

**WORLD ECONOMIC TRENDS**

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**EXECUTIVE SUMMARY**

The world economy, not just the US, is in recession and for the moment slipping further. The central scenario is for a US upswing in the second quarter-- driven by the overdue fiscal package, a year of monetary easing and the low-oil-price bonus.

<i>Table 1 Growth Outlook</i>						
	2001			2002		
	OECD	IMF	Consensus	OECD	IMF	Consensus
US	1.1	1.1	1.0	0.7	0.7	0.6
Japan	-0.7	-0.	-0.6	-1.0	-1.3	-0.8
Euroland	1.6	1.6.	1.5	1.4	1.3.	1.0

The upswing is not going to be memorable: in the US where productivity growth remains remarkably high, unemployment will not decline from its recession high; inflation won't be an issue but the vigor of growth is certainly for the moment more a hope than anything to be expected with confidence. Forecasts for Japan are outright unfavorable in that there is continuing recession. Emerging markets are slipping, not credit worthy and hence without the resources for spending. And Europe, while turning down less than the US, has the question of where the upturn should come from. True the oil bonus and upswing for the rest of the world will help but relatively little of "made in Euroland" stimulus has been put in the pipeline or, indeed, can be expected to come. A boom comes once every 30 years; we have just had one and there is none to be expected anytime soon. Of course, without a boom inflation is a non-issue. That leaves the Fed, and in principle the ECB, free to cut rates further so as to avoid a premature run-up of *real* interest rates.

There are two alternative scenarios. One is outright bullish: Bin Laden is caught for Xmas, household confidence is decisively buoyed, the recovery is on and off to the races. The Fed will almost be seen to have overdone the stimulus. The story is far from implausible. Finding Bin Laden is moving a lot closer, the confidence implications are not even remotely in question.

The alternative scenario is quite depressing. In this story the drag of the world economy and continuing recessionary influences on jobs and confidence but also on capital spending weaken the US upturn; the rest of the world with slipping growth and no stimulus of its own undermines the US recovery. As a result, quarter after quarter the upturn is pushed out. The Fed gives everything it has, more fiscal packages come (by 4<sup>th</sup> class mail) but it takes forever to get to growth and even when it happens it is mostly disappointing.

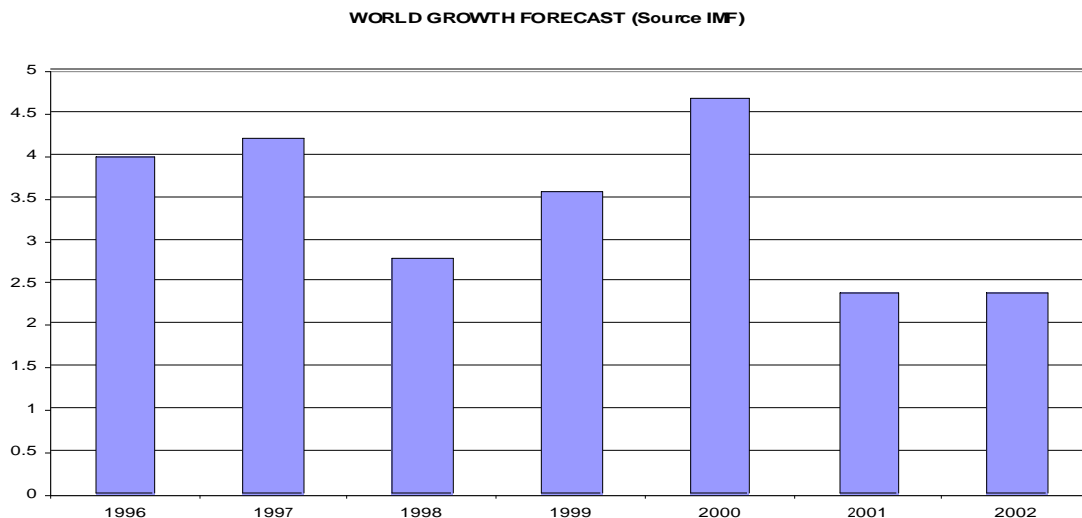
Against these two extra scenarios, the 2<sup>nd</sup> quarter upswing story should receive some 60 percent probability; the postponement view counts for not more than 15 percent.

