Post-Election US and Global Economies & Markets—Prospects, Risks, Issues*

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These remarks are segmented into, first, a look at US and global economy prospects. Basically, the US and global economy are, we think, in the middle of the expansion phase of a global business cycle upturn. Then, I will talk a little bit about the risks to the US and world economy. At the beginning of the year, one must always take account of what might go wrong with the basic view. It is almost inevitable that as the year progresses, events and things will happen that will threaten the basic view. Third, I will briefly provide our look at various markets, including a few comments on currencies, particularly the dollar. I will finish with a review of the post-presidential election range of policies that we expect to see from the current Bush Administration, both economic and international.

US & Global Economy Prospects—Mid-Expansion

2005 looks like a typical mid-expansion year for the US economy. There will be solid, but not robust, growth. Core inflation *ex*-food and energy will creep higher. There will be diminished, but still strong, growth in profits and a moderate rise of interest rates. On average, there will be a higher stock market as the year progresses.

Federal Reserve monetary policy is on course to keep raising short-term interest rates until monetary policy "neutrality" is reached. US fiscal policy looks very active, with some fading of the massive—and it was massive—fiscal stimulus tax cuts and the high rate of federal government spending that occurred in recent years. That fiscal stimulus is fading in the US. But it will be offset to some extent by two new tax reductions passed last year in September and October: the US Family Jobs Act and the Business Relief Act.

In the second term, the Bush Administration will mostly propose "reform". The concentration will not be on strong fiscal stimulus to revive a weak economy, as was the case from 2001 to 2004. It will be mostly on "reform". Reform will range from social security to taxes, to pensions and to the legal system. There will be some attempt to reduce the federal budget deficit. Pressure from the US and other G7 countries on China and Asia to adjust global imbalances and misaligned currencies will likely be applied.

For the US, we are forecasting real GDP growth to be about 3.3% in 2005, fourth quarter-to-fourth quarter. That is lower than the very robust 3.9% of 2004, but still represents a quite solid expansion. The consensus view on the US growth rate is somewhere between 3.5% and 3.75%. Our own view is for a somewhat softer US economy than the consensus of forecasters, and probably of the Federal Reserve itself. We feel that way because there are a number of downside risks facing the US economy. These will keep the economy from getting to 3.5% or 4%. There is not much difference between those two. Our expectation is that we will grow a little below the potential rate of growth in the US.

The overall inflation rate should diminish somewhat—the inflation that includes food and energy. Crude oil prices probably will not get much beyond USD 50 or 55 per

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barrel. That is an assumption, and one of the risks to our outlook. If, for any reason, crude oil prices should soar to 65 dollars or 70 dollars or even 75 per barrel—not impossible in a very difficult world of geopolitics—it would still occur in a world economy that is growing enough to demand oil and energy. If it were to get that high, then we would likely see a significantly lower growth rate than what we are talking about for the US and global economy. Oil prices can be very volatile. Last year, they ranged from the crude oil prices low 30s to as high as 55 and 56 dollars per barrel. At the end of the year, it had dropped to the low 40s. This morning, I saw something like USD 48. If crude oil prices stay fairly close to where they are now, the overall inflation rate in the US, including food and energy, should stabilize and may drift a little lower.

The "core" inflation, that is the underlying inflation rate *ex*-food and energy, likely will "creep" up. It is running 1.5% now. It is a significant indicator because it is the "core" rate of inflation that the Federal Reserve watches and on which it makes monetary policy. At 1.5%, year-over-year, it is in quite a comfortable range for the Federal Reserve. The "core" inflation rate is not the reason why the US Federal Reserve is raising interest rates. The main reason is to remove the extra easy monetary policy that was in place between 2001 and the middle of 2004. The Federal Reserve thought that was necessary to revive the US economy in a sustainable way. We think the "core" rate will drift up, even as the overall rate of inflation drifts down a little. The two will get closer to one another. The "core" rate will likely approach 2%, or a little more.

The exact technical indicator the Federal Reserve watches is the consumption deflator *ex*-food and energy. If that particular measure of inflation were to move significantly higher than 2%—or even if there were a risk that it looked like it might move significantly higher than 2%—the Federal Reserve might raise interest rates faster than the basic view we have. The basic view we have is that approximately at each meeting for almost all meetings this year they will raise interest rates 25 basis points at a time. *Inflation is key to the picture on interest rates in the US this year.*

The jobs market should continue to improve, although unevenly so, with the unemployment rate moving lower to near 5%. It is currently at 5.4%. Jobs growth in the US last year was 183,000 per month. That is on the nonfarm payroll measure. The well-known Establishment Survey, a survey of companies, counts the number of jobs, not the number of people working. The calculation of the unemployment rate, as many of you know, is based on people working *versus* those not working, relative to the labor force, which includes all those who are actively seeking work. Jobs growth in the US has been much weaker during this recovery than others.

We think there are structural changes in the labor market in the US that are pronounced and pervasive. These structural changes will continue. These changes are in the technological displacement of a lot of intermediary jobs, in the outsourcing of jobs from the US to countries like India, and in the outsourcing of production to low-cost production countries, which is the nature of multinational companies these days. Jobs, of course, go with that globalization. The structural changes in the labor market can also be seen in the corporate psyche of US-based multinational corporations. Such companies are reluctant to hire people because the costs, including health care costs, are so great and the drive to maximize productivity, and hence profits, is so intense.

So jobs growth, to go with the 3.3% real GDP growth rate we are forecasting, will be less per unit of GDP than used to be the case in the middle of an expansion. We hope that we will see 200,000 jobs per month. The unemployment rate can go down with as few as 130,000 or 140,000 nonfarm payroll jobs being created per month because of slower growth in the US labor force. We don't need the numbers we used to get on jobs

creation to get lower unemployment rates. We used to need about 300,000 or more jobs each month in order to see declines in the unemployment rate.

