The US & World Economy: After the Iraq War*

My remarks will span near-term activities in financial markets of the US and global economy, and then future prospects.

Near-term, we are all in the hands of what is called these days "geopolitical risk", what the US Federal Reserve in its last statement described as "geopolitical uncertainty."

Financial market movements in response to the ups and downs of geopolitical factors can ultimately have significant effects on economic activity. The very short-run volatile dynamic movements registered in the daily ups and downs of the US and global stock markets, bond markets, and the dollar represent one dynamic of interest. The underlying fundamentals of the US economy, US economic prospects and global economic prospects are yet another dynamic. The third dynamic is, of course, policy, both monetary and fiscal policy, in the major countries and regions of the world which drive world economic activity.

I am going to try to separate these dimensions of dynamics in what is probably the most complicated and difficult setting in which any analyst, policy maker, or business/financial decision maker has ever had to work. I will hopefully shed some light on what is happening to the US economy, what might happen to it, and what this means for the rest of the world.

Along the way, I cannot possibly do this without making allusions to certain geopolitical risks, in particular the Iraqi situation. Geopolitical risks are intertwined with what we see going on in financial markets and economies around the world.

For all practical purposes, in so far as financial markets are concerned, the part of geopolitical risk called the Iraqi War is essentially over. Not fully so in a real time or real world sense, but mostly over in the eyes of financial market participants. A geopolitical vacuum of questions to be answered in the aftermath will now replace the Iraqi War.

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None of these questions—or issues raised by any of the questions that I may mention or not mention—look to be as serious a problem for financial markets as was the run-up and actual execution of the war.

All any of us need do is look at the reporting of the war and at what has happened in the three weeks since the invasion. We can then understand and appreciate the assertion that, from a financial market point of view, the war is over.

The new questions go beyond the war itself and its part in geopolitics. Geopolitics affects markets and economies, and there is more in the geopolitical dimension than the Iraq event. How much resistance will there be? How long will it be until Baghdad is under complete control? How about the ultimate regime change, the new regime, and whether or not Saddam Hussein and others appear in any form or fashion? Have they simply disappeared by flight, by death or injury, or somehow melted away into the mystery of Iraq?

The second question concerns Iraqi rule. Who will rule Iraq? For how long? How long will the US be in Iraq? How much will it cost the US in terms of its budget, and therefore how much effect will it have on US fiscal stimulus? What about a role for the United Nations? These are other geopolitical questions that need to be asked.

A third set of questions has to do with collateral events and the byproduct of terror and terror attacks on Western or US interests anywhere in the world. What will be the religious Muslim response to the US presence in the Middle East? Will this affect the Middle East power lineup insofar as it affects oil, oil supply and crude oil prices?

Then there is an even bigger question. It is the sixty-four million dollar question for the future: Who might be next? Will the ratcheting down of geopolitical risk that comes from the end of the war—has so far accomplished—stay or be replaced?

For example, will there be a conflict with North Korea? Most would say that North Korea is in possession of nuclear materials and is apparently willing to develop and build more. How about Syria? Iran? Are there any other countries that are developing, or might be developing, what are called "weapons of mass destruction"? Will the precedent set by the US in its preemptive move on Iraq—essentially going it alone in the court of world opinion—carry on? Will the US mission not be accomplished until the other so-called "rogue" and potentially "rogue" countries are cleared

away? What risk exists, however small, that they might be using weapons of mass destruction in a way that would threaten the interests of the US, particularly the potential for another event like 9/11 on the soil of the US?

Will the demonstration of a powerful and resolute US in Iraq tone down geopolitical risks and the ambitions of other countries, much as the Reagan Administration attacks on Qauddafi did many, many years ago in Libya? We do not know. We will not know for quite a while.

These are some of the questions that arise with the end of the Iraq war. Again, I stress, not the actual end, and not the end in terms of—what is in US military jargon—"work to be done". And, also not in terms of economic impacts. After all, economies respond much more slowly to changes than do financial markets. In an anticipatory sense, crises register very quickly in financial markets, verdicts in asset prices on what is expected in the future.