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## Economic Outlook

The period 96-2000 was immensely positive for the world economy. The US boomed, Europe did well under the pressure of Euro depreciation, emerging markets had a good time. It is clear from the forecasts in the accompanying Chart, 2001-2002 are nowhere there. Growth is at the level of world recession, a growth rate just south of 2.4 percent. There is no official definition of world recession, but 2.5 or less will meet the test.



No part of the world, other than the US, is driving stimulus; most parts are in outright recession or quasi-recession. How to get out? The only story is a US upturn spreading its

effects, via a gain in world confidence and world trade, around the globe. At this point, there is no other action to speak off. Perhaps Euroland will discover an enthusiasm for *Keynesian* policies and radical rate cuts. For the time being, things are not bad enough; at least that is the perception. So what can be said of the US?

## United States

Having moved into recession in March 2001, it's now time to start the upswing. Rising unemployment-- a lagging indicator, shows widening of the recession. But improving consumer confidence points in the direction of an upswing in the making. While the fourth quarter is presumably slightly negative; the first quarter has some chance of actually bringing some growth. With a cumulative decline of GDP of about 2 percent, by the second quarter recovery should be underway. Forecasts for 2002-- year over year-- reflect the assumption that not much will happen in the first half of the year except moderately or barely making up the growth losses of 2001. The second half of the year-- reflected in Q/4thQ forecasts will then reflect the resumption of growth.

	Growth	Inflation
Consensus	0.6	1.6
Prof. Forecasters	0.8	2.2
OECD	0.7	1.2
Goldman	-0.2	1.5
Morgan Stanley	0.2	1.4
JPMorgan	0.1	0.7
Chase (4 <sup>th</sup> /4 <sup>th</sup> )	2.0	1.7

There are two further points to note about the US outlook. One concerns inflation, the other productivity performance. On the inflation front, a rapid decline is underway. Slack in the labor market, as the unemployment rate rises to 6 percent certainly helps but so oil prices and productivity growth. Of the forecasted inflation rate actually materializes at some 1.5 percent, even with unchanged Fed rates there is built-in upturn of real interest rates. Unless the upturn of growth is strong, the Fed may have to cut further nominal rates to deal with this issue.

The productivity part of the recession is surprisingly positive. Normally, in a recession, productivity declines as output is cut more than employment. Then, in the recovery as output expands, feeding off cyclical labor hoarding, productivity rises strongly. In this recession, so far, productivity has increased strongly. -- 2.1 percent at an annual rate in the 2<sup>nd</sup> quarter when the recession started and 1.5 percent in the 3<sup>rd</sup> quarter. If this pattern continues, there is a strong built-in inflation check. Moreover, because of high productivity growth, the recovery is bound to be jobless for quite a while, just as in the

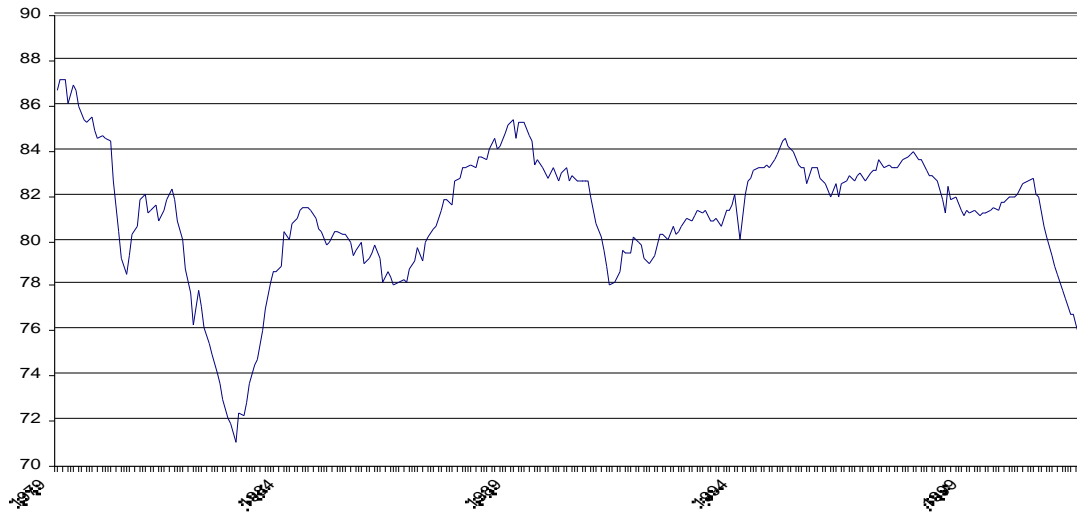
upturn from the 1991/2 recession. That reinforces the perspective of no inflation in sight. Barring an oil shock, inflation is safely on the sidelines and the Fed is unencumbered.