This picture, particularly of jobs growth, in an expanding economy, the low 3% range in terms of real GDP growth, provides support for consumer spending. The strongest underpinning for US growth will come from consumer spending. Consumption spending is expected to be up over 3% in real terms. This is a slower pace than the historical trend for consumption, in the aggregate. That trend is 3.4% per year in inflation-adjusted terms. That's a lot of spending by consumers on average, almost 3.5% per year for the last 40 years.

As you know, the US is a big spending society. The personal savings rate is less than 1%. That should continue. Our expectation, though, is that it will be a softer, though still adequate, year for the consumer in part because of the jobs growth I described, which will generate good growth in income, but not enough to give us the historical trend on consumption. Consumer spending rose 3.7% last year, in real terms. Last year, we had quite a lot of tax cut stimulus that came into the economy to push consumer spending up.

Business capital spending should stay relatively strong. We are estimating 7% to 8% for the year compared with over 10% in 2004. Last year, there was a special bonus depreciation on equipment outlays in the form of a 50% write-off. That will be gone this year.

Over the past year-and-a-half in the US, we have had major increases in spending on technology. This now constitutes a very large share of US capital spending. Indeed, for most countries around the world, technology is taking an ever-increasing share of capital outlays. With weaker capital spending and the loss of bonus depreciation, spending on technology will soften, but still grow positively. That, of course, will ripple out to a number of countries around the world that are strong exporters of technology. The softer picture for consumer spending is still good, but not as robust as last year. This also means demand for consumer electronics will be solid but not so robust as it has been over the past year-and-a-half. That is significant for Asian countries, since so many exports in Asia are technology related, both to the US and within Asia, across the trade flows between countries.

For the global economy, a slowdown is expected compared with 2004. Global economic growth for the 48 countries analyzed and forecasted by Decision Economics is estimated at 3.2%. That's down from the robust 3.9% of last year. Over the course of the past year, because of the massive stimulus—fiscal and monetary—in the US, the US economy grew by almost 4%. Much of the upturn was powered by consumers and consumption and by business capital spending, particularly on technology. That rippled out through most of the global economy. Although China is growing very fast and rapidly absorbing greater proportions of exports from many countries around the world, the biggest buyer for the world is still the US.

In addition, China has been in a boom, as you know. For China last year, growth looks to be in excess of 9%. Between the US and China, a recovery in other Asian countries and a very strong year in the UK and Canada, the global economy never was in a boom last year. Growth was near 4%. That is a very, very strong year. A growth rate like 3.2% is still very good, but the momentum of global growth would be less.

The Japanese, Asian Developed Countries, Chinese and Emerging Asian Economies ex-China all will slow down from what was a big recovery in 2004, where real economic growth ranged from as low as near 3.5% in Japan to over 9% in China. Economic

growth in Japan this year is pegged at about 2.5% versus last year's 3.5%; for the Asian Developed Countries ex-Japan—that's Korea, Singapore and Taiwan—at almost 5% against over 6% in 2004; for Emerging Asia ex-China—the Philippines, Malaysia, Indonesia, and countries like that—between 5% and 6% relative to 7% last year; and for China, a slowdown after currency revaluation—which we are guessing will take place sooner rather than later—to 7.5% or so against 9.2% in 2004. We emphasize the word "guess", since no one can tell what China will do, or when. We expect South Korea to have a "soft" year, with real economic growth at about 4%. Compared with history, this pace of growth lies in the lower end of the ranges typically seen here.

The Eurozone is forecast to exhibit another year of sluggish growth, principally in the main countries of Germany, France and Italy. Less growth in exports, a lagging consumer, and the restraint of a stronger euro all are factors, with growth in potential output for these major countries only 1.5% to 2%. The more peripheral countries of North and South Europe should do better. So should Scandinavia. The transition economies of Europe—Russia, Poland, Hungary and the Czech Republic—should grow strongly.

The UK economy will also be weaker in 2005 compared with 2004. We are forecasting the UK to grow at about 2.5%, down from over 3% this past year. This has been because of, or is likely to be due to, a stronger pound sterling and the rises of interest rates by the Bank of England last year. That was meant to slow down the UK economy, and it is happening. Canada should grow about the same as last year. Latin America is expected to show robust growth once again; for the region 4.5% to 5%, after 5.5% this past year.

Finally, the economies of the Middle East should be better as the region adjusts to the ongoing geopolitical situation and tensions between Israel and Palestine, which, we are assuming, will diminish somewhat. Much depends on the renewed efforts for the peace process and the US role in that. President Bush, now that Prime Minister Arafat is gone, and Secretary of State Rice will move very quickly to try to take advantage of what is viewed as a window of opportunity to promote better relations in the Mideast. A larger policy on the Middle East will be to stabilize the area, and to convince—and this will be very difficult—Middle East countries that a democratic world, a free market world, is the way to go. That will be tough. But you will see that from the Bush Administration, in their tactics and strategies, with allusions to that as soon as this Thursday's inaugural address and, if not there, in the State of the Union address in a couple of weeks.

The main reasons for the global slowdown include: 1) slower growth in the US; 2) some reduction of real economic growth in China; 3) a weaker economy in Japan; 4) still strong, but less so, growth in Asia; and 5) stable, but sluggish, growth in the Eurozone. All-in-all, global business activity should be reasonably active and supportive to continuing expansion.

