THE U.S. ECONOMY IN THE WESTERN HEMISPHERE

REMARKS BY

WILLIAM J. MCDONOUGH, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

before the

2nd PAN AMERICAN CONGRESS
FOREX USA

Chicago, Illinois

October 14, 1994

I am honored to be here today to address the 2nd Pan American Congress organized under the auspices of Forex USA. This group brings together foreign exchange traders and experts in international finance throughout the Western Hemisphere. The dialogue provided by gatherings such as these, both formal and informal, improves our collective understanding of developments in each other's markets. In times of stress, the contacts we develop on these occasions can serve us well, helping us--policymakers and practitioners alike--to do our jobs that much better simply because our understanding of each other is that much deeper.

As most of you know, we at the Federal Reserve Bank of New York have a dual role vis-a-vis the foreign exchange market. For one, we participate in this market in our capacity as the operating arm of the Federal Reserve System and the U.S. Treasury. Second, as the central bank, we have an interest in promoting the smooth functioning of the market. In both our roles, we are very supportive of Forex's current efforts to promote educational programs among its members. We believe that such efforts will further enhance the efficiency and integrity of what remains the largest unregulated market in the world.

In my remarks this afternoon, I would like to share with you some of my views on the changing nature of the increasingly important trade and financial linkages that characterize relations among our countries in the Western Hemisphere today. In so doing, I will touch on such issues as the importance of Western Hemisphere markets for the well-being of our countries' economic and financial policy interests, the impact of NAFTA to date, and the increased financial flows that bind all of our countries in the region and raise the stakes each of us has in the economic success of our neighbors.

Trade linkages are clearly one of the most obvious ways our economies in the Western Hemisphere are bound together. These linkages are critical to the ability of each of our countries to reap the benefits of our comparative advantages and thereby realize our growth potential.

Over the past several years, trade ties among our countries have strengthened significantly, beginning with the historic agreement between the United States and Canada to create a free trade zone in 1989. This agreement has benefitted both our countries by sharply lowering tariff and nontariff barriers and improving our ability to resolve trade differences. Today, Canada and the United States enjoy the biggest trading relationship of any two countries in the world, with two-way trade amounting to about $200 billion in 1993. While the free trade agreement between the United States and Canada cannot ensure that we will always see eye-to-eye on all issues--differences of view are, after all, to be expected in relations between sovereign nations--it does mean that our two governments are committed to finding compromise solutions to whatever differences we may have.

In a second historic trade development, Mexico joined the United States and Canada last year in signing the North American Free Trade Agreement. The implementation of NAFTA at the beginning of 1994 heralds a new process of broader and deeper trade linkages among countries in the Western Hemisphere. Among its other achievements, NAFTA sets the stage for potentially significant gains in trade--and finance--for its three signatories. In addition, NAFTA signals the U.S. commitment to free trade for the hemisphere.

Although only 10-months old, NAFTA has already begun to make its mark. In the six months through June, U.S. exports to Mexico have risen roughly 17 percent over the comparable period in 1993, to almost $25 billion. Mexico, too, is benefitting from NAFTA. For Mexico, NAFTA locks in trade liberalization and further opens the economy to trade and foreign investment. In 1994, Mexico's exports to the United States through June were up 22 percent over the comparable period in 1993. In fact, Mexico has recently overtaken Japan as the United States' second-ranking trading partner.

At the same time as it has been deepening its trade ties with its North American neighbors, the United States has also sought to develop its trading relations elsewhere in the hemisphere. As countries throughout Latin America and the Caribbean have increasingly liberalized their trade regimes--lowering tariffs to an average of 12 percent from roughly 56 percent a decade ago--U.S. exports to the region have almost doubled in the past seven years. Roughly 17 percent of U.S. exports now go to this region compared with about 12 percent in the 1970s.

One of the most notable developments over the past several years, reflecting the more outward-looking trade policies that have taken hold throughout the Western Hemisphere, has been the growing rediscovery of intraregional markets. Today, as never before, multilateral and bilateral trade agreements are being forged throughout Latin America and the Caribbean. Colombia, Venezuela, and Mexico have just recently signed such an agreement. Mexico has a free trade agreement with Chile and is in the process of negotiating a similar agreement with some of its neighbors in Central America. And, the Andean pact countries--encompassing Venezuela, Colombia, Ecuador, Peru, and Bolivia--agreed a few months ago to a common external tariff--25 years after their initial agreement was first signed. Moreover, existing arrangements, such as the Caribbean Community (CARICOM) and the Central American Common Market, are becoming increasingly outward-looking through reductions in tariff rates with the rest of the world.

