programs

for Indonesia. On April 10, 1998, a third IMF agreement was signed. This time the IMF was determined not be euchred by false promises of reforms.

With the issue of the currency board scuttled, market participants turned to the question of whether Suharto himself could survive the crisis. By May 1998, Suharto, the absolute ruler of Indonesia for more than three decades, was forced to resign.

Michel Camdessus, Managing Director of the IMF, would later reflect on the fund's ambitious reform efforts in Indonesia and Suharto's fate: "We created the conditions that obliged President Suharto to leave his job. That was not our intention."[31]

Suharto's handpicked successor, vice president and adopted son, B. J. Habibie, became president. Habibie lost the October 1999 presidential election to Abdurrahman Wahid (popularly known as "Gus Dur").

Indonesia was the greatest victim of the Southeast Asian crisis. The damage to the economy and to the society surpassed everything that happened in the neighboring countries. This was made all the worse because Indonesia is such a heavily populated country. Next in our discussion is Indonesia's neighbor to the north, Malaysia.

Malaysia Pulls a Fast One

MALAYSIA FELT THE consequences of Thailand's distress almost immediately after the Bank of Thailand enacted capital controls on May 14, 1997. Both the ringgit and the Malaysian stock market went into steep dives. The ringgit had been trading around 2.5 to the dollar in May (Figure 4.1). At its worst point, in January 1998, it had fallen to 4.72 to the dollar, which equates to a drop of 47 percent. The Malaysian stock market fell by 75 percent, from July to its nadir in September 1998.

The ringgit was in deep trouble by the time the Bank of Thailand floated the baht on July 2, 1997. The central bank, Bank Negara Malaysia, initially put up a struggle by intervening into the foreign exchange market. It abandoned its efforts to save the ringgit on July 14.

Malaysia's case differs in one important respect from those of Thailand, Indonesia, and to go back further in time, Mexico. Malaysia, unlike these other countries, operated a more or less floating exchange rate for the ringgit. As a consequence, the ringgit was not subjected to the buildup of a large carry trade the way the baht, rupiah, and Mexican peso were.

Malaysia's exchange rate regime was a *dirty float*, a term that distinguishes it from a pure hands-off exchange rate regime governed exclusively by supply and demand. There is, of course, no such thing as perfectly clean float because every central bank at some time or another has tried to meddle in the market for its currency. What makes Malaysia stand out is the intensity with which its central bank attacked the foreign exchange market, or to be precise, the foreign exchange traders.

In the early part of the 1990s, Bank Negara was on a campaign to weaken the ringgit. It feared that the massive flow of capital into Malaysia would strengthen the ringgit and damage the country's export industries. Negara waged a ferocious war against speculation in the ringgit, complete with numerous episodes of intervention. It also had an early experience with imposing capital controls on the foreign exchange market in 1994, something that neither Negara nor the entire foreign exchange community would forget.

In part, that explains why the ringgit came crashing down in the summer of 1997 with all the appearances of a fixed exchange rate currency that had just been unpegged. Everyone who was exposed to the ringgit, either through owning Malaysian investments or by having loans denominated in ringgits, had one thought and only one thought in July—when will Malaysia's irascible Prime Minister Mahathir Mohamad impose capital controls or some form of restriction on the movement of money? This expectation, which was subsequently justified, created panicked selling of the ringgit. The German language has a word for this, *Torschlusspanik*, which literally means "the fear of the door slamming shut."

Still the ringgit's plunge is more fundamentally linked to the condition of Malaysia's overall economy, which was entering a state of severe turmoil. The currency's slide in Malaysia's case was not so much a causal factor in the reversal of the economy as it was a

result of problems that derived from the underlying economy.

Thailand's crisis triggered a reevaluation in the minds of investors of the Southeast Asian tigers, including Malaysia. An acute reversal of confidence in Malaysia followed, in the minds of both domestic citizens and foreign investors. In spite of Malaysia's having ameliorating factors, such as a high national savings rate, the country was damned to crisis for reasons that go deep into its economic and political fabric.

Foremost among these was that the Malaysian economy was dominated by the government's central planning. Economic decisions were made at the highest levels in the government of Prime Minister Mahathir, who came to power in 1981. He, his ministerial flunkies, and his cronies ran the country from top to bottom. Early on they made a decision to invest substantial amounts of the national resources in low-cost manufacturing plants to make computer and electronic components. The bet paid off, but the downside was that success emboldened Mahathir to dream of yet greater glory.

What followed was something a psychiatrist, more than an economist, could explain. Mahathir went out of his way to prove that Malaysia was the best in the world at anything it touched. In the course of his megalomaniacal and despotic rule, tiny Malaysia, with a total land area of only 127,000 square miles and a small population of 18 million, would build the tallest buildings in the world (Petronis Towers), the longest building in the world ("Linear City"), an airport with the tallest control tower in the world, and even a hotel with the tallest flagpole in the world. Malayan economist Jomo Kwame Sundaram summed it up, bravely, as this: "Mahathir has a pharonic side to him. These are modern pyramids."[32]

Mahathir's inner circle was responsible for a national automobile company. Proton was declared a huge national success and its cars were dubbed "the pride of Malaysia." The company looked profitable but, in truth, car sales owed more to a massive import tax that was imposed on foreign-built cars than to Malaysian automotive engineering. In the study of development economics this ruse is called the "infant industry" argument. Industries that other-

wise would not be financially feasible are endowed from birth with local monopoly rights over domestic consumers. What is not reflected in the statements of profit and loss for the new companies is the welfare loss inflicted on citizens who are blocked from buying the foreign goods of their choice.

In 1995, Mahathir promised his country's inhabitants a 7 percent annual real growth for the foreseeable future. His delusions of grandeur were spelled out in "Vision 2020," a sweeping blueprint for Malaysia's next quarter-century. This plan was intended to make Malaysia into a fully industrialized and technologically cutting-edge civilization by the second decade of the twenty-first century.[33] Two years later Malaysians would realize, but dare not say openly, that Vision 2020 was blind as a bat.

As part of the plan, Mahathir dreamed of a broad challenge to California's Silicon Valley with the construction of his $20 billion Multimedia Super Corridor. His new economy needed a new capital, perhaps his ultimate memorial, so he planned for a $8 billion new city, Putrajaya, that would house 250,000 people. All of this required new sources of energy, so plans were developed to make a $5.5 billion hydroelectric generating plant in the heart of Borneo, with connections to Malaysia by a 400-mile underwater cable. When environmentalists protested that the project would destroy thousands of acres of primeval rainforest, Mahathir angrily denounced them as "enemies of the state."

In sum, Malaysia could have given Japan a run for its money when it came to the worst excesses of central planning. It could also compete with Indonesia for the title of the Asian capital of crony capitalism. Indonesia had Suharto Incorporated but Malaysia had Mahathir Incorporated.

Meantime, Malaysia had developed a pattern of running large current account deficits (Table 4.1). Mahathir,[34] stung by comparison of his country's condition to Mexico of the early 1990s (pre–peso crisis), defended the capital inflows as being necessary to support its rapid growth. He insisted that Malaysia's capital inflows were going to worthwhile investment projects, not to consumption. Negara's chief economist expressed the party line as follows:

> Our current account deficit isn't being financed by short-term capital flows, which would be unhealthy, but by longer-term inflows.... Imports of capital and intermediate goods create the potential for production and exports.[35]

What Mahathir and his economist didn't say was that these supposedly worthwhile undertakings, the recipients of the foreign investments, were actually economic losers.

Earlier in this chapter there was discussion of how Thailand's problems in 1997 stemmed in part from its dependence on short-term financing. The trap that Malaysia fell into was thinking that it would be safe to run a massive current account deficit so long as financing was not short-term. This of course leads to another dangerous belief. Long-term lenders may not be able to call for immediate repayment in a crisis but they are not going to sit on their hands. For one thing, they will immediately attempt to hedge their exposure to the local currency. No matter how they go about this, whether it is through the use of forward contracts or other derivative instruments, selling of the local currency will occur. They may even resort to fashioning a crude but effective hedge by going short the stock market to offset losses on their illiquid, long-term investments.

Few analysts did more than note the fact that Malaysia was running what could someday become an unsustainable external balance. No one questioned where all of the foreign investment was going. Mahathir did at times make superficial gestures aimed at reducing the size of the current account deficit, mostly after 1996 when the deficit was projected at more than 8 percent of GDP. What Mahathir really wanted to do was to rearrange the economy so that there was room to import the raw materials that were needed to build Proton cars and construct more trophy real estate projects. If that could be done while at the same time squeezing foreign-made goods out, all the better.

The heavy hand of Malaysia's government was felt in all areas of economic life. Consider these words from Bank Negara's annual report in 1996:

> Despite this positive outlook, there is no room for complacency.... A major challenge for macroeconomic management is therefore to ensure that investments are directed toward strategic sectors that add to productive capacity and promote higher value added while, at the same time, ensure that such activities do not aggravate the balance of payments position. In this regard, priority should be given to projects with the highest economic rate of return, particularly those with low import content and high export potential.[36]

Such a pronouncement can only come from a government agency of a centrally planned economy. In Malaysia the extent of the influence of government planning went well beyond anything experienced in noncommunist Asia.

In the end, it all came for naught when the roof caved in during 1997. Malaysia of the 1990s represented the quintessential case of confusing capital inflows with true economic growth.

When the game stopped in the summer of 1997, Mahathir reached out for scapegoats. At first he lashed out at currency traders and at George Soros, in person. On September 20 Mahathir lectured delegates to an IMF/World Bank conference in Hong Kong that currency trading is immoral and should be stopped. He began to assert that the Western nations had "invented" currency trading to preserve emerging market nations like Malaysia in their state of underdevelopment.

There was an element of blatant hypocrisy in his accusations. The fact is that in the late 1980s and early 1990s, Mahathir's own central bank, Bank Negara, operated like a hedge fund. Appropriate for a country that was fixated on having the world's largest everything, Bank Negara may have been the world's largest currency speculator. Though it chose to refer to these activities as "active reserve management," Bank Negara was openly trading speculative positions of enormous size in currencies based on its directional views on the future moves in exchange rates. This only stopped when the cumulative losses were too steep to stomach. Bank Negara then bowed out of the market.

As things began to get worse, Mahathir took to framing his own

handpicked successor, Anwar Ibrahim, with preposterous accusations of immorality. Anwar was removed from his posts of Deputy Prime Minister and Minister of Finance, put on trial, found guilty of sexual crimes, and sentenced to a long prison term. In destroying Anwar, Mahathir eliminated a political rival and silenced critics of his economic policies.

Next Mahathir began to rail against the IMF, rejecting local calls that he should follow the Philippines, Thailand, and Indonesia in calling for emergency funding.

In his most daring move, Mahathir on September 1, 1998, declared a complete halt to foreign exchange trading. He froze the greatly depreciated ringgit at 3.80 to the dollar and impounded all foreign investor capital to keep it from leaving the country. The success or failure of these extraordinary measures, which produced outrage in investment communities all around the world, will be considered in Chapter 8.

Prepared Statement of Peter Blair Henry

Capital Account Liberalization: Lessons For the Chile Singapore Trade Agreements

Before the
Committee on Financial Services
Subcomittee on Domestic and International Monetary Policy, Trade and Technology
United States House of Representatives

April 1, 2003

Introduction

Chairman King, Ranking Member Maloney and distinguished members of the committee, my name is Peter Blair Henry. I am Associate Professor of Economics at the Stanford University Graduate School of Business. I am also a Faculty Research Fellow of the National Bureau of Economic Research, and my research is funded by the National Science Foundation's Early CAREER Development Program. I have written extensively on the economic effects of capital account liberalization. Thank you for the opportunity to discuss the implications of my research for the financial services component of the recent U.S. trade agreements with Chile and Singapore.

1. What Is My Position On the Importance Of Free Trade in Goods?

Free trade in goods, also known as trade liberalization, is the lynchpin of globalization. All countries can benefit from free trade, because free trade allows countries to export those goods for which they are low-cost producers and import those goods for which they are high-cost producers. This kind of Specialization brings two specific benefits. First, countries get to consume goods for a lower price than would be possible if, instead of importing the goods, the countries produced them at home. Second, specializing in the production of goods at which they are more efficient raises countries' gross domestic product.

Trade liberalization is not costless. Liberalizing trade may cause unemployment by driving inefficient producers out of business. In principle, however, the overall gains in gross domestic product that result from free trade are sufficiently large to pay for the cost of retraining workers in redundant industries. In other words, all members of society can be made better off from trade liberalization, when it is judiciously applied. Therefore, the United States should take the lead in promoting worldwide free trade by continuing to open its borders to foreign goods and encouraging other countries to follow suit. The recent trade agreements with Chile and Singapore provide a small step in the right direction.

2. What is My Position on the Importance of Free Trade in Capital?

Capital account liberalization was once seen as an inevitable step along the path to economic development for poor countries. Liberalizing the capital account, it was said, would permit financial resources to flow from capital-abundant countries, where expected returns were low, to capital-scarce countries, where expected returns were high. The flow of resources into the liberalizing countries would reduce their cost of capital, increase investment, and raise output.[1] The principal policy question was not whether to liberalize the capital account, but when— before or after undertaking macroeconomic reforms such as inflation stabilization and trade liberalization.[2] Or so the story went.

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[1] See the following articles and the references therein: Stanley Fischer, "Capital Account Liberalization and the Role of the IMF," *Princeton Essays in International Finance* 207, 1998, pp. 1-10; Lawrence H. Summers "International Financial Crises: Causes, Prevention, and Cures," *American Economic Review*, May 2000, pp. 1-16.

[2] See Ronald I McKinnon, *The Order of Economic Liberalization*. Johns Hopkins University Press, Baltimore, 1991.

In recent years intellectual opinion has moved against capital account liberalization. Financial crises in Asia, Russia and Latin America have shifted the focus of the conversation from when countries should liberalize to if they should do so at all. Opponents of the process argue that capital account liberalization invites speculative hot money flows, increases the likelihood of financial crises, and brings no discernible economic benefits. Some economists have gone so far as to suggest that open capital markets may even be detrimental to economic development. [3] But I believe that there is a serious flaw with such reasoning. This flaw stems from the fact that those who oppose capital account liberalization have failed to define exactly what they mean.

Why is it important to define precisely what one means by the term capital account liberalization? The reason is that there are many different types of capital account liberalization. Recent research demonstrates that the answer to the question: "Is capital account liberalization helpful or harmful?" depends critically on the type of liberalization undertaken. While liberalization of debt flows has often led to great difficulty, liberalization of portfolio equity flows has been associated with booming stock markets, greater capital investment, and faster economic growth.