We are in the middle of a business cycle expansion, both US and global. Economies in the middle of an expansion tend to be resilient and resistant. The excesses and fragilities, the inflation that brings about punitive monetary policies, really are absent in the global economy today, although there are other risks.

Risks—Downside and Upside

Unlike other mid-expansion episodes, *an unusual number of downside risks exists* for the US and global economics. These include:

- *Unacceptably high inflation,* possibly from either a sharp slide in the dollar,

higher oil and energy costs, rising unit labor costs, or some, or all, of these. Additional Fed tightening on the risk of too high core inflation, beyond moving from "accommodation" to "neutrality," could, with lags, bring down the economy.

Inflation does not have to be too high for it to be unacceptably high for the US Federal Reserve. One of the two goals in the twin objectives of US monetary policy—it is very unusual for a central bank to have two objectives—is the main one of price level stability, essentially the major goal for most independent central banks in the modern working of monetary policy. The range of inflation that matches price level stability is essentially 1% to 2% in the "core" rate of inflation on the particular measure I mentioned earlier, the consumption deflator *ex*-food and energy. That rate is running 1.5% right now, so it is in a very comfortable place. In addition, price level stability, which is defined by a stable low rate of "core" inflation, also has as part of its definition stable inflation expectations. That is to say, behavior in the private sector that is not in anticipation of continual rises in prices.

In surveys and in financial markets, inflation expectations in the US seem to be fairly quiet at this point. They are not an issue. If either the actual rate of "core" inflation or expectations of inflation, measured or observed in various ways, should get out of hand—possibly from either a sharp slide in the dollar, higher oil and energy costs spilling over, rising unit labor costs from a low unemployment rate, or some or all of these—additional Fed tightening on the risk of too high "core" inflation would be put in place. That is, the Federal Reserve would launch a policy that would go beyond moving from accommodation to neutrality, which is their path now, which could, with lags, bring down the US economy. A weaker or recessionary US economy would essentially take the world economy down with it. This is a risk. It is not yet a problem, but it is something we all have to watch.

- *A second downside risk is the negative effects on the economy from fading policy stimulus,* both fiscal and monetary, as the positive effects of the 2001, 2002 and 2003 tax reductions wear off and the Bush Administration tries to restrain federal government spending, which I believe they will do. We have had five tax reductions between 2001 and 2004. That is a record. The amounts are massive. The tax cut stimulus and increased federal government spending of the Bush Administration, I believe, was a major reason, along with those low interest rates held that way for a long time, for the substantial recovery over the past two years in the US and world economies. As time goes by, the stimulative effects of the tax cuts will diminish and no more come in. In addition, the Federal Reserve is raising interest rates step-by-step. A combination of the two could surprise us with weaker growth than expected. That's a downside risk that we have to watch. I wouldn't call the macroeconomic stabilization policies tight. There's still a reasonable amount of fiscal stimulus coming into the economy, interest rates are low, and the flow of liquidity in the US economy is extremely high. But, still, we have to watch this carefully. The amount of stimulus poured into the US economy was extraordinary. It was unmatched by anything since the early years of the Reagan Administration in the 1980s and the Kennedy/Johnson years back in the 1960s.

- *A third downside risk comes out of the financial markets themselves, both in the US and globally.* There are possible tremors in financial markets. Financial market disarray along with continuing dollar weakness, or even a sharp dollar

slide, might create or induce upside inflation risks and unwanted inflation in the US. This would spike up long-term interest rates and then bring down stock prices. Sharp, negative moves in financial markets, if prolonged, could bring down economic activity, further weaken the dollar, and raise interest rates. This would produce a self-reinforcing negative downcycle.

The odds of this are fairly small. There are many imbalances in the US: the budget deficit and the current account deficit; an imbalance in trade with Asia and around the world; a rigid exchange rate tie between the Chinese currency and the US dollar; and lower Asian currencies than might occur otherwise without that Chinese tie to the US dollar. The fragility implied by these imbalances could hurt financial markets. We've seen occasional tastes of this in market trading. I call these "tremors". They aren't big earthquakes. In the 1980s, we had a lot of "tremors" but the big earthquake didn't occur until 1987.

What I've described has low odds. But on the whole screen of possible risks to this year, this good doctor has to look for anything that might hurt the patient and try to be aware of them. No matter how hard we look, almost every year there are things we didn't see or take account of that go on in the US and world economy.

- Finally, there are ongoing geopolitical risks and possible negative external shocks. These range from terrorist attacks; to interruptions in the supply of oil; to OPEC price increases; to new conflicts with countries like Iran, Syria or North Korea; and to Iraq and its future. That is a big list of geopolitical minefields for the US and world to deal with.

There is an upside possibility. It has to do with the unusual way the Federal Reserve is running monetary policy this time. Moving interest rates from a very low level to something called "neutral" will reflect, when done, sizeable increases in short-term rates. As the rates are increased, like a scalpel, they might tone down growth in the US economy and dampen inflation. This way, the normal business cycle and inflationary problems that occur in modern capitalistic economies like the US might not happen; principally not too high a "core" inflation rate.

As we go from beyond the middle of an expansion to the later stages of an expansion, a typical characteristic is rising inflation. The economy gets closer to full employment and employment rises too high for the central bank to handle. Then, in the name of price level stability, interest rates have to be raised. To get inflation down again once it is thus entrenched, the central bank has to take the economy down. That often is the step that leads to a recession.

This is possible. What I've described is a modern version of "Soft Landing." It is a razor's edge result. In this early process of returning the federal funds rate to neutral—a position that would be neither stimulative nor restrictive to the economy—the economy might settle down to near its full employment potential. The unemployment rate might fall and then be stable. Inflation might stay stable. The economy might go on with its expansion for a long time.

