U.S. & Global Recovery: For Real? - Prospects & Risks*

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It is a pleasure to be here in Seoul and to see what appears to be a vibrant country and to be able to tell you that the economy of Korea, as one of the associated implications of a now recovering U.S. economy, has better times ahead.

I was struck by the new airport. It was an extraordinarily beautiful and well-functioning airport that I had not flown into before. It symbolized to me, an outsider, the impression I have of this country, and have had over the years: very dynamic, enterprise oriented, entrepreneurial, free enterprise but working with government, and a very dynamic part of the Asian economy.

For those of you in business, and those of you generally, the news I bring from the United States is that the U.S. economic recovery is for real. The U.S. economy is in a real recovery, going through a transition this year to an expansion that will be sustained and sustainable. Because of the unique nature of this business cycle episode—a year or two ago a big decline in American business and then related effects around the world—as it reverses and the U.S. business sector picks up, so will trade and business around the world.

Perhaps more than in other instances, the U.S. is the lever for a global upturn. It was, after all, the U.S. economy that brought down the global economy in 2000 and 2001 to its weakest expansion pace, its weakest position, since the early 1980s.

The initial move up in the U.S. economy is very lively. In GDP terms, the first quarter—not yet announced—is somewhere in the 5%~6% range. The upturn in the United States is being led by manufacturing. A huge inventory downturn has ended and the turn in inventories—the business-to-business improvement that is showing up in GDP—is being supported by solid consumption, solid housing outlays, and strong federal government spending.

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The downturn that the U.S. went through is controversial in nature. Some say there was no downturn, but that is wrong because if you were, or are, in business in the United States or anywhere around the world, then you know that the last year or two has been very difficult and that there certainly was a recession. The business cycle decline in U.S. economic activity that started a couple of years ago, first in growth and then in a single negative quarter for GDP, was led by the American business sector. For various reasons—unusual ones—it was a business sector-driven downturn, which then spread globally because of the multinational nature of U.S. businesses and through trade flows. Weakness in the world economy reverberated back on U.S. exports, in turn bringing down American business activity further. The U.S. Federal Reserve, as you know, cut interest rates aggressively, and quick tax cuts by the Bush Administration cushioned the downturn in consumption and housing where essentially there was no recession.

In the United States, almost all our recessions have been consumer- and housing-driven, with business weakness following, not leading. This time it was the business sector that took down the growth rate of the U.S. economy. Thanks to aggressive, quick monetary stimulus, and somewhat surprisingly tax cuts proposed by the administration and passed quickly by the U.S. Congress, no noticeable downturn in domestic consumption and in housing was noted.

But through sharp reductions of business activity the global economy had a sharp recession, with the U.S. levering down the world. In calendar year 2001 the U.S. economy showed a growth rate, in GDP terms, of 1.2%. But in the business sector—in profits, in production, in jobs, in capital spending, in inventories, in purchases generally, including purchases of goods and services from abroad—the downturn was severe. Through those trade flows and because all multinational corporations these days have production, distribution and transactional activities around the world, the downturn in the U.S. business sector spread into export oriented countries including South Korea, other East Asian economies, Japan, Canada, Mexico, and, directly and indirectly, Germany. This brought down global economic growth and pushed the global economy, as we measure it to a growth pace of only a little over 1% last year, compared to the previous year's 4%. That was the weakest result on a GDP basis for the 46-

country aggregate that we have analyzed and forecasted since the early 1980s.

The global downturn in response to the U.S. downturn was, I think, severe, adding stress and strain to some economies already under pressure and giving us today some legacy problems in Argentina, Venezuela, some in Southeast Asia, certainly in Japan, that remain as risks to the upturn even now as the upturn is entered.

We at Decision Economics, Inc., expect a long expansion, with business activity improving as we go through this year and into 2003 and 2004, when we should see the heart of this business cycle expansion. It will be the best of times for business in the U.S. and around the world, as is typically the case in a business cycle after the liftoff or exit from recession.

One reason for a long expansion is the opportunities that exists for business around the world. Another is low inflation, generally, throughout the world. Another is increasingly high productivity growth, not just in the United States, but elsewhere around the world as the full use of the new technology is applied in applications, business and finance, aiding productivity of workers and helping to sustain a long upturn.

In the U.S., because of continuing stimulus from low interest rates and ongoing stimulus from legislated tax reductions for individuals that will continue for some years, and, recently, accelerated depreciation tax legislation for business and capital spending, the upturn should be long.