In its broadest form, capital account liberalization can be any decision by a country's government that allows capital to flow more freely in and (or) out of that country. Allowing domestic businesses to take out loans from foreign banks, allowing foreigners to purchase domestic debt instruments, and allowing foreigners to invest in the domestic stock market are three examples. At a minimum, we need to distinguish between two categories of liberalization: those that involve debt and those that involve equity. While this is obviously an oversimplification, it is useful for driving home the following point. Debt financing and equity financing are different. While this point may seem obvious, it seems to have gotten lost in the heated policy debate over whether developing countries should have open capital markets. The rest of this report will demonstrate that the liberalization of debt flows has had very different consequences than the liberalization of equity flows.

A. Debt Market Liberalizations

Let's start with the case of the liberalization of external debt flows. A number of economists have documented that excessive short term borrowing (loans with a maturity of less than a year) in dollars from foreign banks by Asian banks, companies, and governments played a central role in the onset of the crisis. In essence, the mismatch between the term structure of Asian borrowers' assets (long term) and their dollar-denominated external liabilities (short-term) placed these countries in an extremely vulnerable position. Any bad news that made their lenders reluctant to extend new loans was bound to create an immediate liquidity problem. Importantly, a bunching of long-term debt maturity profiles will have the same effect as an over-reliance on short-term debt. Beyond the Asian Crisis, in general it appears that excessive short term borrowing in dollars played a central

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[3] See the following articles and the references therein: Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May/June 1998, pp. 7-12; Dani Rodrik, "Who Needs Capital Account Convertibility?". *Princeton Essays in International Finance* 207, 1998, pp. 55-65; Joseph Stiglitz, *Globalization and Its Discontents*. W.W. Norton, New York, (2002).

role in precipitating the onset of almost every emerging market financial crisis during the 1990s.

Thus, a key lesson is that once external debt flows have been liberalized it is of utmost importance that the magnitude and maturity profile of the country's external debt liabilities are compatible with the magnitude and maturity profile of its assets. That the liberalization of external debt financing can quickly generate liquidity problems for a country is a well-known phenomenon that dates back at least as far as Chile in the late 1970s.

B. Equity Market Liberalizations

While there are numerous studies, which show that premature liberalization of dollar-denominated debt flows in the capital account has deleterious effects, there has been a relative dearth of evidence on the effects of equity market liberalizations. In order to address this deficiency, I conducted three studies.[4] All three studies suggest that countries derive substantial economic benefits from allowing foreigners to purchase shares in their stock markets.

Identifying stock market liberalization dates is the first step in determining whether stock market liberalization has any discernible economic effects. Since markets are forward-looking, the most important question is when does the market first learn of a credible, impending liberalization? In principle, identifying a liberalization date simply involves finding the date on which the government declares that foreigners may purchase domestic shares. In practice, the liberalization process is not so transparent. In many cases, there is no obvious government declaration or policy decree that one can point to.

When there is no salient liberalization decree, I infer the first date on which foreigners could hold domestic shares from the first date on which a closed-end country fund was established. Table 1 presents a list of the 18 countries in the sample, the date of their first stock market liberalization, and the means by which they liberalized. For example, the table shows that the modal means of liberalization occurred through the establishment of a closed-end country fund.

The establishment of a country fund in particular, and stock market liberalizations in general, may seem like a narrow way to define capital account liberalization, but it is precisely the narrowness of stock market liberalizations that make them more useful for two specific reasons. First, focusing on stock markets alone helps us distinguish between the consequences of debt versus equity market liberalization. Second, studies that use broad liberalization indicators focus on cross-sectional data, examining the long-run correlation between average openness and average investment.[5] Examining the correlation between average openness and investment tells us whether investment rates are permanently higher in countries

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[4] For more details on these studies, as well as other references see: Peter Blair Henry "Capital Account Liberalization, The Cost of Capital, and Economic Growth" *American Economic Review*, May 2003; "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices" *Journal of Finance*, April 2000, pp. 529-564; "Do Stock Market Liberalizations Cause Investment Booms?" *Journal of Financial Economics*, October 2000, 301-334.

[5] See for example, Rodrik (1998).

with capital accounts that are more open. The problem with this approach is that economic theory makes no such prediction.

What the theory does predict is that capital-poor countries will experience a temporary increase in investment when they liberalize. Hence, the relevant issue is not whether countries with open capital accounts have higher investment rates, but whether investment increases in the immediate aftermath of liberalizations. The most transparent way of testing the prediction is to compare investment rates during liberalization episodes with investment rates during non-liberalization periods. Because they constitute a radical shift in the degree of capital account openness, stock market liberalizations provide ideal natural experiments for confronting the theory with data.

The first study I conducted found that, on average, opening up to foreign shareholders led to a 38 increase in the real dollar value of the liberalizing countries' stock markets. Since stock market liberalization does not alter the functioning of these companies in any way— remember, the only thing that liberalization changes is the ownership of the shares of the companies listed on a country's stock exchange— is the increase in share prices evidence that capital account liberalization drives domestic stock prices away from the fundamentals and leads to stock market bubbles? Not necessarily.

The price of a stock depends on the expected future dividends to be paid by that stock and the discount rate shareholders apply to those expected future dividends. The discount rate has two components, the interest rate and the equity premium. Stock market liberalization leads to lower interest rates through the inflow of foreign funds. Stock market liberalization also reduces the equity premium, because emerging market stocks provide diversification benefits for investors in countries like the U.S. In other words, stock market liberalization leads to a lower cost of equity capital. In short, there are sound fundamental reasons for share prices to increase when the stock market is liberalized and we seem to observe this in reality.

Exactly who benefits from the increase in share prices and the decline in the cost of capital? Clearly, domestic shareholders benefit: those who sell their shares realize capital gains and those who continue to hold their shares see the value of their portfolios increase. Although foreign shareholders do not benefit from the increase in prices—indeed, they must now pay more to get into these markets— they are better off because their portfolios are more diversified than was possible prior to the stock market liberalization. For less obvious reasons, domestic residents who do not own shares will also benefit from stock market liberalization.

Remember that when a country's stock market increases in value, the country experiences a fall in the cost of capital. For a given capital-raising requirement, a higher stock price means that fewer shares need to be issued. Figure 1 illustrates the fall in the cost of capital that occurs when developing countries liberalize the stock market. The figure plots the average aggregate dividend yield across the liberalizing countries in event time (year [0] is the year of liberalization). The average dividend yield falls by roughly 240 basis points—from an average level of 5.0 percent in the 5 years prior to liberalization to an average of 2.6 percent in the five years following liberalization.

While the immediate effect of liberalization is higher share prices and a lower cost of capital, that is not the end of the story. The lower cost of capital will encourage firms to build new factories and install new machines. The reason for

increased investment is straightforward. Since stock market liberalization reduces the overall cost of capital, some investment projects that were not profitable before the stock market liberalization are profitable after liberalization.

The higher investment that should result from stock market liberalization is particularly important for emerging economies, because more investment should lead to faster economic growth and higher wages for workers. Thus, stock market liberalization should generate substantial economic benefits, even for those individuals who did not own shares before the liberalization and therefore do not reap the capital gains associated with the increase in share prices.

It sounds plausible that a lower cost of capital should lead to increased investment, but what is the reality? Figure 2 demonstrates that, on average, countries experience an increase in investment when they liberalize the stock market. The growth rate of the capital stock rises by 1.1 percentage points in the aftermath of liberalizations— from an average of 5.4 percent per year in the pre-liberalization period to an average of 6.5 percent in the post-liberalization period.

While liberalization leads to a sharp increase in investment on average, it is also important to know whether this is a uniform effect— do all countries experience higher investment, or is it just a select few that drive the results? In order to address this question, I looked at the results on a country-by-country basis. In one study I conducted, only two of the countries in the sample did not experience abnormally high rates of investment in the first year after liberalization. In the second year after liberalization, only one of the countries did not experience abnormally high rates of investment.

Increased investment should raise productivity and economic growth. Figure 3 shows that the growth rate of output per worker rises by 2.3 percentage points in the aftermath of liberalization— from an average of 1.4 percent per year in the pre-liberalization period to an average of 3.7 percent per year in the post-liberalization period.

Stock market liberalizations are usually accompanied by other economic reforms. Therefore, it is important to ask whether these economic reforms would have caused large increases in stock prices, investment and growth, even if there had not been any stock market liberalizations. The financial and economic effects of stock market liberalization remain statistically and economically significant, after controlling for contemporaneous reforms.

C. Do Equity Market Liberalizations Cause Crises?

Is equity market liberalization a good idea for emerging economies? It is hard to quibble with higher stock prices, investment, and economic growth. There is, however, one potential criticism of equity market liberalization, which needs to be addressed: *The opening of equity markets to foreign investors may have led to an initial stock market boom, but it also contributed to the collapse of emerging stock market values during the recent crises in Asia and Latin America.*

In evaluating this criticism it is important to remember that these countries liberalized their stock markets in the late 1980s and early 1990s. Given that these stock market liberalizations took place more than 5 years before the crises (and as much as 10 years before in some cases), the argument that this policy change is responsible for the stock market collapse seems untenable.

The proximate cause of the fall in stock markets during the crises was the revelation that these countries' banking systems had been poorly managed. As news

of imprudent lending and corporate insolvencies surfaced, economic prospects dimmed and stock prices responded accordingly. There is no law, economic, or otherwise, that says stock market gains are irreversible. In fact, it would be more worrying if stock markets in emerging economies did not respond negatively to bad economic news, as do stock markets in developed countries like the United States. In other words, the collapse of stock prices during recent emerging market crises was due to poor short-term economic prospects; the fact that foreigners were active participants in these markets is immaterial.

3. Lessons for The Language in This and Future Agreements on Capital Controls

The evidence I have outlined in this report can be distilled into two key lessons for the capital controls portion of the Chile Singapore free trade agreements. First, the liberalization of dollar denominated debt flows should proceed slowly and cautiously. This agreement, as well as all future agreements, should refrain from any language that inadvertently pushes countries into prematurely liberalizing dollar-denominated foreign borrowing. The second lesson is that all the evidence we have indicates that countries derive substantial economic benefits from opening their stock markets to foreign investors; there is no reason to think that Chile and Singapore will be any different in this regard.

Table 1. Country Stock Market Liberalization Dates

Country	Year of Liberalization	Means of Liberalization
Argentina	1989	Policy Decree
Brazil	1988	Country Fund
Chile	1987	Country Fund
Colombia	1991	Policy Decree
India	1986	Country Fund
Indonesia	1989	Policy Decree
Jordan	1995	Policy Decree
Korea	1987	Country Fund
Malaysia	1987	Country Fund
Mexico	1989	Policy Decree
Nigeria	1995	Policy Decree
Pakistan	1991	Policy Decree
Philippines	1986	Country Fund
Taiwan	1986	Country Fund
Thailand	1987	Country Fund
Turkey	1989	Policy Decree
Venezuela	1990	Policy Decree
Zimbabwe	1993	Policy Decree

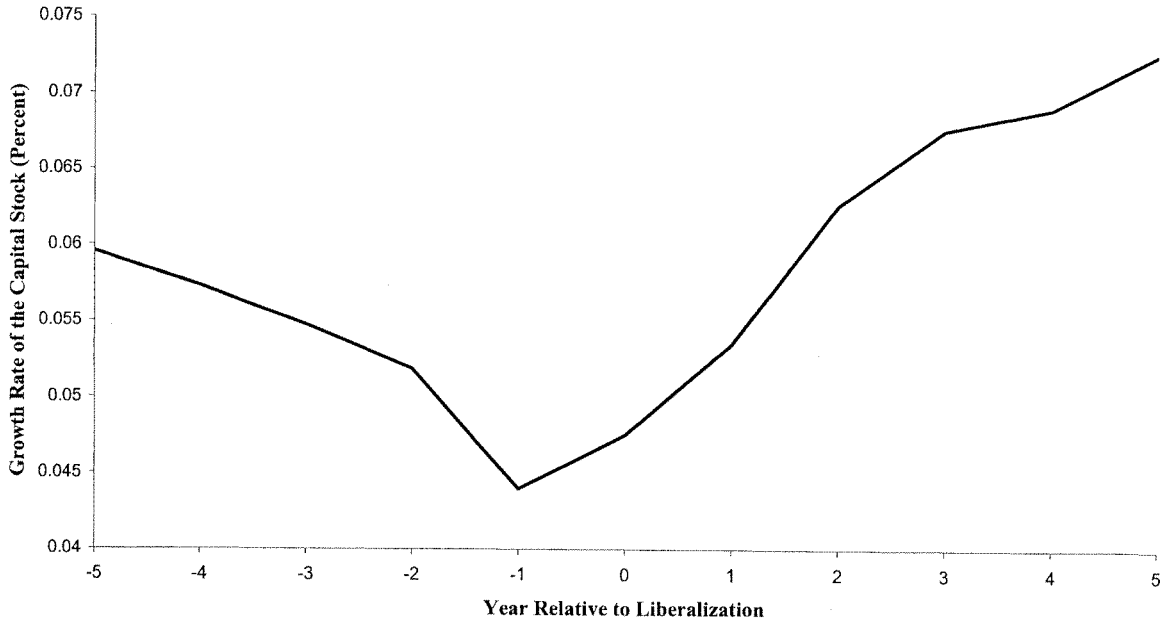

Figure 2. Investment Booms When Countries Liberalize the Capital Account .

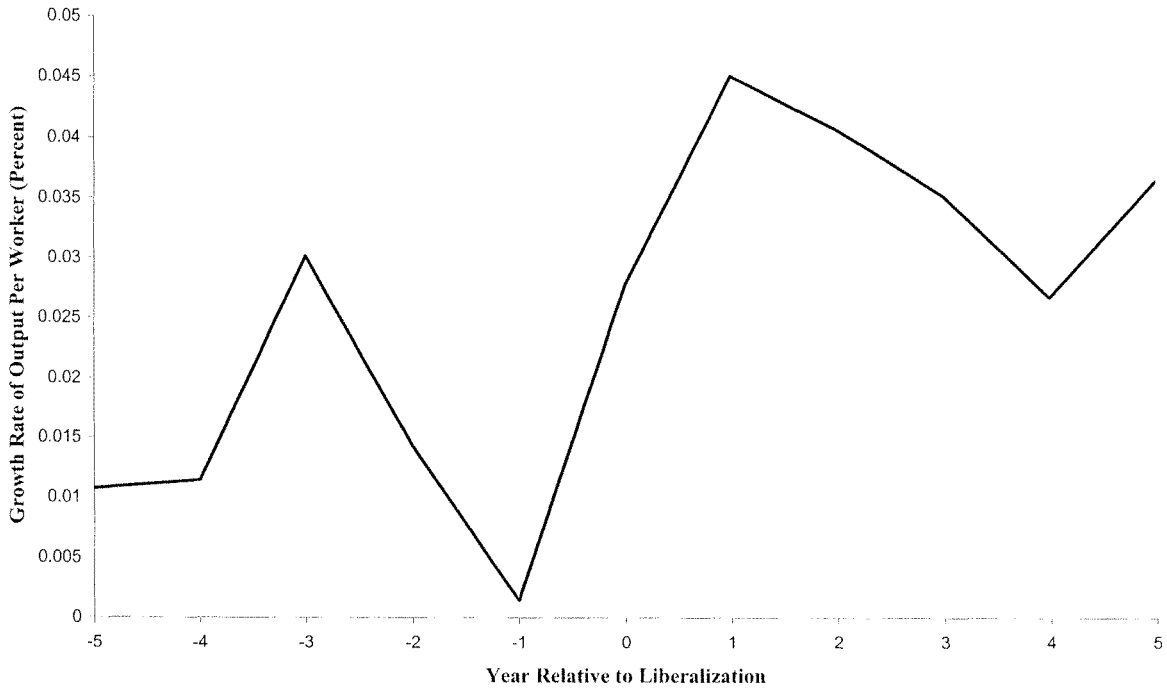

Figure 3. The Growth Rate of Output Per Worker Increases When Countries Liberalize

STATEMENT FOR THE RECORD
BY
MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

HOUSE FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

OPENING TRADE IN FINANCIAL SERVICES – THE CHILE SINGAPORE EXAMPLE

APRIL 1, 2003

Mr. Chairman and Members of the Subcommittee, my name is Marc Lackritz and I am president of the Securities Industry Association ("SIA").[1] SIA appreciates the opportunity to testify in strong support of the just concluded bi-lateral Free Trade Agreements (FTA) with Chile and Singapore.