Something like this happened in the 1990s after the 1994 pre-emptive hikes in interest rates by the US Federal Reserve. If it did happen again today, it would be unusual and probably the first time in history. But the US central bank is playing the game different from history. I've learned that when central banks change how they play the game, we see different market and economy behavior.

Markets—Equities, Interest Rates, Dollar

We have a cyclical view of the stock market and of interest rates in the US and for most of the world on equities.

- *Equities*—In the US, we are in the second leg of an "equity bull market". An "equity bull market" is an expansion characteristic within a business cycle expansion. Equity prices go up, on average, very prominently in history.

  The second leg of this "equity bull market" in the US began just shortly before the election. Last year, the uncertainty of the election and the Iraq situation fed uncertainty. People did not know who would win or what policies would be forthcoming. This held the US stock market down for about six or seven months, between March or April and the end of October. The catalyst for the upturn since has been the end of the election, continuing growth in the US economy and very pro-growth, pro-business and pro-equity market policies that are coming from the Bush Administration.

  We currently estimate fair value for the S&P 500 to be between 1200 and 1225, with upside potential to 1300. This is a target for later this year, during the late summer or early fall, based on the prospects for the US economy that I described, future S&P 500 earnings estimates, and the path and pattern of interest rates in current valuations. If developments turn badly, we could go as low as 1150 or 1125 on the S&P 500. For the D-J Industrials, a possible run at the previous high of 11,772, which was five years ago, could happen. But it would require all the possible good events to occur at the proper times. We don't think the US stock market is quite yet ready to go to such highs.

- *Interest rates*—Interest rates should rise throughout most of the year, particularly short-term rates. The Federal Reserve will remove policy accommodation and reach—or almost reach—something called "neutrality". "Neutrality" would be represented by levels of the federal funds rate—both nominal and real—that are neither stimulative nor restrictive to an economy that is relatively close to "full employment." We expect 25 basis point increases of the federal funds rate at each of the FOMC Meetings, starting with the one on February 1-2, through to the middle of the year. That would take the federal funds rate to 3.25% at the end of June. Other short-term interest rates should move up about one percentage point, or more, as well. The 10-year Treasury note yield is likely to move higher on average, but not that much higher, to near 4.625% and 5% by summer. The yield curve should flatten over time.

  Part of the view on the 10-year yield is due to the way that the Federal Reserve is running policy. It has been aggressive in its use of transparency. It makes very clear where it wishes to go, why, how it is doing policy, and tells market participants what would happen to make it alter its course. For the US Federal Reserve to be that transparent is unprecedented in monetary policy history. We think this openness has taken a risk premium out of the long end of the US Treasury yield curve that normally exists around the uncertainty of what the Federal Reserve is going to do. This openness is being priced-in toward a lower long-term interest rate in the US. This openness allows it to be priced in more than usual. Nevertheless, long-term interest rates will rise by a goodly amount.

- *Dollar*—We have to view the dollar as being in a major downtrend. This is a

necessary adjustment to the large and rising current account and structural budget deficits in the US. However, we do have a couple recent positive fundamentals for the dollar, which appear to reflect its recent strength against other currencies. These positive fundamentals include the rises of US interest rates that I have described relative to interest rates in Japan and in the Eurozone, which will stay stable. They also include the UK, where rates will be stable. These positive fundamentals also include numerous countries in Asia, where interest rates, particularly central bank interest rates, are not likely to go up. The rising interest rate path in the US, particularly for short-term rates, against these stable interest rates elsewhere is a dollar positive.

US economic growth is also a positive. It is higher in the US against major trading partners like Japan, the Eurozone and the UK. That is a dollar positive.

However, against the economies of non-Japan Asia and much of Latin America, we are expecting US real economic growth to be less. That is a dollar negative against those currencies.

The currency markets are reflecting, almost as we speak, some of what I just described. For the dollar, there are many other issues, including: geopolitical risk and US involvement, progress, or lack thereof, in Iraq and the Mideast; the Bush Administration's view of the dollar, currently benign and permissive to further dollar declines; how much, and how long, shifts in holdings of dollars around the world toward other currencies that had previously been underweight against the dollar get taken up; and, finally, whether the returns on investments and loans in dollars are satisfactory to maintain dollar holdings in the portfolios of investors, central banks and others globally.

Our perception is that we have a shift going on around the world in the holdings of dollars. The overweight in dollars relative to other currencies in the 1990s got very large. We think we are in the midst of a rebalancing of dollar positions in many portfolios. One can never know when such a shift is over, but such tendencies tend to be in place for a long time.

Issues: Post-Election Policies of the Bush Administration, Oil and Energy, China and Asia, and Global Imbalances

Post-Election Policies of the Bush Administration—aggressive push domestically and internationally, but US-centered.

- Domestic fiscal policies will be active as in the first administration, but will be reform-centered rather than economy-stimulative. The personal income tax, dividend tax, capital gains and "death" tax reductions that sunset in 2009, 2010 and 2012 will be made permanent. That will be the first order of business. The Republican Congress will have no problem with that. There really is no negative federal budget deficit implication for this until 2009 onward. But from 2009 until 2014, the cumulative total increase in the deficit from making these tax reductions permanent is approximately USD 1.4 trillion.

- Social security reform is very controversial. Essentially, there will be a "partial privatization" of now government-administered, -run and –paid retirement payments to most US citizens. Young families will optionally be able to divert anywhere from 2% to 6% (to be determined in the legislation) of their current Social Security payments to individual accounts (401k-like) invested in safe,

balanced portfolios and administered in the private sector. In no way would any legislation permit families to take a chance with those monies and buy penny stocks, go to the race track, or do such things as that. Some of the critics of this plan say families will fritter away the savings. After all, Social Security payments are enforced savings. For a society and country that save so little, taking a chance on this would make it not worth doing. The legislation will contain provisos that will not allow that.