By increasingly breaking down barriers to trade, these multilateral and bilateral agreements are helping countries in the region become more competitive. They also reflect the willingness of these countries to turn away from their protectionist policies of earlier decades. In addition, the agreements are evidence of these countries' longer term commitments to stable trading conditions within the hemisphere, giving confidence to domestic and foreign investors alike.

As a result of these developments, intraregional trade, which had fallen off dramatically in the years following the onset of the debt crisis in the early 1980s, is thriving. For example, trade among Latin America's eleven largest economies has increased by some 50 percent since 1991. These increases in intraregional trade helped make possible last year's relatively rapid growth of overall external trade in Latin America in a period when world trade was decidedly sluggish.

Among the most important of the new regional trade groups is the Southern Cone Common Market--Mercosur--which Brazil, Argentina, Uruguay, and Paraguay created in 1991 as a free trade zone. Since signing this agreement, these countries have seen their mutual trade more than double. Just recently, the Mercosur countries further agreed to deepen their trade relations by forming a customs union by January 1, 1995. In so doing, they will establish a common external tariff for their imports from third countries, obviating the need for them to agree on rules of origin for imports, which are complicated to negotiate and often potential obstacles to trade. The Mercosur agreement also allows for the future accession of other countries.

Notwithstanding the recent progress of trade integration within the Western Hemisphere, the potential for further and constructive deepening of mutual trading relationships remains substantial. It is conceivable that, over the longer term, Latin America will gradually develop several large trading blocs and that these blocs will be way-stations to a comprehensive South American Free Trade Agreement and an eventual amalgamation with NAFTA. While optimism may be premature at this time, the vision is not totally out of the question either.

It is important, however, that, in the process of creating regional trade groups, barriers to outsiders not be unduly restrictive. Otherwise, trade diversion could outweigh trade creation, efficiency deteriorate, and hemispheric export performance falter. In short, the overriding aim of all these regional trade agreements should be to ensure not only that they do not raise obstacles to hemispheric integration by pushing other potential partners away, but also that they remain outward-looking and consistent with Latin America's need to integrate more efficiently with the world economy.

On balance, I believe that trade liberalization has been a major factor leading to the revival of growth throughout Latin America and the Caribbean. With the easing of policies that produced high labor costs and export taxes, combined with financial reforms that have facilitated access to credit, Latin American exporters have become increasingly competitive. In a number of countries, there has already been a significant shift away from a traditional dependence on raw materials and energy exports toward increases in exports of manufactured goods. This has certainly been the case in Mexico.

To the extent that this new reform orientation in trade takes root and expands to encompass even broader groups of countries, we can be more confident that these regional trade initiatives will work constructively to harness comparative advantages, exploit economies of scale, and thereby boost economic efficiency, competition, and overall economic performance throughout the hemisphere. In this context, I am convinced that prompt passage of the Uruguay Round agreement is critical to the goal of global free trade and to the support of individual countries' own efforts to build truly open economies that can compete in world markets.

While trade linkages among our economies provide the basic underpinnings to our economic relations, the financial flows that accompany these trade linkages are also increasingly important. By channeling savings in the hemisphere to the areas of highest returns, financial flows allow the efficiency gains of comparative advantage to be realized. The growth in the financial linkages among our economies over the past several years also serves to improve the functioning of domestic financial systems, and, by this means, to contribute to the more efficient allocation of capital among our countries. Here, too, changes over the past several years have been dramatic.

As you well know, private capital has once again begun to flow to Latin America, after a decade of negative net transfers. These inflows, on a gross basis, reached a record $65 billion last year, equivalent to 5 percent of the region's GDP. The bulk of these inflows went to the private sector, unlike the situation in the 1970s. Inflows of this magnitude would have been inconceivable five years ago.

Initially, beginning in 1989, the capital flowing into Latin America was primarily the return of flight capital. Today, much of the money going into the region is in fixed-income securities, typically debt of Latin American governments and enterprises that is raised on foreign or international capital markets. This debt, which is primarily of short- to medium-term maturities, tends to be denominated in U.S. dollars.

Most equity investment going into Latin America results from direct purchases in local stock markets. Relatively fewer equity inflows have stemmed from Latin American firms' issuing equity on international markets, although purchases of shares in country funds and the use of American Depository Receipts (ADRs) on the New York Stock Exchange are quite common. Telefonos de Chile was the first Latin American firm to make use of ADRs in July 1990.