There are many trouble spots and risks to this view, and always risks on the road to expansion. They range from country problems such as those in Japan, Latin America, and the Middle East, to the U.S. itself where there is the question on the viability of the U.S. upturn, the possibility of a "double dip" recession, and issues related to home and stock asset prices. But, by and large, the recovery is for real, the prospects are encouraging, business should get better, and in Asia, Southeast Asia, and countries around the world, the reach of an improving U.S. economy should be felt for some time.

Let me turn now to the most recent data on the United States, what people are saying, and a quick rundown of our financial markets. Then I will move to a discussion of the profile of the U.S. upturn, some highlights, and what that might mean to you, the risks, a little about Washington policy, and what I have described as the "Japan Problem".

U.S. Situation Currently

The latest data are providing evidence that the United States economy actually is retreating in growth from a very strong initial upturn of 5%-or-so in GDP. In the second quarter, growth will probably be 2.5~3%. In the third quarter, the same. The economy will then pick up again later this year, and next year, as business capital spending begins to rise.

We are not expecting business capital spending to do much more in the first part of the recovery than get less weak. Part of the U.S. downturn involved a huge drop in capital spending; not just in technology, IT and software, but across-the-board: all equipment, all plant, all durable goods outlays by American companies.

The thought is that with an upturn where, other than in the first quarter, there will be only modest growth until business sales and earnings show a record of sustained improvement and business capacity utilization rates rise, business will not unleash heavy duty expenditures on capital goods. Technology and telecommunications were one of the areas where the downturn was most severe. But we now view those sectors as cyclically oriented rather than enjoying ongoing high growth rates, as in the '90s. That is, when business profits and sales are perceived to be permanently better, and when business generally in the United States begins to spend more—including hiring people—then we expect spending on technology to pick up for expansion purposes.

We do not think this will really happen until next year and in 2004. The capital spending this year will be for replacements, better than the last year or two, but nothing like in the second half of the '90s or generally in the expansion of the 1990s. Technology in the 1990s was a lever for American business to increase productivity, to substitute for labor, to cut costs. As such, it was a growth area in the U.S. economy, almost starting at the beginning of the decade-long upturn in the U.S. of the 1990s.

We now view this sector as more cyclically oriented, and thus expect strength to emerge in terms of expansionary spending on capital goods in 2003 and 2004.

The slower growth pace from the first quarter is probably a good thing, because initially the U.S. economy looked like it might surprise and begin to overheat before it got going. But on the recent evidence, the U.S. growth rate does appear to be settling down. The big positive turn in inventories in the first quarter will not occur again in the second quarter. Business capital spending, which was much less weak in the first quarter than in the fourth quarter, probably won't pick up much more soon. Consumer outlays which were very strong in the fourth quarter of last year—6%-or-so and then 3%-or-more in the first quarter—will probably slip a little to around 2.5% in the second and third quarters.

Auto and home sales are unlikely to push up from the current high pace. Exports are just starting to show some signs of improvement, as other parts of the world begin to recover. We certainly will see, and have seen, strong federal government spending on defense, and on security. We will also see supportive consumer spending, but not strong as in the fourth and first quarters of 2001-2002.

The uncertainty in the Middle East and rises in crude oil and energy prices are a marginal impediment to U.S. growth. They are one element in the slowdown that is expected in consumer spending, having a slight negative impact on profits. The energy cost increases are an impediment to growth, but not really a source of permanently higher inflation that would lead the Federal Reserve and other major central banks to raise interest rates in any systematic way.

Fed Policy, Rates, Stock Markets & the Dollar

With the U.S. economy settling down to 2.5%, 3%, or 3.5% growth—which is not far from its potential rate of growth—the Federal Reserve monetary policy will stay on hold, continue to be balanced on risk assessment, and be in no particular hurry to raise short-term interest rates from the current very low levels. Policymakers' statements recently have been very clear on this. Chairman Greenspan will be testifying this Wednesday. His assessment of the U.S. economy is that it is in recovery, that manufacturing has turned and inventories have turned, but that we will not have a blistering pace of growth, instead growth will be more in line with potential. I expect to see him come forward with that view this Wednesday. That would imply that the Federal Reserve is not going to raise interest rates soon.

