General Outlook on the US & World Economy in 2004*

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I have come here this year with an outlook for the US and global economies that is more certain and brighter than last year at this time. Last year, if you recall, the uncertainty of the geopolitical situation, particularly Iraq, was quite high. That left the US consumer, US business people, and many decision makers around the world cautious, confused and uncertain.

We are now looking at what we think is the real thing: a real, solid, strong recovery and expansion in the US and global economies. It is a real, live upturn, as had been predicted by many—not by us—for several years. It finally arrived in the US around the middle of 2003. We see throughout most countries and regions of the world many signs of increasing business and economic activity and vibrancy. We think it is going to last through 2004 and well into 2005. For me, who has been analyzing the US and global economies, and after having been so pessimistic for about three or four years, this is a nice theme and message to be able to now deliver.

The US is, as it has often been in history, the engine, although not solely, of the upturn we see. The US economy has picked up substantially in its growth. We saw this in the second half of 2003, the data for which came out just last Friday. There was real economic growth of 6%. For all of 2003, fourth quarter to fourth quarter, the US economy rose 4.3%. That is almost Asian-like in its number.

Indeed, part of the story and the reason for that pace of growth is an Asian theme: productivity. Strong productivity growth allows strong demand growth, if policies are stimulative and business gets active, without any inflation threat or problem to impede the upturn.

The pickup in the US economy began late last spring, not too long after the end of the active military side of the Iraq event. We think this pickup has come from a number of sources. First, massive fiscal stimulus. There were four tax cuts in three years by the Bush Administration, the last one last spring. The US$ 350 billion tax cut stimulus passed by the US Congress in late May was mostly front-loaded, and entered the US economy starting in mid-last year and continuing into this year, 2004.

Tax cuts were followed by increased government spending. Part of the government spending was not really desirable. It was for military, security, and Iraq. But the tax cuts combined with increased government spending, we think, was the catalyst that pushed and moved the US economy into its rapid growth pace in the second half of last year.

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We have also had ongoing and continuing monetary ease. Interest rates are very low, the lowest short-term interest rates in four decades in the US. They are being kept low by the US Federal Reserve in order to be sure that the US economy is in an entrenched and sustainable expansion.

I think our upturn also came because of the end of the negative external shocks: September 11, 2001; the war in Afghanistan; the war with Iraq. All of those shocks definitely held the US economy back, hurting confidence and hurting the stock market, preventing an expansion from getting going.

These shocks are now behind us. Geopolitical risks remain in many places around the world. But the problem is constant. It has not gotten worse. In the US we are very thankful that nothing of a terrorist nature has happened on US soil since September 2001. For the economy and the markets, the passing of the negative external shocks, and that fact that there have been no new ones and no step-up in what is admittedly a tense geopolitical situation, has helped and allowed the US economy to pick up steam.

There is a fourth factor. We are several years beyond the bursting of the stock market bubble in the US. The economic boom of the late 1990s and the stock market surge, particularly in technology, which burst in 2000 and 2001, had a lot of aftereffects. Most of those aftereffects, the healing of the financial system, even the corporate malfeasance, seem to now be behind us. The US stock market measured by the S&P 500 was up 29% last year. That does not regain the tremendous losses from 2000 to 2002, but it does suggest that the aftereffects of the bursting of the stock market bubble have been digested in the US situation.

We see once again financial intermediaries working. The intermediation system broke down for a couple of years, and the transfer of private sector savings into the hands of existing and new business was slowed. We see such intermediation working again. Banks with money can lend and invest. Investment banking and brokerage firms are in good shape, and are also able to lend and finance. We see some M&A activity in new issues of stock. The non-bank/non-investment bank financial intermediation in the US economy, through venture funds, private equity capital, and the financing of new small businesses, has become very active.

In addition, the rest of the world economy, ranging from Asia to Latin America to Central Europe, is also picking up in activity. US exports, in part helped by a low dollar, have risen at a 19% annual rate over the last year.

Productivity growth is strong. US productivity growth is at unprecedented highs. This has helped reduce break even points for US businesses and US-based businesses. It has helped to keep inflation pressure down. That has given us five quarters of double-digit growth in business profits. Along with increased sales growth and low interest rates, that has left the US business sector in a position to begin to spend and to add to the economic upturn, and to spend and buy from countries around the world, as we have observed in rising trade flows, both exports and imports.

All of what I have described is part of the business cycle upturn. Much of it is very familiar: the monetary and fiscal stimulus, the lower dollar to help exports and growth, the adjustments in the system to the imbalances of the boom and the bubble, and the clicking in, sector after sector, of what we call the mechanisms of the business cycle upturn. This suggests to us we have entered a sustained and sustainable period of upswing in the US economy.

History tells us that once the business cycle upturn comes into play, we should expect three or four years of expansion in the US economy. We look to those countries that benefit from the pickup in the US for a wave of increased exports, increased transactions, and increased finance. In turn, stronger growth outside the US reverberates and comes back to pick up US exports. This is part of the global business cycle mechanism. We have very tightly woven inter-related economies and markets now. When an economy as large as the US, or an economy as large as China, or an economy as large as Japan, or a region as important to the trade of the world as Asia, or the Eurozone, picks up in growth, the effects of the growth from that region will ripple throughout the world economy and be part of the business cycle. It is, we think, for real.

