Seismic Shifts, the World Economy, and Financial Markets in 2007*

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I want to thank all of you for coming to hear my remarks this morning. I wanted to talk to you today about not just the prospects for the US and global economy and financial markets for 2007, but to also bring a bit of a global perspective in terms of what I call seismic shifts; some very major changes in the longer run, secular shifts and themes in the global and US economies that are occurring within the context of the 2007 and 2008 outlook for economies and markets. We have a number of them. There are at least ten shifts that we have identified. "Seismic," as you know, is a word that refers to the shifting earth, earthquakes, and major shifts in the landscape. "Seismic shifts" refers to major shifts in the US and global economies and in some instances, to societal changes that are going on. They are longer-run, from what we observe. They are not necessarily events or processes that each day are noticeable, but over time, the shifts that are making for how economies and markets will behave.

One of them has come to be called the changing economic geography. It refers to the emerging importance and greater role and influence of countries and groups of countries that previously were not in the center-stage of world economic activity. Indeed, one theme for 2007, and again last year when I spoke to you, was that the US economy was going to slow down in its growth, but the non-US economies, collectively, the global economy, were going to speed up. We saw that happen in 2006, and think that in 2007, the shift in the pace of growth in the United States, Asia as a group of countries, the Eurozone, and the emerging world- that relative growth rates across those regions will maintain their shift in speed. Part of it is the changing economic geography; the emergence and presence of rapidly growing economies, such as China and India, and groups of countries such as emerging Europe, the former Soviet Union and Eastern European countries, and countries in Latin America, the emerging world, the developing world. They are now so much a part of the global economy, and influencing in a greater way than before how the global economy will behave, changing economic geography.

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But one example, and an obvious one, is China, now by our measures, the forth-largest economy in the world. India is growing rapidly, with 8-9% GDP growth per year- that's been going on now for several years- and is increasing in its role and importance in the world economy. And there's also a whole range of countries. There's Vietnam and other Asian countries, previously not forces, not even having emerged on the economic scene, which now are actively growing, and in many cases growing more prosperous by the day. Or personally, in our vacation by ourselves, my wife and I went to Chile and Argentina, and that's quite a long way from here. We came back just a little over a week ago. We spent time in Patagonia, the southern part of Chile, all the way to the straits of Magellan, parts of Argentina, and also Buenos Aires. But in the outlying areas that we saw, in Chile and Argentina, it is striking to see how modern, up-to-date, and tourist-friendly relatively small towns are in Patagonia, which see so many tourists, but are also very active in fishing and agriculture. Indeed, the growth rates of Chile and Argentina are very strong. In Buenos Aires, there are signs of tremendous prosperity. Now, perhaps not to you but to me when I come to Seoul each year, I see in a very superficial, quick way, how it appears. I'm sure you would not agree; 4.5-5% growth is anemic by South Korean historical standards. But it feels good, and it's relatively prosperous here. And when I go to Tokyo, it again feels good. Those of you who have been to China know how active China is, and of course, so is India. It is striking to see what has happened around the world in areas and regions that five or eight years ago were not really part of the global economy, nor active, nor even modern. They're a major force!

When I talk about changing economic geography, that's part of it, but with economic growth and increased wealth goes political influence and power. So, when looking around the world, it seems to me that it is a immutable force as long as we do not have major external shocks, wars, or terrorism all over the world to upset things. It seems immutable that the relative influence in power of regions around the world is changing and will change immensely. Three or four years, when we look back, it will be very different.

A second seismic shift that has been going on for a while is called globalization. In part, it is a source of the changing economic geography. It means more countries participating in the world economy, more spending by more populations in more countries, more investments, more opportunities for investors around the world, and more production of various goods and services. In the case of goods, more countries are producing the kinds of goods that businesses in South Korea have produced over the years. There is much more competition. This is a problem on the trade side for South Korea. But it's part of growth for countries like Vietnam and China, and for the emerging countries that are entering the global arena, producing agriculture and basic commodities, and selling into the world economy. Indeed, globalization also means pools of labor, and pools of finance and capital, able to move quickly around the world for opportunities. In the United States, we see globalization in quite an intense way through the outsourcing of so much labor work to India, and the outsourcing of production by US based countries all over the world. That has been part of the Asian scene, the outsourced production, and various parts of the Asian world for many years. It's now global. This part of globalization lowers costs. Technology allows companies to build, buy, and transport components of production from where they are produced in one part of the world, to another part of the world where they are assembled at very low cost, then distributed and sold all over the world, and advertised all over the world. Products from Patagonia where we were can be sold here in Seoul, Korea, in winter. It was summer there, but we needed winter products because it was very cold. We saw some glaciers. It is just so striking to see this.

And of course, there is modern technology, telecommunications, the internet, the ability to see in one part of the world what is going on, and might be bought and transported for another part of the world, and finance, and the portability of the finance function, which is so important to development, ample finance for opportunities anywhere in the world. If there's a real estate recession in the United States, investor money that might have gone into real estate goes into somewhere else in the world where there are opportunities and unexploited chances at high returns in real estate in some part of the world heretofore not helped with the transfer of capital. Of course, it's not that hard these days for a small resort/tourist town in southern Chile to build roads from one town to another, and to bring in the infrastructure again, assembled from not just companies in Latin America, but from companies all over the world, and to very quickly replicate what one can see in an emerging country in Asia, or countries in what we used to call Eastern Europe, what we now call "Emerging Europe" to do the same.