During the first Gulf War. The bombing on one night in January, 1991 showed up in financial markets as a financial market verdict that the US had won that war. That is the case again today. Over the very, very near term we have seen the reverse trend and a ratcheting down of the geopolitical dimension. For quite a long time, starting in December with the run-up to the war, there was a negative ratcheting-up of geopolitical risk. This was occasioned by anticipation and uncertainly on war and what it might mean.

I want to emphasize that what we saw and have seen in the markets then and even today are short-run trading reactions of large pools of money. They trade the consequences of geopolitical risk in one direction or another. They do not necessarily represent trends.

When geopolitics worsened because of US involvement in Iraq, US stocks went down. The dollar went down. Bond yields went down. The safe haven movement from US dollar-based monies went into US treasuries. Crude oil prices went up, that is, crude oil futures being bid up in case of interrupted oil supplies and what that might mean. Gold was a preferred safe haven since the dollar and the US were not. The Swiss franc went up. The euro got a bid against the dollar. The Australian and New Zealand currencies did better, and probably the won received a little help too. Concerning interest rate safe havens for global money, it was easier to put money in *bunds* and in the front-end of the eurozone yield curve than to put it in the US.

There was, and is, rationality in these directional financial market moves. They are based on the

analyses, economics and politics, of what is going on. The market moves were induced by global traders in macro-based hedge funds

With an improvement in geopolitical risk, these directional movements in markets got reversed. On the events on the weekend, the surprising possession of parts of Baghdad and the absence of resistance, as well as the endgame of the war for all practical purposes, caused market reactions in stocks and in the dollar. It affected US fixed income rates, European rates, and currencies around the world in the reverse way of what I described much earlier.

What I want you to understand is that some, indeed a large amount, of what you see in markets around the world is short-run responses. These movements are trading responses to the geopolitical dimension of what is going on. For those of you who are long-run oriented, and for those of you who are investment managers or who are in the business of moving money around strategically, be careful about the signals that are offered in the markets. Understand where it has been coming from.

That's one dynamic of what has been going on: the financial market dynamic. It has very little to do with the underlying economic fundamentals of the US and global economies.

Let me now turn to those fundamentals and describe for you what we are seeing in the fundamentals of the US and global economy at this time. I will offer you some explanation of what is going on and then go on to after-war prospects.

We have raised a cautionary flag for the US economy, and are on what we call a "Recession Alert". As we speak, we are assessing the chance of another recession in the US at about 40%. That is a high-risk of recession, since the US went through a recession in 2001 for three quarters. Double-dip recessions are very rare.

The brief recovery that followed the latest recession was not quite as anemic as the recovery after the 1991 recession. But it was the second weakest. It was far weaker than the average of all ten post-recession recoveries up until this last recession.

We are in the second year since the US recession. It is in that time span—the second year being the third quarter of 2002 until the third quarter of 2003—that we have raised our "Recession Alert" flag.

In US economic history since the second world war, we have had only one true double-dip recession. That is a recession, followed by a recovery, and then a fall back into a full-fledged recession. A double-dip recession occurred in 1980, 1981 and 1982. The first one pushed the US into a recession for six months. An external shock at that time—credit controls imposed on the system from outside—was the catalyst. On the removal of credit controls, consumer spending bounced up and the economy went into a recovery. Then, the fundamental problems of high inflation and high interest rates, as well as the necessity of the central bank to get very high inflation lower, propelled the US economy into a second recession.

We have had some other periods when US GDP turned negative for a quarter after the beginning of a recovery and expansion. That to me is not a double-dip. When I talk about a double dip recession, I mean a fall back into another full-fledged recession.

We have taken the temperature of our patient, so to speak, by looking at high-frequency data—daily, weekly, monthly—from the US economy. There are a lot of signs of a possible recession.

A US recession or near recession obviously ripples throughout the world through trade flows. The risk of a recession or a near recession in the US will dampen economic activity around the world at the time and shortly after it happens. That includes Japan, the *euro* zone and a number of other countries. Much of the rest of the world will be severely impacted by another US recession, should one occur.

It is a little like the SARS virus. It is going on, in this case in the US. Then it spreads. Some places will be hit more, some less. But it is almost inescapable that in economic activity and in business spanning the next few months the US recessionary "virus" will be seen by everyone in this room.