There are a few arguments about the recession and recovery that need special attention. Perhaps the central one is that this is a capital spending recession, not a consumption recession. In fact, the consumer has held up heroically. It is, of course, true that capital spending did the boom-bust as the accompanying table for equipment investment shows. It is equally true that, so far, investment has held up. The latest Michigan Survey shows a gain in confidence. So who knows whether this becomes much at all of a consumption recession or is mostly an issue of equipment and, of course, inventories.

<i>Table 3 US Equipment Investment</i>			
	Share in GDP	Growth 95:I-2000:QII (% annualized)	2000:III-2001:II (% annualized)
<i>Total</i>	9.04	12.4 (1.1)*	-4.0 (-0.4)
Information	4.23	20.3 (0.7)	-2.1 (-0.1)
Industrial	1.65	4.8 (0.1)	1.4 (-0.1)
Transport	1.73	8.1 (0.2)	-12.8 (-0.3)
Other	1.45	6.6 (0.1)	-4.2 (-0.1)
Source: NY Fed *In brackets. contribution to GDP in % points.			

But there is probably an exaggeration in the fear that a capital spending recession, being a new event, has as easy an answer as traditional recessions. The cost of capital and the availability of lending, in addition to direct fiscal stimulus, give every reason to expect a return of capital spending. The fact that utilization ratios are low was also true in previous recessions, and dramatically so in the 1982 case. By October the utilization rate had dropped to 74.6 percent, not quite the 72.3 bottom of the 1982 recession, but uncomfortably close to record postwar low! The explanation is easy: from January 1999 to October 2001 capacity grew at 9 percent, industrial production grew cumulatively by zero. No surprise then of a very large built up of spare capacity.

US UTILIZATION RATE (%)



The most obvious implication of these utilization rates are two: First, nobody is in a great rush to add to the capital stock except for reasons of technological obsolescence. This is an issue, of course. The other is that even in the 1982 recession the upswing of utilization was pretty fast even though the recession was extremely deep. Then, too, there was just monetary and fiscal policy just as now. No reason to expect that the present low utilization rates condemn us to stagnation or worse. But there is also, of course, a double bonus. On one side there is a far younger or technologically more advanced capital stock with favorable effects on productivity. Second, via productivity and low utilization rates, we can expect very little inflation in the upswing. This comes over and above what can be attributed to reduced utilization rates for labor, oil and the inflation-mitigating effects of a world economy. As a consequence, the Fed can do more on interest rates and that, as well as targeted tax incentives, will help create more appetite for capital formation. The notion that excess capital must be "squeezed out" the hard way is excessively "Austrian".

Another theme, running in the opposite direction, argues that Fed policy is creating yet another bubble: there was the 1987 bubble created by just arrived Fed-chairman Greenspan in response to the stock crash, there was the post-LTCM policy and there has been the past year. Everything, in this view amounts to trying to sustain the unsustainable, with the effect of rising imbalances and larger painful adjustments down the road. The Fed answer, not obviously accepting this monetarist interpretation, has been this: better sustaining financial markets than become like Japan; if we must suffer, let's do that later.

<i>Table 4 US Aggregates (%)</i>				
	M1	M2	M3	Debt
Oct 87-Oct 88	3.6	5.4	6.1	9.1
Sep 88-Sep 99	1.4	6.8	7.4	1.5
Oct 00-Oct01	5.6	10.4	13.8	5.3

There is no question that monetary aggregates are rising very rapidly, and far more so than in the previous two episodes. But what to make of it? We also have a dramatic reduction in interest rates; the increase in aggregates is merely a reflection of the increased quantity of money demanded as rates decline. There is certainly no econometric evidence of "money burning holes in pockets", separately from and in addition to the effect of lower rates.

