THE FORUM REPORTS

A series of discussions on vital issues concerning the Bay Area

Volume One *Number One*

Global Financial Turmoil:

Implications for the Bay Area

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Panel Discussion

Stanford University
October 7, 1998

Global Financial Turmoil Implications for the Bay Area

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Industry Perspective	Mr. Richard Kashnow Chairman, CEO & President Raychem Corporation
Comments by	Mr. Samuel H. Armacost Chairman of the Board SRI International
Closing Remarks	Dr. R. Sean Randolph President Bay Area Economic Forum

Gerhard Casper

I thank all of our panelists for coming. I am Gerhard Casper, the President of Stanford, and I am not a panelist. I would like, however, since I am a constitutional lawyer, to make a couple of points about the institutions that we may not be taking sufficiently into consideration. One, is the fact that clearly the American government goes into the next phase of this turmoil greatly weakened and the country seems, in its usual parochialism, quite willing to put up with that. The other big institutional change that is coming, and that nobody seems to be discussing in the United States, is the fact that as of January 1, Europe will go to a common currency. In fact, a common currency is already in place for most of Europe. That the Euro will have an impact, I think, is without question. That is, it will create tensions for the governments and institutions in Europe and it will eventually create tensions, I think, for us and our role (especially, in case the Euro, contrary to what Milton Friedman thinks works well.)

John Taylor

I want to set the tone of the discussion by listing some points that I think are important to discuss. In thinking about the current situation and all the trauma, it is good to start with a little background about what has been happening over the longer-term in the United States economy, which is of course, the largest in the world. I always emphasize to people that we've had a remarkable period, not just this current expansion but the last two expansions in America, which are the first and second longest in peacetime. The one we are in now is actually the second longest peacetime expansion and if it goes much longer, which I think it will, it will become the first longest by the end of the year. [The first longest now is the 1980's expansion and back-to-back with the 1990's expansion it has been quite remarkable.] This has also been a period of low inflation, which I think is one of the reasons why we have been able to maintain this very long period of steady growth. The recession we had in 1990 and 1991 by national standards was very small and mild. I know by West Coast standards it was a big one, but nationally it was quite small. The other thing to keep in mind in terms of the longer-term is that if we are moving into a recession at this point, it's the first one, in my studies or memory of the last 100 years, where it has not been preceded by some run-up in some inflation. That is why, I think, there are still very few economists actually forecasting a recession.

There are several reasons why people have lowered their estimates for growth for the rest of 1998 and into 1999. The Asian crisis has cut into net exports. Japan's situation has gotten worse recently, although the Japanese economy has been performing abysmally through this whole expansion of the 90's in the U.S., so poor Japanese performance is nothing new for our economy. We've resisted this quite well, but this recent period is even worse for Japan and that certainly could add to our problems. The mechanism, of course, is the lowering of demand for our net exports, which means we are selling less abroad on a net basis. Also, the exchange rate appreciation increases the demand for imports from those countries so the export base declines, causing the economy to slow down.

Another factor that people are worried about is that the savings rate, the amount of income people have left over after they have consumed, has been very low in the United States, especially in the last year. It is hard for it to go much lower. And that suggests there's got to be a slowdown in consumption growth. We've just been consuming an awful lot. That coupled with the fact that the stock market of course has interrupted its boom. One would think that the lowering of wealth would reduce consumption, so the stock market decline is another reason why people's demand for goods will decline. One thing I always emphasize, however, is that you can easily overdo the effect of the stock market on consumption. There's actually a fairly small effect on consumption of movements in the stock market, enough to slow down the economy by a percentage point so far, but certainly not enough to cause a recession.

Another thing that people are concerned about is the so-called downward sloping yield curve. Although the Federal Reserve has been working on that a little bit by lowering the rates on the short end, the long bond yield keeps going down and so the yield curve is about as steep as it has been. A downward sloping yield has always been a sign of recession in the past. Long bonds (30-year bonds) are below 5% right now, even lower than short rates. One thing that is weird about all this is that the high-risk securities have gone the other direction so the risk premium, the risk between governments and corporate or junk bonds, has widened tremendously. In fact, that has been the source of the problems of Long Term Capital Management. It is very unusual to go in this direction.

Another factor is that we still see few visible signs of inflation, and it is quite surprising. Money growth is still very strong. Milton Friedman has been saying the economy is going to boom, and we're going to have inflation because money growth is so strong. People have worried about that, but so far nothing. The unemployment rate is still very low (4.6%). It is a very strong economy. Among the factors that could explain low inflation is that the dollar has appreciated and we've had global commodity price deflation, which has held prices down in the United States.