Globalization as a seismic shift has been going on for some years. It is a major, continuing seismic shift, changing how economies act and perform in the here and now, and for the future.

I would like to mention two or three other shifts. One is, as I mentioned last year, inflation. It is quiet now, in much of the world economy, in part because of recent declines in crude oil and energy costs. It is certainly quiet in the US, on the well-watched core inflation index, at least in the last few months. But for us, in our view of the US and global economies, and the active nature of the sustained expansion globally that we find ourselves in, our sensitivity to inflation, rising (on average) around the world, remains quite high. It's not just a cyclical upturn, the decline in inflation rates in the US or other countries that we are dealing with. We do think it's secular.

Of course, recently commodity prices have tumbled, including Copper and Gold, at just the hint of the slowdown in the United States, particularly in the housing and residential construction area where a lot of copper is bought and used. This is probably a motivating force in the big slide in copper prices, and the stock markets of those countries that are copper exporters being hurt. But the longer-run trends for commodity prices in the kind of inter-related global economies that we see with interest rates relatively low in nominal and real terms, and huge pools of funds, and the quite ample global availability of credit, suggests to us that inflation on average will continue to rise.

We have to live with another seismic shift, a major change in the world backdrop. They are geopolitical risks, terrorism, the threat of outbreaks of confrontations or terrorist events almost anywhere in the world, at any time, and the costs and the infrastructure that has to be developed to deal with it. In the case of the United States, there is still a preoccupation with the war on terror, with the situation in the Middle East, and around the world in other trouble spots. Security is tight, and going on at all times in order to prevent the small risk of a very bad event of terrorism from happening.

There are two more seismic shifts to mention for you. One is global aging populations. It is true in Japan, South Korea, and the United States. There are longer lifetimes, and more of the population is in older age groups. There is a need for societies to support aging individuals as they retire, and a need for pension fund reform in many countries. And certainly healthcare costs are a major issue for countries around the world. There is a strain on government budgets in order to provide support. As a corollary, there is tremendous technological change and innovation that goes on in healthcare services, particularly on the product side, and somewhere, someday, there will hopefully be a rationalization in the United States of the provision of healthcare services in a cost-effective way, so as to prevent a complete drain on the federal budget deficit, which continues to loom for the United States in the future.

And the last one I want to mention before I turn to more mundane things such as relative growth, and interest rates at central banks, is the political. Obviously in the United States we recently had the major off-year congressional elections. They were quite significant. As you know, it was a complete sweep of Congress by the Democrats, a strong (for the time being) repudiation of the international policies of President Bush and the Administration by the body politick: Quite a strong message of discontent sent by the American people in the off-year congressional election, which happens from time to time. I think the last time we saw so strong a voice shown by Americans in the off-year elections was in 1994 when Republicans were swept to power, and before then, it was in 1980, the election of President Reagan in the aftermath of the Carter years of 1976-1980, which are now viewed by historians as a failed presidency. In the United States, I've been involved as an advisor to politics, though I've never publicly supported any candidate. I've always been neutral and non-partisan. It was a very significant election, with a message of change to Washington, a message of unhappiness with Washington, and a message of disconnect between how Americans feel about the future and how the US economy is today. The US economy is in excellent shape, by all standard measures and conventional statistics. And yet, a whole range of polls show that Americans are uncomfortable, and don't feel good about things, particularly the future. On many of the things I mentioned, including the issues of retirement, healthcare, the budget, issues related to Iraq, the war, the insecurity with regard to terrorism, the apparent inability of Washington to get much done, questions about immigration, energy, Americans are very concerned.

The observation I would make on this potential seismic shift in American politics, is that when we get the kind of election result that we saw a couple months ago, it is a sure tip-off that we are going to have a historic election for president in 2008, and we will have major shifts in policies coming out of the United States, which will reverberate around the world. Perhaps the most significant one in the near term is trade and protectionism, where in a democratic controlled Congress in the United States, protectionist sentiment is rising. It is particularly focused in China, much less on Japan this time, and certainly not on South Korea. How that plays out, and what it means for economies and markets remains to be seen. It's one of the political issues in the United States highlighted by the resounding message of the American voters to Washington:

"We're unhappy about the future. It's time to do something about it."

Well, in the US and global economies, 2007 is shaping up in a very positive way, as we see it. We are expecting to see the global and US economies to sustain the solid expansion that now exists. We are expecting to see the slower growth in the United States that began in 2006 continue, and the on average stronger growth outside the United States continue. In part, this is welcome, because it is one step in the rebalancing of global imbalances that are so pronounced around the world. For years, the United States has been growing much faster than Japan, the Eurozone and the UK, fed by American consumers spending quite aggressively, and financed by countries that are lending and investing in the US, who are growing more slowly and saving more than the United States. The shift in relative growth that began last year is slowing down in the United States and speeding up in growth of other regions around the world is the beginning of a long, slow process, not generated on purpose by any major policy shifts in countries around the world, but just happening as the natural force of the global economic system. Slower growth in the United States, still very strong and fast in the Asian region, faster growth in the Eurozone, strong growth in the UK, and in the emerging world, strong, if not dynamic growth in most of the developing countries of the world. But for the United States, the economy slowed down quite significantly starting in the second quarter of 2006, extending well into the fourth quarter, and now the economy is picking up some. We think that the US economy is escaping a recession, or recession like results, and will grow at a reasonably solid rate of 2.5-2.75%, on average for 2007. In 2006, the economy grew a little over 3%, and the slowdown in 2006, which is masked by the overall GDP growth number, showed up in the second quarter growth of 2.5%, 2% in the third quarter, and a very slow first part of the fourth quarter.