The argument about sustaining or creating bubbles should then be directed at Fed interest rate policy. But who would argue that the Fed was wrong, has overdone things, would have created a more stable world economic environment by keeping real rates high and allowing them to rise. The Japan argument is relevant; there are important risks in the world economy and it is folly to argue that stabilization is inappropriate. Here, indeed, lies the great difference between US and European policy makers. The US view, of course, is that recessions should be fought aggressively and if inflation is absent, no holds are barred. In Europe there is a view that an aggressive attack on recession, in time, becomes the next inflation problem or asset bubble.

Doubts about an upswing are not surprising. There are credible countercurrents that make the timing and fact of an upswing a real issue: the rest of the world is weakening and the dollar remains strong; households are dissaving once again and, as unemployment rises sharply, there is some question about their stamina holding up. As noted, capacity utilization remains low and thus raises the issue of the chicken & egg: can investment lead the upswing or will it only follow on richer utilization levels. Against these doubts run a few important arguments. Dramatic Fed rate cuts have put in the pipeline, by conventional model-estimates, 400 basis points of GDP stimulus, fiscal policy yields another 1 to 1.5 percentage points. That means a literal bombarding of the recession. And, indeed, it shows as in car purchases or even broad retail spending. Moreover, such mechanisms as refinancing and low oil prices add on the stimulus front. Lastly, inventories are low so that, at some point, production will have to rise unless demand is about to collapse. An upswing is very likely; unfortunately it is not a no-question, foregone conclusion.

Note, however, that should there be genuine questions about an upswing, moiré will come from the Fed, in fact everything the Fed has to given, and as certainly extra fiscal packages. Congress is just being mobilized by the high unemployment rates and the inevitable hope to trip up a popular President; Congress cannot afford to get the blame for

the recession. Unfortunately the stubborn capital-gains-tax-cut Republicans are no more mature than the liberal Democrats who think that anything with “corporate” in front is a scheme to rob workers.

## Japan

We have argued for a while that Japan is trapped in a no-growth scenario: monetary policy is gone unless one thinks of “making inflation” as monetary policy. Fiscal policy, while limiting the downturn is both unaffordable and, with its construction focused mandated by LDP patronage, unpopular. Nobody wants the extra bridge to nowhere except the extra 1.5b million construction workers laid on in the past few years. Balance sheets of the government—both in terms of public debt and of unfunded pensions—of banks and of insurance companies are horrific. The holes in balance sheets are unrecognized as is apparent from the difficulties the IMF faces in auditing the banking situation or the rating agency statement that the governments v11 billion Yen estimate of bad loans might 50 trillion of the mark.

The whole financial structure is a disaster area with no conceivable chance of recovery. And so is, of course the spending area. Households not only lost massively in their wealth and, being old, must be concerned to rebuild their assert position. Moreover, their spending is limited, rightly, by uncertainty about jobs and pensions and insurance claims. None of this will change. Reforms, The magic word once uttered by Koizumi, is kept alive as a myth but it is pushed out beyond the horizon; the politics do not support a reform at a time where it might deepen recession. Reforms, of course, mean first and foremost an increase in unemployment and nobody has the stomach for that. It is not clear whether Koizumi's advisors have a clue or are just trying to bluff it out. Nobody has a right top expect that Japan will return to growth in they first place and certainly not at a pace that allows it to outgrow the balance sheet nightmare.

<i>Table 5 Japan Growth Forecasts</i>		
	2001	2002
Consensus	-0.6	-0.8
Goldman	-0.8	-0.9
JPMorgan	-0.8	-1.9
Morgan Stanley	-0.9	-1.0

The remaining hopes entertained by optimists abroad are just these: reforms and inflation. Japan is probably the only place on earth where Wall Street persuades itself that making inflation is a really good idea. But it helps to think twice. Inflation has a negative effect on confidence – people’s retirement assets will be eroded, and that means it might well

backfire to lower rather than raise consumption. If there is a significant risk in that direction. Surely the BoJ would be poorly advised to go that route. Indeed, they are not.