In 2003, the US economy grew 4.4%, 6% in the second half. The growth path of the US economy is now much higher than it has been for several years. We are expecting to see growth fluctuate up and down around an average somewhere in the vicinity of 4% to 4.5% in real terms. We think the expansion will last well into 2005, and the first significant chance of another recession will not be until 2006.

Imbalances have been created, as part of the stimulus provided to the US economy to pick it up in growth. Those imbalances, ranging from high current account deficits, to very large budget deficits, to extremely low interest rates, to some imbalances around the world, are the reason why, as time passes, it is hard to see and forecast more than a cyclical upturn for the duration of only three years or so.

This is not to say we could not have an expansion in the US and world that might go on for years, as was the case in the 1990s and the five or six years in the middle of the 1980s. It is only that this time around, the manners by which the US economy is brought to its feet, and the interactions of the US with other world economies, are such that a number of imbalances were created. What happens to these imbalances, in the policies of countries around the world as they affect these imbalances, will determine whether this expansion can last for many years.

The growth prospect for the US for this year is accompanied by, very likely, a very low rate of inflation. The upturn in the middle of 2003 occurred at a time when the US economy had considerable slack and immense unused capacity. This was part of the aftermath of the boom, the stock market bubble, and the collapse in business sector profits and spending. The slack in the US economy is also made larger by the strong supply-side productivity growth seen of the US economy.

Potential growth in the US now looks to be about 4% a year. That’s probably the highest ever in the history of the country. Productivity growth in the last two and three quarters has been perhaps as high as in the 3% range per year. This is structural productivity growth, along with a labor force growth of 1% or higher. This gives us the estimate of potential upward growth, for the capacity of the economy to grow on the supply side, of 3.75% or maybe as high as 4%, but no less than 3.5%.

With that kind of growth rate for potential output, the US economy can grow at a rapid pace without the threatening rise of inflation, something that would cause interest rates to rise or the Federal Reserve to tighten money to slow the economy and keep inflation down.

It is unprecedented in the modern history of the US to have this kind of supply-side growth in productivity growth that we are seeing in the data, and which we suspect has ratcheted up very recently. An economic growth rate of between 4% and 4.5% in 2004 will just be a little bit more than the growth rate in the capacity of the US economy. Given the entrance into the upturn, and the situation with a gap between potential and actual output of about 2%, which is a very large gap, it will take a very long time before that slack between supply and demand is absorbed, and before we would have upward pressure on inflation.

Indeed, inflation in 2003 decelerated in the US, even as growth picked up. That 4.3% growth rate over 2003 was accompanied by a decline in inflation, measured by the consumption goods price deflator, and then by an even bigger decline when you strip out the volatile food and energy components for the core rate, the ex-food/energy rate of inflation. According to a report we received this morning in the US, the December-over-December inflation rate of the consumption of goods and services deflator, ex-food and energy, was just seven tenths of a percent (0.7%), year over year. One year ago at this time it was 1.7%.

The US economy's growth rate soared, particularly in the second half of 2003, but inflation fell. The unemployment rate fell from 6.4% to 5.7%. How can that happen? Productivity growth is the answer. The US economy has somehow become even more productive during this last recession than it was before. We are seeing the results of that in the slack in the economy between supply and demand and the falling inflation rate, even as the economy has picked up.

As time goes by, if the US economy grows at 4% or 4.5%, we will absorb the slack in the economy. Capacity utilization will rise. It is only 75.8% right now. The unemployment rate will also gradually work lower. Eventually, we will absorb enough slack to put upward pressure on inflation. And, yes, eventually, the US Federal Reserve will raise interest rates because of that. But that "eventually" is not soon. The amount of slack is very large, and because productivity in potential growth are so high, the slack in the economy will remain for a long time and inflation in the US will stay low.

Jobs growth is just beginning to come onstream. Profits growth has been superb. In the fourth quarter, the S&P 500 operating earnings result is running at about 25% year over year for the companies that have reported. It's a combination of a lower break even point, as well as higher revenue growth. We're expecting about a 15% rise in profits in

2004. The parameters suggest to us we are in the early stages of a significant upturn in growth, and that impediments to growth, so long as there are no negative external shocks, and that could happen any time on the geopolitical side of the ledger, we should move smoothly through 2004 and well into 2005. The rest of the world will benefit.

In other countries and other regions, we see the following. The Japanese economy has picked up in growth. In calendar year 2003 it grew at 2.5%. That's the best growth rate in Japan in a long time. We are expecting almost 3% growth this year, and we are more optimistic than most. We are well above the consensus in our expectations for Japan.

