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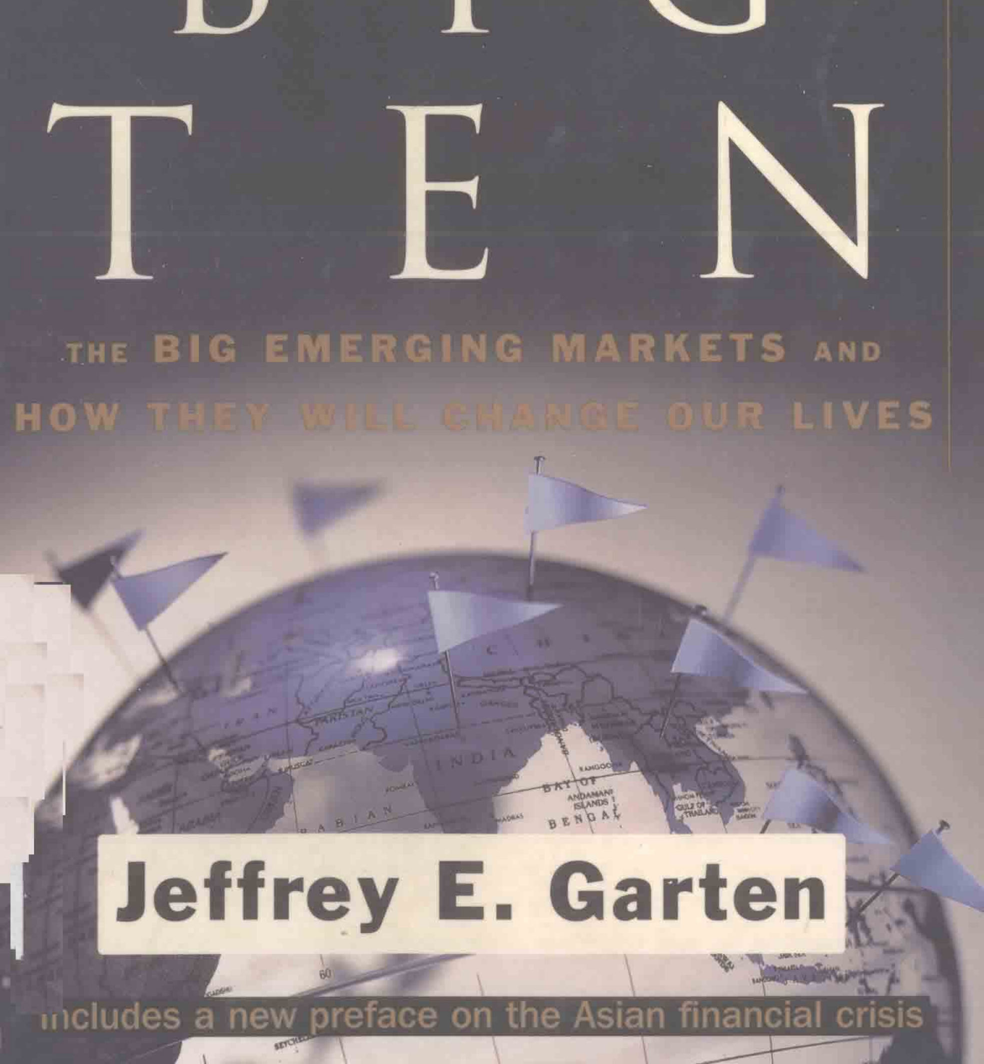
THE BIG TEN

THE BIG EMERGING MARKETS AND HOW THEY WILL CHANGE OUR LIVES



Jeffrey E. Garten

Includes a new preface on the Asian financial crisis

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THE BIG TEN

ALSO BY JEFFREY E. GARTEN

A Cold Peace:
America, Japan, Germany, and the Struggle for Supremacy

For Ina

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Preface

THE MOST IMPORTANT foreign policy question facing the United States at the end of the twentieth century is not how we will deal with Bosnia, Russia, or the Middle East, but how we will approach the rapid expansion of world trade and investment—the phenomenon of "globalization." In the increasingly interconnected world economy, how can this country grow faster to create better jobs, stronger communities, and wider opportunities for its citizens? How can we prevent crises abroad from undercutting our well-being at home? How can we use global commerce to build effective ties to other countries so we can have more influence over the control of nuclear weapons, improvement of human rights, and protection of the environment? These are some of the key issues that will determine what kind of nation we will be, and how we as citizens will fare in the coming decades.