The FTAs are comprehensive, and represent a key building block of President Bush's drive to open foreign markets to U.S. business, consumers, and investors,

[1] The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated $280 billion in U.S. revenue and $383 billion in global revenues.

resulting in new opportunities to create jobs, and bolster economic growth. Moreover, we believe the Administration's policy to simultaneously pursue the liberalization of trade in financial services on global, regional, and bilateral tracks, is a wise, indeed the best, approach.

This provides U.S. industry with multiple opportunities to make commercially meaningful progress and other nations with the opportunity to create the infrastructure for growth in many different ways.

In addressing the specific requests of the Subcommittee, my testimony will address the following key points: 1) the industry's overall goals for the negotiations; 2) the importance of financial services to the U.S. economy; and 3) the securities industry's focus on regulatory transparency.

Open and Fair Markets

We believe that the U.S. bi-lateral agreements with Chile and Singapore represent a "win-win" for all countries involved. Although Chile and Singapore already have well developed capital markets, free trade agreements can play an important role in creating the environment for the entry of long-term capital, advancing best practices, providing cutting-edge technology, and innovative products and services.

Importantly, the increased trade in financial services that will result from these pacts will enhance and strengthen capital market efficiency and bolster financial sector stability. Increased competition stimulates innovation and provides consumers with the broadest range of products and services at the lowest cost. There are additional special benefits from financial services sector liberalization, which have a "multiplier" effect for economic growth, both in individual countries and globally. This results in enhanced opportunities abroad for all U.S. firms.

U.S. securities industry measures the success of financial services trade agreements by the following key criteria:

- Permit 100% ownership, as well as right to establish in corporate form of choice;
- Provide national treatment (i.e., treat foreign financial sector participants and investors on the same basis as domestic investors for regulatory and other purposes);
- Commit to procedural aspects of regulatory transparency (including commitments on prior comment);
- Eliminate economic needs tests; and
- Permit dissemination and processing (within country and cross-border) of financial information to provide clients with services necessary for the conduct of ordinary business.

We believe that the U.S. agreements with Chile and Singapore meet these criteria, and we therefore support them. Importantly, we believe these agreements are excellent precedents upon which to negotiate ongoing and future bilateral and regional trade discussions.

The Financial Services Sector is a Catalyst for U.S. Economic Growth

The U.S. financial services sector is a key component of the U.S. economy. Importantly, its continued strength is dependent on unfettered access to foreign markets. Whether firms are raising capital for a new business, extending credit for a corporate acquisition, managing savings for a retail customer, or supplying risk management tools to U.S. multinationals, this sector touches all aspects of the U.S. economy. In light of the financial service sector's unique role in the U.S. economy, its health is essential if the U.S. economy is to continue to show rates of economic growth and job creation it has during this decade.

The strength of the U.S. financial services industry is impressive. Financial services firms contributed $820 billion to U.S. Gross Domestic Product (GDP) in

2000, or about 8.3 percent of total GDP. More than six-million employees support the products and services these firms offer. Perhaps most impressive is how this industry has increased its relative importance to the U.S. economy. From 1989-2000, the U.S. securities industry's contribution to total output of the U.S. economy increased by 3.2 times – nearly double the 1.8-times increase in GDP.[2] A vibrant and healthy U.S. financial services sector is key for U.S. and global economic growth and job creation.

Importantly, financial services firms are also exporters. In 2001, exports totaled $15.2 billion, with a trade surplus of $6.3 billion. Foreign individuals, institutions and governments eagerly seek cutting-edge services and products – such as portfolio management, advisory work in corporate finance activities, and global custody services – that U.S. financial firms offer.

The reason for the U.S. financial services sector's increasing commitment to foreign markets is clear. Over the last decade, the U.S. economy and securities markets – while still the largest in absolute terms – have seen their share of the global pie shrink. More than two-thirds of the world's GDP, half of the world's equity and debt markets, and 95 percent of the world's consumers are located outside the United States. Indeed, many of the best future growth opportunities lie in "non-U.S." markets. U.S. investors and corporations have already tapped these new markets, with U.S. securities firms establishing substantial foreign operations to support the growing international focus of their clients.

Expanding Business Opportunities for U.S. Financial Services Firms

The U.S.-Chile FTA will be the first comprehensive trade agreement between the United States and a South American country. The Singapore agreement marks a milestone for Asia. The free trade agreement with Singapore will advance its goal of becoming a key international financial hub, and will provide U.S. firms and

[2] U.S. Department of Commerce.

their customers with significant opportunities; over half of SIA's top twenty members (ranked by capital) are members of the Investment Management Association of Singapore. Underscoring Singapore's role as an international financial center are the substantial capital flows to the U.S. In 2002, investors from Singapore acquired $9.2 billion of U.S. securities – in comparison, of EU members states, only UK investors exceeded this total ($143.3 billion). In addition, purchases and sales of U.S. securities topped $252 billion, ranking in the top dozen most active countries.

The agreements reinforce Chile and Singapore's predictability and credibility with the foreign investors – an important goal in today's competition for capital. The agreements will result in increased commerce between our respective countries. Already, U.S. companies have substantial investments in Chile, with direct investments of nearly $11.7 billion; and in Singapore, where U.S. direct investment tops $27 billion. Moreover, in Singapore, it is estimated that U.S. majority-owned affiliates account for almost 12 percent of local GDP, while employing more than 113,000 people; in Chile, the comparable number is 3.9 percent, with 55,000 employees.

In both cases, the already close economic relationships will be further strengthened, providing new opportunities for U.S. securities firms and additional jobs in the United States. We believe, for example, that the increased opportunities could result in increased interest to list shares in the United States. To date, Chilean companies have 27 listed ADR issues in the United States, while companies from Singapore have 28 listed issues.

SIA's Objectives and Goals

SIA strongly supports the Chile and Singapore bilateral agreements. Both agreements successfully achieve many of the securities industry's specific objectives, and are defined by the following core principles. The major commitments follow:

Permit 100% Ownership/Market Access

Both Chile and Singapore are open markets and provide U.S. securities firms with full market access via the establishment of a subsidiary, or the acquisition of a local firm. Since the conclusion of the 1997 WTO Financial Services Agreement, both countries have undertaken extensive liberalization of their financial services markets. These agreements not only "locked-in" current levels of access, but also produced commitments by both countries to eliminate and reduce some of the remaining establishment barriers.

Specific Commitment

Chile made no commitments in asset management in the 1997 GATS Financial Services Agreement. The FTA would, for the first time, afford legal certainty to U.S. firms to establish a wholly-owned affiliate in Chile to provide asset management services on a national treatment and non-discrimination basis.

Singapore also made commitments guaranteeing U.S. membership on the Singapore Stock Exchange, as well as for the acquisition of equity interests in local securities firms.

Provide National Treatment

Increasingly, services must be delivered through a business presence in the host country. As a result, the ability to operate competitively through a wholly-owned commercial presence or other form of business ownership must be a fundamental element of any agreement. Non-residential financial services companies must be given every opportunity to establish a viable business presence outside their home country. These agreements will guarantee the ability of U.S. securities firms to enter into these markets through the establishment of a subsidiary, or the acquisition of a local firm. Once established, U.S. securities firm will receive the same (i.e., national) treatment as domestic companies.

Specific Commitment

The FTA with Chile provides national treatment to U.S. asset management firms in managing the voluntary portion of Chile's national pension system and the ability to manage the mandatory portion of the pension system without arbitrary differences between the treatment of providers. In Singapore, U.S. firms will now be able to compete for asset management mandates from the Government of Singapore Investment Corporation.

Commit To Procedural Aspects Of Regulatory Transparency

Obtaining commitments on regulatory transparency was the industry's major goal for the agreements with Chile and Singapore. We view the provisions contained in these agreements as excellent. While Chile and Singapore already provide for regulatory transparency, the industry viewed the FTAs as critical benchmarks for future efforts.

Improved regulatory transparency will help eliminate many of the nagging regulatory problems that we face in foreign markets. In both emerging and developed markets, regulatory practice in the financial services industry has developed unevenly and often at odds with the market access and national treatment commitments of WTO members. As a result, the experience of the industry in both emerging and developed markets has been one of increasing frustration with the regulatory process.

In light of that experience, SIA members believe that future trade agreements – whether bilateral, regional, or multilateral – should contain regulatory transparency commitments. In this regard, we applaud the Administration's communication to the WTO that contains proposals on regulatory transparency.

Regulatory transparency is an essential element in making regulation effective and fair – and is therefore a fundamental underpinning of deep, liquid markets.

We have worked with the Administration to seek commitments in regulatory transparency in these bilateral negotiations, as well as trade forums, as part of a wider effort to achieve international regulatory transparency reform more broadly. Lack of transparency in the implementation of laws and regulations can seriously impede the ability of securities firms to compete fairly. Financial services firms, face non-tariff barriers in the form of regulatory restrictions, and lack of transparency in the implementation and application of regulations. These barriers can prevent access in much the same way as tariffs but, unlike tariffs, no quantitative mechanism exists to reduce them.

From a business standpoint, ensuring a high level of transparency is as essential to a successful financial services agreement as tariff cuts are to an agreement on trade in goods. Lack of transparency in the implementation of laws and regulations – including limited public comment periods on proposed regulations, non-transparent approval mechanisms for firms and financial products, or other practices that are not dealt with pursuant to written regulations – can seriously impede the ability of securities firms to compete fairly.

Regulatory prohibitions also limit the ability of U.S. firms to compete in foreign markets. In some cases, the sale of specific products requires regulatory approval. In other instances, the ability to establish is impaired by restrictions on new licenses. Elimination of these barriers is complicated, especially when countries claim that they are "prudential" in nature; that is, they exist to protect the safety of consumers and the soundness of the marketplace. However, we believe that many of these restrictions go beyond any legitimate prudential objective.

Specific Commitments

The specific financial service transparency commitments in the FTAs will require that rules can not be adopted without appropriate notice and opportunity to comment, that requirements and documentation for

applications be clear and applicants be informed of the status of applications, and that decisions on applications be made in a specified or reasonable time. These commitments are important precedents for other trade negotiations.

Eliminate Economic Needs Tests

In some markets, national regulators of financial services or other sectors have employed so-called "economic needs tests" to screen and often discourage new foreign direct investment. Economic needs tests, which typically use, the number of existing firms, level of competition, and the size of the domestic market as criteria for granting licenses to establish a commercial presence, are subject to abuse. Such subjective determinations may ignore how a local market will benefit from the introduction of a new competitive entrant or supplier, and the resulting benefits to investors and issuers. As a result, the use of an economic needs test can significantly or even completely eviscerate commitments on market access.

Specific Commitment

In the FTA agreement with Chile, U.S. securities firms will no longer need to meet this test. In Singapore's case, economic needs tests for securities firms had not been previously applied.

Permit Dissemination And Processing Of Financial Information

The ability to freely transfer and process information is essential to the business of modern financial services firms. Indeed, many products, such as instruments built around market indices that are vital to smoothing out risk, could not function without timely data flows. Nevertheless, too few countries have committed to this key link in the financial services infrastructure. The free flow of financial information acts as an important prophylactic against the build-up of market imbalances and subsequent financial crises. Countries that allow a free flow of

financial information across their borders are likely as a result to be rewarded with lower capital and borrowing costs.

Commitments to permit the flow of data without risk of interruption are critical if securities firms are to offer innovative and risk-reducing products, price risk, and respond rapidly to their customers. Apart from its use in product creation, financial information is used to respond to market demand for current prices, for foreign exchange data for currency hedging, for information for use in risk management models, for background information for corporate finance transactions and advice, and to enable the market to react appropriately to breaking news.

Specific Commitments

Financial Information commitments by Chile and Singapore mark a major step forward. Chile made no commitments in financial information in the 1997 GATS Financial Services Agreement, while Singapore made a limited commitment. The FTAs will now give U.S. firms the legal certainty to process and disseminate financial information both domestically and cross-border.

Capital Transfers

I would like to turn briefly to the so-called capital controls provisions of these agreements. Investment and trade flows are interdependent. Therefore an essential element of a free trade agreement is a regime which permits the free flow of investment capital between nations. As a general matter, our members believe that restrictions on those flows deprive both parties of the benefits of cross-border investment. This is of particular concern to financial services companies and others engaged in portfolio investment.

We welcome the general commitment in both agreements to permit the free and immediate transfer of capital related to an investment. However, we regret that

both agreements contain significant exceptions to this general commitment – exceptions that, in our view, are unwarranted to meet the motivating concern of addressing so-called hot money flows. While I do not propose to review treaty text with you today, I would say that our members fervently hope that these exceptions to free capital movements will not form a template for future agreements, and that U.S. negotiators will work with our industry to ensure that future provisions relating to the flow of capital and investment are as least restrictive as possible.

Let me reiterate that our members strongly support congressional approval of the agreements with Singapore and Chile. The comprehensive benefits of these agreements are clear. But that broad support should not be interpreted as an endorsement of restrictions on the flows of investment capital.

Conclusion

Mr. Chairman, we believe these agreements offer Congress another opportunity to secure open and fair access to foreign markets for U.S. firms and their clients. The start of the 21st century finds the U.S. securities industry on the leading edge of international technology, finance and innovation. If it is to remain there, however, it must be able to meet the demands of its U.S. and foreign clients.

The impact of the President's trade promotion authority can be seen immediately with the trade accords reached by the United States with Singapore and Chile. The pact will result in benefits to consumers and businesses in both countries, as well as globally. SIA looks forward to continuing to work with the administration in developing a fairer, rules-based trading system that enhances U.S. economic competitiveness.

