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The global financial markets after September 11. What has changed?

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Thank you very much for that kind introduction that was very thoughtful. First, I'd like to apologize that I am not able to talk to you in Spanish. I understand some but I think you would be all leaving soon if I try to speak in Spanish, so please forgive me while I speak in English.

In preparing my comments for tonight, I took the liberty of looking at the annual report of CARI, and reviewing some of your background and I am familiar with CARI but I wanted to became re-familiar with what you're doing or have done historically and I was reminded of a session. I was in New York recently at the Council on Foreign Relations, which is your counterparty organization in New York, and the President of the Council of New York, where I am member is, General Leslie H. Gelb, a very prominent former public policy maker and journalist for the New York Times. I was there in that particular day because Leslie Gelb has brought together about 75 of the highest level private and public officials of nation the for a one day event, which was on a Saturday, and all these very important people came on a Saturday for the entire day from 8 in the morning till 7 at night; we came from all over the East Coast to simulate an international financial crisis. The Council on Foreign Relations had created a simulation and he was basically asking these very senior knowledgeable an practical of the public and private sector, what would you do if the United Stated and the world would confront a serious crisis?.

I was reminded of that very interesting session when I read about CARI and your annual report, because Leslie Gelb said in that morning "the Council of Foreign

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Relations has to change". Traditionally we have focused almost exclusively on the political aspects of international relations and profusely on other subjects like economics and finances, and so forth, but our main thrust for the last 75 years have been on the political dimensions of international relations He said, "the Council on Foreign Relations, like to world around us, has to change". This international financial crisis simulation was one example of how the Council has changed. And I mention this in a way to suggest as diplomatically as I can that CARI also has to expand and deepen its curriculum to be more multidisciplinary, in the way that it looks at the global arena. It is much more than diplomacy today, and this new era of globalization is about economics, it's about finances, it's about a number of subjects that we did not think of very much as part of this arena a few years ago, and I was looking at your permanent study committees and at you publications, and I was thinking of the Council on Foreign Relations of New York just a very short time ago, which looked very similarly and has begun to change in recognition of a very new world out there that requires an entirely new arrange of expertise and knowledge If we needed any reminder of the importance of this, we see the morning of September 11th in New York and Washington. We know now that the world has changed unimaginably and will never be quite the same, not for Americans. And not for the world, and it is going to require that institutions like CARI or the Council on Foreign Relations in New York take a new approach to how they look at the world and the types of programs they run. So I just mention that in passing because I was very stacked by this when I read your annual report.

What I would like to do, very briefly –because this is a very distinguished audience and I would like to generate some discussion amongst you– is to spend a few minutes making some observations about the consequences of the tragic events of September 11th, for global financial markets generally and for emerging markets in particular. I am going to try hard not to focus too much on Argentina; but I imagine that sooner or later we will have some questions about Argentina.

I would really like to talk more generally about how the events of 9/11 have changed the access which countries and companies have to sources of finance in the international financial markets. Let me make one comment: what happened on 9/11 is not going to be repeated, at least not in the magnitude that it had; this was a very disruptive event, not only in term of the human lives that we have lost, but psychologically for our country in terms of the nervousness and uncertainty created. I am going to make some comments on what I think is going to happen in the future; obviously, these comments would be different if I knew that something similar was going to happen again in our country which I don't expect to happen but certainly there is the possibility and I think that everybody in the United States is no longer pleased about that possibility. Anybody now recognizes that what happened once could happen again, and we live our lives that way day to day.

But before I talk about post-9/11, I feel that, in all the reading and the talking that I have done in the last three or four weeks, many of the analysts that have been writing about our economy and financial market seem to have very short memories and have exaggerated what 9/11 meant for our economy and the global financial markets. By that I mean simply that if you remember back to September 10th, you have to acknowledge that this was a very weak global economy; there were some very bad things that were already happening. In the United States, our economy is weak and getting weaker by all indicators; many people, including myself, believe that we were heading into a recession before 9/11: growth rates have been declining for over a year, industrial production was way down; the unemployment figures were begging to grow quite sharply and we were likely to continue going up, and many of our key industries –including for example the airline industry and telecommunications, technology– were in very bad shape and were getting worse. All of this was very logically and rationally reflected, as you may remember on September 10th and before in the stock market. We have lost a tremendous amount of value in the stock market, which were more or less at the same level, in early September, where they were thee years earlier, in 1999. Three years of gains have been whipped out and people were beginning to change their spending habits. As a result of these losses, Mr. Greenspan before 9/11 had already reduced short term interest grades in the United States seven times in 2001 in an attempt to stimulate the economy and it had not yet had much effect. If you read the corporate earnings reports in August and early September, they were very pessimistic in many of our most basic industries, and earnings were expected to continue to decline in some of our basic industries; and so the United States was already in a pretty bad economic shape. I don't want to paint a picture of disaster because I will tell you in a minute I think it's fundamentally a very strong economy, but we were going downhill.