U.S. interest rates will likely stay low for a good while. Not until later this year, or next year, when the U.S. economy shows more growth, vibrant growth, and moves into the heart of its expansion will we see any systematic hikes in interest rates.

The U.S. equity market backdrop right now is mixed. The thought is that we are in a new equity bull market. The U.S. equity market went through the initial upturn last fall after the terrorist event of Sept. 11. Sept. 21 brought the low in the U.S. equity market. The equity market anticipated the turn in the market that came in the first quarter, and now is consolidating and going through some difficulty, made worse by the Middle East uncertainties. It will likely keep on like this for several more months, and then will move up into the next phase of the equity bull market, which should be reasonably strong for the U.S.

Most other equity markets around the world are also in bull configurations, certainly South Korea. As the equity markets move further ahead, reflecting economic upturns around the world, we would expect generally rising stock prices, with greater performance coming from a number of Asian equity markets and some emerging market equity markets, relative to the overall performance based on the weighting for indices, such as the MSCI.

On currencies, because of the U.S. economic upturn, the cyclical upturn that is in place, we are bullish on the dollar for the long-term. Of course, views on currencies must take into account the other side of the currency cross: the dollar-yen, the Japanese side; the dollar-euro, the Euro Zone side; the dollarpound sterling, the British side; the dollar-Asian currencies, the Asian side. But, fundamentally for a country where the economy is entering a business cycle upturn, where there is a high potential growth rate—among the G7 countries the U.S. has the highest of nearly 3.5%—where monetary and fiscal policy settings are stimulative, and where companies are competitive in terms of exports, the general movement of the currency momentum is up.

In the case of the dollar against the yen, the Japanese situation and Japanese problems make us expect that dollar-yen will eventually move significantly higher. It is weak now because of the U.S. involvement in the Middle East and all of the associated risks that exist for the U.S. on the political and geopolitical side of our involvement there. The U.S. is knee deep in the Middle East problem and it needs to be clarified and cleared away before the dollar can make its next major upturn against the yen.

From the side of Japan, we are not seeing much working for the yen or the Japanese economy other than some cyclical response—a positive one in terms of exports—to the general world upturn. But on policy, politics, and the ability to compete, decision-making, societal issues and problems, the long-run trends in Japan look unfavorable. That will be reflected ultimately in a higher dollar against the yen and some sympathetic response in Asian currencies against the dollar as well. Dollar-yen expectations for us are in the 140s, and perhaps even higher. As we move through the year, weakness near-term on geopolitical risks and a weaker U.S. economy can be expected. We, at this time, do not see, on a three-to-five year basis, how Japan can return to its prior state in the world economy against dynamically, fast-moving countries with extremely fast-moving local economies, like China and South Korea.

Highlights of the U.S. Upturn

Let me now briefly outline the general pattern of the upturn in the U.S. One of the striking supports for U.S. GDP growth comes from federal government spending: defense, aerospace, and security spending in the U.S. This, I think, is permanent. This is a three-, five-, eight-year phenomenon. When we exited the recession of the early '90s, federal government spending, in real terms, went down. The U.S. economy's GDP growth rate was very weak.

You will recall the U.S. was moving from a rather high federal budget deficit situation to one of surplus. Cutting federal government spending, particularly in defense, was part of that process.

Just the opposite is the case now. One reason is the previous federal budget surpluses. This year the U.S. will run a deficit, about US$ 125 billion, which is small as a percent of GDP, which is US$ 10 trillion. Next year, our thought is a deficit of US$ 75-100 billion. These are cyclical deficits. They come from the under-performing economy. The spending side, particularly on defense and the military, has been ratcheted up and is part of the fiscal and international policies of the Bush Administration. Much would have happened anyway without Sept. 11 and the War Against Terror, and without the ratcheting-up of tensions in the Middle East. I submit to you that this is something you can expect to persist. It has significant business implications undoubtedly for a number of South Korean companies.

Second is something I mentioned before. It has to do with technology and capital spending by American companies. South Korea is active in technology. Those kinds of exports are coming, but mainly next year and the year after, not so much this year.

Third is the consumer and autos. American consumers are in relatively good shape, contrary to what you might hear. Financial positions of American consumers are mildly overextended, but nowhere near as much as in many other cycles. Tax cuts are helping immensely and pumping into the private sector some US$ 70-80 billion of new money for consumers each year. Last year, lower oil and energy costs essentially acted as a tax cut, also providing stimulus.