Thank You.

James E. Mendenhall, Assistant U.S. Trade Representative for Services, Investment and Intellectual Property

Testimony before the
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
Committee on Financial Services
U.S. House of Representatives

Good morning Mr. Chairman and members of the Committee. I appreciate this opportunity to come before you today to testify on the financial services chapters in the Chile and Singapore free trade agreements (FTAs). I particularly look forward to this discussion because I am newly appointed to my current position as Assistant U.S. Trade Representative for Services, Investment, and Intellectual Property, and this is my first opportunity to discuss these issues with you.

The Singapore and Chile Free Trade Agreements and the Broader Trade Agenda

Since the passage of the Trade Act of 2002, we have pursued an aggressive trade agenda. As stated by Ambassador Zoellick, "We are proceeding with trade initiatives globally, regionally, and with individual nations. This strategy creates a competition in liberalization, with the United States at the center of a network of initiatives. By moving on multiple fronts, we can increase America's leverage and influence around the world. If others are reluctant, the United States will work for free trade with those who are ready."

The recently completed agreements with Singapore and Chile represent the first of the next generation of trade agreements. We have also launched FTA negotiations with Morocco, Central America (Guatemala, Nicaragua, Costa Rica, El Salvador, and Honduras), Australia and the Southern African Customs Union (South Africa, Botswana, Lesotho, Namibia, and Swaziland). At the same time, the Free Trade Area of the Americas negotiations have entered a more vigorous phase, with market access negotiations underway, and a January 2005 date for completion. On the multilateral front, just yesterday the United States submitted its initial offer in the current round of services negotiations in the WTO.

Why Chile and Singapore

For several reasons, Chile and Singapore provided a good point of departure. First, the United States has a significant economic interest in trade with these countries.

- Singapore is America's 12th largest goods trading partner. Two-way goods and services trade reached $ 38.8 billion in 2001. Services trade alone amounted to $ 6.1 billion, with U.S. exports of private commercial services reaching $ 4.1 billion, up 54 percent from 1994.

- Two-way trade in goods and services between the United States and Chile totaled $ 8.8 billion in 2001, one-quarter of which was accounted for by trade in services. The United States had a surplus of $ 472 million in services trade with Chile. In the seven years to 2001, U.S. services trade with Chile expanded by 37 percent.

Second, specifically with respect to financial services, Singapore and Chile have taken steps to open their financial sectors. Both countries respect the concept of rule of law and were in a good position to explore market access enhancing concepts relating to transparency of regulatory structures. They have already committed to moving in the right direction for many sectors, and our FTAs will reinforce these trends.

Finally, the Chile and Singapore FTAs provide good toeholds for expanding liberalization in South America and Asia respectively.

Importance of Financial Services

The liberalization of financial services was one of our main objectives in negotiating the Chile and Singapore FTAs. In the final texts, we achieved the objective set forth in TPA to "reduce or eliminate barriers to international trade in services, including regulatory and other barriers that deny national treatment and market access or unreasonably restrict the establishment or operations of service suppliers."

The United States already enjoys a significant competitive advantage in financial services in international markets. The market opening initiatives in the Chile and Singapore FTAs, and in other fora, should create additional opportunities for our financial services suppliers.

U.S. provides a substantial part of the world's financial services. In 2000, for the financial sector, sales of U.S.-owned affiliates (not including commercial bank affiliates) in foreign markets reached $ 101.8 billion. The United States also excels in providing financial services on a cross-border basis. Cross-border insurance premiums totaled $ 8.7 billion in 2001. U.S. banking and securities firms recorded cross-border exports of $ 15.2 billion in 2001 (including some banking activities but not core deposit-taking and lending business). Regarding cross-border trade for non-insurance financial services, the U.S. enjoyed a surplus of $ 11.2 billion in 2001. (Cross-border figures are for exports to non-affiliates.)

For Chile, U.S. cross-border exports of banking, securities and insurance premiums reached $ 130 million in 2001; this represents approximately a $ 108 million surplus in financial services with Chile. For Singapore, U.S. cross-border exports of banking, securities and insurance premiums reached $ 329 million in 2001; the U.S. enjoyed a surplus of $ 264 million. (Data on sales through U.S. affiliates is not available.)

Opening foreign markets for exports of U.S. financial services has two added advantages. First, it creates jobs and expands economic opportunities. For example, states like New York, California, Florida, Illinois, Massachusetts and Pennsylvania depend on financial sector activity to contribute

to their economic growth and the tax base. Also, by expanding access to financial services, it enhances prospects for economic growth at home and abroad.

Second, the opening of foreign markets for financial services creates export opportunities for other sectors. For example, banks, insurance companies and securities firms rely heavily on specialized software and data processing, thereby creating increased demand for computer-related services, another strong point of the U.S. export picture. And as countries develop their economies with the help of foreign financial services, those countries consume a wider range of goods and services, which benefits U.S. exporters more generally.

Core Provisions in the Financial Services Chapters of the Chile and Singapore FTAs

The financial services chapters in the Chile and Singapore FTAs cover all means of supply that are relevant for financial services trade, including, for example, through the establishment of a foreign subsidiary or branch or through channels of cross-border supply.

The financial services chapters require national and most-favored-nation treatment, which ensures that U.S. financial service suppliers are treated on equal terms with their foreign competitors. They also include a "market access" obligation to ensure that measures, such as non-discriminatory quantitative restrictions and requirements regarding forms of legal entities (for example, no branching), do not undermine general market access rights.

We have also sought to address more subtle, but equally insidious, market access barriers arising from non-transparency in foreign regulations. The financial services chapters contain strong regulatory transparency provisions relating to the openness of regulators to consult with interested persons, procedures for advance notice and comment on draft regulations, and an obligation to publish final regulations, including a summary of comments received. The transparency obligations also include concrete time frames for regulators' review of applications for licenses and requirements regarding provision of information.

We also recognize that the financial services sector, like other modern, vibrant economic sectors, changes rapidly. The industry is constantly changing, developing creative and valuable new products and services. We have, therefore, provided rights for foreign-owned institutions to introduce new financial services when certain conditions are met. For example, the agreements allow suppliers to bring a product to market that has already been introduced in the home market.

Finally, I would like to say a word on the issue of capital controls. This issue is not addressed in the financial services chapters of the FTAs, but is nevertheless related because the transfers obligations of the investment chapters apply to financial services. The issue of capital controls is clearly complex. We have to recognize, however, the potentially serious negative impact capital control could have on U.S. investors. We believe that our FTAs protect our investors, while at the same time they grant Chile and Singapore a certain degree of flexibility to manage financial flows.

Advantages of FTAs

In line with our general approach of using the FTAs to spark competition in liberalization among our trading partners, the Chile and Singapore FTAs mark a significant advance over commitments in other fora. For example, unlike in some other agreements, our Chile and Singapore FTAs adopt a presumption that national treatment will apply unless a sector is specifically carved out.

Chile and Singapore have agreed to commitments across a wide array of financial services, including insurance, banking and securities, and other areas, that exceed the level of their current GATS commitments. In some cases, they have undertaken commitment to preserve existing levels of openness that go beyond their GATS commitments. Chile has, for example, made great strides in liberalizing its banking and securities regimes in recent years. The FTA provided a means to lock in these improved levels of access.

In other cases, our trading partners have agreed to commitments that go beyond their current practice. For example, Singapore's banking market was largely closed to new entrants. As a result of the FTA, Singapore has agreed to groundbreaking liberalization of its banking regime over time, including for wholesale and retail banking. Chile and Singapore have also agreed to liberalize their regimes to allow important forms of cross-border supply of insurance.

These are just some of the many new commitments Chile and Singapore have undertaken. We would be pleased to discuss other commitments with you here today or to meet separately with you or your staff to discuss in further detail.

Domestic Regulation

While we have moved aggressively to open foreign markets, we are sensitive to the careful balance struck through our own political and legal processes between regulatory and commercial interests. In fact, while the United States agreed to a high level of access under the Singapore and Chile FTAs to complement its existing GATS commitments, implementation of the financial services chapters in the FTAs will not require any changes to U.S. law or practice.

The chapters incorporate several other mechanisms to ensure respect of regulatory authorities. These mechanisms include, for example:

- Flexibility to negotiate on a sectoral basis in light of the regulatory sensitivities associated with cross-border supply of financial services, and the ability to negotiate reservations for particular measures based on country-specific sensitivities.

- An exception for prudential measures based on a similar provision in the WTO General Agreement on Trade in Services.

- Special procedures allowing for the use of financial experts to resolve disputes involving measures related to the supply of financial services.

Conclusion

As I hope this survey demonstrates, we can expect real benefits to accrue to the U.S. economy as a result of the Chile and Singapore agreements. As we advance a strong trade promotion agenda, we remain ever-mindful of the objectives Congress asked us to achieve when it granted Trade Promotion Authority. I look forward to working with you and your staffs as we strive to continue opening markets around the world.

STATEMENT OF
DANIEL K. TARULLO
BEFORE THE
SUBSCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
April 1, 2003

Thank you very much for your invitation to testify today. I am currently a professor at Georgetown University Law Center. Between 1993 and 1998 I held several economic policy positions in the United States Government, ending as Assistant to the President for International Economic Policy. I testify today purely in my individual capacity as an academic, with no client interests or representation.

Let me say at the outset that I support the negotiation of bilateral free trade agreements with Chile and Singapore. Both have bipartisan origins and bipartisan support. Let me also say at the outset that I do not come before the Subcommittee as an advocate of capital controls. I do come to criticize the inclusion in these two proposed trade agreement of rules penalizing emerging market countries for employing restrictions on capital flows, even in the most dire of circumstances. Our government's insistence on such provisions is bad financial policy, bad trade policy, and bad foreign policy.

It is ironic that the Administration would insist upon such measures in agreements with Chile and Singapore, among the most open and well-managed emerging market economies in the world. Indeed, it should give each member of this Subcommittee pause to realize that these two developing country governments – which declined to impose controls on capital outflows even in the midst of the global financial crisis of 1997-98 – believed it important to preserve the right to do so in exigent circumstances. They eventually

compromised, but I doubt their views have changed. Of course, the Administration was attempting in these negotiations to create a "template" for future negotiations, importantly including the proposed regional trade agreements in this hemisphere. Thus I believe the Congress should send a strong message to the Administration: Such provisions are inappropriate in any agreement and may do substantial harm to both U.S. and emerging market interests in agreements with countries that are not as financially sophisticated as Singapore or Chile.

The Tenuous Case for International Financial Integration

The Administration has publicly defended its position in the Singapore and Chile negotiations by asserting the benefits of liberalized capital flows. It has invoked well-known theoretical arguments such as the increased mobilization of capital that occurs from the deepening of capital markets and the economic stabilization that comes from more efficient risk-spreading. These are appealing arguments and, in the context of a deep and well-regulated capital market such as the United States, convincing as well. The problem, though, is that in the context of developing countries, the evidence that these salutary effects occur is far from well-established.

Just a few weeks ago, the International Monetary Fund published an extensive review of the economic literature on the effects of financial globalization on developing countries. The study was nuanced, and its authors were careful not to jump to conclusions on the basis of their policy predispositions. On the central point, though, the study's conclusion was unequivocal: A fair-minded reviewer of the existing evidence simply cannot assert that global financial integration promotes significant economic growth in developing

countries. The fact that the International Monetary Fund was the source of this paper makes this conclusion even more significant. It was not so long ago that the Fund was preaching the virtues of more or less complete capital account liberalization for everyone. The financial crises of the 1990s led many at the Fund to reexamine its policies and the premises on which those policies were based.

Note that this conclusion contrasts markedly with the overwhelming, though not unanimous, conclusion of empirical studies that trade integration *does* help to promote economic growth in developing countries. It is also important to note some potential explanations for why financial integration does not have a similar, demonstrable effect. Most of these explanations revolve around the relatively undeveloped character of legal and market institutions in emerging markets. That is, financial integration and increased capital flows may yield the hoped-for economic benefits only where the capital can be channeled efficiently within a developing country. Forcing capital in before the necessary institutions are in place may, the evidence suggests, have little positive effect on overall growth prospects.

We are, in other words, in that murky world of second best. The theoretical advantages of unregulated capital flows appear to be realized only where other important conditions obtain. Where they do not – as is often the case in most emerging markets – the benefits may simply not be forthcoming. Surely most countries will want to develop financial markets that will eventually allow them to realize the benefits of unimpeded capital flows more readily observed in highly developed financial markets. But the sequencing of steps that will most readily achieve this desirable end is far from clear.

As the recent IMF study and other reviews make clear, the ambiguity and inconclusiveness of the present evidence does not mean that the case will never be made for the growth-enhancing character of free capital flows. Indeed, there is already a much stronger body of evidence for the benefits of foreign direct investment (as opposed to portfolio investments such as stocks and bonds) for economic growth. And there have been a few studies purporting to find a positive correlation between financial integration and growth. But most do not. At this juncture, at least, an assertion that global financial integration promotes economic development for most emerging market countries must be attributed more to economic creed than to economic evidence.

The Potential for Economic Disruption

If the positive economic case for requiring full capital liberalization cannot be established, perhaps the Administration's position can be justified on the ground that capital flows have at worst a neutral effect, and may sometimes have significant positive effects. Unfortunately for this possible justification, there is evidence that the liberalization of capital flows can make developing countries more vulnerable to financial crises. Again, the reason is not that capital flows are bad in principle. Sometimes, though, developing countries are not able to absorb increased flows in their relatively embryonic banking systems and capital markets in a manner consistent with sound credit standards. Moreover, sudden inflows of capital can be used to finance consumption. But – and this is the most important point – the spigot can be, and is, turned off as quickly as it is turned on.

Capital from the advanced industrial countries often flows into emerging markets in search of higher returns during periods of low interest rates at home, or following a sudden

spurt in an emerging market's rate of growth. But it will cease flowing as soon as signs of a slowdown or banking problems emerge, or as investment opportunities at home become more attractive. Indeed, knowing that the markets of many developing countries are relatively illiquid, investors may quite understandably be quicker to withdraw their investments from a developing country market than they would disinvest from a developed financial market. Herd behavior is a very real phenomenon, and one that is not irrational from the standpoint of the investor.

As foreign short-term capital is withdrawn from the developing country, its currency can depreciate rapidly, leading in turn to more capital flight. Meanwhile, import prices soar, harming the country's economy. Once the crisis hits, the developing country has no good options. Raising interest rates dramatically may stem the outflow of funds, but at the cost of a serious recession. Borrowing money from the IMF can help reassure investors that they will be repaid. But IMF packages are rarely big enough to cover all obligations and, of course, they increase the debt of the affected country.