The other economy I would mention briefly is Japan. Japanese monetary policy has eased slightly recently. In my view, the main problem with Japan in most of the 90's has been a very poor monetary policy. I think they have been too restrictive. Now interest rates are so low that people are saying, "How can they go any lower?" That is so-called "zero bound constraint." Zero is the lowest interest rate. But I believe there's still room for monetary policy to be a lot easier in Japan. It is basically just a matter of printing money, to be simple about it. Forget the interest rate, just print money. That will stimulate the economy, and I think that is essential. Banking and restructuring are difficult political issues that are going to be necessary long-term. Things still look bad for Japan and it seems to me the only way out for Japan now is for a substantial easing of monetary policy.

Europe is about to engage in the experiment of a single currency. The UK is not part of that right now, nor is Sweden. What this means is quite remarkable. It means that in January there is going to be a group of people, much like the Federal Open Market Committee, who are going to meet in Frankfurt and are going to decide on the interest rate for all of Europe. It's not really a single

currency yet because there is no paper money Euro circulating, but there are Euro denominated securities which this bank, the European Central Bank, will be buying and selling in order to move European interest rates around. I do think it creates some risk that is going to be added to all the other risks we have in the world economy. I have given advice to the E.C.B. on how they should set interest rates. No matter how skeptical you are about a single currency or how hopeful you are, you really want to make sure they do the best they can. I say they should do something close to what the Federal Reserve does. Europe is going to be about the same size as America. Why not do the same thing?

Finally, I would list the globalization issues, or capital market flow issues, which have been discussed tremendously. President Clinton's proposals recently, whether they amount to much or not, really have to do with these capital flows, capital flows going into Asia and then coming out very rapidly. As an economist, I always remind people to put these capital flows in some perspective. We have had capital flows for a long time in the world. In fact, capital flows were larger 100 years ago than they are now. One example is when the U.S. ran huge current account deficits, huge deficits with respect to trade with other countries in the last part of the 19th century. A lot of that capital went to build the railroads across America. Being from Stanford, I always say the reason we're here is because the British lent America all this money to build railroads helping Leland Stanford get the resources to found Stanford University. So flows were large then too, and they were very useful. That's why we were able to expand the way we could in America, and the same is true in Argentina, Australia, and other countries. So it is not unusual to have large capital flows and it is healthy to have them. That's where growth comes from. That's where the extra capital comes from for expansion.

But they have caused problems now and there are going to be some policy changes. Hong Kong and Malaysia are investigating capital controls. There are big questions of what kind of exchange rate system we should have. The Wall Street Journal wants to have fixed exchange rates. I look at the situation differently. Flexible exchange rates work better. You can't find one country that's had an international liquidity or banking crisis that had a flexible exchange rate system. But capital controls definitely look like they are coming. People also want to make the I.M.F. even more aggressive or active. I personally think that could be more harmful than helpful at this point.

The last point I would make, and perhaps the most important for people in business, is that it seems to me that in times like this it is good to think about opportunities. If we keep that in mind, we will come out of this current financial crisis much better than we otherwise would.

Chang-Lin Tien

I am not an economist, but have been drawn into this Asian financial turmoil mainly because of my ethnicity and my many professional activities in Asia. With the deepening Asian crisis, I have been involved more and more as an advisor in many of the regions and countries, so I will speak mainly with an Asian focus.

First, when we talk about Asia, we always regard it as a single, large entity; this perception can be very wrong. Of course there are many commonalties among Asian countries: for instance, very inexpensive labor resources, a very huge potential retail market because of the large population base, and transactions that are more relationship-based. But there are also differentiating characteristics, tremendous incongruities in Asia. Roughly, we can divide Asia into four sub-regions: One is in North East Asia (Japan, Korea), representing the more developed economies. Then you have regions of Chinese language and culture like China, Taiwan, Hong Kong, and Singapore. A third group—Indonesia, Malaysia,—is multi-cultural, with many religions, much diversity, and is not very well developed. Their problem is primarily political stability. Indonesia will have two elections next year and that could change everything. Malaysia right now has a political battle between Mahathir and his former successor designate, Anwar. And so they have tremendous instabilities over there. Finally, we have South Asia (India, Pakistan), but their problems at the moment are more, from the world scene, nuclear proliferation issues.

With that perspective in mind, I see two major issues affecting the Asian financial crisis. One is Japan: My Chair Professorship was donated by NEC, and when I go to Japan several times a year, (also to visit many universities and other big corporations), the amazing thing is that when I say, "You have got to change," they always say, "We have changed so much, its unbearable. We are near collapse and what more do you want us to do?" From our point of view, they haven't changed fast enough. I think that this inertia will be a major problem. It is not that they don't want to change. It is a social, cultural issue there, which makes change very hard and does not speak very well for Japan's quick recovery. China is another uncertainty. In many ways they are doing quite well, and still growing very rapidly, but there are always undercurrents of instability. When you change too fast, in their case, you may encounter tremendous unemployment, social unrest and so on. Due to those uncertainty factors, it is very hard to say when Asia can come back on a more clear-cut recovery path. I think it will take two to three years and depend mainly on Japan and, to a lesser degree, on China.