Over the past few years, there has also been a marked increase in the amount of foreign direct investment going to Latin America. According to some estimates, recent inflows have accounted for almost a quarter of total funds flowing into the region. Guided more by the longer term profitability of domestic enterprises than portfolio investment, foreign direct investment also provides host countries with increased access to foreign markets and new technology.

In addition, banks have resumed lending to Latin America in recent years, typically providing short-term credits for trade finance and working capital to private sector borrowers. There was also some increase in medium- and long-term lending beginning in 1993.

As private capital inflows to Latin America have expanded during the 1990s, the investor base has broadened to include institutional investors, such as pension funds, mutual funds, and insurance companies, in addition to securities traders and citizens living abroad. This widening of the investor base has been facilitated by changes in allowable investments in a number of industrial countries. The growing diversity in investor base may help to lower the risk of a sudden and simultaneous drying up of funds for the region, such as took place during the 1980s.

What all of these capital inflows reflect, of course, is increased confidence on the part of foreign investors in the willingness of countries in the region to adopt comprehensive stabilization and structural reform programs as well as optimism about the potential for growth stemming from these efforts. In most cases, reform programs have been grounded in commitments by governments to extend significantly the role of market forces in the allocation of resources. As a consequence, measures adopted to reduce government budget deficits, control inflation, eliminate price controls, reduce subsidies, privatize state-owned enterprises and deregulate and broaden the financial sector have opened up opportunities for new investment with potential rates of return sufficiently high to attract foreign investors. Foreign investors have also been attracted to the region by the progress so many countries have made toward normalizing relations with their external creditors, which has reduced concerns about external debt burdens.

In addition, investor confidence in the region has been boosted by a host of other structural reforms. Restrictions on the ability of foreigners to acquire assets have been eased at the same time as taxes and transactions costs have been reduced. Moreover, gains have been made in upgrading not only the quality of market oversight and regulation but also the technological capabilities of markets, such as automating stock exchanges. Improved systems in clearing and settling financial transactions have also been introduced, as have measures to decontrol interest rates, reduce directed credit programs, and stimulate competition among financial institutions.

There can be no doubt that the recent surge of capital into Latin America has also been facilitated by the increased technological capabilities of our global financial markets to mobilize private capital, direct it to attractive markets, and monitor its exposure to risk. Vast improvements in communications technology together with the rapid evolution of computer and data-management technology have transformed the nature of our financial markets and institutions and dramatically altered the ways in which business is conducted, making it possible to execute and manage an investment strategy on a global real-time basis.

A number of other supporting reasons also helped generate capital flows to Latin America after 1989. Among the most important of these were the high returns available in Latin American markets relative to those in most industrial countries. This was particularly so after the decline in U.S. long-term interest rates in early 1993.

The impact of capital inflows on the domestic economies of these countries has been profound. On the positive side, the inflows have contributed to increasing domestic investment and offsetting comparatively low saving rates. Moreover, private capital inflows have also facilitated the privatization of public enterprises and contributed in the process to the development of domestic capital markets, helping local firms mobilize capital at lower costs.

At the same time, however, it is important to acknowledge that these inflows do entail risks and may raise policy dilemmas for some countries. Without being exhaustive, let me suggest a few potential difficulties.

A main risk, of course, is that the inflows may be not only unsustainable but also subject to sudden changes in market sentiment. A lapse in policy, a domestic event that suggests social or political unrest, or an external shock such as a change in global interest rates all provide grist for global investors to reassess their risk exposures and alter their investment decisions. To the extent that portfolio flows are motivated by investors acting on economic fundamentals in the host country--characterized by that country's pursuit of consistent macroeconomic policy--the inflows should be more sustainable than if they are motivated by investors seeking to take advantage of temporary profit opportunities arising from the implementation of less consistent macroeconomic policies.

The sharp declines in both share prices and bond financing in early 1994 throughout Latin America, following the increase in U.S. interest rates in February, are a reminder that many of these markets can be more volatile than those in industrial countries. At the same time, it is important to bear in mind that these markets are not nearly as developed as those in the industrial countries. To this extent, these markets may be more vulnerable to speculative bubbles and wider price swings than might be expected elsewhere. Note also that the volatility in these markets can be caused by volatility in developed country markets, but the ripple effect is even greater.