Unfortunately, the *real* SARS virus problem will take down, and is taking down, economic activity in this part of the world. We look at this mainly as a regional non-Japan Asia problem, hopefully non-Korean. Note it is far smaller in terms of its potential impact than is a US economy slipping into another recession.

What do we see that makes us assess a recession with a 40% chance? Before I answer, let me note that in the interest of truth-in-lending, understand that this view is on the pessimistic side of the analysts who look at, and forecast, the US economy. We are probably in the more pessimistic 10% or 15% of distribution of analyses, including analysis at the Federal Reserve.

Will we be right? Will we be wrong? We believe that where there is smoke, there is fire. There is a bigger chance that we will escape a recession and simply grow at low, or fairly low, single-digit figures than there is of a chance of recession. But at the moment, this is the momentum that we see.

We observed a lot of data this past quarter. The data and our forward work on economic indicators suggest that we have had a very significant negative shock. This pre-war and war shock occurred on top of an already fragile US and global economic recovery.

The data show that we had a major downturn in the growth rate of consumer spending in the fourth and first quarters. The economic fundamentals surrounding the US consumer have been poor for quite some time. They remain poor now. Just about the only positive note is the ability of households to tap real estate equity and to refinance through mortgages. That would bring home cash out of the equity build-up in real estate assets and household balance sheets. That would then fund US consumer activity. We also have tax cuts, two of them so far for individuals, that could help provide some funding.

Against those positives, we have a terrible jobs market. Jobs declines continue. The unemployment rate is quite high for the labor force growth we have in the U.S. Deteriorated balance sheets due to the huge fall-off in equity wealth has been in progress since the end of 1999.

There have been major declines in consumer sentiment, undoubtedly in part because of a bad stock market and concern over the war, but also in large part from poor consumer financial positions and the lack and inability to get jobs once out of a job. We have not yet had the normal adjustment by consumers in their spending, savings and balance sheets that typically happens during the US business cycle. That adjustment appears to have started sometime last year and to have intensified in the fourth and first quarters.

Consumer spending has down-shifted to a growth rate that is still positive but far below the historical average spending pace of US consumers. The average rate of growth in consumer spending in the US over the past 50 years is 3.5% per annum, in real terms. That's an Asian growth rate very high. The spending rate of US consumers now is approximately 1.5%. When you look back at US economic history, the figures I just mentioned are fairly rare. They normally only occur when the consumer is under stress.

In any case, for whatever reason, consumer spending has fallen. The pace is two quarters long. As a result, we are seeing a ripple effect elsewhere from this downshift in consumption.

Consumption is 2/3 of the US economy. We're seeing, therefore, a slippage in housing activity. We are seeing the leading edge of it as it impacts business, as business gets disappointed on the failure of sales to grow the way business had hoped. It is impacting business profit. We are seeing businesses go through another round of cutbacks even before the business sector has revived. It looks like inventories are building up relative to sales. Orders are down. Shipments are down. Other measures of the business and manufacturing sector are in recession territory. For several months, the business sector will probably be stagnant in response to the downwave of consumption, even with the end of the war.

That process, the data, and the presence of the overhang of geopolitical risk is why we have raised a “Recession Alert”. There is a 40% chance we might have a recession, or be in one now. There is a 45% to 50% chance that will narrowly escape a recession and that the economy will turn up again and begin to recover and expand as we move through the second half of this year and into next year.

Still, the resulting performance of the US economy will be sub-par. It will be far weaker than the average of all recoveries and expansions after recessions since the Second World War.

The first year of recovery across all previous post-recessions has been over 7% growth in real GDP. During the first year of recovery for the US, we had a little over 3% growth. During the second year of recovery, or business expansion, the average growth in real GDP for the US economy has been 5%. We are estimating 2% growth between the fourth quarter of last year and the fourth quarter of this year. Again, this is less than half the average second year up-turn in the US economy.

The ripple effects of such weakness around the world will be commensurate. The global economy will not have a buoyant pick-up. It is barely growing, in our estimates, and only a little above recession territory. That describes the general nature of business.

Why is this doctor, Dr. Sinai, giving such a prognosis of the US and global economies at this time? What about the medicine that the doctors and policy makers in the US and the rest of the world applied? Getting the patient up-and-running and back to full-blown health, if it happened,

would resonate around the world in better business, better profits, share prices all up, and would surely bring a bull market for world equity markets.