The Japanese economy pickup may be similar to that of Korea. It relies on: exports, directly and indirectly helped by the US pickup and helped by very strong growth in China; some business spending, particularly on capital goods and technology; and not very much on the consumer. Japanese consumer spending continues to lag, much as it is lagging here in South Korea, and much as it is lagging in Germany and countries in the Eurozone.

The uplift in the global economy that we see is very much trade driven. The sizeable pickup in the US is, we think, sustainable and will be sustained. It is very much business-driven. It is not consumer-driven, but business-driven. This is reverberating through increased export and import flows all around the world. The US remains the major buyer of the goods and services of many of the leading countries around the world. China is increasingly a big buyer of goods and services. So when the US picks up, our imports pick up, and the exports of a lot of countries pick up. We see that footprint in the economic activity which increases in almost all the countries around the world. This, in turn, drives business to spend more in many countries, and probably last will come the consumer. Usually it is the other way around, with the consumer first. But this time, the consumer in Japan—and South Korea, Germany and the Eurozone—will probably come on stream last, in terms of spending.

Japan's inflation rate, as you know, is negative. Our expectation is it will turn positive sometime this year. We still expect Japan to maintain a 0% interest rate policy, but probably in 2005 it will think about raising interest rates for the first time in years.

In Asia, China is growing very strongly, at 9% in 2003. We are expecting 8.5% in 2004. These numbers are higher than they truly are, but even if you subtract three percentage points or so from those numbers, for perhaps a real or more accurate take on the Chinese economy, the Chinese economy is in a boom state. It may be a bit over-heated. We think that's, in part, because of the fixed currency. But the tremendous domestic demand out of China and the trade impact of China is having a major positive effect on the economies of Japan, South Korea, and of Asia. Also, then, as those economies pick up, will lift other economies as well.

India is growing very strongly. The growth rate there this year, we think, will be in the 6% to 7% area. You are probably familiar with the exporting of jobs out of the US to India. Part of India's dynamism comes from its low-cost labor, not for textiles, not for automobiles and not for steel, but for technology. The anecdotal evidence is very strong.

There are a number of US firms, particularly financial firms, that are hiring in India at a very high professional level.

The force of US hiring in that country, and as US and other countries outsource production to Asian places where labor costs are cheaper, particularly China, is a major dynamic of the very strong pickup we see in the Asian area.

Just to give you a few figures for 2004—and not to bore you with numbers but to contrast the look of the global economy this year to 2003—the global economy, as we look at 48 countries around the world, grew, we think, in 2003 by 2.4%. In 2002, by 1.7%. It's a plus number, but it signifies a recession. A small expansion is seen at 2.4% growth. There's a quirk in the data. The dividing line between expansion and recession, in our data, is about 2%.

For calendar year 2004 we are expecting for the US, 4.5% growth, and for the global economy, just a little under 4% growth. In 2005, we expect pretty much the same. As we look around the world to Japan, we see 3% in 2004. Developed Asia—that is, Korea, Taiwan, Hong Kong and Singapore—are looking at growth this year of 5.5% to 6%. That compares with about 3% in 2003, almost double the growth rate. As you know, last year was a problem. Not just because of the weakness in the economies, but there was also the SARS problem that devastated, for a time, several of the Asian countries. I have already covered China and India. For what we call emerging Asia, we are expecting 7% to 7.5% growth.

So the global upturn is actually being led by Asia, both developed Asia and emerging Asia. It is reinforced by a cyclical pickup in Japan, the best Japanese picture we've seen in a decade.

Moving elsewhere in the world, we are observing in the Eurozone a pickup there as well. There, trend growth is much less, in part because labor force growth is much less, and that is a demographic issue for the Eurozone. But growth in 2004 is expected a little more than 2%. It was only 0.5% in 2003. Countries like Germany, Switzerland (which is not in the Eurozone), and France had recessions for part of 2003. The data tell us those countries are now growing. Indeed, very much in the same dynamic as I described here: exports first, business to business second, and probably consumer spending to come thereafter. The UK is growing nicely. We're expecting almost 3% growth in 2004, after a 2% year in 2003.

Latin America is turning, led by strong growth in Argentina and a pickup in Chile, and a turn in the economy of Brazil. Latin American growth will be about 5% in 2004, against a little over 1% in 2003.

Then when we go to Central/Eastern Europe, we are looking at 6% or so growth for Russia. For countries that are candidates to join NATO and the European Union, we see almost 5% growth. That's against near 4% in 2003. Those are the countries Poland, Hungary, Czech Republic and Turkey.

The picture around the world is increasing growth, increasing business activity, against a backdrop of relatively low inflation and then, for policy makers, no compelling reason for any of the monetary authorities to engage in interest rate increases, or a series of them, that would stop momentum from continuing well into 2005.

Let me turn now to policy in the US and bring you up to date on how we see that. Then a few of the risks and imbalances, negatives, things that might go wrong that I think all of us need to consider.