Social Security benefits would be maintained for those 55-and-up, although a change in indexing to price inflation rather than wage inflation and/or a gradually increasing retirement age may be legislated. The change in the indexing to price inflation, which is now to wage inflation, could, over the next 75 years, take care of the present value of the whole shortfall of the Social Security program.

Wage inflation in the US typically rises faster than price inflation. But Social Security payments are indexed to wage inflation. Yet US citizens purchasing a basket of goods and services rely on prices. So many think this would be good to do. But if it is done, it does mean reductions in benefits, because wage inflation normally rises faster than price inflation. Add to this a gradually increasing retirement age and it means lower benefits and longer enforced working years for US citizens.

These possibilities will be controversial. The demographics of the US, like those in other countries, many of them in Asia, and Japan certainly, are of an ageing population. This leads to increasing numbers of beneficiaries and demands on Social Security and Medicare and Medicaid. This is a major problem for the US and global economies. So, increasing the retirement age makes some sense. But it will be politically controversial, if suggested.

The transition "gap" between the Social Security benefits that must be paid and the incoming funds could be USD 1 trillion to 2 trillion over the next decade. This would require either additional special US government financing, tax increases or spending cuts. Tax increases will not come from this administration. Some spending cuts will, but not enough to take care of the "gap". So this prospect is disturbing to numerous people in financial markets. Heavy US Treasury financing could raise interest rates and restrain the economy.

At this time, prospects for Social Security reform must be regarded as uncertain. The Bush Administration is going to suggest a revolutionary change for Social Security and retirement in the US.

- Tax reform is a third part of the Bush Administration's proposals. This administration wants to simplify the now very complicated US tax system with a slant toward a broader-based more flat tax with fewer exemptions for individuals and businesses. It also wants to allow the immediate expensing of capital equipment outlays by business. That is, it wants to allow full expensing for equipment whose lifetimes, particularly in the technology area, are very short.

  The studies on accelerated depreciation in which I've been involved have always suggested that we get a very big bang for the buck on capital spending out of accelerated depreciation. This is a pet policy for me; I hope it happens. It would raise capital spending, particularly in technology. That would have

implications for countries all over the world, including, of course, Korea.

A Bipartisan Commission is supposed to present its findings by the end of July. Recommended legislation will come thereafter. Before the Congressional Elections in 2006 will be the time of tax reform. Tax reform is supposed to be revenue neutral so as not to raise the budget deficit.

- Deficit reduction is now recognized as a problem by the administration. This is, in part, a byproduct of the necessary fiscal stimulus of the past four years, which I have described here as "massive". A freeze is likely to be recommended on discretionary non-defense spending, but this is only 15% of budgeted outlays. Defense spending requests are being pared down, but they are still large. Along with additional funding requests on Iraq worth perhaps USD 100 billion and spending on terrorism and homeland security, spending in these areas will be hard to control. Some limits are being talked about on the growth of entitlements, the biggest source of out-year federal budget deficits. I call these "societal demands" on the budget. These are likely to begin hitting in a very big way starting in 2007, and then in 2008, 2009, 2010 and 2011. Most of that comes from rising health care costs for the government as more and more US citizens age and go onto Medicare and Medicaid. The health care inflation rate far exceeds the overall inflation rate, accelerating these costs.

  There is no answer to this issue. No major efforts are being made. It is, to us, the single biggest reason why we are projecting very large out-year structural budget deficits for the US. If those structural budget deficits are maintained, they will also keep current account deficits high and could lead to some serious financial consequences in US financial markets, and perhaps worldwide.

  A day of reckoning is still a good way away. Raising the retirement age would change the calculations of healthcare benefits on Medicare and perhaps Medicaid, as well as Social Security outlays. We will see what happens.

Legal Reform—The Bush Administration is also very strong on legal reform. It wants to reduce litigation costs and to reform the tort system with caps on settlements and changes in the court system administration of litigation. This has a good chance, with a Republican Congress, of seeing something done.

International—Decision Economics expects a continuing presence in Iraq with the associated expenditures necessary to do that. Those are rather sizeable, perhaps USD 100 billion this fiscal year. We expect the spread, or attempted spread, of "democracy" into the Middle East, working with Israel and Palestine in the peace process, attempts at better relations with European Allies, and working through G7 for purposes of changing currency alignments. Surprises, of course, in the "international" arena cannot be ruled out. We've seen many before.

These are just a few of the issues in what looks like a very active policy year for the US. In retrospect, the Bush Administration was a very activist administration in its aggressive use of tax cuts and strong government spending, in some of the measures in education, and in some other attempted measures during the past four years. Certainly, it was a very activist administration on international affairs, where a whole new US policy—to some extent preemptive—was put into place.

President Bush is that way. The pattern is clear. I say this being non-partisan. I say this not as a plus or a minus, but as an observation. The way in which the US conducts its

policies domestically and internationally, affects the whole world. President Bush did not go to Washington to twiddle his thumbs and to pass on, as he puts it, problems to the next generation. Since the expectations of this president were not very high to begin with, which has been part of his history, he probably figured, "How much is there to lose?"

He's a very controversial president. The policies are very controversial. This Bush Administration will make its mark on history. They have proven themselves, at least as I've observed them, on the tax cuts and during the election, to be surprisingly savvy on the political side. Certainly, the president has been less than well received internationally. He has not had the impact internationally that he has had in the US, except by use of US force. But if I had to bet, I would probably bet that this administration would get some of its Social Security reform done and that we will see a very much changed US tax system, the form of which may be clear by a year from now.