In such circumstances, the imposition of capital controls may be a viable tool to help stabilize a country's currency and give its government some breathing space for financial reform. This was the approach taken, with apparent success, by Malaysia during the 1997-98 global financial crisis. Alternatively, the country may design and implement a system of capital restrictions to forestall sudden inflows or outflows. This was the approach taken by Chile itself during the 1990s. There is disagreement among economists as to the relative importance and effectiveness of Chile's capital controls compared to its other economic policies. There can be little doubt, however, that Chilean officials believed they

were taking prudent, limited steps within the context of very sound macroeconomic policies.

Capital controls can be – and often are – ill-conceived, poorly implemented, or both. Even effective capital controls would not be costless. Some useful investments would be prevented or discouraged. There may be opportunities for political favoritism and corruption in the administration of the controls. Perhaps even more serious in the longer run, capital controls may be used as a means to *avoid* reform, rather than to provide breathing space within which to implement reforms. Like all policy instruments, the costs of proceeding must be measured against the benefits and against alternative policy approaches. This calculus will, by definition, vary from case to case. Yet the Administration's negotiating position in the Chile and Singapore talks was that capital controls are *always* bad and should be prohibited by the rules of a bilateral trade agreement. Indeed, Administration officials have publicly stated this view in on-the-record comments.

The Administration is repeating the mistake which the IMF itself made a decade ago. At that time there was substantial enthusiasm within the Fund for making full capital account liberalization mandatory for all Fund members. This enthusiasm was based on the same theoretical advantages cited today by the Administration. Appropriately, perhaps, the financial crisis broke out in Asia just as the campaign for full capital account liberalization was being accelerated. Fund staff, developing country officials, academic economists and others all recognized fairly quickly that large, short-term capital flows can sometimes have deleterious effects in relatively undeveloped capital markets. They further recognized that these effects will be exacerbated in countries pursuing ill-advised macroeconomic policies. But requiring full capital liberalization would not then, and will not today, magically make

developing country capital markets more liquid or bank regulation more effective or macroeconomic policies more sustainable.

We do not live in a textbook world, but in that complicated second-best world I mentioned earlier, where theoretically beneficial policies may at times do more harm than good. Remember, too, that the textbooks themselves must be rewritten after each major financial crisis, which results from a different set of proximate causes and unfolds in a different way. The prominence of privately held debt in precipitating the crisis that began in Asia in 1997 surprised nearly all government officials, market actors, and academics, who had become accustomed to focusing on the sovereign debt and balance of payments positions of developing countries. I suspect that the origins of the next widespread crisis will also surprise us, even though we will see in retrospect some of the same vulnerabilities. One can understand, in such a world, the nervousness of even the most orthodox developing country officials. One would also think that this is an occasion for modesty about our understanding of the effects of capital flows in particular circumstances.

The desirable aims of the United States related to developing country capital flows and policies are, in my view, fairly clear: We should continue to encourage official and academic research into the effects of capital flow and capital controls in developing countries, so that empirical work can provide a solid basis for policy. We should, though multilateral financial institutions such as the IMF, encourage the adoption of sound economic policies and assist the improvement of banking and capital market regulation in developing countries, so that they will be able to gain the benefits of liberalized capital flows without undue risk of financial crisis. We should, both directly and through our participation in the IMF, warn countries away from reliance on capital controls as a

substitute for policy reform and the strengthening of market and regulatory institutions. But we should *not* attempt to impose a policy that penalizes an emerging market country beset by financial contagion that adopts temporary capital controls in accordance with the best judgment of its own financial officials following consultations with the IMF.

The Infirmities of the Negotiated Provisions

As has been well reported in the press, the governments of both Chile and Singapore resisted the Administration's demand for a rule in the trade agreements prohibiting the use of capital controls under any circumstances. Singaporean officials, for example, were quoted as saying that Singapore needed to "retain flexibility in extreme cases" to use controls. Again, we see this concern even on the part of an emerging market government that has followed orthodox macroeconomic policies and that did not institute controls during the turbulence of 1997-98. The Administration refused to agree to an exception even for the most extreme of crises. In the words of an Administration official, "The U.S. view is, we're not going to sign on to the notion that capital controls are justified in any circumstances."

The Administration accordingly shifted its strategy and sought the provisions that we have in the texts of the agreements. These provisions provide for direct, automatic compensation of U.S. investors by Chile or Singapore should one of those countries ever impose capital controls of any sort. This "solution" compounds the Administration's mistake on financial policy by distorting trade policy as well.

The agreements give any U.S. investor the right to obtain compensation for any "loss or damage" arising from the use of capital controls. If the control "substantially impedes"

transfers, liability begins to accrue from the moment of imposition. If the controls do not substantially impede transfers, then damages begin to accrue after the controls have been in place for a year.

Thus, for example, an investor enjoying the higher yields that come from assuming the risk attendant to lending in an emerging market would presumably be able to claim damages for the imposition of capital controls if exchange rates moved unfavorably during the period of controls. This right exists even if the IMF approves the control. In a sense, then, the investor would be receiving a free insurance policy for its investment. Believers in the market-efficient internalization of costs by economic actors might think instead that a participant in a financial market should assume the cost of hedging against credit and market risk.

The investor would have a right to proceed under the so-called investor-state dispute settlement provisions of these agreements. This procedure in essence gives the investor a direct cause of action before an international arbitral tribunal, the decision of which can be enforced in directly in the domestic courts of the parties. Members of the Subcommittee may recognize this dispute settlement process from the controversies surrounding Chapter 11 of the North American Free Trade Agreement. The arbitral panels that decide such cases have generally been composed of people with the kinds of backgrounds one finds among traditional commercial arbitrators. They will not likely have macroeconomic expertise. Indeed, by the terms of the agreements, it does not matter how good a reason the country had for imposing controls in the first place.

Furthermore, the decision of the arbitral panel is final. It may not be appealed on its merits and is subject only to the loosest of constraints by domestic courts for exceeding its

jurisdiction. The first decade of experience under Chapter 11 reveals that some arbitral panels have not hesitated to take a very broad view of the obligations of the government in question. Indeed, in response to some of these cases, Ambassador Zoellick and his subordinates have appropriately begun to narrow the language in some of the provisions which arbitral panels have expansively interpreted. But the fact remains that the arbitral panel continues to be, for all intents and purposes, the final decision-maker.

It is important to correct some misimpressions concerning the provisions we are discussing today. A number of people with whom I have spoken recently, including some from the financial services industry, have agreed that an absolute prohibition on capital controls is ill-advised. But they are consoled by what they believe to be mitigating features of the agreements as negotiated. Undoubtedly, any qualification on an absolute prohibition is an improvement on the Administration's negotiating position. But I fear that some observers read too much into the qualifications we find in these agreements.

One mitigating feature mentioned is a letter from Under Secretary Taylor to Singaporean monetary officials which is appended to the text of the investment chapter of the U.S.-Singapore trade agreement. This letter provides, among other things, a gloss upon the meaning of the "substantially impede" language explained earlier. It would be a mistake for those favoring retention of sensible discretion by emerging market finance officials to take much comfort from this letter. As a law professor, I must say that it is not a model of clear drafting. It leaves ample room for investors' lawyers to argue for damages in almost any imaginable case. Moreover, even were the language more clear, it is not necessarily a practical limitation on the discretion of an arbitral panel to award damages. To say in the abstract, as the letter does, that damages must be proven and not speculative

is not to assure that a decision-maker will take a suitably skeptical view of damage claims. The Subcommittee should be very clear that, once these agreements are approved, the arbitral process is largely autonomous from the governments themselves. Overreaching in a particular case cannot easily be corrected.

A second key misimpression is that the agreements do not give investors a right to collect damages for capital controls that have been in effect for less than a year. Those who believe that there is a role for capital controls, but only controls applied for a relatively short period, would be reassured by such a limitation on damages. Unfortunately, this is not what the agreements say. The agreements do require an investor to *wait* one year before filing an arbitral claim. However, this is *not* an exclusion for losses arguably incurred during that year. The damages begin to accrue from the moment controls are imposed. It is only the collection of those damages that is delayed. Because the agreements provide for interest to be paid on awards to investors, the only relief this provision gives the developing country is that it need not pay the compensation immediately.

It is true that the agreements exclude recovery of losses resulting controls that do not "substantially impede" transfers. But this provision just returns us to the uncertainty surrounding the meaning of "substantially impede." The glosses in Under Secretary Taylor's letter and press comments by an Administration official suggest that any measures of sufficient robustness to help an emerging market though a financial crisis would, in the Administration's view, "substantially impede" transfers and thus be subject to compensation claims.

Foreign Policy Consequences

Not only is the Administration's approach to capital controls bad financial policy and bad trade policy. It is also bad foreign policy. I would certainly favor a provision that guaranteed U.S. investors no less favorable treatment than that granted investors from the country imposing the capital controls or from third countries. American investors should not be singled out for adverse treatment by host countries. But the provisions in the agreements require what will likely be *more* favorable treatment for U.S. investors than for other investors, domestic or third country. If a country party to one of these agreements imposes capital controls, it will have to compensate American investors but not others.

Let us play out the consequences. A developing country is faced with a severe financial crisis. It seeks IMF assistance, raises interest rates, and imposes temporary controls on portfolio capital flows. While the IMF assistance and the controls help to stabilize the country's external financial position, they do not prevent a serious recession, the usual outcome of emerging market financial crises. The country's gross domestic product declines significantly. Unemployment and poverty rise. Unless the country is very lucky, these consequences will be felt for years rather than months.

Then, as the country struggles to emerge from its recession and to repay its debts (many of which will have been deferred or rescheduled), U.S. investors file their claims for compensation. And, of course, under the bilateral trade agreement they are entitled to that compensation. Thus the still-suffering citizens of the country are treated to the prospect of U.S. investors being made whole while everyone else bears losses from an economic catastrophe that has afflicted the entire nation. Regardless of what one thinks on the merits of capital controls, one would have to be naïve not to think that an anti-American backlash

would result. Instead of the United States being perceived as providing leadership to help the country back on its feet, we will be perceived as grabbing everything we can while the country is flat on its back.

This approach is not only at odds with a sensible strategy to maintain the goodwill of developing countries towards the United States. It is also at odds with efforts to develop a set of fair and efficient procedures for the resolution of sovereign debt problems. The U.S. Government would have no authority to defer or reject the claims of investors. Our government would thus be unable to deflect the foreign policy problem of U.S. investors suing in international arbitration while other investors are being asked to forbear while an approach to a country's debt problems is fashioned.

There is a great irony here: Under the version of sovereign debt restructuring procedures currently being advocated by the International Monetary Fund, sovereign payments could be suspended for a time while debts are rescheduled or written down. Many people – myself included – have some questions about these proposals. But a number of people who favor a less top heavy, more "market friendly" mechanism for sovereign debt restructuring rely upon the possibility of a developing country being able to impose temporary capital controls in truly extreme circumstances as part of their justification for opposing a world bankruptcy court. That is, they believe that most of the time a market-based restructuring negotiation would be adequate, but that on some occasions the imposition of capital controls by the developing country might be necessary to allow the process to work smoothly. The Administration position on capital controls would, if realized in other agreements, undermine the reserved authority of a developing country that could allow a generally less intrusive framework for debt restructuring. It

might, thereby, build support for a more activist sovereign debt restructuring mechanism that would override U.S. and other domestic legal processes.

Finally, there is another possible foreign policy consequence. As investors from other countries realize that U.S. investors are given preferential treatment and insulated from losses if capital controls are imposed, they will have an incentive to channel their investments through a U.S. intermediary which qualifies as a U.S. investor under the agreements. After a time, the United States may, for these purposes, resemble an offshore financial center that helps investors from other countries evade taxes or money laundering regulations or regulatory requirements. A moment's thought as to how we in the United States have traditionally regarded such offshore centers will reinforce one's foreign policy uneasiness at the prospect of these provisions being exercised.

The Problems with Templates

As earlier noted, the Administration intends the provisions of the Chile and Singapore agreements to be a "template" for future bilateral and regional trade agreements. This expectation raises two serious concerns beyond the uncertainties and disadvantages I have mentioned in the context of Chile and Singapore.

First, does this intention mean that the Administration will seek to force removal of *existing* restrictions on capital flows as it negotiates more trade agreements? That is, will it seek to obtain the right for U.S. investors to obtain damages for effects from existing restrictions. The stated, absolutist view of the Administration would suggest an answer in the affirmative. As we know, Chile and Singapore do not currently impose controls and have no apparent present plans to do so. But not all of our potential trade agreement

partners are similarly situated. To remove controls rapidly, and without proper cultivation of financial and regulatory systems, would be to fly in the face of something we should have by now learned – that capital account liberalization, desirable as it may be as an end point, needs to be carefully sequenced with the development of appropriate legal, economic, and market institutions to handle the resulting capital flows without undue risk of financial crisis.

Second, if the United States continues to insist on similar provisions in its bilateral and regional trade agreements, it will be affecting not just bilateral relations but international financial policy as a whole. We will be subverting the authority and influence of the International Monetary Fund in an area in which it shows appropriate nuance. We will be imposing unilaterally our doctrinaire view of financial policy. And, as illustrated by my comments concerning debt restructuring proposals, we will have undermined cooperative efforts to fashion a sensible set of crisis prevention and crisis response measures.

Conclusion

In closing, I want to reiterate that I am not offering a brief for capital controls in general or, indeed, in any particular circumstances. I share with others the concern that this tool often causes more problems than it solves. But existing empirical work does not allow us to say in sweeping terms that free capital flows are always good for development, or that restrictions on capital are always a mistake for a developing country. Current knowledge does not permit a broadbrush rule. Even when we learn more, it is possible that an

inflexible rule will never be justified. Instead, presumptions and standards may be the most we can with confidence derive from experience.

The Chile and Singapore agreements do not take account of these subtleties. The implications of the Administration's absolutist position for international financial policy and U.S. foreign policy interests seem not to have been considered. The potential for negative effects upon the interests of both the developing world and our own country will only grow if such provisions proliferate. The Congress should serve notice to the Administration that this is not a template which it wants to see adopted in future agreements.

Thank you very much for your attention. I would be pleased to answer any questions you might have.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

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John B. Taylor
Under Secretary of Treasury for International Affairs
Testimony before the
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
Committee on Financial Services
U.S. House of Representatives

Chairman King, Ranking Member Maloney and distinguished members of the House Financial Services Subcommittee, thank you for inviting me to testify about the financial services provisions of recent trade agreements and, in particular, the Free Trade Agreements (FTAs) with Chile and Singapore. I will also discuss the investment and capital transfer provisions in these FTAs and how they relate to the successful 20-year program bilateral investment treaties (BITs) that guarantee the free movement of investment-related capital across borders.

Financial Services Provisions in the Chile and Singapore FTAs

Strong financial services rules and commitments are an essential component of any comprehensive trade agreement. Reducing barriers to trade in financial services is a necessary part of meaningful economic integration. Recent studies have shown that countries with an open and well-supervised financial services sector experience substantially increased growth rates. Downstream sectors that consume those services benefit from their enhanced efficiency. And a strong financial sector increases both the amount of national savings and the efficiency of its allocation.