But I want to end on a very positive note. I think the long-term pros-

pect still is very good, if you can see the potential market, the labor, human resources and many other things. Asia, in the long-term can be very important, especially from the Bay Area viewpoint. Sometimes we don't realize how the Bay Area is connected to Asia, not by export and import, but by many other issues. The City of San Francisco has more than 30% Asians, mostly Chinese, and professionals in the Silicon Valley are 30% Asian: scientists, engineers, and venture capitalists. Most of them are new immigrants that sometimes we call bi-coastal: bi-coastal of the Pacific Ocean, commuters who will have a tremendous impact on the Bay Area in the future. So I remain very optimistic for the long-term, but in the short-term, I think we will have some tough adjustments in the next two to three years.

Bruce Magid

Thank you very much. My background is both as an economist and as a businessperson, so I am going to be presenting a mix of both optimism and pessimism. I think it is clear to say, that Latin America is a growing and important source of export sales for Bay Area and Silicon Valley companies. Yet, [to the outside observer] the region's economic vitality seems to have vaporized almost overnight. But let me outline why I believe this dramatic drop is a passing event, and why in fact I believe the Latin American region will bounce back more quickly than other emerging markets. Most observers believed that Latin America would sidestep the global Asian flu. Yet Latin America's successful integration into the global economy over the past ten years doomed, if you will, the region to be exposed to this global financial contagion. Five fundamental forces have simultaneously converged on the region. First: the access the region had to plentiful and inexpensive credit in the global bond and syndicated lending market was cut off. Second: short-term capital began to flow out of the region as hedge and mutual funds began liquidating their positions in all emerging markets and nervous local investors and savers pulled money out. Third: foreign investors began to back away from bidding on privatization opportunities and began to slow down and in some cases suspend new investments and expansion plans. Fourth: world prices for the regions major commodities weakened, and in some cases collapsed. Copper, coffee and finally Latin America's manufactured exports began to lose market share to less expensive Asian goods and, Asia as a destination for their exports dried up entirely. The reaction of government officials in general has been to defend their exchange rates. They saw what happened in Asia, and with the notable exception of Colombia and Ecuador, which devalued their currencies by 10%, the overall effort has been to fortify or resist the temptation of maxi devaluations. The policy response instead was to raise local interest rates, begin to cut back on public spending, scrutinize the local banking system, increase the capital base of local banks and more tightly scrutinize lending practices. So the combination of global financial turmoil and tightening monetary and fiscal policy has basically put a slamming of the brakes on the regional growth rate. The region, which was projected to grow at 3.5 - 4% for this year now will experience growth of around 2%, a cut of almost half. It is still a growing, but a far less dynamic market than it was projected to be.

The region is not homogenous. Its countries are different, even in terms of growth. If I look out at next year, Argentina, Chile, Mexico and Peru, will still achieve relatively strong growth in 1999. However, the general impact of a switch from strong growth to slow growth has to have an impact on Bay Area firms operating or selling to the region. In the short-term, I think during the rest of 1998 and 1999 Bay Area firms dealing with Latin America will experience the following difficulties: 1) a decline in exports; 2) a reduction in sales and profits in the region; 3) heightened credit risk; 4) an increased exposure to devaluation risks or capital controls; and finally, 5) financially weakened local partners.

However, I do not expect the entire region to sink into a long protracted recession. Actually it is the opposite. I believe that growth will remain positive in 1999 and be about 2%, rebounding in the year 2000. The reason is because of expected international support. International support will be the pivotal factor for Latin America to escape a regional recession. The G7 Countries and the IMF and World Bank are now viewing Brazil as the key country in which to contain contagion in Latin America and perhaps in the rest of the world. Just this past week, President Cardoso of Brazil won re-election. He becomes the first democratically elected president to finish his term in that country since 1926. And thanks to a bill passed in 1997, the first to have a second term. So there is clearly international support to encourage the political process in Brazil.

Q. And he promised higher taxes in his campaign?

Yes, he did promise high taxes and still received 51% of the vote. There will be a bit of political play, however, and he is waiting for major state elections to take place. He wants his party's candidates to win in the major cities of Brazil, and shortly thereafter a very strict program of reducing spending and increasing revenue enhancement measures will be put in place. In exchange, multilateral agencies, EXIM Bank, private banks, and probably local investors will come in with support ranging anywhere from 30-50 billion dollars. In the case of Brazil, they have been experiencing a hemorrhaging of international reserves, and have lost over 20 billion dollars in the last month. Now their reserves stand at about 45 billion dollars. Yet they say that

they do not want to have a maxi devaluation, and expectations are that with this level of financial support they'll be able to avoid it and maintain their managed, gradual depreciation of the currency. I would expect that the Brazilian package will be announced as part of a broader support mechanism for the entire region.