If you continue around the globe, the situation was very similar. Remember Japan,on September 10th and before Japan has been in and out of recession for almost ten years now. Paul Krugman, the well-known economist who sometimes writes for the New York Times, called Japan a "slow motion recession". It has never recovered from the problems of the early nineties, not standing the fact that interests rates are at zero and the years in massive government spending to stimulate the economy –there have already been two or three government interventions to rescue some of the largest banks in the country– Japan continues to be mired in deep economic malaise. This, you will recall, is the second largest economy in the world.

Continue around to the other part of the industrialized world Europe, which was a little bit better but not much. Economic wealth was declining, many of their basic industries were reporting lower earnings, and this was also reflected in the performance of their stock market, so they were a little bit better than in the United States, but not much better. There was a sense of pessimism in most of the European Union in August and September. Again, if you want some evidence of this, look at the performance of the Euro. This great new currency in Europe had begun to come up from its lowest levels on the spring but still was very weak in September, against the dollar and the yen, and it was not performing anyway near the way we had expected.

Then, of course, we have the emerging markets of Latin America –by those I mean your country, Brazil, maybe Chile– and South -East Asia. If you look at the performances, one indicator of where they were prior to 9/11, the picture is even worse. Emerging markets mutual funds had declined in value some 32%. Latin American mutual funds that were invested by international investors were down 29,5%. Now, other global funds were also down, very badly, but it is an indicator of the situation of the economies. It is also an indicator that international confidence on the emerging markets generally was not very good prior to 9/11.

So what can we say? Up till the time to this great tragedy, the global economy is weak, weaker than at any time in the past ten years, and most forecasters were predicting that there is worse to come. And so, the tragic events that occurred on 9/11 did not cause, in my view, what has happened since then in the economic and financial world, but it certainly aggravated the situation and probably accelerated the declines that have occurred over the last month. It should be very clear that although the global economy today is not in very good shape, relatively speaking, this was not caused by 9/11. This situation was aggravated, I would argue, by 9/11.

But what about the events immediately after this event? The damages were absolutely catastrophic. First of all, the physical destruction made it almost impossible for the financial market to function at all. The stock market closed down for four or five days. Over five thousand individuals lost their lives on 9/11. The psychological damage to the city was immeasurable and the psychological damage to the financial industry was immeasurable. I can not even begin to describe the aftermath of this in terms of the trauma that affected those who did not die on 9/11. It was very difficult for anyone to go back to work. It was a complete shock to the system. For the first time in the history of our nation, over two hundred and ten years, we learned that no amount of military and economic power can make a nation invulnerable to outside threats. But a mist this tragedy, in the enormous shock in the immediate aftermath I would argue that the streanght and resilience of the American economy and the international financial markets shown through very brightly, it could have been, in other words, much worse, under the circumstances.

Let's look at what happened in the first few days after 9/11, and I think my point becomes evident. First was the policy response by the Central Bank, the Federal Reserve. This came right out of the tax book and it worked as well as one could hope for, the market set literally stopped functioning on the morning of 9/11 and yet hundreds of billions of dollars transactions were in process. In this kind of a circumstance, it is very easy to imagine, not only paralysis, but total financial panic. And that is exactly what you would expect to happen when people run to take out their money, banks are not able to complete transactions and hundreds of hundreds of billions of dail y transactions that occur daily could come to a halt.

What did the Federal Reserve do? The Federal Reserve, on the same afternoon as the event, came out with an announcement assuring the markets and the public that they will supply as much liquidity to the market places as was necessary. This was fundamentally important. On an ordinary day in New York, the Central Bank provides somewhere between half a billion and a billion dollars of funds to the discount window to banks that require emergency assistance to meet their reserve requirements. Half a billion to a billion dollars is a normal day of the Central Bank founding of the banking community. On 9/11 the Federal Reserve pumped fourteen billion dollars of liquidity into the market to calm the market and to insure the banks had enough liquidity to saddle trades. And this sent a very powerful message to the markets: that the Federal Reserve, the US government, was going to do whatever was necessary to provide the necessary liquidity to ensure that the markets continue functioning.

On the following day, September 12 another fourteen billion. But in addition, now the European Central Bank and the Bank of Japan – with whom they coordinated over the night– were also supplying liquidity to banks around the world. This was a very important policy initiative in a highly coordinated fashion, in an unprecedented emergency that gave the market confidence, calmed things down. There was no panic, the markets continued to function and stayed open. I think that this was very important for the stability and confidence of the system.