Our trade agreements have traditionally contained separate provisions on financial services. The FTAs with Chile and Singapore are no exception. The FTA provisions on financial services:

1. Secure the right to invest and to establish financial institutions in our FTA partners' territory and ensure that our FTA partners do not apply measures that discriminate against U.S. financial institutions, investors and investment in financial institutions, or cross-border financial service suppliers as compared to domestic or other foreign counterparts.

2. Secure rights with regard to expropriation and the transfer of capital and investment returns as well as the right to resolve disputes with a host government through binding international arbitration for these obligations.

3. Provide exceptions for prudential measures and for monetary and exchange rate policy in order to provide the regulatory flexibility required by financial regulators. (Regulators'

concerns about dispute resolution procedures are addressed by provisions that encourage or require the use of financial experts, particularly in cases involving prudential measures.)

These provisions apply to all types of investment in financial services unless an FTA partner identifies and negotiates exceptions called "non-conforming measures."

In the case of the Singapore FTA, we were able to achieve significant liberalization in areas where markets were not previously open or were not sufficiently transparent. For instance, Singapore has agreed to substantial new access for U.S. banks to Singaporean customers. Within 18 months of entry into force of the agreement, it will lift its ban on new licenses for banks authorized to provide the broadest range of services, and it will lift its ban on wholesale banks 18 months later. It will end discriminatory restrictions on the number of customer locations two years after entry into force of the agreement and will allow our banks to negotiate access to ATM networks run by locally owned banks.

Chile does not currently have major restrictions of this nature, but it too will implement some changes. For instance, it has agreed to adopt changes to its financial services regime to provide for prior notification and comment on new regulations. Moreover, Chile will not apply its economic needs test to U.S. financial institutions managing assets under its mandatory pension system.

The FTAs we have negotiated with Chile and Singapore provide financial service suppliers the opportunity to compete in these markets, providing benefits to people in Chile, Singapore and the United States.

Investment and Capital Transfer Provisions: Some History

The investment chapters of the Chile and Singapore FTAs provide for the free transfer of funds related to an investment into and out of each country. These provisions reflect a continuation of the United States' long-standing policy of assuring that investment flows may move unimpeded by controls. Therefore, before describing the details of the investment and capital transfer provisions contained in the Chile and Singapore FTAs, I would like to review the history and basis for this policy.

Foreign investment is vital to economic growth around the globe. In the case of the United States, annual flows of U.S. direct investment abroad increased from an average of $28 billion between 1983-91 to $91 billion between 1992-2002. On average, the sales of U.S. affiliates abroad exceed $2.2 trillion annually; these sales help support jobs and business activities in the United States. In total, about two-thirds of all U.S. exports since 1989 were made by U.S. companies with investments overseas. Foreign investment *into* the United States also provides a host of economic and social benefits. Like domestic investment, foreign direct investment in the United States creates good jobs, increases productivity, and raises U.S. living standards. It also strengthens U.S. firms and makes them more competitive in the global economy.

Foreign investment is also a principal means to spur economic growth and development in poorer countries. It can provide the financial, technical, and managerial resources to expand economic potential in these countries. FDI can act as an engine for economic development by bringing in new technology and management practices, and by setting standards for local suppliers, thereby making those suppliers more competitive at home and abroad.

There are several ways the Administration is seeking to help developing countries attract investment. Most recently, we are working very hard to push forward the President's Millennium Challenge Account. The MCA will allocate development assistance to those countries that are committed to the adoption of sound policies. The strong incentive provided by the MCA is intended to spur countries to improve contract enforcement, the independence of the judiciary, and the security of property rights. Only those countries that are pursuing responsible monetary and fiscal policies, removing the barriers to business formation, and investing for a healthier and more educated work force will be rewarded. The key point here is that the MCA will make those countries more attractive to investors.

The bilateral investment treaty program, which started in the early 1980s, is another way of encouraging private sector investment flows to developing countries. The existence of a U.S. investment agreement can affect the location decisions of U.S. companies. Surveys of U.S. companies with investments in developing and emerging market countries indicate that U.S. companies factor political or non-commercial risk into their investment decisions. One of the most important elements they consider is whether there is an environment based on the rule of law. U.S. investment treaties are intended to foster the rule of law and lower political risk by, among other things, obligating countries to honor contracts, encourage economic and regulatory reforms, and agree to international arbitration as an alternative to biased or corrupt court systems.

The United States now has over forty Bilateral Investment Treaties (BITs) with other countries. U.S. investment agreements facilitate investment by assuring investors, among other things, six basic rights:

1. The fundamental right to transfer capital and investment returns freely into and out of a country without delay and at a market rate of exchange.

2. Both pre- and post-establishment rights to the better of national or most-favored-nation (MFN) treatment.

3. Limits on the ability of a government to impose inefficient and trade-distorting performance requirements such as local content and export requirements.

4. Protection against expropriation of an investment that is not in accordance with customary international law standards.

5. Right to resolve disputes with a host government through binding international arbitration as an alternative to domestic courts.

6. Right to employ top managerial personnel of their choice, regardless of nationality.

The first of these rights—free transfers of capital and investment-related returns—is a mainstay of U.S. international investment agreements. It has weathered some twenty years of change in the economic and political climate and held fast through Republican and Democratic Administrations. The right of free transfers is considered by the business community as one of the most important protections conferred in these treaties.

Protection of free transfers is also a key part of a sound investment climate, which is particularly important for emerging markets and developing countries. In a world where countries must compete for scarce international capital, countries that offer investors a high-quality investment climate will be more successful in attracting investment—investment that is needed to create jobs, raise productivity, and increase living standards. Conversely, restrictions on capital flows serve to discourage investment.

Despite the long history of protecting the right of free transfers, some have contended that the Asian financial crisis showed the need for limits on the free movement of capital. They argue that restrictions on capital flows into developing and emerging market economies are needed in times of financial crisis. I disagree strongly with this view for several reasons.

First, I know of no conclusive evidence that capital controls have corrected an economic crisis. To the contrary, such controls have negative economic consequences. Capital controls weaken investor confidence and can reduce inflows of foreign investment. Indeed, foreign direct investment in Malaysia fell after imposition of controls even though the controls did not apply to FDI.

Second, capital controls involve significant administrative costs. Governments that impose controls must administer them through strong regulation and enforcement because controls create circumvention incentives. Countries are often forced to pass new legislation to address the circumvention of capital controls. Maintaining capital flow restrictions is a difficult, expensive, and often futile task. For countries in the world that are already battling cronyism, the imposition of capital controls offers another avenue for rent-seeking behavior.

Third, capital controls artificially reduce the pressure for countries to institute needed economic reforms. Capital controls tend to forestall the execution of difficult reforms that are needed to build the foundation for economic growth and rising living standards.

Fourth, capital controls increase the risk to the domestic economy in a time of crisis. Capital controls prevent domestic investors from diversifying into international markets, with the consequence that any shock to the domestic economy is amplified. In addition, capital controls on inflows limit sources of credit and investment for domestic companies, which is particularly problematic in a period of crisis. If domestic credit markets dry up because of a shock, the inability of domestic industries to tap foreign investment flows will subject them to additional pressures resulting from the ensuing credit crunch.

Some proponents of capital controls argue that requiring governments not to interfere with capital movements is an infringement on national sovereignty. But ensuring free capital transfers

does not imply that host countries forfeit their sovereign right to pursue domestic economic policies. The host country continues to have the ability to pursue other adjustment mechanisms that are consistent with free transfers, such as monetary policy (which effects changes in international reserves, interest rates, and exchange rates) and fiscal policy.

Investment and Capital Transfer Provisions in the Chile and Singapore FTAs

In the negotiations of the Chile and Singapore FTAs, all sides agreed on the importance of free transfers and avoiding capital controls. The investment chapters of the Chile and Singapore FTAs provide for the free transfer of funds related to an investment into and out of each country. The flows covered by this provision include foreign direct investment, profits, dividends, the proceeds from the sale of an investment, and payments for loans or bonds issued in a foreign market.

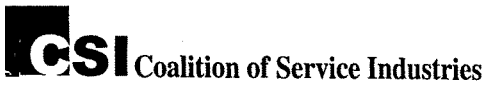
The Chile and Singapore FTAs contain a special dispute settlement mechanism that would apply in the event that Chile or Singapore takes measures to restrict the transfer of capital. Under this mechanism, U.S. investors cannot file claims for violations of the free transfers obligation for up to one year on certain capital flows, provided the restrictions do not "substantially impede transfers." If the restrictions are lifted within a year, the affected investor will not have recourse to dispute settlement on these restrictions. If the restrictions are in place for more than a year, the investor may take a claim to dispute settlement, and may seek damages caused by the controls after their first year in operation. Investors will have the burden to prove the existence and extent of damages caused by the controls. The cooling-off period for other issues before a claim may be taken to dispute resolution is six months.

These new provisions are found in an annex to the investment chapters of the FTAs. Whether these provisions are appropriate for other countries will be determined on a case-by-case basis.

The free transfer provisions of the Chile and Singapore FTAs meet an important Trade Promotion Authority (TPA) objective – "freeing the transfer of funds related to investments." These provisions provide U.S. investors with substantially strengthened transfer rights over those available under the IMF Articles of Agreement and the General Agreement on Trade in Services (GATS). These agreements, like most multilateral agreements, represent a floor for investor protection. Our position is to seek greater protection for U.S. investors than the IMF Articles of Agreement and the GATS afford. In addition, unlike those other agreements, the FTAs provide for effective investor-state arbitration provisions to enforce free transfer rights.

The approach undertaken in these FTAs is consistent with the shared economic philosophy and policy perspective of the United States, Chile, and Singapore. The inclusion of the free transfer provision in the Chile and Singapore FTAs with the United States sends a strong signal to the markets that all three countries support the free flow of capital and recognize its importance in the development of an economy. Without a doubt, these agreements represent a win-win situation for all involved countries.

I wish to thank the Subcommittee for this valuable opportunity to discuss the Administration's trade in financial services and international investment policies.



Statement of Robert Vastine
President, Coalition of Service Industries
Before the
Subcommittee on Domestic and International Monetary
Policy, Trade and Technology
Committee on Financial Services
House of Representatives
April 1, 2003

Financial Services Provisions of the US-Singapore
and US-Chile Free Trade Agreements

Mr. Chairman and members of the Subcommittee, it is a pleasure to present the views of financial services members of the Coalition of Service Industries on the provisions of the US-Singapore and US-Chile Free Trade Agreements relating to financial services.

The United States is very competitive in global financial services trade, even though many barriers to our international operations remain in a large number of key foreign markets.[1] US financial services firms have thus taken a strong interest in expanding their trade by removing barriers to cross-border trade, to investment, and to the movement of key business personnel.

Removing barriers to financial services trade, and indeed to all US services trade, is a very important US policy objective. The US has run a surplus in its cross border trade with the rest of the world for many years. Last year's surplus of $46 billion offset by 10% the chronic structural US deficit on trade in goods. But the services surplus could be much greater if, through multilateral and bilateral agreements, we were able to remove all barriers to our services exports. A much-cited study under the auspices of the University of Michigan estimated a welfare gain to the US of $450 billion each year were all barriers to our services trade to be removed.

Dual Paths to Liberalization

Since the Uruguay Round concluded in 1994, the US Government, and industry, have focused on removing services trade barriers through multilateral negotiations within the framework of the General Agreement on Trade in Services (GATS). The Uruguay Round mandated a further, separate negotiation on financial services. The first effort to secure this agreement failed in 1995 when the US determined that the draft agreement

[1] Detailed lists of specific barriers to US financial services companies' overseas operations are available from CSI on request.

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was not sufficiently liberalizing. A subsequent negotiation was concluded in 1997 with full support of the US financial services industry.

Also as mandated by the Uruguay Round, negotiations covering most traded services were begun in the WTO in 2000. After two years of work mainly on rules, the services talks were wrapped into the "Doha Development Round" of negotiations launched in November 2001, in Qatar.

The emphasis on multilateral negotiations in the WTO has given way to a dual approach. With the passage of trade promotion authority (TPA) last year the negotiation of the Singapore and Chile agreements kicked into high gear. The US Trade Representative, Ambassador Zoellick, completed these two FTAs. And this year USTR began talks with the Central America Free Trade Area (CAFTA), Morocco, the Southern African Customs Union (SACU), and Australia.

The drive to secure bilateral FTAs is a bipartisan policy. President Clinton initiated the US-Singapore Free Trade Agreement. And, because the Chileans had long sought an FTA, his Administration also launched negotiations with Chile. Both were expected to be negotiated quickly, but this was not to be the case. Neither agreement was really finished until two months ago, and both are still subject to "legal scrubbing" during the Congressional review process that began when the two FTAs were notified to Congress at the end of January.

This extended effort was necessary to complete complex agreements that would come as close as possible to meeting our goal of providing substantially free trade in financial services. It was very important to industry to get these Agreements right.

Chile and Singapore are not large markets. But our members knew that these Agreements would be very important as precedents for pacts with other countries. If we could "get it right" with Singapore and Chile it would be easier to negotiate good agreements with future partners. We therefore devoted substantial time to this effort.

Both agreements provide meaningful new advantages for US financial services companies and provide a valuable precedent for future FTAs.

US Commitment to the Multilateral WTO Negotiations

The move to secure FTAs has stirred critical comment abroad. The US determination to negotiate meaningful, liberalizing bilateral agreements is said to reflect a lack of commitment to the WTO and to the multilateral process.

As the tabling of a comprehensive US GATS offer yesterday demonstrates, this charge is not accurate. The US government and the services industry remain committed to the WTO as an institution and as a negotiating forum. We simply see - as does our government - that we can make progress bilaterally at a time when the WTO services

negotiations are being slowed by disputes about agriculture. Indeed we intend that our bilateral achievements will help motivate progress in the multilateral negotiations.

Further, we believe that these two FTAs can achieve greater economic and trade impact through replication in their regions. We hope equally strong agreements can be negotiated with members of ASEAN, and with members of the Andean Pact, a number of whom, like Colombia, have already expressed interest in an FTA—and with other countries.

Coverage of the Agreements

The two agreements cover barriers both to cross border trade, and to investment. They embrace strong commitments to transparency in regulation. In insurance they also take steps toward better quality regulation. They contain useful commitments to freedom of movement of key business personnel.

Cross-border trade refers to sales and consumption of services from one Party into the territory of the other.[2]

The US has consistently run a surplus in its cross border financial services trade with the rest of the world. This surplus amounted to $6.3 billion in 2001. We have positive cross border financial services trade balances with Singapore and Chile, as Chart I demonstrates.

Sales to foreigners by all affiliates of US services companies operating abroad are an even more important element of our services trade. These sales totaled $393 billion in 2000, of which financial services were $101.8 billion. In the same year, total affiliate sales were $5.4 billion in Singapore, and $3.1 billion in Chile, as shown in Chart II.[3] US foreign investment in services generates the need for extensive support, including substantial new jobs, in home offices in the US.