I wrote *The Big Ten* to provide a framework for looking at the future of the United States in the global arena. My basic premise is that when we think of the greatest opportunities and the greatest risks in the world economy, a small group of countries hold pivotal positions. I call them the "big emerging markets," or "BEMs." They number ten: in this hemisphere, Mexico, Brazil, and Argentina; in Africa, South Africa; in Central Europe, Poland and Turkey; in Asia, I have identified four— India, South Korea, the Chinese Economic Area (which includes China and Taiwan), and Indonesia (together with its close trading neighbors such as Thailand, Malaysia, and

Singapore, all of which comprise the Association of South East Asian Nations, or "ASEAN").

The BEMs have become important to America for several reasons. They are crucial players in the world economy. They are gaining political influence, in global institutions like the World Trade Organization, and on international issues like the protection of the environment. They are crucial participants in stemming the spread of nuclear weapons and in maintaining peace in areas like the border between North and South Korea, the straits between China and Taiwan, and the India-Pakistan border. They hold the key to improving human rights and labor standards around the globe. American exports of goods and services have been growing in the BEMs much faster than in industrial nations—9.1 percent vs. 5.2 percent in 1996, for example. In 1996, moreover, total U.S. exports of goods to the BEMs were valued at $198.1 million vs. $195.0 million to the European Union and Japan combined. A growing proportion of America's capital is gravitating toward these markets, not just for short-term returns but also for retirement income. Most Fortune 100 firms have targeted the BEMs as critical markets for their future growth.

The Crisis in Asia

When *The Big Ten* was first published, in late spring of 1997, a friend in the investment business said to me, "It's about time someone wrote about emerging markets. I can't wait to read about the up-and-coming industries of the new information age."

"Sorry," I said, "I wrote about a different set of emerging markets—the Chinas, the Brazils, the Indias."

"Oh," he replied, "What's the big deal about them?"

I doubt I'd get the same question now. In the last several months, the BEMs have dominated the news as a full-fledged financial crisis erupted in the emerging markets of Asia, sending shock waves throughout the world economy. Today far fewer people will ask why we should be concerned about these countries. As nations from South Korea to Indonesia enter a period of rapidly diminishing growth, as their prospects affect the health of our own companies and our economy, as economic turmoil mixes with political tension from rising unemployment and multiple bankruptcies, it becomes much clearer how intertwined we are with these countries.

The calamity in Asia exemplifies the risks and the opportunities inherent in the emergence of the big ten onto the world stage. In retrospect it is clear that many of these Asian emerging markets were not well equipped to manage the phenomenal growth that swept over them. While they may have competitive manufacturing industries, their banking systems were not sophisticated enough to operate in a world where massive amounts of capital can move in and out of countries with lightning speed. In many cases, national governments were directing their banks to lend without proper credit analysis, thereby bankrolling shaky projects. Banks were also hiding bad loans by failing to disclose their operations to the public. Politicians used banks for their own pet projects, many of which were not economically viable. Even many Asian private companies did not know how to borrow prudently in global markets, failing to appreciate the risks and to hedge against them.

To be sure, a lot of what happened to Asia was not just the fault of the governments and companies in the region. First, low interest rates in the United States, Europe, and particularly Japan created "easy money" around the world, tempting even the most conservative businesses to overborrow. Second, many Asian currencies were tied to the U.S. dollar. As a result, the value of the Indonesian rupiah or the Korean won increased in tandem with the American greenback. At the same time, however, the Chinese currency, the yuan, was devalued, and the Japanese yen plummeted. These two forces, moving in opposite directions, created a scissorlike effect which made the export products of most of the Asian emerging markets increasingly uncompetitive compared to China and Japan. International lenders and investors became worried that easy money had led to reckless lending, and that the Asian export engine was damaged. They looked closer and found a host of other problems, too.