Over the long-term, vulnerability to a change in global interest rates or a change in portfolio preferences can only be reduced by a country's success in eliminating its external and internal imbalances--in short, by the country's commitment to pursue sound macroeconomic policies in a sustained way. In today's markets, investors are quick to shift out of a country's assets if they perceive any worsening in its risk/return outlook. It's that simple.

A second difficulty is that, for some countries, the surge in capital inflows has complicated the ability of the monetary authorities to control domestic money and credit growth and maintain exchange rates at a competitive level. In such cases, these countries could confront a weakening in the competitiveness of their exports in world markets and a further widening in their current account deficits.

Policymakers have some options in dealing with these problems, but all entail potential disadvantages. For example, policymakers may opt to impose certain types of capital restrictions, such as higher reserve requirements or negative interest rates on nonresident bank deposits, to help moderate the pace of the capital inflows. But these measures run the risk of distorting financial flows. In addition, policymakers can, in principle, intervene in the foreign exchange market to sterilize the inflationary effects of the capital inflows on the domestic money supply and domestic credit growth. This option, however, can prove difficult to implement if financial markets are not sufficiently developed.

Furthermore, how foreign capital is used will also have a bearing on whether these inflows prove to be beneficial or a burden. In this connection, it is particularly important that the bulk of the inflows are used to promote domestic investment. While investment ratios in Latin America have certainly shown some increases over the past few years, notably in Chile and Mexico, investment still accounts for a much smaller share of GDP in Latin America than it does in Asia--19 percent on average in Latin America compared with 29 percent in Asia.

A third issue of some potential concern has to do with the highly concentrated nature of the capital flowing into Latin America today. Some estimates show that in 1993, for example, over 80 percent of the fixed-income inflows were directed to three countries--Argentina, Brazil, and Mexico. Equity inflows appear to have been similarly concentrated. As more and more countries in the region continue to deepen their reform efforts--and as the investor base continues to widen--it is likely that capital flows to Latin America will be distributed more broadly throughout the region than has been the case to date.

Until a broader distribution of capital flows occurs, however, financial support and policy advice from the official international lending institutions remain as crucial today as they have been in the past. Moreover, these institutions may also be helpful in exploring new ways to join official with private finance to meet some of the longer-term financing needs of all countries in the region. The recent decision by the Inter-American Development Bank to allow lending of up to 5 percent of its capital to private borrowers without government guarantees is a welcome step in this direction.

Finally, if they are to continue to attract foreign capital, Latin American countries simply cannot relax their commitment to economic and financial reform and structural change. Although it is impossible to minimize the remarkable accomplishments of so many countries--large and small--in such a comparatively short period of time, particularly considering how uncertain the outlook was only a decade ago, the agenda going forward is still daunting. Let me cite just a few of the major challenges these countries face:

- To raise domestic savings--so as to reduce the dependence on foreign capital--and to increase domestic investment--so as to improve the productivity of the economy, build a strong base for export growth, and thereby ensure future repayment capacity.
- To strengthen the financial sector both by deepening financial market reforms, thereby developing more efficient money and capital markets, and by improving prudential supervision of the financial system.
- To implement social measures--such as increased attention to education, health care, low-cost housing, and the environment--without widening budget deficits and rekindling inflation.
- To ensure that the gains of reform--that is, the benefits of growth--are perceived to be sufficiently widespread so as not to be undermined by increased unemployment and social pressures.

In these efforts, governments must play a constructive role. Markets by themselves simply will not suffice. For us in the United States, it is especially important that we raise our national saving rate by encouraging private saving and continuing to contain and lower our budget deficit.

Whether we like it or not, the world is a smaller place today than ever before, and no more so than in the world of trade and finance. The technological revolution of the past several decades has immutably altered the nature of our interdependence within this hemisphere. The globalization of markets means that we are all affected directly by changes in each other's economies. The stakes we have in each other's well-being are thus higher--and riskier. Weakness or slackening in economic performance can--and will--have ripple effects.

In my view, the main job each of us has in this environment is to be aware of the impact our policies have on each other and do our utmost to contribute to running our own economies as wisely and as sensibly as we possibly can--by sustaining policies that promote growth and contain inflationary pressures. The consequences of not pursuing sound policies are increasingly more immediate: flows of capital, saving, and investment are affected. The impact on our economic prospects is direct.

In part because of the size of the U.S. economy and in part because of the reserve currency role of the dollar, I believe that we in the United States have a special responsibility in these respects. I can assure you that, for my part, I will do my very best to contribute to whatever extent I can to meeting this commitment.

Thank you