The motive force for it was a major slide in residential construction: a huge, quick, and pronounced recession in home sales, housing starts, and residential construction. The whole residential real estate business of the United States essentially tumbled between the end of 2005 and the end of 2006. Our Federal Reserve describes it as a cooling, first as a gradual cooling of housing, and more recently in their statement, a collapse. Home sales and housing starts fell almost 30% from the end of 2005 to late this past summer. Home prices, not in the public indices tumbled. Appraisal values went way down. The homebuilding industry, in terms of housing starts, ground to a stop. Housing starts fell from 2.5 million starts to 1.5 million starts; that's about a 40% decline.

Supplying companies and industries to homebuilding and housing were hurt very badly. The US economy downshifted in a major way, levered by the slide in housing and residential construction. At the same time, motor vehicle sales eased off, flattened, and the US auto industry cut back on production and jobs, and that weakened the economy as well. In some areas of manufacturing, and in some areas of consumption related to housing and autos, we saw quite a bit of weakness. What I've just described seems to have stabilized at lower levels of activity, about two or three months ago. As we exited the year, the slide in home sales and housing starts seemed to have stopped, and some key forward-looking indicators of housing activity, mortgage applications, builders' sentiments and expectations, and consumer sentiment in terms of buying a house has picked up, and it does seem as if the worst is over in terms of this area of activity in the US economy.

Now, as far as we can see in the data, the trouble in housing and autos does not seem to have spread anywhere else, and other analysts and observers have the same view. If we look at the economy as a patient, and the patient came to my office and I'm the doctor (I am a doctor, Doctor Sinai), it's as if the US economy came in and had a huge wound in the leg. And the huge wound was infected, it was red around the edges, but the whole leg was not infected, and the whole body was not infected. The analogy here is that housing and construction are the wound, and the redness and spilling over around the edges are some of the collateral areas of spending and production that feed into construction and housing, but the rest of it is intact. Historically, declines in housing and residential construction have been early indicators of a full-fledged recession, so in the US, the watch has been on. Indeed, our fixed-income markets have been expecting a full-fledged recession, and that still is a risk.

The patient's wound is not yet healed. It looks like the worst is over, but we can't be sure, because there are second round effects from that collapse in housing activity, that could bring problems in consumption, and in turn, bring the economy down to a very weak state. Those second-round effects, on our research, have to do with falling home prices, and the way that residential home prices have been used to fund other areas of activity, particularly consumer spending, in recent years in the United States. The tapping of previously untapped equity in real estate through the use of new kinds of mortgage-financing instruments is part of what I'm referring to. And of course, the long period of artificially very low interest rates in the United States made the money borrowed on real estate essentially free. It was irresistible to borrow and use, and levered by the asset value of collateral real estate. All of this was a major force in raising US consumer spending far above its trend growth path, and is part of how the US economy managed to lift the rest of the world's economies through the bootstraps of the American consumer.

Now with home prices falling in the published indices, almost flat against a year ago, and some of them negative, we're expecting US home prices to show up as down 5-10% year-over-year in the next three to six months. The potential effects of that are on the asset value of real estate collateral, and loans outstanding, the difficulty of raising more funds for American homeowners to use for purposes other than housing, capital loses on real estate, and a negative wealth effect because household wealth from real estate is going down.

All of that carries a second-round risk to the economy, which has yet to play out, one way or the other. At this point, we are not seeing any significant second-round risk from the collapse in housing activity that went on over 2006. The spending side of it (the sales, the starts, and residential construction, which lags sales and starts), probably won't go up, but won't go down so much in the first half of 2007. We'll just have to see whether the financial effects are significant or not. Certainly they were very significant in the housing boom that we had (some people call it a bubble), but it doesn't have to be as harmful, as the boom has turned to a homebuilders bust, as it was helpful during the homebuilding boom. There are forces, I think, that will not make it as much of a problem, as it was a help in the housing boom. In any case, the data are suggesting that we have gone through the worst of this negative impact from residential construction.

It may well turn out to be a correction of the excessive housing boom and bubble-like activity that we had in the United States. Residential construction, housing will not be an active generator of growth in the economy in the future, neither will the finance from it, but there is sufficiently strong growth in jobs, a sufficiently low unemployment rate, strong enough corporate sector spending and capital investment, strong exports, as part of the world export boom that is going on, and generally outside of housing, strong consumption, to carry the US expansion into and through 2007, and well into 2008. That's the basic view that we have, and this is the basic story behind the US slowdown in growth, now a pickup into a 2.5-2.75% range of growth on average for 2007. The major risk to that view on the US economy is probably more downside risk, having to do with what we have still another down-leg on real estate activity, and will those falling home prices cause bad trouble for consumers and lenders, in turn, causing businesses to cut back, hiring to stop, the unemployment rate to rise, and a full-fledged recession. That is a downside chance and risk, and we give that maybe one chance in four.