Many services must be sold from establishments in foreign markets, or not sold at all. Some forms of financial services can't be sold on a cross border basis. For example, life insurance policies can't be sold to Singaporeans from an office in Chicago or New York. To do so requires direct investment in operations in Singapore.[4]

This means that trade agreements must provide rights to establish businesses in foreign markets. Investors should be able to establish in whatever form best suits their business objectives, whether as a branch or subsidiary, whether wholly owned or majority owned. The Singapore and Chile FTAs provide these rights.

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[2] In the General Agreement on Trade in Services (GATS), this is "Mode One" of services supply.
[3] These statistics aggregate all sales to Singaporeans and Chileans by US affiliates. Breakdowns by sector are not available.
[4] In the GATS direct investment is known as commercial presence, or "Mode Three" of services supply.

Significant Provisions of the US-Singapore Agreement

Singapore commits to permit a wide range of cross border financial services offered by US financial institutions including for example financial information, financial data processing and software, leasing, corporate financial advisory services and trading in money market instruments and foreign exchange.

Singapore also commits to market access and full foreign ownership of financial institutions including insurance companies.

Banking:

With the exception of banking, the Singapore financial services market has been substantially an open market thanks to internal reforms. At the outset of the negotiations Singapore officials made clear that they wished to preserve a domestic Singapore banking industry and thus exclude foreign banks from certain lines of activity. This included maintaining a limit of 6 on foreign Qualified Full Banks (QFBs); a rigid limit on the number of customer service locations (including ATMs) a QFB could open, and a prohibition against foreign participation in locally owned ATM networks or debit services through electronic funds transfer at point of sale (EFTPOS) networks.

The Agreement modifies these restrictions for US banks. Limits on the number of QFBs will be lifted for US banks 18 months after entry into force. United States QFBs will be allowed to establish up to 30 customer service locations upon entry into force, and these limits will be removed altogether after two years. QFBs are permitted to link their proprietary ATM networks to facilitate the creation of a foreign bank network. United States QFBs organized as subsidiaries may participate in local ATM networks two and a half years after entry into force, and QFBs organized as branches may participate in such networks four years after entry into force. Singapore committed to consider applications for access to local bank ATM networks for non-bank issuers of charge and credit cards.

Singapore's limit on 20 new wholesale bank licenses will be removed for US banks 3 years after entry into force of the Agreement.

Asset Management:

The Agreement also provides important benefits for US asset management companies. US firms can compete for asset management mandates from the Government of Singapore Investment Corporation, which manages $100 billion in assets. Also, US firms that establish affiliates in Singapore will be able to use the resources of their US facilities to manage Singapore mutual funds on a cross border basis. Singapore has also liberalized onerous staffing requirements that operated as barriers to entry for US firms.

Insurance:

As noted above, the operating environment for US insurers in Singapore has been favorable because of its internal reforms. The Agreement locks these in, and Singapore liberalized further its regime to include all the types of cross border insurance that we sought. These provisions permit trade in reinsurance, auxiliary services including actuarial, adjustment, and consultancy services, MAT (marine, aviation and transportation) insurance, and brokerage services for reinsurance and MAT. The market access provisions as noted above permit US insurance companies to establish in Singapore without limits on number, and allow full ownership.

The Singapore Agreement contains an important benefit for US insurers. This is the provision permitting insurance companies to offer many products without requiring product filing and approval. In addition, the Agreement provides that when Singapore does require filing and approval, Singapore will allow the product to be introduced in commerce, unless it is disapproved within a reasonable time. This provision is sometimes known as a "deemer" provision, that is, a product is deemed to be approved unless denied. The US sought a similar provision in the Chile Agreement, but obtained a best efforts provision.

Significant Provisions of the US-Chile Agreement

The US-Chile Financial Services Chapter provides the same essential cross border and market access rights as the Singapore Agreement. Because Chile has substantially liberalized its financial services markets the Agreement locks in Chile's commitments to liberal trade in banking, securities, asset management, and insurance, and provides for freedom of transfers of financial information.

Chile commits, as does Singapore, to allow a wide range of cross border services in banking, securities, and insurance. Chile must change its laws to comply with its commitments for cross-border supply of insurance.

Asset Management:

The Financial Services Chapters of both Agreements state that the Agreements do not apply to social security systems or public retirement plans. Thus the US social security system is excluded from the scope of the Agreements. Furthermore the US has taken reservations in the Investment and Financial Services Chapters that give it the right to adopt any future measures applying to its social security system,

However, the Chile Agreement gives US firms the right by March 1, 2005, to compete equally with Chilean firms in managing the *voluntary* portion of Chile's national pension system. Also, US firms will be provided access to manage the *mandatory* portion of Chile's pension system without arbitrary differences in the treatment of US and domestic providers.

The Agreement also allows US mutual funds established in Chile to provide offshore portfolio management services to Chilean mutual funds on a cross border basis. This has been a central industry objective, and this commitment and the similar one contained in the Singapore agreement will be important precedents for future trade agreements.

Insurance:

For both the Chile and Singapore Agreements, industry sought to structure commitments for market access, investment, and regulatory best practices for insurance based on a framework referred to as the Model Insurance Schedule, which industry believes has been substantially accomplished in both Agreements.

The Chile Agreement assures cross border trade in certain insurance products as does the Singapore Agreement. However it does not provide an immediate right for insurance companies to branch, as does the Singapore Agreement. Instead, Chile allows branching within four years of entry into force, with the proviso that Chile may apply certain regulatory requirements to such branches. US insurers will surely follow closely Chile's implementation of this commitment.

The Chile Agreement repeats the provision in the Singapore Agreement that commits the Parties to "recognize the importance of...developing regulatory procedures to expedite the offering of insurance services by licensed suppliers."

Advantages Common to Both Agreements

New Financial Services:

The Agreements contain a presumption that Singaporean and Chilean regulators will use the flexibility allowed under their laws to permit the supply of new financial services in Singapore and Chile, provided they are already offered in the US. The two governments may determine the institutional form in which the new financial service may be supplied and impose other criteria. If a company wishes to offer a service that is new to both the US and the other countries, the Agreements assure the right of the company to seek approval to offer the service, consistent with the laws of the country in which it is to be offered. These provisions apply equally to the US.

Transparency:

The Financial Services Chapters of both Agreements contain very good transparency provisions. These provisions build on the general transparency provisions that apply generally throughout the Agreements, and to transparency provisions in their Services and Investment Chapters.

For financial services they require to the extent practicable the publication of regulations in advance, and provide opportunity to comment. Each Party should allow reasonable

time between publication of final regulations and their effective dates, and, at the time they adopt final regulations, governments should address in writing comments received.

In addition there are specific provisions regarding applications to provide financial services. Essentially these require regulatory authorities to: disclose all the documentation and other requirements for completing applications; inform applicants about the status of applications and any additional information required; make decisions on applications within 120 days where practicable; and promptly notify the applicant. The rules of self-regulatory organizations (SROs) are also to be made publicly available.

These provisions of the Agreements are consistent with US law and practice and thus require no changes in US law.

CSI is very encouraged by the transparency provisions of the Agreements, because we have been at the forefront in asking US negotiators to seek strong transparency provisions in the GATS negotiations. In 2000 we prepared and provided to USTR a "Framework for Transparency in Services," which helped inspire a US negotiating proposal on transparency tabled in Geneva in July 2001, and the US transparency request tabled last June 30.

The acceptance by Singapore and Chile of the types of transparency commitments that the US has set forth in the GATS should influence those negotiations. Many WTO Members question the value of transparent regulatory processes and doubt their own ability to apply them within the framework of their governmental institutions. These Agreements should provide substantial encouragement.

Temporary Entry:

One of the most important ways in which services are supplied is by the movement of people for temporary assignments abroad. These can be employees of a company needed for temporary assignment in a foreign operation of that company, or to service the foreign clients of that company. Or they can be experts contracted to solve clients' problems in any part of the world. These services are required in the financial services industry just as they are in professional services such as accounting or consultancy. But lengthy and complicated visa processes materially impede these transfers.

Both Singapore and Chile commit to allowing freer movement of US persons to supply financial and other services in their countries. Both will provide for multiple entries of business visitors, traders and investors, intracompany transferees, and professionals. For the first three categories of visitors, the only change required in US law will be for Congress to declare that the FTAs qualify under US law so that Singaporeans and Chileans may obtain treaty trader and treaty investor visas. For the last category, professionals, a new visa will need to be created.

The Agreements offer substantial advantages for the US. US financial services and other professionals can enter Singapore and Chile freely and without limit. Singapore and

Chile addressed US concerns by agreeing to strict numerical caps on the numbers of Singaporean and Chilean professionals that can enter the US: 5,400 for Singapore, and 1,400 for Chile. These caps cannot be increased. Singaporean and Chilean professionals seeking entry to the United States must comply with US labor and immigration laws. The US will require the completion of an attestation certifying compliance.

Freedom of Capital Transfers and Related Provisions:

In the organization of the major multinational institutions and agreements following on the Bretton Woods Conference in 1944, the motivating principle was to create an open world trade and payments system. The United States led this effort, in the belief that such a system would prevent a recurrence of the protectionist policies that led to world wide depression and World War II.

The principle of free capital transfers is embedded in the Bilateral Investment Treaties we have negotiated with 45 countries. Thus it is consistent and appropriate that the US should have sought, and secured, such provisions in the Singapore and Chile Agreements. On the other hand, these Agreements also provide that, should the Parties determine to impose capital controls, they must employ measures to compensate private investors. Other witnesses will have discussed these provisions in more detail. From the standpoint of foreign investors either in portfolio or in direct investments, however, restrictions on movement of funds can chill the investment climate. They may warn investors that a government may choose to impose regulatory solutions to try to cure instability, rather than adopt sound, market-based provisions that fundamentally determine the value of currencies and the stability of economies. In addition, the imposition of even short-term repatriation restrictions raises regulatory compliance issues for US mutual funds that may affect the willingness of US mutual funds to purchase securities in the country. Thus, insistence on the right to control capital flows will likely discourage investments that can contribute to the growth of capital markets.

The Negative List and Acquired Rights

It is one of the strengths of these Agreements that they were negotiated on the basis of the "negative list" approach. One of Ambassador Zoellick's first – and welcome – decisions related to services was to convert the Singapore Agreement from a positive to a negative list approach, and USTR has subsequently sought to base new FTAs on the negative list. Under this approach, also used in NAFTA, only those services *not* liberalized are reserved or excepted. This allows the negotiation to focus on narrowing the other Parties' reservations. By contrast the positive list approach used in GATS requires countries to list all the services that will be liberalized. This often leads countries to hold back offers, requiring other negotiators to laboriously extract concessions.

It can be considered a disadvantage of the negative list approach that existing rights, or acquired rights, are not specifically stated. In its reports to Congress on the Agreements, the Industry Sector Advisory Committee on Services, ISAC 13, asked that in order for

commercial interests to realize the full benefits of the rights provided by the Agreements, a definitive explanation of those rights should be provided as part of the legislative history of the Agreements.

Conclusion

We have learned in these negotiations that the United States is able to secure meaningful new commercial opportunities through bilateral free trade agreements. We have both secured bindings of liberalization taken by Singapore and Chile autonomously in years prior to the Agreements, and we have achieved new commitments to additional liberalization. This is because of the efforts of dedicated USTR and Treasury negotiators. They sought industry advice on the barriers that should be removed and other provisions, such as transparency, that should be obtained, and we are grateful for their efforts.

CSI members wholeheartedly believe that the Agreements, and their Financial Services Chapters, provide substantial, meaningful new commercial opportunities as indicated above, and we strongly recommend that the Agreements be approved by Congress.

US Trade in Private Financial Services with Singapore and Chile

CHART I
US Crossborder Trade in Private Unaffiliated Financial Services with Chile and Singapore, 2001

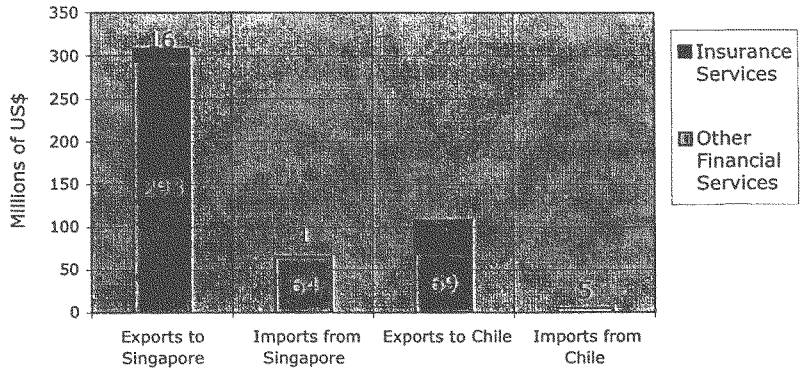
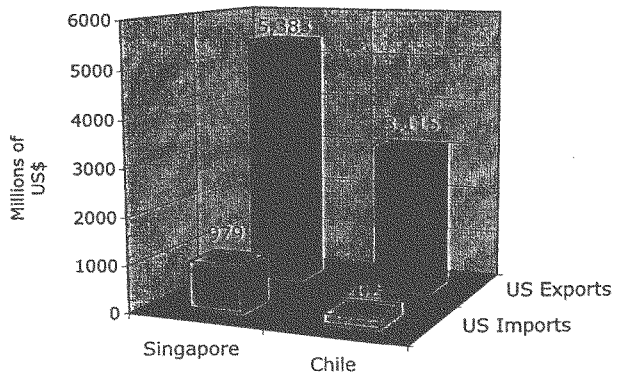


CHART II
US Sales of Foreign Affiliates in Singapore and Chile, 2000*



This chart shows sales of foreign non-bank affiliates of US firms to Singaporeans and Chileans in 2000, nd vice versa. Data on sales of bank affiliates in 2000 are not available. Data on trade through financial ervices affiliates in Singapore and Chile are unavailable.

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Statement Prepared for the April 1st, 2003 Hearing on The U.S.-Chile and U.S.-Singapore Free Trade Agreements

Subcommittee on Domestic and International Monetary Policy & Trade, House Committee on Financial Services

By

Nancy Birdsall
President, Center for Global Development

In December the Chileans finally succeeded in their long quest (more than ten years) for a free trade agreement with the United States. Chile's record of fiscal good sense, unilateral trade liberalization, democratic politics, and respect for human rights made it an obvious candidate for the Bush Administration's emerging strategy of negotiating bilateral agreements with favored countries of the developing world. With WTO-sponsored multilateral trade talks floundering, more developing countries are likely to want to get in on the kind of deal Chile made, with its enormous benefit of unusual access to the U.S. market.