This year, the help from lower oil and energy costs will be gone. Oil prices and energy prices are higher. The help from the move to lower interest rates, on mortgage refinancing, and the use of those monies for spending, will be gone. The help from home prices and the portion of wealth that resides in housing will still be supportive. Jobs growth should begin to improve later this year. Real income is rising nicely in the United States because of high productivity growth. The movement of funds out of the federal government sector, through tax cuts, to consumers is also a help. Our view on the consumer is that we will see some slackening in the pace of consumption as we enter the recovery, but no real major decline, something on the order of 2½%-3% growth.

Auto sales this year are not expected to rise beyond current rates, somewhere around 16-17 million units overall. However, the market share of foreign imports, because consumers are under some pressure, are very likely to keep rising, the reason being cost competitiveness and quality. Foreign automakers are doing well in the U.S. market. But doing well in the U.S. auto market will not be from increased sales due to a big increase in consumer spending. That isn't going to happen until next year sometime. Better business will come from better penetration, from better competitiveness, quality and service, something that American consumers pay more attention to when they are under some pressure than when times are good.

The pattern is not seen as an unusual business upturn, except that the business response is the starting mechanism. It will be seen first in manufacturing, then some better spending by consumers and housing. This will not occur much over the next 6~12 months, but beyond that. What was very different this time around and in this upturn is the support that came from government spending. Since the U.S. economy didn't go down that much in consumer spending or housing, we will not go up much. What is very different is that the downturn we just ended was led by business, and so the upturn will be led by business as well. The notion on capital spending that I presented to you is actually very typical of business cycles. It is just that this is different from that seen in the 1990s.

In Asia, and around the world, we expect a nice pickup in economic activity this year, but even better times next year and the year after. The pickup from the U.S. will be through exports. So we favor countries that are high export countries, like China, South Korea, India—particularly on software—the Philippines, and Thailand. We think these countries will do very well and pick up the most. Perhaps, as South Korea is finding, they will be surprised positively on the upside by upward revisions in expectations rather than downward revisions. Those countries which have also employed stimulus—monetary and or fiscal stimulus during the downturn—will do better because domestic spending will respond. Singapore is yet another example. Australia is also, we think, going to stay strong.

In Asia and the Asian area, Japan will be hard put to expand. Exports should pick up in Japan, but it is consumption and capital spending that is very depressed there, along with continuing declines in prices, particularly asset prices in real estate. There is no policy stimulus left to try. This makes it hard to see any significant cyclical move up by Japan.

That means, if roughly right, that many countries in Southeast Asia will have growth pick up nicely to a relatively strong pace, and far outstrip the pace of growth in Japan. We noticed that in export-import propensities in Asia, more trade has been diverted away from Japan because of the natural tendency of business over time to move production and distribution activities away from a country that is not doing well. At the same time, because of the declining yen, on a cost basis, allowing for exchange rates, Japanese goods that are competitive with those of other Asian countries are becoming cheaper. It is a natural response for the currency go down in a country where growth is weak. We will see little help from Japan in terms of its purchases from other countries in the area. There is weak domestic demand and, at the same time, increased competition for exports competitive with those of other countries. There would be increased competition through a declining yen.

In Washington, D.C., American policy is absolutely dead set as pro-growth. Make no mistake about it. The administration is pro-growth. This year approximately US$ 155 billion of fiscal stimulus is coming into the U.S. economy. That breaks down into, initially, tax cuts enacted quickly after President Bush was elected. This was the passage of a ten year, marginal, individual tax rate reduction program worth US$ 1.35 trillion. Secondly, the pushing forward for the beginning of those tax cuts from 2002 to 2001 in the name of shoring up a weakening U.S. economy. That was worth about US$ 40 billion. This year, last year's US$ 40 billion stimulus for individuals, plus another US$ 15-20 billion from phased-in marginal income tax reductions in 2002. That adds up to about US$ 55-60 billion. To this, add US$ 60-70 billion in government spending stimulus. Now that's worth US$ 120-125 billion. Finally, there is the recently passed business tax cut of accelerated depreciation aimed at shoring up capital spending. And, another US$ 8 billion of unemployment benefits were extended to American workers who were out of work for a long time. That all adds up to US$ 155 billion.

Almost US$ 150-160 billion of fiscal stimulus this year is 1.5% of GDP. That's one of the largest doses of fiscal policy stimulus ever and it was enacted more quickly than typically the case since, as you know, passing tax cuts can take a long time and government spending can be slow in its impact on the economy.