It has been a long time since we could use the phrase “bull market”. We have been in a bear market for almost three years. We think the lows were October 9, 2002. Since then, in a very volatile manner, we are very cautiously working our way into a better stock market environment.

Why this diagnosis? It is daunting to me as a policy economist who has given what I thought was good advice to the current administration on both fiscal and monetary policy

To see that happen, and then to have to describe the US economy in the way that is actually very discouraging. After all, some good medicine has been recommended, provided and given in a timely fashion, why has it not worked so far?

In the US there has been twelve cuts of interest rates. As you know, the Federal Reserve cut interest rates eleven times in 2001. These were the fastest, and most decisive reductions in interest rates in Federal Reserve history. The downturn was not even registered in GDP when the Federal Reserve acted. Since then, unfortunately, there was only one cut. The reduced rates by 50 basis points last November. Many of us think we need another interest rate cut as soon as possible.

On the fiscal side, there has been two major cuts in individual taxes and one for business; there also is a lot of spending stimulus, if only because of the war and security build-up in the US. We had a bonus of huge amounts of funds released into the economy through mortgage refinancing last year, something like US$ 250 billion. With all that, I am still describing for you a 40% chance of recession in the here and now.

There is a 5% chance that the US will encounter a worst case scenario. This is the, “Can It Happen Here” Scenario. The “It” is Japan. Could the US be in a situation that is similar to Japan's? There is a 15% chance of that happening.

Here are our reasons. One, there is tremendous over-capacity in the US and global economies. This was occasioned by an extraordinary ten year boom and, yes, an economic bubble that culminated in the year 2000. Capacity is still very high all over the world. It is being taken down everywhere you look. It is being taken down in financial institutions, the airline industries, and even manufacturing. There is too much supply, Too much overcapacity.

I cannot calibrate how much since it is so unusually high. Nor can I calibrate how long it will take to bring capacity down to the more anemic pace of demand. I do not think it will take a year. I think it could take two, three or four years. I cannot calibrate it. There is no parallel in the last 50 years to allow me to do a good estimate of how long it will take for that capacity to go down.

Second, we had a stock market bubble in the US and in a number of other countries. We cannot describe a decline in the S&P 500 of 49% from March, 2000, to October 9, 2002, in any other way than to say it had to be not just a bubble in technology and telecommunications, but a stock market bubble generally. Indeed, similar numbers can be applied to the *euro* zone as well.

There are aftereffects of the unwinding of a stock market bubble in terms of credit, debt fallout, balance sheet effects, deficits for governments, pension fund problems for corporations, and, yes, the grievous, horrible cheating and breaking of the law by a number of individuals and corporations. This cannot be calibrated into how long and what the effects are, both in the US and worldwide. Nothing like that stock market decline has occurred since 1939-1942 and 1929-1931. We do not have enough data to tell us the anatomy of working out of these effects and be sure of how long it will last.

Third, there is an unusually weak global economy and a lack of policy stimulus that must come from major centers of the world. These centers need to drive the world economy in addition to the US. In Japan, the string has run out on monetary stimulus, there is little, if any, room left to fiscally stimulate. The government, banks and insurance companies are in a massive debt position. The *euro* zone could have been more stimulative but has erred in not being more stimulative on monetary policy. They have an anachronistic, old fashioned way of running monetary policy. Also, the stability pact essentially forces economies that run big deficits because of bad economic times to balance their budget. This in turn makes economies worse rather than make them better, much as the IMF prescriptions did for Asian country after Asian country during the Asian crisis. In that case, the IMF forced countries with big deficits to cut spending, raise taxes, and punish private sectors in order to solve their problems. Indeed, it made their problems worse.

The weakness in the global economy translates into very poor US exports. In turn, poor business, lack of growth in the US economy, which in turn hurts the world economy. It is unusual.