Move ahead four or five days, to the New York Stock Exchange on the Monday after this tragic event, and as you now know, in a very rational way, the markets were understandably, extraordinarily nervous, uncertain, afraid. It was the highest trading volume in history of the New York Stock Exchange: 2.37 billion shares traded in hands in one day, on the first day of trading after this event. And it worked. There were no breakages, there were no transactions incomplete, it worked like clockwork.

This is an extraordinary event, you could imagine that even going to work on Monday was a mayor achievement for most of the people that work on Wall Street. Yet, 2.37 billion shares were traded without barely a hitch. Another example of the strength, of the resilience, and the determination of the market place. And I think this is a tremendous achievement that we shouldn't lose sight of. The market went down that day. The stocks were down that day, some five hundred points, which seems like quiet a large decline; but to put that in to perspective, it was not in percentile insurance in the top ten declines in history of the New York Stock Exchange. It wasn't that big of decline. If any of you can remember back to that faithful day in October 1987, when the Dow Jones declined twenty two and a half percent in one day, if you put that in terms of what happened last September the marked would have declined two thousand points, it declined just over than five hundred points.

So, the market went down but it responded in a way that it was orderly, without panic, and I would argue, quite rationally in the way you would hope that the market would respond. As you know the market recovered smartly after that. Today the NASDAQ index and even the Dow are more or less on the same level that they were on September 10th. So the market has bounced back remarkably, given the events that have taken place and again have shown me the determination and the resilience of the market place.

That isn't to say that this is not a period of uncertainty in the financial markets. Not because of the events of 9/11, but certainly partly because the US economy is now definitely going to enter in a period of recession, I would expect that there is going to be a protracted recession. I don't like to forecast to much but I think that although it is going to be a period of considerable economic discomfort in the United States and globally, I think the fundamentals of the economy remain strong, the markets remain strong and I am not exceedingly worried about this.

What happened that affected the emerging markets during this period? Because, frankly, I am much less optimistic about the rest of the world than I am about the United States and our economy. There is a natural tendency in a period of crisis, and by crisis I translate the word crisis to mean uncertainty, which can translate to mean risk. So if you use that train of thought, in a period of extraordinary, historically unprecedented uncertainty, what happened on 9/11 and afterwards is what you would predict to happen which is what we call a "flight to quality". When people, scared and don't know what's going to happen, they look for a safe heaven. I think it's ironic that although, this terrorist attack was on the United States, most of that flight to quality was into the United States, something you wouldn't expect, logically. The dollar has strengthened significantly against the yen, has strengthened a little bit against the euro but it is a natural tendency to go to a strong currency in times of crisis. There was an enormous demand for US government securities, the safest securities for anyone to hold in the world. You can argue that should be true or not, but the reality is that the demand was very high. On the other hand, the more risky securities declined even more precipitously than had before, the high risk junk bond market was affected very precipitously. People wanted to get out of anything that was high risk before and fled to high quality instruments. The venture capital and prívate equity industries that were already suffering their worst year in 25 years before 9/11, that industry has come to a standstill in terms of new investment activity. Now, this is a short term phenomenon. I expect that it won't last very long. The IPO market, the market for new companies coming to market to raise capital, stopped in its tracks after 9/11 and has yet to recover. In other words, everyone that was contemplating raising money in the capital markets, there were no investors there, and that whole activity halted. So what you had after 9/11 was a flight to quality, a temporary halt. People wanted to stand back and wait to see what happened, and of course, this is not very good for emerging markets, as you can imagine. Emerging markets are preceded by most international investors as being towards the end of the spectrum in terms of risk. So everyone was looking for shelter after 9/11 and I think that they still are. The markets have not calmed down completely.

Let me mention one other factor that exenterated and aggravated this, the "wealth effect". The wealth effect refers to the amount of money that investors had gained over the last seven or eight years putting their savings into the stock market, riding the wave as the value of their portfolios went higher and higher. Even though they didn't spend that money, it changed their perception of their wealth. Not only the perception, in reality, if the value of your stock portfolio is much higher, you are wealthier on paper. Now, some people, sold their stocks and spent those gains, but economists would tell you that a certain percentage of that gain, 5%, 10% of that paper gain that you have, you will psychologically translate into wealth and you'll spend it even though your salary may not have gone up and your cash flow may not have grown, you feel wealthy. So you spend more. That wealth effect was one of the phenomenon that was driving the economic growth in the United States into the year 2000, when the stock market started to decline.

Subsequent to that, when the stock markets began to decline in the middle of 2000, the reverse happened. We have lost –depending on which estímate you listen to– 3 to 4 trillion dollars of paper wealth from the stock market losses in America. What happens is the same thing, in reverse, which is why people begin to pullback; they became scared that their portfolios are not going to be worth as much. That affects their spending patterns. Why do I mention this? Because after 9/11 this kicks in very strongly on top of all the other fears. Uncertainty about the future. Portfolios were worth a lot less and people began to pull back the way they spend, and that aggravates the decline in the economy by slowing down the consumer spending and we're already beginning to see evidence of slower levels of consumer spending.