The Bush Administration is pro-business and pro-growth. Today, even now, the President is continuing to argue for a permanent installment of those ten year tax cuts that he has talked about. Fiscal policy in the U.S. is actively stimulative, more than any other country that we are watching at this time.

On monetary policy, you all know that the U.S. Federal Reserve cut interest rates 11 times last year. Short-term interest rates were taken down almost five percentage points over the course of the year. That was the fastest, biggest rate cuts ever in response to a cyclical downturn. By the middle of last year, the Federal Reserve understood that those reductions of interest rate couldn't turn the business sector around. Businesses don't really spend a lot just because interest rates come down. Businesses spend, particularly for expansion, if sales are expected to be strong and profits and cash flow are strong, and if opportunities are exciting. Then, you see heavy duty expansion by business.

I think the Federal Reserve understood that interest rates alone would not turn the U.S. economy around last year, once they began to understand that the downturn was driven by the business sector. The strategy was to take rates down fast and a lot to prevent the business sector downturn from taking down housing and consumption, which would have given the U.S. a very, very bad recession. That strategy appears to have worked. Consumption spending weakened but did not turn down badly. Also, housing outlays stayed strong.

Whether this continues the rest of this year and next, especially if the Federal Reserve raises interest rates some time this year or next as they probably will, is one of the risks to the U.S. outlook. But, for now, it is quite clear that monetary policy in the U.S. has been stimulative. There is no major or even noticeable inflation issue for the Federal Reserve, so interest rates can be held low for a lot longer.

Indeed, in looking at the United States, if you follow American monetary policy, you should note that the main objective of the Federal Reserve—the stated objective—is to maximize the sustainable rate of long-run growth. In the wording of the U.S. central bank, you will see this phrase again-and-again. The goal is to maximize a sustainable rate of long-run economic growth along with price level stability. U.S. monetary policy has twin goals: growth and inflation. No other central bank puts it that way. Indeed, I can tell you from first-hand knowledge—from my participation in the seminars and discussions, and from conversations with members of the Federal Reserve, including Chairman Greenspan—that the goal of the U.S. is to maximize long run growth. That is another way of saying the goal is to maximize the standard-of-living of the American people. There is no more worthy goal for any central bank than to maximize or try to raise the standard-of-living of its people to the highest possible level, as long as it doesn't bring with it unacceptable inflation.

I look at this as a statement that is pro-growth. If there is not inflation risk, there is no growth rate in the United States that the central bank will act to stop. Whatever our productivity and potential growth allows, the Federal Reserve will allow. The '90s are a prime example for this. So, particularly on macroeconomic policy, Washington's policy posture is pro-growth on monetary and fiscal policy, and I wanted to make sure you understood that. That's good for the world economy so long as the U.S. doesn't run into any inflation problems somewhere along the way.

On trade, the signals have been mixed from Washington, the latest being steel import tariffs. That, indeed, is a problem for countries with heavy production of autos and steel, certainly here in South Korea. As an economist, I have to tell you that I don't think there is an economist who is in favor of tariffs. Certainly, I am not. I think we all understand and know, however, that political crosscurrents are tricky and difficult, and sometimes economic policy gets wrapped up in domestic political considerations and, for a time, can move in a direction that is not appropriate from an economic policy point of view. That is the excuse that I offer for this particular policy move by the United States.

My perception is that the U.S. is a free and fair trade country, that competitiveness, business-driven, and market-driven are the themes around the world, and I think what you saw is regrettably part of the coming election year's economics. I do not think that is the long-run policy posture of the United States. We are hopeful and expecting that the U.S., the European Union and other countries will work their way through this, and do not expect any major trade confrontation or trade war. That would be very detrimental to the world's economy.

The "Japanese Problem"

Finally, the Japanese problem and the prospects for Japan in so far as what it might mean for the currency, and the perception I have of the way out for the Japanese economy at this time. I mention these because I think they have relevance here as it relates to currencies. We are unable in our research and in our examination of Japan to see how Japan can easily, or perhaps ever, work out of its difficult situation. Our expectation for Japanese growth this year is another small negative. Next year, a small positive; on a three-to-five year basis, no more than 1.5-2% growth per year. Compare that to South Korea where we think we can see growth this year of almost 6%, more than that next year. Of course, that will mean higher inflation and higher interest rates. The Bank of Korea will have to raise interest rates. But, it will represent a vibrant, dynamically-growing South Korean economy that will be affecting Asia in terms of what it buys, sells and produces.