Finally, there are the geopolitical risks. Here, the phrase for us is “terror and terrorism”, “Middle East hostilities”, that is the Israeli/Palestinian problem, the “Iraq Situation”, which is rapidly

diminishing as a element of risk in geopolitics. It is also the possibility that the “Iraq Situation” might be replaced by another big risk conflict with North Korea, Syria, Iran, or other countries that could be viewed in the same category as Iraq, and therefore dealt with in a similar fashion by the US. And finally, I would add to this because it is a currency issue, “How The US Handles These Problems,” not just in the eyes of US citizens, but in the eyes of the world in a diplomatic sense. That is to say whether the splits and disagreements between the US and the *euro* zone, the US and other allies, will end up splitting the world, as opposed to unifying the world, as it deals with problems that are not just geopolitical, are problems that also appear economic and financial.

For the Iraq War and its damage to the US economy, our rough quantitative assessment is that across the US economy. The loss was 1% or maybe a little more of growth at an annual rate in the fourth quarter and the first quarter. We get to that by starting with a stock market which began to tumble when it should not have tumbled about a year ago on intensification of geopolitical problems. This was not too long after Afghanistan, in February, 2002. It was occasioned by a heating up in Middle East hostilities. That quieted down, but the stock market was worried. Then along came Iraq, and a very clear, from a market perspective, intent of the US to deal with Iraq. That was a problem for equities because of the uncertainty, raised by these geopolitical events. Our estimate of the stock market decline last year, due to geopolitics, is about ten to fifteen percentage points and a very hefty decline in the S&P 500.

The effects on consumer spending came through negative impacts on wealth, on in consumers and business confidence, the effects of a poor stock market on the cost of capital and business capital spending, as well as the direct effects on confidence and business of the war. And certainly higher oil prices, which until quite recently were raised significantly in the run-up to the war, was yet another. One to maybe a little more than one percentage point of growth is estimated to be lost. This was a significant part, but not all, of the US problem.

But now that the war is over from a financial market point of view and, I think, practically, what should be expected? Well, certainly the end of the war is going to help. On balance, there are two scenarios. One, the end of the war, or the Iraq part of geopolitical risk, removes the negative external shock of that risk and the negative effects, at least in part. We could see, because of it, a better stock market. We have seen that, and derivative positive effects with lags, in credit financing and balance sheets.

We should see improved consumer sentiment and probably some lift in consumer spending in

the near term. We should see relief to business from the end of the war, but not necessarily a lift in spending or hiring. Business spending and hiring depends on rising sales and profits and the belief that the increases will be sustained. Businesspeople will not believe that the end of the war necessarily will be the end of all the US economic problems. It will have to be proven to them.

We should get some stimulus from lower crude oil prices for consumers and business. High-frequency data in April and May that described the temperature of the patient should get some lift, therefore, and in this scenario it is possible that after a month or two business would respond to increased sales and more optimism, and the economy then move into a self-sustaining expansion, 3% to 4% growth, sometime in the second half of the year. Jobs creation would lag, but would begin sometime during that time, and 2004 would be a good year for the economy. That is one scenario. That one basically says that, with a few qualifications, the end of the war is the catalyst for consumer spending and then business spending that gets the US economy out of its slow-growth path and lifts it to a healthy state. One scenario. One possibility. We will be watching the data and everything else to see if this is how it occurs.

A second scenario is that the end of the Iraqi war removes this part of the negative geopolitical risk dimension. We get a better stock market and some positive derivative effects, although there are lags to the better stock market in spending, and those lags can be very long. We certainly will get, in this scenario, lower oil prices. That will help consumers and business. In this second scenario, we would still expect better consumer sentiment in the near term and business to be relieved, but the negative fundamentals around the consumer, specifically the poor jobs climate, might well dampen that. The business response could be very slow, so slow so as to not occur this year and not until next year. Then, in this scenario, after the expected bounce up in April or May, we would get fading growth and the non-geopolitical impediments, the overhang of capacity, working out of the stock market bubble, and the poor world economy, and the US economy would just not really bounce back.

Our own view and expectation is more the second scenario than the first, although we are watching and hoping for increased GDP growth in the US, 2% this year fourth quarter-to-fourth quarter, and next year 3%, which is still sub-par, still below potential, but better. Almost any scenario suggests the US economic situation will be better—though not necessarily good—as we go through this year, and even better in 2004. That is an optimistic message. The pessimistic and risky message is the path of this year.