Based on coordinated financial support for the region, I believe that Latin America's strong economic growth of the past few years will be resumed within two years. So I am looking at a two-year adjustment process. My premise, in fact, is that over the next two years there will be immediate and very rewarding opportunities for Bay Area firms looking south toward Latin America. Indeed, I would say now is the time to look at making acquisitions in the region. Asset prices for viable companies have plunged below book in many countries. I would also say that now is the time to negotiate favorable terms with local joint ventures and seek EXIM Bank support and other kinds of political risk insurance to grow rather than shrink market share. In short, I believe that the international community will believe that Latin America is an important battlefield in the global financial war and that Latin America is now viewed in Washington as too close and too integrated with the United States economy to fail.

Robert T. Parry

I'm going to talk about some of the effects on the U.S. and Bay Area economy of global developments. I would note that John's interpretation of the recent good economic times we've had, and especially his emphasis on the importance of low inflation definitely qualifies him in my mind as an honorary central banker. The other point I'd like to comment on is the European Central Bank, because I think there is a good chance that this development could turn out to be one of the most significant political events since the end of World War II. One thing to keep in mind is that when nations or states get together and decide to pursue a common monetary policy, they are saying, in effect, that they are going to share the same economic objectives. That's extraordinary! In the United States, we have a state like Arizona, which has done very, very well and a state like Hawaii, which is number 50 in terms of economic performance. Obviously, if they could, these states would prefer to have different monetary policies. But they have agreed to be controlled by the same monetary policy, goals, and objectives as all the other states. That is what is happening in Europe, and it will be fascinating to see how the nations adapt to this new system.

Let me talk a little bit about the effects on the U.S. of recent global developments. I want to talk about the same two channels that John did: the effects through trade and the financial effects. There is little question that economic performance has deteriorated very significantly in Asia, and that has led to a significant deterioration in our trade balance. However, the effects on the performance of our economy have been surprisingly modest up to this point, and a couple of factors explain why. One is that trade with Asia really represents only a small part of U.S. output. As a matter of fact, merchandise exports to East Asia represent 2.4 percent of our output. Second, when problems in East Asia first surfaced in July of 1997, most economists feared that the tremendous currency devaluations there would lead to a flood of imports into the United States. That really hasn't happened. One thing that had not been taken into account was that financial problems, particularly in the banking sectors of most of those countries, have prevented many East Asian firms from finding the necessary credit to produce and ship their goods to us.

Now I can't say for sure when Asia's problems are going to be fixed. But I would agree with many people who have said the solution depends importantly on Japan. And the news in that area could be better. It is hard to conceive of solving the problems in Asia without a dramatic change in the economic performance of the Japanese economy. When John and I were in Japan and Korea in June, we were lamenting about how much had to be done, and today, as we were talking just before this meeting, we agreed that very little has been accomplished, especially in Japan. So clearly, Japan has a lot of things on its plate, and that makes it not only more difficult for that country to improve, but for Asia to improve as well.

Let me talk now about the financial impacts on the U.S. Clearly the financial turmoil that we have seen in Asia, as well as in Russia and Latin America, has had an impact on our financial markets. First of all, the perception of risk has increased, and this is having an effect on our stock market. In addition, there has been a "flight to safety," meaning that investors have moved to safer investments such as U.S. Treasuries, which, as John indicated, now reflect very low yields. At the same time, we have seen an increase in the risk premia that a lot of borrowers have to pay. If you are an issuer of high-yield bonds or if you are trying to do an initial public offering, this desire to avoid risk has had an important effect. I think all of these factors together—these uncertainties associated with global events—have increased the risk for the U.S. economic outlook. And, quite frankly, that's why the Fed decided to change the stance of policy last Tuesday, September 29. If we had looked at just the performance of the U.S., and even at some traditional U.S. models, the decision wouldn't have been obvious. But when you look at the risks that could result from these financial problems globally, and their impacts in the U.S.—the impacts on trade, it led us to believe that it might be wise to reduce rates.

Let me make two points that haven't come up in this whole discussion of global events and their impact on the U.S. One is about the positive effects on the U.S. economy. Up to July of this year I think they have been significant. First of all, the dollar appreciated quite a bit and commodity prices declined, so even with 4.5 % unemployment and very rapid growthægrowth that seemed to accelerate in recent yearsæwe have not seen inflationary pressures. I see that as a positive development that gave us the latitude not to tighten. Secondly, the influx of money into "safe haven" investments has had a positive impact in certain industries. Look at residential real estate. I think this sector would be in a much different position today if it had not been for this flight to safety.