Thailand, Indonesia, Malaysia, and South Korea were forced to swallow bitter pills as foreign lenders and investors halted their activities. They had little choice but to raise interest rates to sky-high levels—often over 40 percent—to keep more money from flowing out. They were compelled to stop major projects in mid-stream. They watched their currencies and stock markets plummet. Unable to obtain foreign money to repay their foreign debts, they had to turn to the International Monetary Fund for loans. (As of the end of 1997, Malaysia was the exception, but it followed IMF-type advice.) But such help came with severe conditions: These countries' financial systems would have to be restructured. They would have to be better supervised and disclose all operations to the public, and the tight links between top politicians and top bankers could no longer be permitted to guide lending and investing. To Americans, these reforms may sound logical and not even very dramatic. But they amounted to a drastic change in the close-knit political cultures of Asia, where national economies have generally been run by a small number of officials and business leaders without even the participation of legislatures, let alone the public.

Asia, the Global Economy, and the United States

The crisis brought home how interconnected the global economy is and how large a role the BEMs can play. Americans became vaguely aware of how BEMs might affect us during the 1995 Mexican crisis, because it occurred on our border, raising fears of a slowdown in American exports and an increase in illegal immigration. But we were surprised to see the impact South Korea was having around the world. As the crisis unfolded, for example, Korean firms like Samsung and Daewoo interrupted important projects in countries as far away as France and Brazil. Korean investors dumped substantial holdings of Latin American and Russian bonds, causing serious problems in those markets. Hundreds of small firms in California, headed up by immigrants from South Korea and geared to selling to their homeland, discovered that a large number of Korean importers couldn't pay for goods for which they had contracted. In addition, lenders and investors who had extolled the advantages of emerging markets began to pull back their funds in all of them. Brazil was particularly hard hit, as was India. The crisis in Asia's emerging markets also dealt a blow to Japanese companies and banks, which were deeply involved in the region, putting added pressure on Japan's sluggish domestic economy and causing reverberations throughout the world. Indeed, the full ramifications of a contraction of lending and investing in emerging markets, with the implication for global economic growth and trade, not to mention the continuation of economic reforms in countries now under additional economic and financial pressure, have yet to be fully understood as I write this.

No one can predict the precise course of the Asian emerging markets. But the political and human pain of restructuring these economies is likely to be severe and last for a few years. Certainly there will be dramatically slower growth through the end of this century. There will be more unemployment and more bankruptcies in countries that have experienced very little of either in many decades. Many American and other foreign companies will see their sales slow, too, and this will undermine their profitability and economic growth in their home countries. The United States will see its imports soar as Asian products, made cheaper by devalued currencies, flood our market. The American trade deficit will no doubt become a big political problem over the next few years. At the beginning of 1998, the International Monetary Fund, whose projections are generally too optimistic, predicted that the Asian crisis would result in almost a 1 percent decline in global growth. Moreover, it predicted a dramatic shift in global trading patterns, with Asia importing much less and exporting much more than in the past few years.

Nothing is simple in the global economy these days, and for the

United States the news is by no means all bad. Competition from Asia will help hold down prices and interest rates in America. Turmoil in Asia will also cause funds from abroad to seek safe and profitable havens elsewhere, particularly in U.S. dollars and U.S. Treasury securities and perhaps also in stocks of American companies. All this could prolong the seven-year U.S. business expansion through the end of the century.

The Asian Comeback

We are seeing the first act in the emergence of fully developed Asian markets. It will surely be a painful transition, possibly characterized by political turmoil as overburdened governments confront difficult economic and social choices, widespread labor unrest, and a growth of anti-Americanism as Washington becomes a convenient whipping boy for the free-market reforms that Asia will be forced to undertake. But it is a region, after all, with very strong fundamentals: energetic populations, high savings, high investment rates, savvy businesspeople, increasing emphasis on education. At some point, economies will have stabilized, and currencies and stock markets will have found a steady level. When this happens, money will begin to flow into the BEMs again. The Asian emerging markets will then be supercompetitive, because their low exchange rates will make their products very inexpensive in world markets. Their financial systems will have become more open and better supervised and, therefore, more effective. The crisis will have been no more than a two or three year detour on the road to the Pacific Century. East Asia will still hold enormous commercial opportunities for American companies. And trade and financial ties between the United States and the region will still be the pivotal factor in our relationships, although Washington will need increasing skill to deal effectively with countries under constant and severe pressure to cope with excruciating economic and political problems.