Where are the policymakers in the US now in their own thinking? It is a very uncertain environment, and it is very difficult to make policy when you have something like the Iraq war out there that surely had some negative effects on the economic data. If you are a member of the Federal Reserve and making Federal Reserve policy, how can you separate out the problems being caused by the run-up to the war and the war, from the reality of the fundamentals. That is the quandary and the difficulty that our Federal Reserve is in.

Where the Federal Reserve seems to be is on the side of so much uncertainty in a technical sense, and certainly in such a sense that you cannot even assign probabilities to what is going on, that they have stepped back and said, "We will wait to see how the war goes, how it ends. We are reading the data as not accurate data, that is, the measurements are not accurate because of the external shock of the war, and we will wait to see what the data say when the war is gone, before we can make a judgement as to whether we should cut interest rates any more," or the strange possibility that they might raise interest rates. That, I do not think, is at all a possibility. That is what the Federal Reserve told us in their last statement and I encourage you to believe what they say in the Statement. That is their best shot at it.

They did not even want to make a judgement on the down-side risk to the economy from everything that is going on because for the majority of them, and I assume this includes Chairman Greenspan, could not be assigned probabilities to the situation. That is how uncertain it was. It was a rather curious statement from a central bank, widely criticized by analysts and others. I do not think we will see that statement come from them again, especially since the war is clarified and that uncertainty is now really out. So, the central bank will watch the data and watch the fundamentals to see how things go. Their prior is that the US economy will get into an up-and-running state *ex* geopolitical risk sometime in the second half of the year. So their bent at this moment is not to cut rates any more.

Our own view and scenario is that we are more likely to be disappointed in terms of the reality of the fundamentals of the economy. I think I have given you the reasons why. We think the economy and the markets will push the Federal Reserve to cut interest rates some more, a quarter point at a time, at the end of June and once more in the summer, to try to ensure that the US economy does better than just struggle along at a fairly low growth rate.

On fiscal policy, the administration and congress are going to give us some more fiscal stimulus. This week is a key week. The president has an economic plan that recommends US$ 725 billion of

stimulus over the next ten years, in addition to the stimulus of before. The Senate has rejected that and signed on to $350 billion of stimulus. I do not think, politically, they are going to get $725 billion of stimulus, but they are trying very hard. That is because of deficits, war costs, and the possibility that the US federal budget deficit could be as high as $400 billion, next year $500 billion, which would be about 4.5% of GDP. There are a lot of unknown factors related to government spending and the deficits and the Congress, particularly the Senate where the Republicans have a majority, would just not sign on to a big number.

We are very likely to see something in-between. The administration will be lucky to get $538 billion out of their program, which is basically half way in between $350 billion and $725 billion. That will still give us a possible budget deficit picture in the range of $400 billion this year, depending on what the costs are for the war against Iraq and the aftermath, how long the US has to stay there and that kind of thing.

For the measures, probably the administration will have to give on the dividend exclusion from taxation measure which was 100% exclusion, and will get some portion of that, but not the full amount. My guess is they are going to go for, since they will have to make some rational decisions, the acceleration of tax cuts for individuals in all brackets and a few other measures that could make up the bulk of $350 billion. That kind of stimulus, along with a little more reduction of interest rates by the Federal Reserve, the passage of time as we get farther away from the problems and the impediments I have mentioned, and no other geopolitical risks of an Iraqi nature in the next three to six months, underlie the view that the US economy will work its way toward a higher rate of activity, not strong, but better, over the second half of this year, and an even better year in the economy of 2004. There are a lot of "if"s, but 2% GDP growth, fourth quarter-to-fourth quarter, and next year 3%, are some measures of that view.

For markets, if it evolves this way, the US stock market should end up this year higher than last year, and the bear market should be over as of last October 9. That is our expectation. That is our forecast: a 7%-10% higher US stock market at the end of this year compared to the end of last year, which would put the S&P 500 somewhere in the 950-1000 range. Remember, that as we move through this year the equity market will be looking at 2004. And in almost any possible scenario, the odds are that 2004 will be a better year for the US and global economies than was 2003, and than certainly was 2002.