But on one issue the outcome of the bilateral negotiation with Chile looks like a case of special interests in the U.S. trumping good sense. The U.S. pushed for and got agreement that reduces Chile's freedom to manage its own capital account. Chile long ago disavowed any controls on the ability of foreign investors or creditors to withdraw capital. After all, controls on outflows would discourage the inflows it seeks to boost its productive investment and its access to new technology and best management practice. But it has in place legal arrangements that permit its government, when and if the need arises, to "tax" inflows of capital. The idea is to throw sand in the wheels of hot money inflows during global booms -- a sensible tool for managing the effects of surges in inflows on the exchange rate, and for encouraging capital inflows associated with productive investment rather than financial speculation. With the decline in such inflows since the late 1990s, Chile has in fact kept that rate at 0 – but still retains the legislation to raise the rate should events make that sensible.

Nonetheless, the U.S. demanded and got an arrangement to "protect" U.S. firms from the unlikely danger that Chile would suddenly and surprisingly impose harmful capital controls. The U.S. "won" the right of firms to request damages

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should they suffer "substantial" losses due to restrictions on taking capital out, and restitution (only) should they suffer substantial losses associated with bringing capital in. Chile, standing to benefit greatly from the trade part of the trade agreement, and having no desire to send even a faint signal that it would ever restrict capital movements anyway, accepted this administrative solution. It managed to have the arrangement relegated from the investment section of the agreement to the dispute resolution section, where it is less visible and less flexible for potential complainants, and obtained a cooling off period (six months on outflows, one year on inflows).

The deal raises troubling issues for those in the U.S. anxious to support the Bush Administration's efforts to expand free trade arrangements globally. Most economists now agree that the global capital market is subject to booms and busts, and that emerging market economies are particularly vulnerable to the problems that hot money inflows and sudden panicked outflows of capital pose for financial and economic management in developing economies. That was one hard lesson of East Asia's experience, where heavy inflows and the resulting asset boom in the early 1990s contributed to the 1997-98 crisis and ended up threatening global financial stability. The IMF has made it clear that its emphasis of the early 1990s on opening of capital markets has been tempered by the hard lessons of that crisis. Even where financial markets are reasonably well developed (and Chile is one of the best of the emerging markets on this score), gradualism and limited intervention can make sense – including in the enlightened self-interest of U.S. investors. There is no religion, either from theory or from practice, that dictates that in this imperfect market, developing countries should give up flexibility and autonomy – at the very least to manage inflows.

It would be ironic if Chile, a country with a demonstrated track record of keeping its economy open, sets a precedent for U.S. bullying on this issue in other bilateral negotiations. The Administration's strategy of pursuing bilateral agreements to maintain momentum in the global struggle for free trade can make sense. But what if the Chile arrangement becomes the opening position of the U.S. in negotiations of the Free Trade Agreement of the Americas? And what effect will this deal have on the treatment of developing countries' capital account regimes in the multilateral trade round?

The pressure for bringing the capital control issue into a trade agreement purportedly came from the U.S. Treasury not from the U.S. Trade Representative. Whether due to Wall Street influence or free market fervor at Treasury, it's an unfortunate step. Let's hope that the new Treasury Secretary will be more businesslike and pragmatic on this issue, and free U.S. trade negotiators to stick to forging sensible trade agreements.

Nancy Birdsall is President of the Center for Global Development. She was Executive Vice-President of the Inter-American Development Bank, 1993-98.

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Professor Joseph E. Stiglitz
Finance and Economics

WHY RESTRICTIONS ON INTERNVENTIONS IN CAPITAL MARKETS SHOULD NOT BE INCLUDED IN AMERICAN FREE TRADE AGREEMENTS

Joseph E. Stiglitz
Professor of Economics and Finance, Columbia University

I am sorry that because of previous commitments, I cannot appear before you today. The importance of the subject of these hearings cannot be overestimated. There are implications for global economic stability and poverty reduction, and continuing progress in trade liberalization, as well as for broader relations with other countries around the world.

The provisions in the recent trade agreements with Chile and Singapore limiting government interventions in short term capital flows are a major source of concern. Everything should be done to eliminate them from the agreements, and to make sure that such provisions are not inserted into future trade agreements.

The purpose of trade agreements is to facilitate trade, and to eliminate trade barriers among countries. In principle, reducing such trade barriers can be of benefit to all

parties, as each country is enabled to take greater advantage of its comparative advantage. Shifting resources from low productivity protected sectors to high productivity export sectors enhances growth and incomes.

Problems are encountered, however, when trade agreements go beyond trade issues, as in this case, forcing countries to undertake measures which should be a matter of national sovereignty. Such provisions have earned trade agreements a reputation for undermining democracy, and I believe that sometimes these accusations are deserved.

It is of salient concern when the particular provision risks imposing considerable harm on the country. Much of the instability in global financial markets in recent years, especially in emerging markets, has been related to short term capital flows. Capital rushes into a country, and just as quickly rushes out, leaving havoc in its wake. The crises in East Asia were largely caused by premature capital market liberalization. Moreover, liberalizing fully short term capital flows inhibits the ability of a country to engage in countercyclical macro-economic policies, which helps explain why so many of the countries that have liberalized capital markets have exhibited so much volatility. This volatility is particularly hard on the poor, and indeed serves to create poverty. It is the low skilled workers who bear the brunt of the recessions and depressions.

While econometric studies have confirmed that capital market liberalization is systematically related to greater risk, and an enhanced likelihood of a crisis, there is little evidence that liberalization increases growth. It is a case of risk without reward. And this is to be expected, for several reasons. First, the risk itself is bad for investment. Crises force firms, especially small enterprises, into bankruptcy and destroys entrepreneurship—always scarce in developing countries. Foreign firms too find countries with greater stability more attractive for investing. Secondly, one cannot build factories or create employment using money that can leave overnight, and it is these *real* investments which gives rise to growth. Indeed, capital inflows often lead to exchange rate appreciation, which makes it more difficult for countries to export or to compete against imports. Thirdly, in today's world, there is increasing recognition that prudential

policies on the part of government require that they maintain reserves equal to the amounts that they hold in short term foreign denominated liabilities. Hence, when a firm within a poor developing country borrows short term abroad, it in effect forces the government to set aside a corresponding amount in reserves, typically held in U.S. dollar T-bills. In effect, the country is borrowing, say, $100 million from an American bank, paying say 18% interest, and at the same time lending precisely the same amount to the U.S., and receiving today less than 2% interest. The country as a whole loses on the entire transaction. The money the government put into reserves could have yielded far higher returns, say invested in education, roads, or health. It is no wonder then that so many countries have been so skeptical about capital account liberalization.

Chile, in its period of rapid economic growth, in the early 90s, imposed restrictions on the inflow of capital. I believe that such restrictions played an important role in its growth and stability. In particular, it meant that when global capital markets suddenly changed their attitudes towards emerging markets, and when capital started flowing out of them and the markets insisted on far higher interest rates, Chile was spared the pains inflicted on so many other countries (though of course it still faced problems caused by changing copper prices.) Such restrictions on capital inflows are of limited relevance in the current economic situation—with an overall dearth of capital flows to emerging markets—hopefully, at some time in the future, when capital flows are more abundant, Chile might find it in its own best interests to dampen these flows, to avoid the irrational exuberance that has afflicted so many countries. Whether Chile chooses to do so should be a matter of its own determination.

By the same token, the developing countries in Asia that have grown the fastest, done the most to eliminate poverty, and exhibited the greatest stability have all intervened actively in capital markets at critical stages in their development—and many continue to do so today. They have shown forcefully that one can attract huge amounts of foreign direct investment, without fully liberalizing markets to short term speculative flows.

Today, there is also growing recognition that in times of crises, it may be desirable to impose restrictions or taxes on capital outflows. Malaysia did so, and as a result, had a downturn that was shorter and shallower than many of its neighbors. Malaysia was able to emerge from the crisis with less of a legacy of government debt than the other countries who had not imposed such controls. Again, while economists may continue to debate about whether other countries should, in circumstances similar to those confronting Malaysia, chose to impose controls, and while they may also continue to discuss whether it is better to impose exit taxes or explicit controls, it is clear that this is a matter of such importance to each country that it should be left up to themselves to decide. Arguably, the United States pushed Korea towards premature capital market liberalization (when it was already in the process of formulating a gradual path of liberalization), and the crisis which it faced four years later was, in part, the consequence.

Let me be clear: while there are certain financial interests in the United States that might benefit from forcing countries to open up to these short term capital flows—and there are even some who have benefited from the resulting economic chaos, by buying assets at fire sale prices, only to resell them at great profits when economic calm has been restored—forcing countries to open up their markets to these short term capital flows is *not* in the interests of the United States. It is in our interests to have a more stable global economy. It is in the interests of our businesses that are investing abroad that there be greater economic stability in the countries in which they are investing. Yet economic research has identified short term capital market liberalization as the single most important factor contributing to the instability both in East Asia and Latin America.

Today, there is a growing consensus among economists *against* liberalizing capital markets for short term capital flows for most emerging countries. Even the IMF has recognized this. The extent and form of capital market liberalization is a matter which should be left for each country to decide, through democratic processes. We can encourage a full democratic debate on these issues, with a public discussion of experts from developed and developing countries debating the advantages and disadvantages, the risks and rewards, including alternative designs for interventions. But we should not be

using our economic power and the promise or hope of increased investment and exports, to impose the viewpoint of particular set of interests, or particular ideology, on our trading partners. Trade should be bringing us all closer together. Trade agreements with these kinds of provisions are likely to do just the opposite. This is especially the case if the kinds of patterns we have observed in recent years continue, with the short term capital flows contributing so much to instability, and with its accompaniment of insecurity and poverty.

The arguments for trade liberalization totally distinct from those for capital market liberalization. They share in common but one word, "liberalization." There is an emerging consensus among economists that emerging markets should be particularly wary about full capital account liberalization, exposing themselves to the vicissitudes of short term speculative capital flows. It makes little sense for our trade agreements to be pushing on our trading partners restrictions which fly in the face of sound economics.

The author was formerly Chairman of the Council of Economic Advisers (1995-1997) and Chief of the World Bank (1997 He won the Nobel Prize in Economic Science in 2001

Statement of the Investment Company Institute
Before the
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology
Committee on Financial Services
April 1, 2003

The Investment Company Institute is pleased to present its views on the Free Trade Agreements (FTAs) with Chile and Singapore, which have been submitted to Congress pursuant to the Trade Promotion Authority Act. The Investment Company Institute is the national association of the US investment company industry. Its membership includes 8,912 open-end investment companies ("mutual funds"), 554 closed-end investment companies, and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.254 trillion, accounting for approximately 95% of total industry assets, and over 90.2 million individual shareholders.

The FTAs with Chile and Singapore achieve many of the asset management industry's specific goals and contain significant benefits for the US asset management industry. Specifically, the agreements contain important market access commitments in asset management, eliminate several key regulatory impediments that prevent effective market access for US firms, and provide for greater transparency in the regulation of financial services. For these reasons, we urge the Subcommittee to support the passage of the FTAs.

The Institute's statement describes the strides the agreements make in assuring that US asset management firms receive effective market access in Chile and Singapore. Moreover, as described below, many of the achievements in these FTAs will serve as important precedents for other trade negotiations.

I. Specific Market Access Commitments in Asset Management

Chile

The market access commitments obtained from Chile represent a major step for the asset management industry. Chile made no commitments in asset management in the 1997 GATS Financial Services Agreement. The FTA would, for the first time, afford the necessary legal certainty to US firms to establish wholly-owned affiliates in Chile to provide asset management services on a national treatment and non-discrimination basis. Moreover, the agreement specifically would provide national treatment and most-favored nation status to US firms in managing the voluntary portion of Chile's national pension system and provide US firms with access to manage the mandatory portion of the pension system without arbitrary differences between the treatment of US and Chilean providers.

The agreement achieves another industry priority – it allows US firms to provide portfolio management services to mutual funds on a cross-border basis. This commitment, which is an important precedent for other trade negotiations, addresses a significant issue for US firms establishing affiliates in Chile. With the commitment, US firms will be permitted to use the services of an affiliate outside of Chile in managing Chilean mutual funds, allowing them to achieve economies of scale and use their global expertise in serving Chilean clients.

Singapore

Under the FTA with Singapore, US firms will be accorded most favored nation status when they compete for asset management mandates from the Government of Singapore Investment Corporation, a fund containing over $100 billion in assets.

The Singapore FTA also contains a commitment, similar to Chile's commitment, to allow the cross-border provision of portfolio management services by asset management firms to mutual funds. This commitment will permit US firms that establish affiliates in Singapore to use the services of their US affiliates in managing Singapore mutual funds, thereby allowing US firms to achieve economies of scale and bring their global expertise to the service of Singapore clients. Singapore also has agreed to liberalize minimum staffing rules that have operated as barriers to entry for US firms.

The specific commitments described above made by Chile and Singapore achieve most of the asset management industry's specific objectives for the negotiations. The United States, however, was not successful in obtaining commitments to liberalize quantitative limits on pension investments outside of the country. Countries that do not impose quantitative limits, but rather allow pension plans to be invested in accordance with the prudent person concept, generally experience higher returns on pension assets. Thus, quantitative investment restrictions are not in the interest of pension participants and we hope that US trade negotiators continue in future negotiations to seek liberalization from Chile, Singapore and other trading partners in this important area.

II. Regulatory Transparency

The specific financial service transparency commitments in the FTAs are of particular significance for highly regulated financial services firms, such as asset management companies. The commitments generally will require that rules not be adopted without appropriate notice and opportunity to comment, that requirements and documentation for applications be clear, that applicants be informed of the status of applications, and that decisions on applications be made in a specified or reasonable time. These commitments are important precedents for other trade negotiations.

III. Capital Controls

It is in the interest of the US asset management industry in serving its clients that trade agreements not reserve the right to impose repatriation restrictions or other types of capital controls. We are pleased that the Chile and Singapore FTAs provide for the

free flow of capital while setting forth the remedies available to industry if a country imposes controls. The provision that requires investors to wait for twelve months after the imposition of controls before submitting a claim, however, is troublesome for the mutual fund industry. The imposition of even short-term repatriation restrictions raises regulatory compliance issues for US mutual funds (which must maintain liquid portfolios and stand ready to redeem on a daily basis) that may affect the willingness of mutual funds to purchase securities in the country. We recognize that the capital control provisions in the FTAs represent a first step in addressing a contentious issue, and we hope the US will continue to pursue this issue in future trade negotiations to make further progress in ensuring the free flow of capital for portfolio investment by mutual funds and other investors.

IV. Conclusion

The FTAs with Chile and Singapore achieve many of the industry's most important objectives and represent significant strides in opening up markets for the US asset management industry. In particular, the commitments on regulatory transparency and on the cross-border provision of portfolio management to mutual funds set extremely important precedents for negotiations for other free trade agreements and in the WTO. We believe that the agreements are beneficial to the US and to Chile and Singapore. We urge the Subcommittee to support the passage of the FTAs.

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