The Fate of American Firms

For American firms, the Asian crisis will cut several ways. Many will see their sales slow because of declining Asian economic growth and the devastation in local economies caused by widespread bankruptcies. Many of the large infrastructure projects in which American energy and telecommunications firms were so heavily involved are sure to be curtailed or postponed. Big-ticket items like aircraft or the expansion of automobile production may also be adversely affected. Competition with European and Japanese firms is sure to intensify because there will be fewer good deals to go around, and everyone will be trying to justify the sunk costs of previous years.

For many U.S. companies—particularly those that produce goods in Asia for export to Europe or America—the prospects will be much brighter. Lower exchange rates in the Asian region will mean that raw materials and labor will be much cheaper in dollar terms, giving American (and other foreign) firms a new competitive edge. As *The Big Ten* says, however, low wage rates abroad are already seen as a big political problem in the U.S. Congress, and we can expect our politicians to look even more carefully at labor rates abroad. This will be especially true if it appears that more companies are moving production from America to Asia to take advantage of low wage rates.

IMF pressure will force many Asian countries to dismantle many of their protectionist barriers as a quid pro quo for new loans or debt restructuring. For the first time, American companies will have the chance to buy Korean firms, and American investors will be able to take big positions in the Korean stock market. Similar opportunities will occur all the way down to Indonesia. Americans will get a bigger foothold in Asia, drawing the United States and the region even more closely together than before.

Other Recent Developments in the BEMs

The Asian crisis is not the only important development since *The Big Ten* was written. Several other events illustrated the critical importance of these countries and markets to America's broader interests around the world.

For several years Washington has been trying to negotiate a global agreement to open foreign markets to our banks, insurance companies, and securities firms. The agreement could never be concluded because of the refusal of several BEMs to sign. In December 1997, the treaty was finally wrapped up as Brazil and Indonesia, among others, made far-reaching concessions.

In the same month the United States and over a hundred other countries met in Kyoto, Japan to negotiate a treaty on global warming. Much progress was made, but Washington will not sign the agreement until two BEMs, China and India, agree to participate.

Two other important accords were signed in 1997, both aimed at the BEMs and other emerging markets. The Paris-based Organization for Economic Cooperation and Development, composed of thirty-four "advanced" countries, signed a treaty outlawing the participation of their members in any bribery abroad. In addition, apparel companies like Nike and Reebok signed a voluntary code of conduct regarding the employment practices in developing countries.

What all this shows is the emerging markets have moved to center stage in terms of the global issues so critical to American interests as a new century dawns.

In the last several months, a host of important developments regarding individual BEMs occurred, too.

The Big Ten underlines the importance and the fragility of true democratic transitions in the BEMs. Nineteen ninety-seven was a banner year. For the first time in over fifty years, Mexico elected a parliament in which the opposition parties had a majority. Turkey replaced its Islamic government with one decidedly more secular. South Africa entered the post-Mandela era as the revered Nelson

Mandela declared himself an honorary head-of-state and passed the baton to his deputy. Poland elected a new government pledged to free market reforms, and prepared to enter the European Union. And South Korea elected a longtime dissident as president. All of this proceeded peacefully and orderly.

Despite the gloom of the Asian financial crisis, there was good economic news, too. Mexico surprised everyone by rebounding so strongly from its economic crisis of two years before. Brazil accelerated its economic reforms, using the Asian crisis as a reason to move even faster to open its economy, narrow its budget deficits, and privatize its companies. Argentina achieved some of its strongest growth in decades. Poland continued its upward economic trajectory. China absorbed Hong Kong peacefully and declared its strong intention to accelerate important economic reforms, particularly the slimming down of its bloated state enterprises.

Not all the news was so encouraging. India's government fell again, and prospects loomed for continued weak coalitions and slower economic reforms. South Africa, despite political progress, had yet to figure out how to spread the benefits of economic progress to the 30–40 percent of the population that is unemployed and illiterate. Turkey was decisively rejected as a candidate to join the European Union, a move that could radicalize politics in a country of enormous strategic significance to the U.S. and the West. And little progress was made on one of the most important trade issues before Washington and Beijing—China's entry into the World Trade Organization.

America's Record

The essential point of *The Big Ten* was that the United States should recognize the importance of the BEMs and deal with the opportunities and the risks. How have we been doing? The record is mixed.

To his great credit, President Clinton spent a good part of the sec-