Growth is strong in the US. Jobs are just beginning to be created and generated in the US economy. We have a very unusual job situation in the US. The typical upturn in jobs that occurs with the kind of growth I've described has not happened. We think it's because a lot of outsourcing jobs by US-based companies that are very intent on keeping labor costs down. The outsourcing involves outsourcing jobs to other countries. Software production and creation to new companies in India. We think it comes from outsourcing production to other areas of the world, such as China, Southeast Asia, and the northern part of Mexico, where labor costs are cheaper.

We see a lot of outsourcing in the US, simply letting functions and people go, taking them out of the company environment, because their overall costs are so great, and putting them on their own into the private sector. We see US companies paying lump sums amount of money to individuals to retire them, taking the cost as a one-time charge, but lowering their operating expenses by this tactic.

Of course, we see all the time technology and the use of technology eliminating one job after the other, as the people who used to serve us, sell to us, and deliver to us, no longer are needed in jobs that are replaced by machines and consumers and business people will go right around the intermediaries, and agents, since they no longer need them. It's a world wide phenomenon, but it's very intense in the US.

So we are not expecting the jobs creation we always do see on a 4% economy. We're expecting to see it to be anemic. But it is beginning to get better. One of the concerns and risks around the US situation is, "How can the economy grow at a high enough rate if we're not creating jobs?"

Our answer is that as time passes, more jobs will be created. We will see through the mechanism of world trade and world finance a feedback effect from the jobs that are created outside the US, and the stronger economies outside the US. We will see a feedback effect, through US exports, and increased US demand on the export side, that will employ people. Over time, enough jobs will be created to sustain the expansion.

The Federal Reserve, with this kind of growth, this kind of inflation, and an artificially low short-term rate—the federal funds rate—will, at some time this year, think that they observe and are absolutely sure that the US and global economies are up and running and are in a sustainable expansion, from their point of view. From our point of view, we are already there. But I think the Federal Reserve wants to be absolutely sure that the US economy is in a sustainable expansion before it begins to raise interest rates. Then sometime this year, it is very likely they will come to that conclusion and raise short-term interest rates from their abnormally low levels.

How much? Well, with inflation running under 1%, and all the slack that exists in the US economy suggesting that inflation will have to first bottom out before it picks up, and given how low inflation is, they will probably not raise interest rates very much or very many times. So over the course of the year, short-term rates in the US might go up half a point or three-quarters of a point. That is not very much, and it will not be designed or serve to impede the growth picture that I described, nor to diminish the pace of growth of the US economy, and indirectly the world economy.

Long-term interest rates in the US could go up more, as time goes by, from a combination of factors. One would be if the Federal Reserve begins to raise short-term rates. Second would be a change in the direction of inflation from decelerating, to bottoming out, to picking up some. Third would be the increased financing that would come from the federal government because of very large budget deficits. The deficits have played a significant and positive role in getting the US economy to pick up. Another factor may well be the financing of the US's current account deficit and the purchases of US fixed income securities by countries around the world as they invest in the US and lend to the US. Those funds may not be forthcoming by as much. So we think long-term rates in the US, that is the ten year treasury rate, could go up by 5% or maybe a little more by the end of the year.

Those kinds of interest rate increases will really not stop the growth dynamic, or impede it or abort it. The US and global economies should continue to grow even with those rate increases.

The Federal Reserve these days in the US has a very complicated communication system, in terms of how they explain to the world, the public, and those of us who analyze what they do, what they are thinking about. It has become so complicated I don't think I can easily explain it to a non-technical audience, in terms of monetary policy. But I think, in their latest statement last week, they have put us on notice, in the language of the statement, that they will not keep the federal funds rate at 1% forever. At some point they will get less accommodative. They are going to be patient and wait. They could wait a long time, all of this year. They could just wait until mid-year. But they are going to be patient before they raise rates.

In between the lines, so long as US inflation is so low, there's absolutely no reason for the central bank to try to raise interest rates to a point that it would impede the growth activity of the US economy, and hence the world economy. To put it simply, the Fed will not be in the way of the US and global upturn this year, and I don't think it will particularly get in the way of it in 2005. The path is open. The US central bank and other central banks around the world are going to be accommodative. They are going to support the business upturn and business activity for quite a while.

Today in the US we had the release of the Bush Administration's budget for this coming fiscal year. The US budget is heavily in deficit. I think we had to tactically accept a much bigger budget deficit as a cost of the tax cut stimulus and government spending stimulus that was so necessary to pick the US and global economies up. In this particular episode without the tax cut stimulus, I don't think the US economy would have picked up very much, and the global economy would not be enjoying the beginning of a resurgence we see unfolding at this time.

But there is a cost to that short-run stimulus, the tax cuts. The cost is a large federal budget deficit. The administration estimate is over US$ 500 billion. The Congressional Budget Office estimate is over US$ 477 billion. We are a little more optimistic; we are US$ 460 billion. That's almost 4% of GDP. That's a pretty big number. When we look out, and others look out, for the next five to eight years, we see nothing bud red ink. That's an imbalance. That will have to get corrected at some point.

The US economy is not being hurt at this time by the large budget deficits. It is being helped. But it will be important for whoever is elected in the US, for whichever administration is in place, to take action as soon as possible, to tone down the spending side, to revisit the tax side, to see whether government can be made more efficient, and to start a new downward glide path for deficits in the US economy.