The other point I'd make is about the size of the interest rate cut we made. Some might ask, "Why didn't we cut the interest rate more than one-quarter?" Quite frankly, to my mind the fundamentals about the economy suggested that we have performed very well and that there are very few signs of weakness in the performance of the U.S. economy. Now, the most recent employment numbers did show some weakness, but interpreting these data is complicated when you take into account some past revisions that showed even greater strength. Furthermore, for the last three years the actual growth of the U.S. economy has outperformed our forecasts. In other words, it has done better than our models suggested. On the basis of fundamentals, I think you could say that a quarter point cut was appropriate. And if we begin to see tangible signs that the economy is deteriorating—that is, if the numbers look as though they are going to be weaker and if the models suggest that growth is going to be a lot weaker—then I think that would be supportive of additional moves.

Let me make a comment about the Bay Area. I think you can easily document the effects of East Asia on the Bay Area economy, especially in high-tech manufacturing. When we look at the data for manufacturing employment in California and the Bay Area, we do see a significant change. For example, in 1997, job growth in manufacturing increased 5.8%, but in the first eight months of this year it's down 1.9%, and I think you can attribute a significant part of that to East Asia. But the story is complicated because an imbalance in the inventory and sales relationship in the high-tech area probably has caused something of a slowdown as well. I would summarize conditions in the Bay Area by saying that given our high-tech orientation, we probably are more vulnerable to the problems in East Asia. California, too, is more vulnerable than the rest of the nation—we have trade in merchandise exports with East Asia, that is 5.5% of our gross state product as opposed to 1.9% for the rest of the county. So the vulnerability is there and I think it will be focused on high-tech, but quite frankly, the other fundamentals of the California economy suggest that we are in a position that would enable us to withstand these kinds of pressures.

Richard Kashnow

I can offer you a brief perspective and perhaps one data point from Raychem's recent experience, which flows, from our perspective as a global manufacturer. Raychem is a forty-one year old company founded in Redwood City back in 1957, and as the company has evolved more than two-thirds of our revenues are in fact from outside of the United States. Revenues last year were about 1.8 billion dollars. We do have a big presence in the Bay Area, with about three thousand people here, and this is about one-third of our population around the world. Asia, over the past few years, has been about 20% of our revenue and until very recently, I would say the quarter that ended in December (1997), that piece of the pie was growing at about 20% a year. So going from 20% growth progressively to 0% and then in the June quarter into at least a small contraction, obviously has a big impact on the top line. Overall, we have been growing in the high single digits over the last several years, so losing 20% of 20% means about half of the top line growth momentum was taken away in a reasonably short time and it certainly had a noticeable impact on short-term performance.

Having said that, one perspective I have is that the Asian recessions, which looked like a discontinuity in many ways, really are superimposed, on some continuous changes. The Asian contagion has accelerated or maybe exacerbated some trends we would have seen anyway. I'm talking primarily about the changes in purchasing behavior by our customers around the world as a result of globalization and consolidation. Raychem's products are sold to a wide variety of customers in the electronics, telecommunications and infrastructure industries. We don't have any one customer that represents a very large fraction of the total and we get to see the purchasing behavior of virtually every telephone operator in the world, every power distribution company and many people in process industries, and quite a lot of OEM's, whether they are automotive, aerospace or computer manufacturers. If I were to sum up what is going on there, it's that the purchasing power and purchasing behavior of all these customers has been changing in the last couple of years. Our customers are becoming more global themselves or are a part of much more integrated global markets. These trends mean they are more demanding and are more effective in demanding lower pricing, faster delivery and even in some cases, that we now provide engineering services in addition to the products we have traditionally supplied them. And it means that our sales in a particular country reflect not just local business conditions but the state of demand globally. For example, we are suppliers to battery manufacturers in Ja-

pan, who in turn are producing batteries for cellular phones whose end use is being driven by everything from Finland to the United States.

So it gets to be a little bit difficult for us, and probably misleading for us strategically, if we focus too much on exactly what is happening in a particular country or region without looking more broadly at end use. About a year and a half ago, before these latest trends were not quite so obvious, we were seeing these sorts of leading-edge marketplace changes because we operate in about 85 countries, but we only manufacture in nine or ten. You can imagine what our currency translation calculations are like every quarter. I can assure you that they are impossible to predict. We have enough trouble explaining them after the fact and during the past year adverse currency translations had a much bigger impact on us than probably at any time in our history. Just to calibrate you, adverse currency cost us 30 million dollars at the pretax income line last year, primarily because of the strength of the dollar and the sterling against the yen and the continental European currencies. That's probably abated in the last several months. But I mention the currency moves because when that became apparent, a lot of people would say, "Why don't you ship some of your manufacturing to some of these countries where sales are, to get a better balance between manufacturing and sales." Obviously, changes in where you manufacture products vis-a-vis where you are selling them are changes you make with a much longer time constant than what happened in the last quarter or for that matter, what you think is about to happen. Superimposed on this uncertainty, then, are strategic considerations that have a much longer time constant. So during these more dramatic moments of change, we have stayed focused on some of the basics—making sure we maintain resiliency and our focus on productivity and, as some of the speakers have said, keeping a clear eye toward opportunities that can arise during times of discontinuity. To make sure we have the ability to pursue opportunities, obviously we are trying to maintain a very strong balance sheet. Fortunately, the company has been blessed with enough diversity and strong positions in our more mature businesses, so that we have and can continue to be a strong cash generator and have the capability right now to pick our shots and be careful.