Then there is another risk, that we might have a better result, that the US residential recession will turn out to be a lot like the one that occurred in the United Kingdom, where for a while, the UK economy softened, housing fell, prices went down. But that passed, and now the UK economy, inflation and home prices are often running again. The risk of being wrong here is that in my view, it is more likely that the US economy will do better than worse, and why do I say that? Our federal reserve has kept interest rates stable. There are ample funds available for housing and other activities. This is not what normally occurs when we have a residential housing recession. Typically, in most business cycle episodes where we have gone into a full-fledged recession, interest rates have continued to rise, the availability of credit has tightened, housing goes down, and it affects the economy, but other areas of the economy including business spending go down too, because of the generic and general effects of rising interest and the restraint in the availability of funds. By stopping the hikes in interest rates last summer, the US Federal Reserve probably aborted and prevented the cumulative downturn that might otherwise have occurred. Of course the funds available in the United States, cash-rich corporations, lots of funds in financial institutions, and even more funds in non-bank financial intermediaries, the new wave of pools of money not in banks but being deployed around the world for all of the opportunities that globalization offers, that is really a very dynamic, powerful force. It makes me think that of the various choices for 2007, if wrong on the basic forecast, it could be more active, rather than less active.

In any case, the US growth rate at 2.5-2.75 or even 3%, somewhere in that range, is a lot less than the growth rate of recent years, which ran 3-4%. A good deal less than most regions in the world, including Asia, the Eurozone, the UK, and most of what we have called the emerging world, but less than Canada, and less than Australia and New Zealand. The US is probably going to lag in growth for the first time in years, compared to all the other regions in the world. And number one this year for non-US economies and regions is of course Asia and the Asia-Pacific, as was the case last year, led by dynamic growth in China (we're marking 9.5-10% for China), India 8.5-9%, Japan, almost 3%. Japan is now part of the dynamic up-movement in Asian area, growing faster than trend, with an unemployment rate that the Japanese say is at full employment. Of course, the unemployment rate here in South Korea is not all that high anymore either. I think your last figure was 3%. That's probably not full employment; I remember when it was much lower than that. But 3% is the lowest unemployment rate in South Korea in a long time. In fact, around the world what we are seeing is declining unemployment rates, even in the Eurozone, as more and more people find and create jobs. Business and corporations around the world are not hiring so actively.

But in the new world of the Internet, individuals and small companies, opening up anywhere, able to sell products anywhere around the world, ship products anywhere around the world, or participate in production anywhere around the world (it's not quite anywhere around the world, but in most places around the world), are creating a tremendous amount of energy in the US and global economic system, which is showing up after a long time in lower unemployment rates. The lower unemployment rates that we systematically see almost everywhere around the world also tell us that these global pools of labor that have shown up because of globalization and the ability to hire and produce anywhere in the world are being absorbed by an actively growing world economy. That tells me that workers around the world, particularly those who are educated, and in the service oriented areas that are in such demand all around the world, are going to earn very good money, and in turn have money to spend. That is a pillar source of expansion. It is also a likely source of higher inflation coming from the cost-push side as companies try to pass on these costs in the form of higher prices. Part of the view over the long term is that inflation will continue to rise higher. It's part of the view that we will continue to have rising inflation. Inflation rates around the world are fairly low, but in time, I think they are going to get higher.

Well, for South Korea, we have a conventional estimate: 4-5%. It looks like South Korean growth was 5% for the fourth quarter 2006, depending on your estimate. We are in the 4.5% range for 2007. There will be sustained expansion here, as part of the global and Asia-Pacific trade framework, which is so active in terms of exports and imports, and technology, but of course a much more intense and competitive world for South Korean companies on both the goods and services sides. The wave of demand and growth in countries like China and India, particularly as consumers begin to spend more money and look outward, is a healthy dynamic for growth in this area.

I think the second area that I have to point to is the Eurozone. For years, decades, on average growing much slower than the United States, Eurozone growth in 2006 is 2.75%. US economic growth in 2006's second, third and fourth quarters was and is below that number. The Eurozone is actually growing faster than the United States. Though there will be some hesitation in growth in Germany because of an increase in taxes, Eurozone growth of 2.5-3% above the trend is our view for 2007. In part, the Eurozone, which is now 13 countries, and I think the European economic union is now 27 countries, is benefiting from a boom in what used to be called Eastern Europe, the new "Emerging Europe" countries that are growing very rapidly, and trading and buying from Germany, and contributing much to the European economy. Northern and Southern Europe are as strong as those countries have been for quite some time. Germany and France are actually still lagging, and Italy also, in part because of the goods-nature of the Italian economy suffering on competition on basic items; competition, say, from China.

Emerging Latin America, as well, looks strong to us. In Latin America, there will be 4.5-5% growth in 2007, and that's quite solid. The United Kingdom and Canada are also growing faster than the United States. So, sustained expansion worldwide. Our number, we cover 45 countries, is in the 3.5-3.75% range. This year it was 3.75%. Global growth slows down some, and that's because of the US. On average, US holds to the slower growth that it fell to during 2006, and many regions of the world hold the growth advantage that emerged during 2006. Over time, if these growth differentials are maintained, huge trade imbalances should begin to redress themselves, particularly if the Dollar goes down on average. We do think that process is in train, and now it has started. We're now going to see these trends continue for several years.