Interest rates in the US should bottom out during this time, and next year rise. Depending on

those budget deficits and the US current account deficit, long-term interest rates could rise sharply during 2004. It will not prevent the US economy from growing, however. The global economy various regions of the world, will benefit if this is the path over the next year-and-a-half, so that the global economy this year, just barely escaping recession, will next year be in a modest expansionary phase that will stretch across a wide range of countries, of course Korea, which is not growing by historical standards all that fast, but still at a solid pace. Korea and Asian businesses, 2004 should be a pretty good year.

Let me summarize what I said to you: we have a complicated world. I tried to help you understand the ups and downs of financial markets. I am telling you, in a sense, to put that aside to trading off the geopolitical risk dimension and the ups and downs of that. I made the assertion that from the point of view of markets, and later on economic activity, the Iraq war is over. It's not really over, but it's over in that sense. The relief of the end of that war, if not replaced by any other geopolitical risk, along with time, more monetary and fiscal stimulus in the US, will for a struggling US and global economy, lead to stronger activity, stronger expansions in 2004, but not really that good by historical standards.

In the here and now, in terms of current economic activity, there is a risk that we could drop into a recession. If so, it would be fairly brief, but it is something to note.

Also, all of the things that might go wrong, including the overhang of impediments, lags in response to stimulative policy, need to be watched as you run your businesses, invest your money, advise other people, and as you watch this country. The range and number of things that could go “wrong”—delay and prevent a vibrant upturn in activity—is probably greater than the number of items that could go “right” to produce upside surprises over the next year or so.

Questions & Answers

Q Over all, in the past ten years, as you mentioned, the US was the engine of growth for the world. But in effect it was financed by deficits. This situation certainly, with or without the war, cannot be sustained. Therefore, if you eliminate that factor, realistically how is the world positioned for growth?

A Much of the US growth of the ‘90s was financed by lending to the US and investing in the

US by the rest of the world, in the form of financing a very large and growing current account deficit. Can that go on?

I think the answer is no. When we only had a current account deficit of size and growing, and everything else was going well, the US was an easy place in which to invest. That is not the case now. We also have a growing budget deficit. It is fair to say that it is not easily calculatable because it has geopolitics mixed in, much as was the case when we fought the Vietnam war. The possibility that the US will be involved in other geopolitical events exists, and the US economy is not doing well. That is a recipe for questions to be asked by lenders and investors in the US, and particularly to question the dollar.

The dollar is doing well here because the war is over in the eyes of currency people. Whether the dollar does well three, six, nine or twelve months from now, given these conditions, is yet another question. Concern about the dollar translates into issues of lending and investing in the US. The dollar is vulnerable here for the first time, in my view, in many years. So is the ability and ease of US financing from the rest of the world.

Investors and business people all around the world are looking for alternatives. If there were some really good alternatives, the dollar would probably be 20% lower than it is now. But it is a little hard to see a good alternative in yen based investments, business or otherwise. It is a little hard to see it in the *euro* zone, given the *euro* zone history and prospects. It is kind of tough to see anything, other than the US, among the major G7 countries, to find places to lend to and invest in. Certainly China is very appealing. But it is not so easy to invest in China. And China has a very big current account surplus. It is financing itself.

So the dollar gets saved here by default, as does the ability of the US to finance its current account deficit. But it is a vulnerability and it is a reason to expect, in one form or another, a slow on-average growth path for the US.

Q Regarding the US$ 75 billion administration requested to Congress for financing the war, which does not seem to be really a significant amount in terms of proportion of GDP, how much impact will this have on the US economic recovery?

A The president has requested a little more than $79 billion for the next six months for the rest of this fiscal year to finance the War and related payments, including payments to other countries that have been involved in helping the US.

Those estimates are very tentative. Often they are too conservative, which is my own reaction to them at this point, except for the following. The war has gone well. It is over,

probably more quickly, than we expected. Notice there was no bombing of Baghdad last night, no expenditure of missiles and bombs, no flights of that nature, because Baghdad is occupied with US soldiers.

So it could be that the $75 billion estimate will be OK. Beyond that, how much is expended will depend on the US presence and what else goes on in the Middle East. That is very tough to know. The economic impact of that is not helpful to the US. It only lifts GDP, but it does not do much for the private sector. We would prefer to see less spending, rather than more. It would also make it easier to do more policy stimulus for the private sector. But at the moment the inclination I had initially—which was that $75 billion was a gross underestimate—is tempered by the fact that the war is ending faster. So it may be OK.