We have not rushed out and made a lot of acquisitions in Asia or Latin America, although we continue to look for such opportunities. We have been finding more acquisition candidates in Europe lately than we have before. But one thing that we have been doing, and I'm sure other companies are as well, is trying to be thoughtful about finding ways to express commitment to customers during tough times. We selectively liberalized credit terms to our Korean customers, for instance, who were experiencing difficulty securing financing through normal channels. Steps like these make sense because we plan to be involved for the long-term and believe there is value in supporting our customers. Beyond that, we have and will continue to have a major commitment and presence in the Bay Area, but again that is a strategic reality which transcends any of the short-term economic dislocations we are seeing.

Casper:
Thank you very much. We now have a little time for discussions and questions and I would take the privilege of the chair to ask one question, in particular of Bob and John and Chang-Lin. You are all in agreement as to how important Japan is. Bob said "crucial" and John is obviously convinced of that. [Chang Lin said, "the Japanese, as he encountered them, are tired of change, not to say sick and tired of change. We cannot change anymore."] You all believe that change in Japan is still necessary, so, what kind of change is possible in Japan and how do we get it?

Taylor:
The first element of change I emphasize is that monetary policy has to be more expansionary. Japan has been reluctant to be expansionary for many reasons. The reasons change over time, but there is still the same reluctance. I see some positive things there. There is a more open decision process on monetary policy. But the more fundamental longer-term things have to do with the banking sector and I think that looks very pessimistic still, because there are a lot of political issues that have to be faced up to. I don't think they have faced up to them yet.

Parry:
I would agree. In terms of monetary policy they probably ought to do a bit more. I don't know exactly what they can do when the interest rate is 0.25%, but they could add high-powered money to their system. I also think there is more room for tax changes. Although they say they are doing something, when it gets down to direct impacts—particularly of public development-type works—they just don't show up. But I would agree wholeheartedly with John's comments about financial reform. The position of their banks is quite troubling. Their failure to recognize their asset problems is tragic, and a lot has to be done to rectify that situation before you can see a fundamental improvement in their economy. There are some positive signs, though. Today, for example, there was talk that the government is finally going to do something in that area, and maybe we will see some progress.

Tien:
I'd like to speak on two paths. One is perhaps a little bit pessimistic, but the other is more optimistic. Institutional relationships in Japan are very closely knit, say as between government and industry. Institutional change in Japan,

like financial policy, tax policy, and these government-industry relationships may not change as fast as we like to see, because again that reluctance to make a quick response and change seems so much a part of their society and cultural heritage. However, I think we should not overlook the fact that there is and will be a rapid change in terms of generations. Today you see many very young Japanese CEO's, like NEC's CEO in fact, who are in their 50's. That has never been heard of in Japan before. IBM Japan's President assumed his office in his 40's. Many of the new, big Japanese corporations are now headed by totally new, Westernized, educated, very open-minded, leaders, and this is also the case in the government. But even for them it is hard. I know many of those young CEO's, but when they get into that environment they somehow have to accommodate many of their seniors. So those two different forces are at work in Japan, and I think it depends how fast one force overcomes the other. But by and large, I'm still not that optimistic about a rapid turn in Japan's economic recovery. However, Japan will not collapse. It is so huge, and we cannot afford to let that happen. So they will drag on and maybe we can do some incremental marginal things to accelerate their recovery.

Q. I wonder if you could give us your view on the rescue of Long Term Capital Management, whether that was required, and if so, why and was it a good policy or not?

Taylor:
I can't speak with any inside information about the balance sheets or who was on the line. But my feeling is that the role of the Fed in this case seemed to be a little bit too much in the way of coordinating. If the bailout had been through the proper creditors working together, I would have been more comfortable. I'm concerned about the implications for other financial crises in the future.