When we get to 2007 or 2008 in the US, the demands of an ageing population are going to be quite huge. This is a familiar theme around the world. That includes social security, Medicare and Medicaid. Inflation in medical care is quite high, pumping up the numbers in what are mandatory categories of spending by the federal government. It is in these areas that we think we will have to look to get relief on the budget deficits. Tax increases really won't help, because they would hurt the economy.

Our deficit is because the US economy has been languishing, because of the tax cuts, and because of the increased government spending for terrorism and security. There are also increasing demands from the US population on the government, particularly on the health care side, to fund those public sector needs. This is an imbalance. This is a problem. But now it is helping growth. By 2005 or 2006 if the deficits we see now are not dealt with in advance, we would be concerned that those deficits could create disarray in markets, that is to say sharply higher interest rates, perhaps problems with the US currency, excessive volatility. This, in turn, would damage growth of the private sector and raise the risk of a downturn by 2006.

We will see. We will see what the administration says in terms of its plans and proposals. The budget released today, we have not fully studied yet. It probably does not go far enough in terms of actions to reduce to a low enough level the structural budget deficit of the US.

The second imbalance and risk relates, really, to the current account and trade flows. This is a world imbalance. It is a complicated situation. A huge current account deficit for the US represents a demand and drain on world finances to fund the US current account deficit. On the other side of the ledger are imbalances that exist because of exchange rate immovability, in part because of a fixed Chinese exchange rate to the dollar. For trade reasons, attempts by Japan and other countries in Asia to keep their exchange rates competitive, so as to encourage exports and trade in economies that have just begun to start to move up.

This process is not sustainable. There is a risk here. Intervention and, through intervention or other means, fixing exchange rates or moving them in desired directions to help trade can work for a while, but ultimately in the longer run the markets will have their way and exchange rates will have to go where they go.

The answer to the current account imbalance of the size of the US's is a lower dollar. That's one answer. Another answer is a more competitive US and a pickup in US exports because of increased demands around the world. It just has to move that way.

For Japan, the answer to a live and sustained expansion is not continued intervention to keep the yen from rising to where market fundamentals think it should go or will take it. The extraordinary purchases of US treasury securities and the holding back of the yen through intervention and, in turn, other Asian countries to stay competitive with Japan intervening to keep currencies from strengthening and injuring exports, ultimately will not work. All that countries can do, or should do, and central banks can and should do as agents of ministries of finance, is to control the pace of appreciation or depreciation of a currency through periodic interventions, but more properly through appropriate policies. No one can, for any long period of time without creating imbalances that someday come home in a negative way, can interfere with exchange rates and markets that want to move exchange rates in a particular direction.

More properly, for Japan, full reform of the banking system, greater efficiencies in the Japanese system, would do more to help the Japanese competitive situation than trying to hold back the yen, which in turn is inducing or encouraging other Asian countries to do the same with their exchange rate. This contributes to imbalances, the main source of which is the US current account imbalance. It's a risk. Market prices have to move, hopefully, in a reasonable way and not in an excessively volatile way, in order to permit the imbalances to work themselves out.

Fortunately, looking at 2004, the imbalances on current accounts and trade that exist around the world, and the US budget imbalance, should not prevent: the US and global economies from having a very good year in economics; stock markets around the world from enjoying another year of good gains, though not as good as last year; all of us from enjoying a period of relatively low and stable interest rates. Beyond 2004, the imbalances I have mentioned will have to be dealt with by the market, or by policy makers, to make sure that this expansion, what I called the "real thing", which has been long in coming, lasts for as long as we can make it last, to encourage and sustain a prosperous global and US economy for many years.

Questions & Answers

Question #1: My question is about the economic upturn and the US presidential election. Will this recent economic upturn work favorably for the incumbent?

Answer #1: The economic prospects and the way things are going in the US economy cannot hurt President Bush. They will certainly help President Bush, and he will, I think objectively, take credit for the tax cut and the fact that the tax cuts really are stimulating the US economy. Without them, we probably wouldn't be having this upturn.

Now, it is interesting that almost always in a US presidential year the strength of the economy is decisive. It would be automatic to say that, with the economy we have and which is emerging in the forecasts, President Bush would be a shoo-in in the election. In commenting on the US scene from a broader perspective, though, I cannot say that. The international dimension and the involvement of the US in Iraq and all the conditions that gave rise to that, and which is still a difficult problem for the US, is hurting the president. It's clear in the polls. The economy is not the only factor. It certainly *should* help President Bush in an election attempt, but there are other things that seem to be bothering US people other than the economy. They are international, and it may also be the style of the administration.