Let me turn to interest rates, and then to the currency, and leave some time for questions. On central banks, we think that short-term interest rates will rise on average. It's a view that grows out of the view on US and global economies, and their expansion, and the desire of central banks to keep inflation in price-stable territory. Almost all the central banks of the world have price stability as their major goal. As you know, in the United States, we have duel mandate of price stability and maximum sustainable growth. There's also a third part to that called moderate long-term interest rates, but that follows from the first two if the first two are achieved. As they were a year ago, central banks around the world are in different stages of dealing with the price stability issue.

In the case of Japan, for example, there is no issue of price stability. On the preferred measure of the Bank of Japan, inflation is very low. It's the CPI which now stands at two tenths year over year. There's hardly any inflation in their preferred measure existing. As the US has already done and completed, the Bank of Japan is in the process of normalizing back to what is normal for an economy that is in reasonably good shape. We expect the Bank of Japan to continue the process, as the data permit it, through 2007. Last year, the Bank of Japan raised interest rates one time to 25 basis points from zero. We're expecting a 25 basis point increase at the January 17-18 Bank of Japan meeting, another in late spring, and perhaps one more this year, if their key inflation indicator continues to rise as we are forecasting. That would take the Japanese-called "money rate" to 0.21% late this year, and the ten-year JGB yield to somewhere around 2%. You know, those interest rates are absolutely not punitive at all. There's no way that interest rates at that levels in Japan will do anything but worry the financial markets for a short period of time, in terms of their potential negative effect. The Japanese economy is solid. Business profits are strong. Consumers are starting to spend more on average. The unemployment rate is low. Japanese consumers are optimistic. Those interest rates are not going to interfere with anything.

We expect that China will raise interest rates this year to deal with some inflation. We've seen the Bank of China raise reserve requirements several times.

We would not be surprised if the Bank of Korea raises interest rates another time or two, given the concern about real estate prices that exist. There's not really an inflation problem here in South Korea that we can see, but we respect the views of the Bank of Korea on this issue. We probably don't fully agree with rate hikes, but it's part of what central banks do in terms of keeping price inflation under control. Some more interest rate hikes are probably coming.

In the Eurozone, certainly the European Central Bank will raise rates at least two more times, maybe three, as Jean Claude Trichet and his colleagues work to hold price inflation low.

In the United States, interest rates are on hold; the Federal Funds Rate is at 5.25%. We think that that rate will stay there for almost all of this year. The risk of recession in the United States does appear to be diminishing. Core inflation on the major indicator of the Federal Reserve is coming down, but slowly. And at the Federal Reserve, we have some members that will not be ready to reduce interest rates until core inflation is somewhere around 1.5%. It's over 2% now. It's in the middle of the 1-2% range that we think they watch. And in addition, for reasons of credibility of the US central bank, these members of the Federal Reserve (they are at least Mr. Moscow, Mr. Lacker, and Charles Plosser, the head of the Federal Reserve Bank of Philadelphia, and probably some others) are not at all in the mood, nor have they suggested to us in their public comments that they're going to cut rates, and they don't think that the US is going to have a recession. We don't think the US is going to have a recession either. So they're not going to cut rates. Those of the Federal Reserve who might want to reduce interest rates to make sure the economy grows close to it's potential aren't going to do that as long as core inflation is over the upper bound of 2%. That includes Janet Yellen, and perhaps Mr. Bernanke, the Chairman himself. In other words, on the scenario that we and the consensus have in the United States, where the US growth rate, which touched down to a lower level in 2006 thanks to the housing recession, comes back up to 2.25-2.5-3%, somewhere in that range, and core inflation comes down but stays sticky, there's no reason to cut rates, and there's no reason to raise rates. The expectation for the US central bank is that they simply sit there at 5.25% for virtually all of the year, and if there's any sort of change, it's just going to be a fine-tuning change, a little bit down, or a little bit up. Of the choices, I would say a little bit up, not a little bit down.

The long-term rates in the United States aren't likely to change very much on a scenario of growth at 2.5-2.75%, core inflation a little lower, and a stable Federal Funds Rate. The ten year treasury rates will range from 4.5-5%, interest rates stable in the US, and that says that the US can continue to sustain it's expansion, and to provide support to the rest of the world on the consumer side. The rest of the world will sustain expansion as well. It looks like a pretty good year. Higher rates will come from many central banks around the world, but not high enough to punish any economies a lot, to interfere with growth, and not high enough to cause the availability of funds to diminish. The powerful funding that is now going on around the world, a lot from non-bank financial intermediaries, to fuel economic growth.

This picture of sustained growth means good profits growth, although diminishing in the US, good profits growth in other countries of the world, interest rates not rising to interfere with valuations, and stocks around the world should have a good year. For the US, we are roughly marking our expectations of the Dow Jones Industrial Average as up 10%, not necessarily right away, but over the course of the next ten months. This will put the S&P 500 at 1550, and the Dow Jones approaching 14,000.

Most Asian stock markets had a wonderful year in 2006. South Korea's stock market did not. Asian markets, particularly emerging Asian markets had a wonderful year, and we think that we will see more of the same, though not the same returns as last year. We are over-weighted, as we have been, in the Japanese stock market, as the Japanese economy continues to do better. Stock markets around the world, we think, will enjoy a very good year.