Parry:
I understand John's point, and the thing to keep in mind is that these calls are always difficult. Basically, the Fed is trying to deal with the potential for systemic risk, that is, the risk that problems in one organization will spread throughout the entire financial system. And knowing ahead of time with certainty whether or not that will occur is extremely difficult. The conclusion in this instance was reached that if something wasn't done quickly, then a margin call could lead to dumping those securities, and that would have implications not only for LTCM but for others as well. John made the point that he wishes that the Fed hadn't been so visible in it. So do I. Quite frankly, if there had been a way for us to get the meeting convened without having our name associated with it, it would have been better for everyone. Say the president of the Federal Reserve Bank of New York had called (David H.) Komansky at Merrill Lynch and said, "Look, why don't you set up this meeting? Let's have it at the Waldorf, not at the Fed." Maybe that would have put the Fed's role in the proper perspective. I'll tell you why it didn't happen that way. Everybody was very concerned at the time to make sure that people really got together. You've got to remember that Merrill Lynch is a competitor with a lot of these other people, so otherwise they might not have shown up. In fact, another offer to get people together was made by Buffett. I want to know more about that whole situation, but my understanding is that in order to get that offer accepted, all the outside investors and lenders to LTCM would have had to approve it. That couldn't have been done by Wednesday morning, and this is one of the big reasons that offer was rejected. Maybe it would have been better, from society's viewpoint, if it could have been done in a different way. As it turned out, the rescuers, the people who put capital in, are actually current investors and current lenders.

May I make one final point? There is going to be a lot of call for regulation, and the Chairman [Alan Greenspan] has said he doesn't want regulation. We've got to understand what really happened there before we say we want regulation. I think that it was not a problem of derivatives. It was a problem—as it was in Orange County—of leverage. So the issue is finding ways to keep these kinds of funds from being able to leverage themselves so much. The issue isn't the derivatives. And that's why I get nervous when you have the CFTC and others saying "we have to regulate this product." The products aren't the problem. It was the leverage that this company had, and that left it with insufficient capital to deal with the problem of suffering a more severe loss than it expected to experience.

Armacost:
I would like to speak to the LTCM issue and its rescue. I don't know what went on in that Fed conference room, but I've sat in that room before and I could paraphrase the language and the threat of not getting something done on a systemic basis. I think it ties back to what John was saying early on, that capital flows were at a previous stage in our history very large. He also mentioned they found their way into productive uses like building railroads and other infrastructure. Not too long ago, in the early 1980's, the international banking system was trying to recycle petro-dollars, with the consequence of huge flows of capital sloshing around international markets seeking employment where the natural ability of a particular market to absorb that capital flow just wasn't sufficient. The banking system did that with some official encouragement and possibly coercion, but ultimately everybody paid a price for that because of the unwinding process of those capital flows. Then we had historically high interest rates and historically high inflation. Now we have very low rates in markets and low inflation, but again extraordi-

nary high flows of liquid capital, resulting, in part, from the boom environment in U.S. equity markets. This capital is seeking returns in international markets through hedge funds and other devices that is probably way beyond the productive use of capital in those markets.

Remember, leverage works in both directions and when employed productively, it is fun if you sit in a house bought 10 years ago and is up by three times. It's not so much fun if you're a young family moving to the Bay Area and have to deal in that market. The unwinding effect of leverage in the 1980's through the S & L crisis saw a major drop in residential real estate values, destruction of wealth, and a reduced tax basis in communities represented around this table. The parallel today which worries me is the impact on economies and people caused by the unwinding of leveraged positions in speculative capital in places like Malaysia and Thailand, irrespective of economic fundamentals. Thailand markets fell in part because an unwarranted inflow of capital financed bad projects through a weak banking system. When it ran for cover, borrowers couldn't capture value quickly enough to pay it back. The extension of that speculative process through Russia, into capital flight in Brazil and Latin America is an increasing concern of the people who sit around the European Central Bank, the G7 and the U.S. Central Bank tables. Capital flow regulations may be coming and dealing with them is something that is going to be a major task and carries serious long-term market effects. You've got a lot of capital flow sloshing back and forth that is well beyond the ability of many markets to absorb it.

The people who invested in hedge funds can well afford to lose the money because by definition they are knowledgeable investors and speculation carries high risk. There is no doubt in my mind the reason they (LTCM) were rescued is because in banking trading rooms and other hedge funds there were similar large positions. When Bob and his colleagues at the Comptroller's office send their examiners out in this environment to review that, the inclination by banks is to restrict the flow of credit to those kinds of enterprises. Suddenly, there is a potentially large reduction of credit availability, a reversal of capital flows and an explosive liquidity issue on your hands. The way this ties to the Bay Area is that you've got a generation of young people whose metrics of success are which model of Porsche one drives based on the latest IPO, or leveraged oneself into a house well beyond their means, and plan to retire at the age of 32 or 33. There is currently underway a destruction of wealth of companies in the Bay Area. As Dick knows, the average NASDAQ stock is down 59% from the highs. That's a slaughter. What people do and think about doing with their money is what, I think, moves the economy. If you think that consumption is one of the last drivers of current economic growth then we need to be concerned that the bubble in the Bay Area doesn't reverse itself too rapidly. I'm not an alarmist, but it is something I'm worrying a lot more about lately. The linkage in my mind is a lot more visible than it would have been six months ago.