Again, these are all short term phenomenona, but one has to have a little bit of perspective on all this and remember that we're in the very early days in the aftermath of the historically unprecedented event. But certainly that wealth effect was quite important in my view.

In Latin America the situation subsequent to 9/11 has not been a very pretty picture, as you know well. It has driven most international investors a way. All the three mayor Latin American economies (Argentina, Brazil and Mexico) are suffering very serious economic problems right now, partly reflected in their stock market performance. I don't have to tell you what happened to the Merval, which is in the slowest levels in ten years; Bovespa, similarly is suffering a tremendous setback, some surprisingly given what we expected even a year ago. Mexico's GNP grew 7% in the year 2000, was considered to be the star of Latin America. Mexico possibly would be the one that suffers the most as a result of 9/11. Mexico gains the most because of its proximity to the United States and the socalled special relationship that it has with the United States, it gains the most in the good times and it loses the most in bad times. 90% of Mexico's export goes to the United States. They are going to suffer enormous losses. 80% of Mexico's tourism industry, which is very substantial, comes from the United States' traffic. You could imagine these weeks and months after 9/11 are hitting Mexico very hard. They'll be lucky to have any growth this year after evidencing 7% growth in the year 2000.

So the situation is not very attractive in Latin America. If you move to the other emerging markets, I'm afraid I can't be very optimistic either. The weakness in the United States and in Japan, which I talked about a minute ago, suggests that the major emerging economies of Asia are in for a very rough time. In a way, even more than Latin America because as you may know the South-East Asían economies in Korea and Taiwan are countries that are very export oriented, very heavily dependent for the economic performance, much more so than Argentina, Brazil, Mexico. With their two mayor markets in decline, in recession or close to recession, this has a traumatic impact on their economic performance.

There is another dimension however of some of these counties which we want to keep our eye on. You do not want to make any predictions, but look at Indonesia: a country with the fifth largest population in the world, in worst economical shape than Argentina, if I may say that has the largest Muslim population in the world. Malaysia has a very substantial Muslim minority. The Philippines has a significant Muslim minority. l'm not sure if this is a curse or a blessing for these countries right now, but certainly they're getting more attention today than they would have one month ago because of their place in this global equation. We're trying to figure it out in terms of how to battle the terrorist threat. So the short term outlook seems to me is not very good for these countries. Let me just end on a more optimistic note. I'm talking primarily about short term effects. In the United States we have just completed a historically unprecedented period of prosperity and sustained economic growth. From the early nineties till the year 2000 we just went like this. An entire generation of Americans almost forgot a basic rule that is still valid about economics, that there are cycles, there are business cycles. We go up, we go down, we go round and round. All my students have never known a period of economic decline, none of them. All the people I used to work with in Wall Street, that were under 35, had never known a bear market, had never known a recession. So this is tremendous, but I think, in some ways, a healthy reminder to a whole new generation that economies are cyclical, and that they do recover. I think that when the fundamentals are sound, there is a certain resilience that economies will rebound. And I have no doubt that in the United States, at least, and I think in Europe as well, there will be a rebound.

Going back to the policy framework in the United States, Mr. Greenspan's interest rate cuts –which continue– are going to begin to have an effect. We have very large physical stimulants with a tremendous amount of new government spending coming on stream and tax breaks. This economy will bounce back fairly confident and we need this economy because the United States' economy comprises more than 30% of the world GDP. If you put Japan and Europe on top of that, it sums to 70%. When all three of these regions or countries are in economic decline, you have a serious global economic problem. But it is cyclical. I'm not sure about Japan, but in Europe and the United States I am recently confident that the recovery is going to take place. But I think that you have to go back to the fundamentals and you have to concentrate on the fundamentals in arder to ensure that this recovery is able to take hold.

Finally, let me say that we are coming to grips in the United States and around the world with what 9/11 meant over the long term. This battle that we have just started against international terrorism is not going to be over with a few cruise missiles or a few sorties from some of our F-16 or F-14. I think that most people in Washington believe that this is going to be a very long, very difficult, and very complex battle to win this war of international terrorism. If that is correct, there is going to be a period of uncertainty and risk. People are going to go to their safe heritance financially, as well, until they have a higher level of confidence, that this battle is going to be won, which I have no doubt that it will. But this is a new era. There is a great deal of confidence in the world today and until that confidence is restored, and I am confident that it will be, I think that it will be very difficult for countries that are not very strong economically and financially to gain access to the international financial markets, and this obviously does not bound well for Argentina in the short term and maybe in a discussion we can talk a little bit more about your particular situation and what might be done.

That's a very quick endure overview of what I think is going on in the market place and I thank you for your patience and endurance.

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