Or, compare our view on Japan to the view on China. China is doing very well on exports. Its economy is not actually that open and it does not have a very high export-to-GDP ratio. It's a huge domestically driven economy where the prospects are 7-8% stated growth rates per year. That's a little high. Our own calculations, using our own numbers, would come out with a lower growth rate. But still, there is very strong growth in China and increasing competitiveness and share of market coming from China.

Contrast that to Japan. In the Japanese forecast of Decision Economics, Inc., exports should directly and indirectly pick up as the world economy picks up. My friends in Japan also tell me that the inventory downturn is over. But that's about all. In the tracking of the Japanese economy, we are not tracking anything other than continuing declines in consumption, and capital spending. Fiscal stimulus through increased government spending cannot work anymore. Japan, as you know, has huge government deficits and debt. Once again, the sovereign debt has been downgraded, just this morning, or yesterday, I think. There will be further downgrades. The sovereign fiscal position of the Japanese economy is very, very difficult.

Tax cuts, which would be preferred as a way out, much as the U.S. has used tax cuts, and which remains one of the suggestions I keep making to my Japanese friends, have previously been rejected by the policymakers in Japan. But it would still be helpful. Japanese tax rates, both individual and corporate, could come down and that would be positive. But the Japanese policy makers have shown no sign of doing that. So, we have run into a dead end in policy stimulus in Japan.

In the financial system of Japan, the banking system is in difficulty. The insurance industry is in difficulty. The financial intermediary system, so important for a vibrant economy, which transfers an easy monetary policy into the private sector, is broken. That transmission of money into the private sector and into lending that will help raise consumption and business capital spending and support the private sector, cannot happen. More likely than not, the non-performing loan problem in Japan will not improve. It will get worse before it gets better. It appears the banks simply don't want to reform. The policy-making bodies of the Japanese government don't seem to be able to make the banks reform. Bank reform simply is not happening in Japan.

As for politics and the ability to compete, that is also a difficulty in Japan. We observe some problems in the policymaking leadership and political leadership as well.

All of this is to say that, try as we may and as much as we research the situation, the prospect, objectively taken, on the Japanese economy is still negative. That does have implications for the exports of South Korea. It does have implications for business strategy and where marketing by companies needs to go. It has implications for the currencies. Natural market forces suggest the yen against the dollar is very likely going to decline some more. In turn, that will create some further competitive problems for South Korea and other Asian countries, and perhaps bring a sympathetic downward movement in those currencies against the dollar as well.

I see no way out of this situation at this time. It seems inevitable that the yen will have to decline over the long-run as part of the mechanism of adjustment to help Japanese exports, as part of some cyclical help for the Japanese economy. In addition, my guess is major countries and governments around the world will accept that a declining currency is one of the ways out for countries in cyclical trouble. This is particularly so for a country like Japan where there is severe deflation. A lower currency can help reverse that deflation. There will be significant declines in the yen against the dollar as we move forward this year, and next, given how things look at this point.

The Middle East

Finally, the Middle East situation, oil, and the U.S. and world economies. This is one of the great uncertainties and risks for the U.S. and world economies this year. No one can say where this Middle East confrontation will go or end up. It is laced with scores of years, hundreds of years, conflict and hostility. It is as complicated as any geopolitical issue can be and it has just one tangible economic outlet: the price of oil. How crude oil prices go, and this conflict goes, can have major effects on the world economy.

For now, for the moment, we are viewing the modest rise in crude oil and energy prices as a marginal impediment to growth in the U.S. and world economies, particularly the oil-consuming nations. The U.S. is one of those. Japan is another. Korea, yet a third. This is not decisive. Not devastating. It is not anything that will interrupt growth. Indeed, to some extent in the U.S. case, it is helping because it will keep our Federal Reserve from raising interest rates sooner, since consumption spending will be weaker because of higher oil and energy costs.

But, if for some reason the confrontation extends and enlarges, and if oil prices should move up to US$ 35-40 per barrel, then I would have to say that the world recovery would be in jeopardy. Not just in economics and in the impact of oil and energy costs, but also because the kind of situation that would give rise to a US$ 35-40 oil barrel most certainly would mean an intensification of the conflict, and enlargement of the conflict, to something that none of us would want to see.