One recent poll had President Bush even with the now-very-likely candidate, Senator John Kerry. That is not odd at this stage. Once incumbent presidents begin to campaign, the polls tend to change. But for the way the economy is going, the direction of anecdotal evidence, and the confidence in the economy that is showing in the confidence surveys, the current standing of President Bush in the polls is unusual. At the end of the day, I think the president will be re-elected. The economy will do it. There is still time between now and election day for the Iraqi situation to be resolved better. The candidates on the Democratic side are generally weak at this time. There is not a real tough competitor to the president from the Democratic side. That even makes the current poll results *that* more interesting, making me wonder whether something is going on in the US psyche which could be reflected in a change, if Bush is re-elected, in composition of Congress. That would have significant effects.

From a market point of view, this pro-growth administration, Bush, is definitely preferred. From a stock market point of view, that is a definite preference. If the Bush election is in doubt, and if a Democratic candidate—almost all of whom are proposing anti-growth types of actions, rolling back tax cuts or portions of the taxes, for example—wins, our stock market would have trouble. If Congress changes so that the Republicans lose control, that, too, would change the policy outlook and affect what goes on beyond that.

Question #2: You touched on this issue, but I would like a more specific answer. What have been the effects of this Iraqi war, September 11, the Afghanistan war, and so forth, on the US economy? As the defense outlay positive? How did it affect the US economy's performance? Secondly, did those geopolitical factors affect the US budget?

Answer #2: Yes, it was positive. We spent more money. But it was very negative. We think it cost us a lively upturn much earlier. We think it cost us anywhere from 1% to 1.5% percentage points of growth. How did we get that?

Well, the whole process—September 11—was a devastatingly negative blow to the US economy and state of confidence. The Afghanistan war went very well. Then there was the Iraqi war, and the time it took to lead up to it. I was here last year in the middle of the run-up to the Iraqi war. I talked about it as the major uncertainty last year. It hurt the stock market badly. It hurt confidence badly. It made business people hesitate.

There were effects, because consumer spending weakened on business sales. This delayed the up turn in the economy. It was only two months after the military side of the Iraqi war was over that the US economy began to pick up. It's one of the elements that did it.

It was definitely a negative. Those were significantly negative shocks. If we had another shock of that sort—an attack on US soil—that would re-mobilize us again. We're more resilient in the US economy than we were before. Or, if, and I don't think this will happen, before the election a confrontation with another country like Syria, North Korea or Iran, occurred, we would have negative impacts on the markets and on the US economy.

Question #3: What are your thoughts about the twin deficits? As you said, twin deficits—even if it *is* the US—cannot go on. This year, the current account deficit will be over 5% of GDP. Now, if the US were a normal country it would have suffered a currency crisis. But since it happens to be the US, it has had no currency crisis yet because the global economy is under a *de facto* dollar standard. How long can it go on? How will this series of twin deficits be resolved?

Answer #3: We do have twin deficits. That is the correct phrase. Technically, it's not for sure that when you have a high budget deficit you have a high current account deficit. After all, we had the high current account deficit before we had this budget deficit. But the spending and tax cuts that drove the budget deficit up, will, because they create a stronger economy, bring in more imports. Since the volume of imports is so much larger than the increased volume of exports, the current account deficit goes up. You do have a connection between the budget deficit and the current account deficit.

Those deficits and the debt that accumulates on those deficits are like a time bomb. It's a fuse and you don't quite know when it's going to explode. In the US economy now, with all of its slack, lots of liquidity, low inflation, and the ability of the Federal Reserve to keep interest rates low, the debt service that goes with the increasing debt—an international account and a US government account—will stay low. It will not be a problem.

But the day will come when the private sector of the US economy demands more funds than the financial system, and the government keeps selling an awful lot of treasuries, and some of the countries in Asia, perhaps Japan and China, won't buy so many treasuries any more because, for various reasons, they may not be trying to manage their currency. This clash of funds demands from various sources would cause interest rates to rise, particularly long-term rates, very sharply. It could create problems on the currency. Combined with the inflationary effects of an economy with less slack, one that is closer to full employment, along with the crunching effects of interest rates could send the US economy into a tailspin, and the world economy with it.

No one knows when with these kinds of things. In the 1980s people like me alerted, complained, and argued that these deficits that were being run up would hurt us some day. It took four or five years for that to happen. It could be that long this time. No one can really predict exactly when. But as we said in a recent paper, the risk concern and severe adverse consequences through the financial system of ongoing and sustained budget deficits not being met with policies to bring them down.

What policies could bring them down? That's a tougher one, particularly for US society. I think the administration is beginning to set out after the spending side. Their first place is non-defense spending. That is not going to be enough. It is a too-small part of the total. There isn't much on the military side that can be done, given the geopolitical risks. That leaves the economy itself and its pickup in growth to bring in some additional tax receipts to help the deficit, and taxes. In the US we're going to have a big battle over taxes, whether we should roll back some kind of tax cuts or make them permanent, and what that will mean.

For sure, one place to start is on the spending side. Both non-defense and defense spending have risen extremely rapidly in the last two or three years. The spending side appears politically out of control. Non-defense alone won't do it. Raising taxes won't do it either. We have a real dilemma in the US, in terms of how we begin to fix the deficit and set a downward glide path for it. It won't be done over night. It does look like we're going to have to re-visit, as we did in the 1980s, the deficit problem.