It would take much more than the slowdown that has occurred in the United States. It would take trouble outside the United States to interfere with the global growth scenario that I've outlined, and turn into troubles for stock markets around the world. The world, with the changing economic geography that I've alluded to, the world economy is not going to be driven by the US economy the way it used to be, unless whatever it is that might cause the US economy to turn down is generic to the rest of the world. That is, if inflation goes very high all over the world, perhaps because oil prices might hypothetically go to $100 per barrel, and central banks around the world raise interest rates, then the world economy will tumble. But the world economy is not going to fall on a housing and residential construction recession that is local to the United States. Indeed, other real estate markets will probably benefit, because the money that would be invested in US real estate will go somewhere else. It has to be generic to all of them.

Finally, the Dollar: The view on the Dollar remains as it has been for us. It is that on average, looking on the fundamentals of relative growth, relative interest rates, and in the longer run, political and geo-political factors that affect the currencies, as well as the changing role and importance of countries and their currencies around the world, we can only think that on average, the Dollar will go down. It did go down, and reached our targets against the Euro last year, and against the Pound Sterling. It didn't go down very much against Asia. It did go down against the Chinese currency and it went down against the Korean currency. Was it over 1000 Won to the Dollar when I was here last year? Lately, the Won is going up against the Dollar. We would expect the Dollar to be down against major currencies 5-10% over this year. We regard that as orderly. We are targeting on the Dollar/Euro, and expecting 1.45 or so 6-9 months down the road, and the Dollar/Yen at 105-110 6-9 months down the road. We continue to think that the Chinese currency will appreciate, but very slowly, despite the efforts of Treasury Secretary Paulson, and the complaints of Congress. There will still be a slow appreciation. And other currencies of Asia should appreciate some against the Dollar this year. But the movements of the currencies should be orderly, and not call into play any major shifts in policy, nor interfere with the flows of trade and commerce during this year, on average.

Finally, the US political situation as an uncertainty: We are getting a flurry of actions from the new Democratic Congress. They are positive. We've gotten some teeth in some of the ethics and so-called "earmarked legislation" that goes on in our Congress. The house has passed PAYGO legislation, which requires budget-balancing mechanisms to come into play if spending goes up, or taxes are cut. We will see a flurry of attempts to get things done in the first two to four weeks of new Congress. Subsequent to that, our expectation is that the presidential politics of 2008 will take over, and very little will happen in the US, as a whole host of candidates come out of the woodwork for 2008. There will probably be four, six or even eight candidates from each party. It's too early to handicap what's going to happen in 2008, so for the markets, and for US policies and progress or lack thereof on them, our view is that there will be almost no progress on any significant policies in the United States until after the election of 2008. Then we may see major shifts in policies, because the international and domestic problems that have piled up that will face the next president and Congress of the United States are so immense in a rapidly changing global economy. They are so immense that the US will then turn very much inward to deal with those problems, post-2008.

This is one of the reasons that we think the Dollar will be gradually edged out of portfolios, and why we think that the relative proportions of currency portfolios of central banks and investors around the world will gradually shift to a Euro position, or to an Asian centric position, and why there will still be good demand for gold and dollar alternatives.

Thank you very much.

Questions & Answers

Q To deal with employment: since the Regan administration, the US has frozen the minimum wage. It has had the subtle change of increasing employment and lowering unemployment. But now there are going to be minimum wage changes. What will be the impact of this?

A Congress is going from $5.25 to $5.50 to $7.25, after a couple of years. We don't have that many people still on minimum wage in the United States anymore. The impact will be very minor. Given the growth that we've had in the United States, which is the primary determinant of the jobs count, it isn't going to make much difference one way or another. Analytically, on the margins, it will cost jobs, but the numbers are very small. I do view this as a political item, and it's part, a small part, of the view I have on inflation. That is, it is the political system responding in a political way to the demands of workers, those who have been getting the short side of remuneration in terms of the minimum wage. It's part of a society saying that it's ok to have more inflation. I think we're going to see more and more of that around the world. It's a small side.

Q Concerning the housing industries, there is an apparent lack of symmetry. During the real estate booms, it had a very strong impact on the expansion effect. A large impact was attributed to consumer confidence in the asset valuation increase. Do you believe that the lack of an adverse impact is the asymmetric effect of prices not coming down as much as the industry? After the 80's reform, there was a rush by the lenders to get to the consumers. There was probably some unwise lending that had to be held back during the times of recession. Maybe they had sufficient margins this time, and impact was not so negative.

A The housing boom and the levering up of consumer spending, on our research, are what were principally responsible for the negative personal savings rate in the United States. The way that savings rate is defined is to take disposable income, count consumption, and subtract consumption from disposable income. Anything that drives consumption up doesn't get counted in disposable income, which is indeed the funding that comes from cash up financing, and capital gains. That raises consumption, but doesn't show up on the income. It's going to lift consumption, and by definition, take the savings rate down. We no longer look at that savings rate as the right way to see how US savings is going .We look at the household sector balance sheet and the flow of funds data published the Federal Reserve, to get that. In our model of the US economy, we've modeled that, because if I get an extra hundred thousand dollars by refinancing my mortgage at a lower interest rate, and because the asset collateral value of my real estate has gone up, and the lending institutions are willing to lend me 60% of a higher value, at a lower interest rate, then it's irresistible to take some cash out. Our study shows that forty cents on the dollar of that extra cash, over a year or year-and-a-half of that was spent on consumption on the upside of the housing boom. Twenty-eight cents on the dollar of capital gains realized on the sale of a house was spent on consumption within a year. The household wealth effect, the balance sheet effect of having more wealth on your balance sheet, in aggregate, was three cents on the dollar over a year or two. It is a very big propensity to consume the financial lever that came out of the real estate boom