If it is OK, and if nothing more than that $75 billion and maybe another $30 billion gets expended for the next six months in terms of occupation or whatever else goes on around Iraq, $100 billion or so, in an economy of our size, should be tolerable and would be, and is, the number that is included in the budget estimates that we carry: about $400 billion for this fiscal year, and next year about $500 billion. By the way, those are the high-end estimates of private analysts on budget deficits. It’s high enough to be concerned about long-term interest rates next year. But it's not high enough for me to say the budget is going to be, or is, out of control.

The US has a $10 trillion economy, so even if it is $100 billion, that is only 1% of GDP.

Q It seems that nowadays, geopolitics has become the concern of many economists. Let me ask you a question about a geopolitical issue facing many South Korean economists.

What is the international capital markets' perspective on North Korea's nuclear issue? Suppose, specifically, that it becomes known before the end of this year that North Korea has begun to produce nuclear bombs, how will that market react? How do you assess impact of that on the prospects for the Korean economy and of East Asia in general?

A The perception I have—and this is my own conclusion and perception; this is not anyone else’s words, from our administration or anywhere else—that at the end of the day, what has motivated the US to take the action it took, it is a very complicated set of factors, but at the end of the day it is a risk aversion philosophy in an administration that in every form or fashion that I have seen, economic or otherwise, is preemptive: wanting to head off risks before they become reality.

Stylistically, and I’m on that wavelength as a business person, financial person, advisor to senior people in corporations, government and finance over the years, including the

government of Japan, I have seen that the best results come from those that manage risk well. When risks, even if there is even only a small chance of something happening, crop up, actions to avoid the consequences of those risks, depending on the costs of those actions, are wise.

So long as there are, or is—and I am going to use this word not because I would call any country a "rogue" nation; I use this word because it has been used; I would not use this language myself, personally; I think it is diplomatically unwise and unfair to countries that have legitimate aspirations, even though we may have disagreements with them and what they do; All countries, in their own eyes, have legitimate, in their view, aspirations and missions and goals for their people or their government—but so long as there is a "rogue" nation where there is some chance of possession of a weapon of mass destruction, when you have a world filled with terrorists and terrorism, to whom and for whom there is no rationality, simply to create chaos and damage, there is some risk that something, some weapon of mass destruction, some form of it, might get in the hands of some terrorists, and on US soil something like September 11, 2001, could happen again.

Now, given the sense of history that I have, and if I had responsibility for the lives of US citizens, I could not tolerate that risk, as small as it might be. It cannot be tolerated. Now my perception is that is a message of US foreign policy. It is different from history. Very different. It is a shock to the world, to have the US for the first time in its history looking at a risk, taking action to forestall it because we lost almost 3'000 people on September 11, 2001, in the US. That is worse than Pearl Harbour. I do not think history would treat any president or any administration kindly, in any country, that allowed something like that to happen on their watch.

My perception is, at the end of the day, this is where the US administration is coming from. That is my own perception and view. It is easier for a US citizen to feel comfortable with that than a lot of people elsewhere in the world who are not facing the same risk. So I would hope that the rest of the world could understand the US and that viewpoint.

In that context, should North Korea or any other country that has or might be developing weapons of mass destruction, pose a threat of terrorism to the soil of the US, I would expect, and I think you should expect, decision makers in markets, the US not to let that pass. It could be that tactically that might not be the thing to do, given that there is an election in November, 2004, and the economy needs to do well for the administration to win another election. I do not think it is ever going to leave the radar screen of the current administration. I, for one, despite all the costs and all the difficulties and the risks, would probably draw the line in the sand the same way.

세계경제연구원 후원회 가입안내

- 후원회원의 종류 : 법인회원, 개인회원

- 법인회원에 대한 서비스
  연구원 주최 행사에 우선 초청
  연구원 주최 행사에 5인까지 무료 참가 가능
  연구원이 발간하는 모든 간행물 무료 제공
  법인 회원을 위한 특별 세미나 및 간담회 개최

- 개인회원에 대한 서비스
  연구원 주최 행사에 초청
  행사 참가비 할인
  연구원이 발간하는 일부 간행물 무료 제공

- 후원회비는 관련세법에 따라 세금공제 가능

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