The Middle East is a very complicated, fragile, difficult situation. I have, myself, a more optimistic view on the resolution of it. It, unfortunately, involves what we are seeing: the elimination of the terrorist infrastructure in the eyes of the Israelis first. Then when that, in their eyes, is completed, they will be willing to sit down and talk. Of course, they won't want to talk with Mr. Arafat. That will create complications with the Arab world. We are, then, likely to have this up-and-down Middle East situation with us for some time.

History teaches us that business goes on, markets go on, consumption goes on, economies go on, even with ongoing tension. Let us hope that it will not explode into a major confrontation and a war-like situation..

Aside from the geopolitical risks, the prospects for the U.S. and world economy look much brighter now than they did to me last time I was here. As for my view on South Korea, the airport was a symbol of the coming of age of the Korean economy. It was so shiny, bright, and new, and it looked so beautiful to me flying in and walking through it. I thought to myself that this is a symbol of South Korea on the move again. I think you are on the move again and not going to turn back or retreat from that for a number of years.

Thank you very much.

Questions & Answers

Q: The U.S. economy has enjoyed, and is still enjoying, the longest length of prosperity in history. If there was a recession, it was a mini-recession. Or, using the NBER definition of a recession, there may not have been a real recession since there was only one quarter of negative growth. What makes this economic performance different? How was this long prosperity maintained? Was it due to the better availability of data? Technology? Preemptive policies? Allen Greenspan himself? What made this whole business cycle different, as compared to cycles before?

A: I'll start with a technical comment on recessions, and on whether the U.S. really had one or not. On a GDP basis it was a very mild downturn, if indeed we had one. GDP, as you know, is not the technical way that the National Bureau (NBER) defines recession. It is based on a range of monthly economic indicators, particularly four or five key ones. On that basis, consistent over 150 years of history, we definitely had a recession. Mild or not will be decided later on. It looks like it was of average length.

I think it was very severe in the business sector. Business profits plummeted. Business capital spending plummeted. A million-and-a-half people were laid off in a very short amount of time. Industrial production went down 18 months in a row. This is very unusual. It was very severe in the business sector, very much so in telecommunications and technology, as you know. I find as I travel the world that business people still are feeling the effects of this downturn. But on the housing and consumption side, a recession hardly happened. So it is complex and not clear cut. When you look at GDP, the GDP reflects every thing. And, GDP only went down for one quarter.

So why has the U.S. maintained such a long period of prosperity, even, with this downturn as I've described it, escaping pretty well with hardly a dent? I would say the main reason is the surge in productivity growth that emerged over the 1990s. I think a lot of this was market-driven. It was market forces pushing American companies to become more competitive, and to seek and demand technology to help become more competitive and cut labor costs. In turn, when I ask why were American companies so intense in doing this, I come back to maximizing shareholder value. Maximizing shareholder value has a lot of plusses, also a lot of negatives. Look at Enron. That was a negative. Maximizing shareholder value is so intense and engrained in the United States than anywhere else in the world that it drove American companies to demand such technology. So the U.S. responded with the purchase of new technology and the installation of it.

That, plus the pressure on workers, was the major factor driving productivity growth so high. That, in turn, has allowed the U.S. to grow with relative impunity. Let me put it another way: we can now grow faster in the United States without the Federal Reserve having to worry about inflation because our potential growth rate is so much higher.

The second element is a preemptive, forward-looking monetary policy. It was the Federal Reserve, led by Chairman Greenspan, that ran policy in a very eclectic and pragmatic way, not relying on any of the "rules" that we are taught as economists. For example, the natural rate of unemployment was dropped by Chairman Greenspan and the Federal Reserve in the mid-1990s because it became obvious that the U.S. economy could grow with a lower rate of inflation because of higher productivity growth. So the rigid rule, the "natural" rate, which would have had the Federal Reserve raise interest rates sooner, became irrelevant, much as many things have become for the Federal Reserve over recent years. It is now a very flexible central bank, and preemptive monetary policy, changing rates ahead of time, before there's a problem, is really the right way to go.

Those are the two main reasons for the sustained prosperity. I was struck by, and somewhat surprised, by the quick tax cuts of the Bush Administration, and the early attempt by the Bush people to head off a recession. President Bush has been a businessperson. American business people don't want to wait until problems happen. They want to head them off. That's another striking characteristic, a big change, in the U.S. corporate culture. In the 1990s, American business people learned to look for problems and to take care of them before they appeared. I see a lot of nodding of heads here, and that makes me think that business people here in South Korea have the same attitude. In the 1980s, American business people didn't want to hear anything bad. They wanted to hear only good forecasts, only good things about business, and they got behind the curve of trouble. That's not U.S. corporate mentality any more.