We're sensitive to trouble on the downside because of these research numbers. We think that we are the only organization in the United States that has actually structured and estimated this process. But since we've not had a downside bust off this incredible housing boom with the levered use of real estate as collateral, I can't say as a scientist that we'll get the symmetric effect, or that we'll have the same downside effect. I'm quite sensitive to the risk of it: falling home prices, and then through the falling asset value of collateral, and the inability to cash out finance, losing forty cents on the dollar over time of consumer spending and of capital gains, etc. We're monitoring that. But I don't really think it's going to happen that way. I think it will be asymmetric, because the system is geared to prevent a lot of trouble. The banks and lenders aren't going to want to lose good customers like me, who have decent balance sheets. As I've gone to refinance my mortgages at higher rates, I find that I get hurt, and have to pay more per month. But there are lots of products that allow me not to get hurt very badly.

Where there will be trouble and already is, is in the low income, low wealth segment of the borrowing population, and for those lending institutions that have made their business mortgage finance and lending. As time goes by (and there are lags for the next year or two; this doesn't happen instantaneously), they're going to have to write off loans and losses, and we will have at the margin, a number of families and households that won't be able to make those payments will refinance the payments. They will have to foreclose and go into bankruptcy. But it should not be decisive. We and others who invest in certain lending institutions need to watch that, because it could cause NPL problems for some of the lending institutions. But if you look at our financial institutions (the major ones), they are very well diversified in their lending, and they don't just do mortgage lending anymore. And as you know, mortgage instruments are also collateralized and diversified in mortgage-backed securities, so the risk is diversified. So I think we would need a lot more trouble before we would have trouble.

Q How long will this trend of a weakening Dollar last? We had a report yesterday at the American Economic Association's convention. Apparently, Michael Mussa talked about Dollar depreciation, and I think he said something like 20% in 15 years. Also, Martin Feldstein said that the government has a wrong policy of publicly announcing that a strong Dollar is in the interests of the US, and he thinks that it gives an early warning to the financial community, generating uncertainty. What is your view on the speed and duration of the Dollar weakness? Will this help solve the global imbalances we have today?

A For Mike Mussa, 15% in twenty years, or 20% in fifteen years represents a major change in view. He has been of the school that thought that the Dollar might crash. I'm a little surprised how mild that is. In any case, I didn't agree with him when he was talking about a crash, and I don't agree with him now when he's talking about 15% over 20 years, which is essentially no depreciation at all per year. Don't regard this as a big deal, but we are expecting 5-10% depreciation over the next year, in fits and starts, and regularly so. Certainly the Chinese currency is grossly undervalued, and the force is on the Chinese currency to push it up, as well as on related Asian currencies that are going to be with us for a long time.

The Eurozone looks promising to me, as an active area of growth for the first time in maybe decades. Where I've been the last six weeks is a little mind-boggling: I've been in London, Venice, and Prague, and was on a program with Professor Mundell in Prague. Then I was in Patagonia in South America, almost in Antarctica; I said to my wife, "we're down this far, why don't we just go." It was just as quick to get to Antarctica; it was 8 hours by plane, as it was to get to Buenos Aires. I thought, "Why don't we just go walk the glaciers in Antarctica?" But she didn't want to do that. I think she was wise, and now I'm here in Asia.

But in the Eurozone, in an anecdotal way, it was very lively in Italy, and of course, Slovakia and Eastern Europe. I saw some energy and entrepreneurial sense that I have not seen in years. I note that the Eurozone unemployment rate is now under 10%. The central bank has definitely proved its credibility; interest rates are going higher. No, we're rock solid on this view on the Dollar/Euro in the 1.40s. The one that puzzles us is Japan, and the Yen/Dollar relationship. But until their rates get higher (it may be that not even two or three hikes this year will do it) the Yen will continue to surprise and stay low.

Maybe we go down and up, and the average is 15% over twenty years, but no, I would definitely disagree with that. And as for Marty's comment about the government giving a false signal, no one in the markets believes that anyway. I don't think it matters. If they say that a strong Dollar is in our interest, do any of us believe it? Do they believe that a strong Dollar is in our interest, approaching the election year of 2008 with a slowing economy, and a huge trade deficit with a number of countries in the world, particularly in Asia, even if Secretary Paulson says it? I don't think we believe it at all. The US would certainly be quite happy with a lower Dollar, because it would reinvigorate trade and manufacturing. But they can't say it because the markets might tumble and there would be volatility. That's where there is a major political problem for the administration. All of us in the markets know that there is a "hands-off" attitude in the currency markets at the current time, except by China.

Q You said that the US political situation affects the economic policy and performance to some extent. Would it make a difference whether the Republicans or Democrats get elected President?