On the international side, this administration holds the view that terrorism must be dealt with, not just unilaterally, but multilaterally. It feels that wherever weapons of mass destruction may possibly be—and they were not in Iraq—the US will try to take the lead to eliminate them. Along with that belief, there are certain other risks that have to do with confrontations with other countries in the world, one of which is very close to you here in South Korea. Anything along those lines will cause major tremors in financial markets if there are further confrontations, even if not of the Iraq variety.

It's going to be a very interesting year for the US and global economy. In the middle of an expansion, economies can withstand a lot of nervousness and a lot of shocks. There are many such possibilities for all of us to watch carefully during the year.

Questions & Answers

Q In the medium- to long-term perspective—ten years out or more—what is the current rate of population growth in the US? Related to that, Japanese demographics suggest an inherent shrinkage in population is starting to be reached: going out five to ten years from now, we will see a gradual contraction from about 125 million people. What do you see as a consequence of that for Japanese economic contraction? Is a similar effect likely to occur in the Eurozone? I'm just talking at the broad-brush level of overall population: less people, same GDP per capita, and the economy shrinks.

The more complex question, but one with a shorter time perspective, is in the risks category. If we push for a weaker dollar, and if we manage to shake the tiger from the US dollar's tail—that is, to break the linkage between the Chinese yuan and the US dollar—is there not a consequence of more expensive imported goods? That could create domestic price inflation in the US, could trigger a reduction of US domestic demand, and therefore a potential reduction in GDP.

A The ageing population and slowdown in population growth for G7 countries on a ten-year horizon is absolutely a fact of life. It is very important when you think to that time span. The population growth of the US is leading to a slowdown in labor force growth and a slowdown in jobs growth. It will ultimately take down our rate of potential growth and limit how fast we can grow.

However, the US economy has become very productive. Productivity growth plus labor force growth defines potential output growth. US potential growth at the current productivity growth rate that we see could, on that horizon, range from 2.75% to 3%.

That would be later in the future. Over a long period of time, you can juxtapose the US against the rest of the world. Think of China, or, if we could have a stable Latin America, which we have not historically, think of Latin America, or even the transition economies in what we used to call eastern Europe. Compared to numerous economies in Asia, the relative position of the US would decline.

In the case of Japan, that would be even more in force. In a Japan where population declines, consumption as a consequence would rise, on average, by less. The needs of the population would shift in what is now a deficit and debt-ridden country toward the government side and shift toward supporting an ageing population. Its potential rate of economic growth would shrink. This all suggested that on a long horizon—10, 15, 20 or 30 years—the relative position of Japan will be in decline. Where does this leave us? What conclusions can we make?

Economic power—in terms of growth, increasing wealth and perhaps political power—resides in Mainland China. However, I recall looking at Japan in the 1980s. I felt very threatened when I looked at the world in the context such as you have put before me. Nothing is as it might seem. When you look out five or ten years, much can change. It turns out that, for Japan, there were problems in its paradigm that were not easily seen when Japan was the powerhouse of the 1980s. That may also be true about China.

But for me, China is not Japan. Its culture, its energy, its entrepreneurship and its flexibility are very different. As a result, I think, relatively speaking, China will be in the ascendancy. It cannot surpass the US in terms of its position in GDP. Ten years from now, China might be 30% of the world in terms of GDP, compared with 7.5% today. But this is only if it grew at 9% per year and if the US grew at 2.5% per year.

Your other question had to do with the dollar and the expectation that China will re-value. If so, the dollar should initially go down and Asian currencies move up, in line with the Chinese yuan's move up. A lower dollar will carry with it—depending on how far it goes down—some inflation risk. The changing of currencies in this way would move toward changing, with lags, trade and current account deficits: in the US; in China; and in parts of Asia which are less competitive with other parts of the world in terms of how the exchange rates affect them. Over time, there would probably be a net positive effect for the US and world economies rather than a negative one.

If China revalues, one would expect the currency to go up. An initial pass would be to a basket of currencies. This would include the dollar and other major currencies. China would probably float a fairly narrow band, which would then be controlled. Markets don't tend to accept that and would probably drive the Chinese currency even higher. So we could have, and will have, if we have an unhinging of the currency after it has been fixed for so long, some big, big gyrations in financial markets. But financial market gyrations don't necessarily have a major impact on inflation or on economies, unless they continue in the same direction in a pronounced way from the initial shocks.

In ten years' time, if Chinese GDP growth is 8% to 9% and US growth is 2.5%, China's weight in world GDP would be about 30%. The US would still be the biggest source of world GDP. But, of course, a 30% share of GDP would far surpass Japan, and be the second biggest economy in the world.

Of course, if the weight of China in the world economy were to get that high relative to GDP, can you imagine the power of the country in all dimensions that would go with it? It would be a quite different Asian world and a quite different global situation if you had that kind of change in the relative position of economies in just a ten-year span. Those

growth rates are fairly aggressive. We're forecasting 7.7% for China this coming year, on an upward re-evaluation of the currency. Also, 2.5% is less than we're forecasting for the US. So the relative comparison I have given is based on an extreme average calculation.

Q I disagree with your assessment of the movement of the US dollar. You used three words to describe this policy. You said the US administration's attitude to the dollar, its dollar policy, is "benign". You also said the direction in which the dollar would move would be a "tremor" rather than an earthquake. Third, you also predicted the dollar would decline along a "trend". I disagree with each of these three words you used to characterize the dollar movement: "benign", "tremor" and "trend".