Q: As you know, in Japan total trade as a proportion of GDP is very low, maybe less than 10%. So the Japanese economy cannot really recover based solely on trade promotion. We would like to have your view on this.

A: The Japanese export-to-GDP ratio is slightly under 10%. The portion of GDP that goes to U.S. exports is slightly under 3%. The U.S., directly, in its upturn, cannot pick the Japanese economy up. The direct and indirect effects of a U.S. upturn, through Japanese exports, will be larger. So Japan, on the economic activity, should see some sympathetic improvement in exports as the global economy picks up. That will help its GDP. But I think that is about all we can see at the moment. We can't see much coming on the domestic side. We are pessimistic. So I am in agreement with the thrust of the question.

Q: On the Chinese economy, there was recently a report by a professor at the University of Pittsburgh who argued that, based on energy consumption figures, the Chinese economy couldn't grow by 7-8%. Energy consumption numbers, he argued, do not support that figure. We would like to know what is your view on this.

A: The close-to-correct figures on growth are more like 4-5%. That is not so much our own research basis, but that of scholars who follow the Chinese economy very closely, who are on our advisory board at our company. We have had many sessions on China, Southeast Asia, and Japan, and on their basic prospects.

Let's face it. What do business people have to do now when you look at Asia? On a three-to-five year horizon, business people have to decide where they are going to produce, where they are going to have offices, and where they are going to market and sell. They have to decide where the competition is coming from. This is very important for businesses to make those decisions.

So how Japan goes, how China goes, and how South Korea goes is very, very important to many, many of our clients. Surely, very important to people here as well. Those involved in financial markets must choose where to globally allocate their assets. Do you put them in Euro-based investments? Dollar-based investments? Or do you put them in yen-based investments? I am hard put to recommend to our clients to be anything other than significantly under-weighted in yen denominated investments. This is based on the analysis that we have and on what the outside experts that we bring in to help us and our clients say.

As part of that process, when looking at China, it is quite clear that the numbers are not quite what they appear. So our estimate, and those of the experts we have used, is on the order of 4-5%.

Q: You mentioned interest rates briefly. What are your predictions for U.S. interest rate this year and next?

A: The current levels of short-term rates are abnormally low. For an economy that will be, we think, up and running, we are sure that the Federal Reserve will raise interest rates. Not in a systematic attempt to take down inflation risk, which is largely absent in their terms, but simply to move short-term rates in-line with a reasonably solidly growing economy. Our thought is that we may see 75 basis points of higher short-term interest rates in the course of the second half of the year, but not a continued and systematic series of rises in interest rates to attack inflation. There isn't an inflation problem. When the U.S. Federal Reserve attacks inflation, watch out, because the by-product is almost always trouble in the economy and trouble in earnings. We don't see that happening for a long, long time.

Q: North Korea is a very important problem for us. But the North Korean economy, in terms of size, is not that important. However, during your work and while making your forecasts, do you ever take into consideration what is happening in North Korea?

A: Yes, we certainly do because it is a political issue. As you know, the President of the United States has identified several countries as part of, I think the phrase was, an axis of evil. I'm not sure which of his speech writers wrote that phrase. I don't think I would have written that phrase, but that's our President. He's kind of a "black & white" guy; he tells it as it is. It's refreshing. He's not always so diplomatic, but he has identified North Korea as a potential political problem, along with Iraq and Iran.

I think the U.S.—and you need to know this—is clearly telegraphing an intention to deal with terror around the world and that this is something this administration wants as its legacy. This is fraught with risk. This is confrontational. So the North Korean situation, political and economic, is relevant for us because it is part of what we have to decide in terms of what we think the administration might do, and particularly the risks of foreign policy to the U.S. and to its financial markets. Watch those words. I'm not saying that

I'm for it or against it. But I'm saying that they have clearly telegraphed their intentions. The Middle East situation has, in my opinion, taken the administration off track for a time until it gets resolved. It is clear that what they have been talking about in terms of terror around the world cannot be pursued until the Middle East situation is resolved in a more favorable way. None of us know how long that will take.