A I answer those questions on the US election prospects. We have, from time to time, major changes that go on in our history, which grow out of the unhappiness of Americans. We had a major shift in the US electorate in 1980, and president Reagan came into power. Reaganomics, market economics, different attitudes toward labor markets: it was definitely a market-oriented set of policies that have been in effect in the United States for twenty-five years. I do not regard the Clinton Administration and its policies as having been a major departure from what was ushered in by President Reagan and Margaret Thatcher in the UK. So capitalism has had a big run in the US and around the world for twenty-five years.

Indeed, the inequality that we see in the United States now, which is wealth and income inequality, and now creating a backlash of an opposite political view, is in part a derivative of what started in the 1980s. I'm not commenting on whether that is positive or negative. If we look at the performance of the US economy in the last twenty-five years, it is quite enviable in terms of the consumption and standard of living that has been generated. And I'm a market person; I'm comfortable with tax cuts, and supply-side economics, but I'm not comfortable with huge deficits that get the country in trouble. I'm really a fiscal conservative. I'm closer to the kinds of thinking that come out of what people would call "Republican Fiscalism" as manifested in the last twenty-five years, and I would include the Clinton balancing the budget move as part of that. That used to be part of what Republicans did.

What is happening in the United States is that this may well have run its course. Along with the unhappiness that is principally international, and an administration that has obviously spent most of its time dealing with terrorism and Iraq, and has not been able to get other policy initiatives on major US problems into and out of a congress that was controlled by Republicans. Americans are very unhappy about that. The list of problems is not just Iraq; not just international standing; not just the disrespect that the US administration and the United States have in the eyes of the world. All of us who have travel around the world see it and feel it. People are polite, but the standing of the US is not what it was ten, fifteen or twenty years ago. Iraq and the international situation and the controversy are part of that.

But for Americans, there are a lot of problems. We have immigration problems. We have wealth and income inequality. We have abuses in corporate America and in Washington. We have an aging population that does not feel that it has provided for its own retirement. We have skyrocketing healthcare, and we have not rationalized, nor dealt with the healthcare system, and on and on. Well historically, as a historian, in part, we have to think about this, as economists and market people. It looks to me like we have a major change brewing, and that means that shifts in policies that come out of politics. And the shifts in policies are sometime good, and sometimes not so good. I think that our country, Republican or Democrat, will start to deal with some of these problems. But taking, for example, take inequality, and take the rampant rise in capitalism, and all that it has meant, I think that is about to end with the presidential election of 2008. The obvious Democratic candidate, at the moment, is Mrs. Clinton, moving toward the center. The frontrunner on the Republican side is Senator McCain, and the movement, started by Reagan and Reaganomics, in the aftermath of a failed Carter Presidency, after twenty-five years, in US historical time, is about to change. That would have major effects around the world.

Q Do you see the upcoming Korean Presidential election as a factor for Korea's economy this year?

A On the Presidential election of South Korea, I respectfully would say that I never comment on the politics of a country, especially when I'm a guest. Don't even do it in the United States. What I've done here today, if you notice, is talk about the public policy issues that are facing our country. Obviously I'm very a concerned person. I'm hopeful that I can contribute to helping solve them. But that's hard in our country.

I've had feelers from certain candidates, and they ask me, "Will you publicly support the candidate?" I say, "I've never publicly supported a Republican or Democratic candidate. I'm happy to make a contribution to public policy, but public support, and I am not happy to make, and monetary contributions, I refuse to make." So, your influence is diminished when you say, "I'm not going to raise my hand and salute the flag for this candidate, and I'm not going to give him or her $10,000-20,000." They don't talk to you then. So whether I can have any effect or not, I don't know.

Q What is your view on Korea's real estate problem?

A On the South Korean real estate situation, the most-asked question by people outside this country is why the concern? It does not appear from the outside, certainly compared to the United States, that this is a major issue. It's a unique South Korean issue, and not necessarily a generic central bank issue. The United States, and most central banks do not target asset prices. They watch asset prices to see how they affect they economy, rather than affect it by changing interest rates or some other policy. I certainly respect whatever their rationale is for the Bank of Korea in terms of the policy they undertake. Inflation-prevention tactics are very wise for a central bank, because as time goes by, inflation will tend to get higher, and it's better to deal with it earlier. Whether it's the right thing to do in the context of the real estate situation in South Korea is certainly arguable.

Q What is your view on the North Korea situation?

A I have no fear of coming to South Korea, despite the one somewhat failed, and perhaps coming second nuclear device test in North Korea. I've been persuaded again and again by my South Korean friends that it is quite ok to come here. They've told me again and again that the gentleman that runs North Korea is just trying to get attention, and become in his way a member of the world community. It certainly is a huge problem for the Bush Administration, as yet unresolved. It's one of those geopolitical risks around the world. But I think it pales in comparison with the Middle East, and the potential confrontations and inflammations in the Middle East, and the possible affect on oil and oil prices in terms of economies around the world.

We are going to have to live with nuclear proliferation, and we are going to have to hope that the politicians of the world find a way to get in the net of sensible behavior. More and more countries are going to be able to develop and have nuclear devices, as well as other means and weapons of mass destruction. I'm quite concerned about this, and I'm sure all of you are as well, but I don't think we are going to see a disruption of power politics in this part of the world on this particular issue. It's a bigger issue of what the world community should do when you have more and more countries that can develop, employ, use and test nuclear devices, especially given the poisonous nature of the setting off of those devices. If we had an effective UN, it would be an issue for the UN. If we had an effective world community that the US could be an effective leader of, we might get more done.