I think the US is more than "benign" in regard to its dollar policy. Maybe a more accurate word would be that the US is "totally irresponsible". The US dollar is the reserve currency. A country whose currency acts as the reserve currency has the obligation to see the dollar value be maintained in a stable fashion. But the US is not doing anything by way of increasing taxation in a country that is at war. Sure, the current administration is trying to reduce a little bit of spending, but I doubt how much it will be able to actually reduce spending in the current political environment.

I also have a dispute with the word "tremor". I think the possibility is that we may experience an "earthquake" rather than a "tremor". US liabilities held by foreigners is currency nearly 30% of US GDP. Those foreigners are very uneasy about the declining value of the dollar assets they are holding.

If the dollar keeps going down, foreigners, including the Chinese, may want to pull out of their dollar assets. If any one of the major countries starts doing this, it will bring an "earthquake". The movement of the dollar would not be gentle or steady. It would be a crash.

A There is the possibility of a major slide in the value of the dollar. The dollar is vulnerable and there is the possibility that in a short period of time there will be a "crash", though we have to define what that word means. I am with you about the downside vulnerability of the dollar. The fragility brought about by the combination of high budget and current account deficits, which have come for various reasons—one of which very little can be done about, i.e., the healthcare and societal demands on the budget in outyears—makes the two deficits, rising debt, and non-service of debt when interest rates rise that go with it, very scary.

I have previously written about this in a paper about a year ago with Bob Rubin and Peter Orszag. We highlighted the possibility of something called "fiscal and financial disarray," possible at any time. And, it could be triggered by the dollar.

The history of this kind of circumstances tells us, though, that when people in markets are reminded of it—perhaps in a speech by Chairman Greenspan, as happened a few months ago, or a terrible trade number, or something that markets view as irresponsible on the part of policy, or a casual comment by a president or an administration person—the market reaction is outsized. It is in reaction to risk and the fear of an earthquake. But the earthquake doesn't happen.

We saw this in the 1980s. We had many, many tremors. People like me were concerned about the two deficits and their implications and market implications. I talked about it for five or six years. We did learn that it takes a while to happen. So I'm a little bit more

cautious now about your well-placed concern.

I don't think I could use the word "irresponsible" about US tax policy because of the way in which the tax cuts were implemented and the reasoning behind the tax cuts. They were to rescue an economy, and a world economy, that was looking very 1930s-like, and then to deal with budget deficits later because of the choices. What do you do? Do you try to revive the economy and the world economy? Or do you worry about deficits and do nothing? Where would we be if the administration had done nothing? I have done some studies recently that ask that question. The US economy would have struggled very badly. It's a tough choice.

The risk is there, though, and markets will remind us about it at any time. As the US economy gets closer to full employment, if it does, the risk of what you describe will get greater. Along with any dollar declines, there would be some pickup in inflation, also a pickup of interest rates. That combination would be deadly for the stock market. If the stock market went down, investors would perhaps flee to other places where there was less risk, although there would still be risk. Some of those holdings you described could be let loose. Then we would have real trouble.

So, I am aware of what you say. It is a significant risk in our thinking. "Benign" is the choice of words for this administration. They are certainly going to allow the dollar to go where the market takes it. If the market takes the dollar down 25% in a week, I don't think you'll see no reaction, however. If it gradually goes down 10%, or 15% or 20% over the next year or two, there will be no reaction. If it goes down 25% suddenly, you will see a reaction. If it goes down 25%, though, over a year or two, you probably won't see much reaction at all by the Administration.

The real test will be whether or not the policies of the US get fixed and move in a direction that represents soundness, which, in turn, will be the basis for a solid or strong dollar. Given your perception, I hope you don't own any dollar-denominated assets. You should be out of dollar-denominated assets, given the view you have.

Notice, though, that I haven't said anything to counter your view. I can't say anything to counter the concerns you expressed for the long run on how US policy is being conducted.

Q I have three short questions. During the Vietnam War era in 1968, the US expenditures was USD 36.5 billion. Each day, the US spent USD 100 per US soldier in Vietnam. At that time, a New York subway token was about 15 cents. Now, it is USD 1.50. If you also multiply the Vietnam War expenditure by ten times, you get a huge amount. What is the yearly Iraqi war expenditure these days?

Second, what is the 2005 budget deficit you are expecting?

Third, yesterday the London market closed with JPY 100 being equal to USD 1. At the end of next year, what will be the JPY: USD rate?

A The Vietnam War expenditure came on top of an already significantly rising inflation rate in an economy that was actually above full employment. It added a lot of demand stimulus. It was a much larger portion of the US economy than is the USD 100-150 billion annual outlay on Iraq at this time. It is a smaller percentage this time. So as a demand stimulus to the economy, it is minimal. It is an extra-added budget deficit item. That is a negative. But it will have nowhere near the magnitude of the inflationary

impact that the Vietnam War turn in spending had.

Second, we are projecting a US budget deficit in 2005 at about USD 400 billion. The budget deficit will go down before it goes back up again in 2007, if the US economy grows at the rates I described.

Third, we are currently predicting a range from JPY 105 to 100 to the USD. We think we will challenge JPY 100 fairly soon. We are thinking the middle of the year will see JPY 95 or 97. One year out, I'm not sure whether, as the year goes by, the major downturn I described necessarily stays for the dollar in the same scope. So a year from now we see the low rate somewhere in the JPY 90s to the dollar. Remember, that the Japanese economy isn't doing that well. Interest rates are flat and will not change. Those are really yen negatives. The depreciation of the dollar against the yen may not be as great as some may think.