The issue is the relative destruction of real and perceived wealth, and what they may do to people and their expectation levels. In a real sense, and Dick is facing it, if you're in the semiconductor or semiconductor equipment supply business, for example, this is a disaster. People who had jobs there six months ago don't have them today and there'll be more on the street tomorrow. So Bay Area communities will feel the direct impact of that in the near term.

Q. Yesterday in Oakland we announced that we have a new trade center going up with 87 companies coming from China and that one of the issues is that they want to have a wholesale market place to begin to market in the Bay Area and beyond. One of the things that is interesting is, when you talk to the companies that are coming, their frustration with us. First of all, it has been two years since those agreements were first signed until we got to this point. The Bank of China is coming over the weekend and looking at the possibility of putting a branch here so it will have one in L.A., one in New York and one in Oakland. The issue they all raise is that the regulation and flow of capital is a real impediment. As Dr. Tien has already indicated, business is on a very personalized basis. I sometimes wonder if we in the Bay Area may not be over regulated and if that is not, as we look at the future of the Bay Area, a problem. The question to the panel is, what can we do really to facilitate that kind of interchange with the investing possibilities coming in this direction from the Far East.

Parry:
Let me make one point which may address your issue indirectly. Congress passed a law after some of the problems we ran into with BCCI. That law states that for a bank to do business in this country, the regulators have to establish that the home country has comprehensive supervisory responsibility over all aspects of that bank. One of the reasons that some banks have not been able to locate in this country is because they're unable to attest to that, and I don't regret that at all. I think if we can't establish the existence of that supervisory responsibility, I'd just as soon those banks wouldn't be here, even if it costs a little bit in trade. In addition, looking down the list of East Asian countries you see only a couple that aren't in recession. And quite frankly, those countries that are in recession and that have problems with their banks are going to have great difficulties in opening up new branches in this country.

Q. Professor Taylor and Mr. Parry, as I understand it, are saying that Japan is the key to Asia in effect and has to inflate

its economy; you talk about lowering interest rates, printing more money. I read a column that said that you have to visualize Japan as a country of grandmothers. They are not interested in having anything happen to their social security system, and inflating the economy would do that, and that is why they didn't feel there would be any real changes in the Japanese economy in the future. Do you agree with that? Do you think it is too simplistic?

Taylor:
I wouldn't say, "inflate" the system. There is a deflation going on and I would just like to get to price stability: closer to zero inflation rather than negative inflation. So I don't think the grandmother argument applies. More liquidity would offset the deflation.

Monetary policy, despite the 0.25% interest rate, is still powerful. As an example to keep in mind, in the 1930's in the U.S., we had the Great Depression. During the Great Depression interest rates were nearly zero, but as we look back at the period now there is almost uniform agreement among economists that the Fed caused that problem by being too tight. Focusing on interest rates can be very misleading because, with deflation, real interest rates are really quite high. There are other measures of monetary policy, in particular things like money growth. So to me, the lesson from the 1930's is in a depression you stop looking at the interest rate and look at money growth.

Chair: Sean, want the last word?

Randolph:
To draw a short bottom line to the conversation, there is an increased perception of risk in the economic environment overseas, with Japan in Asia and Brazil, in Latin America being the key, and this is a risk on many levels. We are seeing immediate effects here in the Bay Area economy of declining exports, a flight to security in financial markets, and a consumer effect with the destruction of wealth. A number of our speakers have referred to the long-term opportunities and even short-term opportunities for prudent acquisitions and realigning partnerships and have expressed confidence in the abilities of these overseas markets to return. But there are certainly some very rough patches to come in the interim. I believe the Bay Area Council meeting in San Jose in January is going to touch on some of these same themes and the Forum, in partnership with the Council, is revisiting now it's 1996 study done by McKinsey on "The Bay Area: Leading The Transition To A Knowledge-Based Economy." Not only are we going to be re-looking at the figures from that study, we are going to be looking ahead and taking into account some of these international factors and how the global economy is going to affect the future of this region. So with that said, I would like to thank all of our speakers, and would like to thank Gerhard Casper in particular for being a gracious host.◆

The Bay Area Economic Forum, a partnership of business, government, academic, and community leaders sponsored by the Bay Area Council and Association of Bay Area Governments, develops and implements programs to strengthen the region's competitive economy and quality of life.

Forum Reports are produced through the generous support of Pacific Gas and Electric Company

Published by:
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