This time, it's even harder because in 2007 and 2008 the ageing population and the demands for healthcare support and retirement support are going to be much greater. My answer is, "I don't have an answer at this time." That's a pessimistic statement. In the longer run, an imbalance faces the US and global economies. That's the best I can do.

Question #4: My question regards commodity prices, including oil. In this country, there is some concern about the rise of commodity prices, particularly since China's demand for commodities are so high. So commodity prices are going up so fast. What's your opinion?

Answer #4: We think commodity prices are going to be firm and continue to rise, along with the cyclical upturns in the US and global economies. It's a matter of demand versus supply. Countries and producers of commodities cut back capacity because business was tough. It's part of the business cycle. Take the US case, with 1% or less inflation, and the low levels commodity prices fell to two or three years ago, and the trend is up on commodity prices. Will we have run away inflation? No, we won't. There's too much slack in the world, and central banks will step on it and control it. But when you go from 1% or 2% inflation, as in the US, up to 2% or 2.5%, which is still low by historical standards, markets and businesses will have to re-price and re-set what they do in the face of the higher commodity prices.

Oil prices, in part, are higher because of the decline in the dollar. That, too, is a matter of demand and supply. Despite the US$ 20-22 range, and in order to compensate for the loss of revenue due to a lower dollar—since payments are made in dollars—the oil producing countries are quite content to let oil prices go up. We're stuck with higher energy costs.

Question #5: I have a question about something which you just covered, the twin deficits. The current situation is slightly different from the twin deficits of the past. Over the past few years, while the US has been running a current account deficit, the money has largely gone back to the US. Japan recycled it to finance US borrowing. Increasingly, that is now shifting. Japan's surplus begins to shrink. China is taking up the prime position, and China seems to be less inclined to send money back to the US and is increasingly showing its willingness to send the money toward euro-based assets. Increasingly, the US dollar is declining. Therefore it tends to make little sense for outsiders to purchase US debts. How do you see that?

Finally, the world is schizophrenic when it comes to the US economy. They worry about both sides of the coin: US growth on the one side, without which the world economy comes to a stop, and then the US deficit on the other. One thing the world seems to stress about today is the potential crisis of Fannie Mae and Freddie Mac. What are your outlooks for their resolution?

Answer #5: We are negative on the dollar. The dollar is in the process of adjusting to lower levels. There are attempts to impede that, coming from countries with whom we trade. That is partly because of the large current account deficit. It is also because there are opportunities now, more than just in the US, as was the case for so long when the current account deficit was very high but the dollar was still going up. That is to say, Japan looks more promising. China is promising. Asia is more promising on growth dynamics. The Eurozone is also more promising, at least in terms of its stability. So I think global investors, including central banks, being over-weighted in dollars for so long, are making those adjustments.

We are, after all, in the middle of an election year. There's a lot of geopolitical risk. It's not surprising to see money move into other currencies, re-allocated to some extent, and some money going into gold, some into commodities, as a hedge. This does make it, and will make it, harder for the US to sell debt if the perception is that the dollar will continue to get lower. We are not doing anything to interfere with that perception at this point. We think the dollar is going lower.

Concerning Fannie Mae, at these levels of interest rates we are not overly concerned about trouble in those organizations in terms of reverberating back on the fixed income market, spikes up on interest rates, or some sort of withdrawal in the financing for the US housing market. We have artificially and abnormally low short-term interest rates in the US. A lot of lending in the housing market is marked to those interest rates. It is secured by, at this point, very good asset collateral: residential real estate. If short-term rates for some reason go significantly higher, the calculation of those appropriate prices for residential real estate have to change, and the asset value of collateral will have to erode. Then highly-leveraged organisations like Fannie Mae and Freddie Mac could have some financial trouble.

At this point, the Federal Reserve is promising us they will be patient and that interest rates will stay low. I think they are quite aware of this risk. It is a risk. That's one of the reasons why, when we do get hikes in interest rates by the Federal Reserve, they will probably be carefully and gingerly done, in small doses, nothing abrupt. With inflation so low, there is absolutely no reason they would have to move abruptly. They ought to be able to gradually move interest rates up to prevent what could be a real estate bubble at higher levels of interest rates, to prevent that from coming to the forefront and, in turn, devastating the Fannie Mae organisations.

Question #6: According to your analysis, it seems we will have to live with chronic current account deficits in the US for quite some time to come. With that as background, I would ask three one-sentence questions.

First, what are the implications, in your analysis, for US trade policy over the next few years? Secondly, it seems we are re-living the Reagan era of twin deficits, as you said. Is there a possibility of a re-play of the "Plaza Agreement"-type shock? Thirdly, do you see any possibility of the Chinese economy landing hard? It seems to be over-heating.

Answer #6: The US continues to be free and fair in its trade behavior and, I think, it will stay that way. There's no real constituency for protectionism in the US. You noticed that the opinion in the US on steel tariffs was quite negative. This explains part of the acquiescence of the Bush Administration to the World Trade Organization's attempts to have them rolled back.