Q Bush is pushing a series of reforms through Congress. They cover taxes, Social Security and tort. First, about Social Security, as you know the Democrats don't want any reform in this regard. They have gone so far as to even question whether the US really has a Social Security crisis. Against that argument, you also provided some ammunition for them in the sense that, because Social Security is based on waged-based inflation, which is higher than the "core" inflation rate, it provides a rise in Social Security revenue. But this was looking backward. In the past, wages were rising faster. But with the changing reality with US deficits and non-employment keeping up with an expanding economy, this trend certainly will not keep going. The US consumption base also has its weakness. How does this affect your Social Security calculations?

Second, any reform toward a simplification of a single tax rate, as Steve Forbes has mentioned, is certainly anathema to the Democrats once again. What are the chances of Congress passing such a law?

Third, you mentioned a tort law reform bill has a low chance of passing. But I also saw some analysis of the most recent election where people did not really talk much about the fact that John Edwards was a tort lawyer, and in fact did quite a bit of damage against the American Medical Association (AMA). The AMA is very solidly against him. How does this play against tort law reform?

A First, I do think the administration is over-emphasizing the problem of Social Security. It is part of the game. First, everyone has to understand there's a problem. If you don't have a problem, there's nothing one can get done in our society. So their use of the infinite horizon in calculating the present value of the "gap" in Social Security between receipts and payments, which gets to USD 11 trillion, is what is being debated. On a 75-year horizon, the present value of the gap, as calculated by experts like Peter Diamond of MIT, is USD 3.7 trillion. But it still is a problem.

Part of the problem is that there is a difference between the returns US citizens get on the monies invested through Social Security presently and the way in which they are invested, which was part of the original legislation, versus the returns in the capital markets, on average, over decades which one might get. The question is whether you can take advantage of that over 50, 75 or 100 years. What we've seen in the past is that 50% of the returns that exceed 7% or 8%, which exceed bonds by about 2% or 3%, create in a compound interest way a much bigger largesse. That is really the motive force behind the thought of partial privatization. That's part of it. But also, as with a lot of stuff that comes out of the Bush Administration, it is just part of the debate that

ranges from what went on in Iraq to the rhetoric of the election, which overdid much in order to sell what was being sold at the time.

Second, the wage measures at which we look are rising faster than price inflation. That is about 4%, which shows higher wage inflation than the CPI-W. On average, you're right. Wage inflation will not exceed price inflation as much as it used to, partly because of the way we measure it, partly because of the way in which US citizens are paid, and partly because of how corporations are running things. However, the historical relationship of wage inflation over price inflation will prevail, on average, and does suggest we ought to go to price inflation for indexing, which is the way everything else is indexed.

Third, there is a broad constituency for tort reform in the US. I don't know if that affected the Kerry-Edwards campaign in terms of the election. I would say that to get 3.5 million votes, over 50% of the votes for President Bush, was really quite striking. The perception was it would be a very even election, and that it might even be unknown for months. But Bush won handily. The political pundits have not yet figured that out.

But on tort reform, litigation has gotten out-of-hand in the US. The question is what will replace it, maybe a USD 250,000 cap, which among malpractice suits can be too little. But in the present Republican Congress, some sort of tort reform will get through.

Fourth, as far as tax reform goes, simplification will occur. But that means you have to get rid of some tax deductions, close some loopholes, and probably have fewer tax rates. I doubt that our country will do a full flat tax or a value added tax. Even the president has said that if we go that way, he wants to see exemptions for charitable contributions and mortgage interest rates remain, anyway.

At the end of the day, we'll probably have some movement toward less taxation of capital, I would guess a full elimination of the tax on dividends, maybe another tax reduction on capital gains and full expensing of capital equipment, but not all the way toward a flat rate tax or a complete tax on consumption. That is the theory from supply side economists and many advisers to the administration.

Q I would like to ask about the leadership of President Bush in the administration's policy toward the global economy. Do you think Mr. Bush in the US can show leadership in the global economy, including in macroeconomic adjustment and trade policy?

A I try very hard to remain non-partisan. I do not want to suggest anything that may influence your investment or business plans. If you believe what you believe, you should follow it.

But in terms of explaining how the Bush Administration thinks in terms of risk averseness, if there is a small chance of—they have used the word "rogue state" at one time, though they wisely don't use that word anymore—such a country having weapons of mass destruction, and some small chance that those weapons could get into the hands of a terrorist who could show up on the soil of the US, that was a chance they could not afford to take.

The second Bush Administration has had, in the president's words, a ratification of the Iraq policy of the first four years. He's a salesperson. He is quick to take what I would call an "assumed welcome approach," that the sale is done. I don't think that view has

changed. If there is a small chance that there are weapons of mass destruction being developed or existing in a country that has declared itself to be inimical to US interests, and terrorists could get their hands on such a weapon and show up in the US so that something like September 11 could happen, the US will take action to prevent that.

If you understand that mentality—a risk averse mentality, which is the same mentality our Federal Reserve uses, in terms of its twin objectives—if there is a small risk that something might happen to take down one of their objectives and make it not happen, like price level stability, say, that has a big cost. The violation of, in this example, price level stability, would have a big cost in their view. Then, they would raise interest rates mightily to make sure that doesn't happen. This is a risk averse view. It still holds true.

Colin Powell did not fully agree with that, as we all know, and the extent to which that view was part of foreign policy. Condoleezza Rice is, by nature, collaborative and will reach out, along with others, to US allies. But she will be more of a follower of the president than Colin Powell was.

So, yes, I do have a fear that confrontation with Iran, or Syria or North Korea could light up the screen and cause tremendous tremors in markets and potentially harm economies if pronounced. But I also have no illusions. If those countries do not toe the line, the Bush Administration will be very tough.