Yes, we are seeing some very similar reactions in the economy and developments to the Reagan years. The Reagan years were characterized, though, by extremely high inflation, which was coming down, massive fiscal stimulus, increased government spending and tax cuts. But also tight monetary policy, and with that very high interest rates. In turn, those contributed to a much stronger dollar. With trade a lot weaker because of the stronger dollar, the Reagan Administration and the secretary of the treasury, James Baker, engineered the Plaza Accord. The dollar, having over-shot with momentum in the exchange markets, collapsed.

We don't have tight money now. We have easy money and easy fiscals. When you have all the slack we have in the economy, this should work well for quite a while and not bring about a situation where the dollar is vulnerable or needs to be driven down in the way that politically the US engineered the Plaza Accord and a decline in the dollar. You understand, once it got going down, because of all the imbalances, it couldn't be stopped, and it was part of the stock market crash of 1987, and eventually the downturn in the US in 1989, 1990 and 1991. It was a short recession in GDP terms, but it was very bad in terms of the overall economy.

We have time to work our way out of it. The chronic current account deficit, we think, is not as big as its number. You have to remember that some of that deficit comes, say, because the US has a lot of production in Canada and Canada exports to the US. This shows up in the Canadian trade account as a plus and in our account as a negative. But it actually is because of US production is over there and is being exported back to the US. There's a cyclical current account deficit and there's a structural current account deficit. At 5% of GDP, our guess is that the structural current account deficit is more on the order of 2% or 3%. That's still too high. If there are other negatives in the US situation going on, it does say the dollar has to go down to adjust for that.

Concerning China, China is showing all kinds of signs of boom/bust at this point. The Chinese policy makers have been magicians at finessing various problems in the past, and probably can get through this one. But as an outsider looking in, we, though we love the Chinese markets and we have rated the Chinese stock markets as an overweight in our strategy for a long time, we are toning that down some. It is looking a little like a boom/bust.

What do I mean by that? It has a fixed currency that is over-strong. It could strain resources. It now is in a positive inflation range, rather than deflation. That could accelerate. There is a lot of evidence of financial fragility. That exchange rate, some day, has to be let go for the good of all of Asia. We are getting artificial manipulation of exchange rates from a lot of countries because the Chinese currency against the dollar has been pegged for too long.

Question #7: Your view on consumer spending is pessimistic, at least in the short-term. Also, your forecast is that the Federal Reserve will slightly raise interest rates in the second half this year. In terms of that, how can you say that the growth rate is so stable at about 4% for the next three years or so?

Answer #7: Can consumer spending stay strong enough for long enough to sustain the expansion into 2006? In other words, I said the first real risk of recession will be in 2006. You would of course see signs of it before that, in 2005. So that's a three or four year upturn, if we date its beginning from the middle of 2003. Can the consumer do it?

Well, we have a legitimate question about the consumer: the economy is not creating a lot of jobs. Or, at least according to the establishment of non-farm payroll survey, which counts jobs, we are not creating a lot of jobs. I described and gave a lot of reasons why those numbers are so weak, compared to history. We have another survey, though, called the household survey, which surveys individuals who say whether they are working or not working. That's the survey we use to judge the unemployment rate. According to that survey, since November 2001, over 2.2 million people report they have found work of some sort. The non-farm payroll survey, the jobs count, shows a loss of 776'000 jobs since November 2001.

That's a huge difference. One of them says a lot of US people are finding work. They must be earning some money, though maybe not a lot for some of them. But they must be earning money. One survey says they are doing well enough to sustain the expansion.

But the other survey says there’s a risk. If we don’t create more jobs, consumers won’t have enough money to keep spending enough to keep the expansion going for the three year period.

This year, I don’t think we have an issue. Tax cuts are being pumped in to the tune of US$ 150 billion, most of it through the consumer. If they don’t have a job according to that one survey, they are replacing but they are not getting what the government is providing for them.

But this will be a real issue for 2005, in terms of the growth rate projection. This is disconnected from the consumer, if the consumer doesn’t get work and get money to keep on spending. By 2005 our hope is, and the assumption is, we will be generating more jobs on that establishment survey count, more income, so that consumers will still have the wherewithal to spend without the benefit of the full brunt of those tax cuts, which will fade in 2005. It’s a legitimate issue, a legitimate risk, a legitimate question. There are a lot of puzzles, including this oddball behavior of these two surveys on the job being made in the US. We get data this Friday which will maybe shed light on this. We are getting a lot of revisions in the data, and perhaps the discrepancy in the two will change.

I haven’t fully given you a satisfactory answer because there are a lot of puzzles around this issue. In terms of forecasting, I always fall back on this statistic about the US consumer. One way or another, the US consumer spends in aggregate, in real terms, about 3.5% every year. That’s a forty year trend for consumer spending, after adjusting for inflation. So, one way or another, they find jobs, they find money. That is a pretty hefty growth rate. Even if we spend at 3%, less than trend, in real terms the US economy still gets a lot of support from the consumer.