The reform strategy is very plausible; indeed, does not the US serve to showcase the merits of that approach. Yet there is a distinction of reform and restructuring in a vigorously growing economy over a 20-year period and the notion that two or three pieces of reform would jumpstart growth. This is most obvious fore cleaning up the banking system. As the US experience shows, bank clean up does not mean lending – that comes years later once other factors have turned on growth. In the meantime, though, it translates into bankruptcies, job losses and widening recession.

<i>Table 6 JCER Medium-Term Outlook (fiscal yea, % change per year)</i>			
	2002	2000-06	2006-10
<u>Gradual Reform Scenario</u>			
GDP	-0.6	0.4	0.8
Plant & Equip't Invest't	-5.0	-0.3	2.0
<u>Revival Scenario</u>			
GDP	-0.8	0.7	1.7
Plant & Equip't Invest't	-4.6	0.4	4.1

Just in case this is thought to pessimistic a view, consider the latest medium term outlook coming from the Japan Center for Economic Research (JCER), the Nikkei's think thank. The "optimistic" involve no growth to speak of . The removal scenario takes another few years before it gets underway and even though it carries a good growth rate, it is not clear what drives it. Investment (US style) is not part of it. In sum, there are numbers but no story and that has been the case all along. Our guess is that Japan will not grow – no world boom to trigger growth, no domestic measures—and all of politics will be devoted to avoid change. The Yen will depreciate, but not on a scale that would turn on a new growth cycle.

## **Euroland**

Across a wide range of forecasters there seem only two views of Europe. One is that of avoiding a recession, but just. The other, shown in the Goldman forecast, takes a more pessimistic view of the world and hence also of Europe.

Europe came late to recognizing that it was part of the world slowdown. It is not clear what persuaded policy makers that Europe somehow could go its own course. True the trade share in GDP is just 10% and hence external linkages to a slowing world via that channel, are not very important. But it is also clear that the confidence link—both business and household confidence—runs high. Call it the *CNN global effect*. Nobody is left out of that loop and it has operated to spread reduced spending growth to Europe.

Europe's problems are reinforced by a stubborn central bank and, on the fiscal side, by Maastricht limitations on the budget. It is extraordinary to hear policy makers that they allow automatic stabilizers to go forward. Imagine they were not, Hoover-like raising taxes to keep budgets balanced. Automatic stabilizers are a bare minimum; more would be altogether appropriate to be sure this world recession does not get out of hand. With Japan dead in the water, Europe is simply too large to be a free rider on US policy. That attitude risks sinking the boat.

	Euroland	Germany	France	Italy	Britain
Consensus	1.5	0.7	1.2	1.1	1.7
IMF	1.3	0.8	1.3	1.2	1.8
OECD	1.5	1.0	1.6	1.2	1.7
Morgan Stanley	0.8	1.0	1.6	1.5	1.5
Goldman	0.7	0.4	0.6	1.1	1.4

We have argued before that Europe did well while Euro depreciation was pklaying itself out, adding about 1.5 percent to growth for a few years. That effect is gone now. It is good to ask what will produce the upturn for the coming years. Nothing from the fiscal side – automatic stabilizers limit the damage, they are not a stimulus strategy!—nor much from the ECB which has allowed real interest rates to rise. Lower oil prices help, the modest worlds upturn will help but all that does not amount to much.

Europe will have a hard time swinging up to some 3 percent growth in the second half of 2002; the US has just a much better story about getting out of the recession. Just to inject a note of optimism, though, not that the OECD 2003 forecast has Euroland at 3 percent versus 3.8 percent in the US. Not surprisingly, the Euro has difficulties recovering strength. The new currency should help but it is overshadowed by the eccentricities of the central bank.

The coming year is dominated by elections in Germany and France. The slowdown, uncertainties about the new money, untimely German strike threats all put politicians on guard. This is not the year of free markets in Europe. Policy makers will be seen to say some quite extraordinary things about free markets. We should listen because of the

public needs that to return the present governments we should not believe their wink that all is well and this is just about the elections and they will be back soon as best friends of a free market economy.

### Emerging Markets

If emerging markets were unencumbered by debt and otherwise credit worthy they might spend themselves out of the recession, ignoring the fact of a world recession. Of course they are neither. Many are over indebted and many of the others do not have credit standing for lack of reform or even reform prospects. They have been drawn into the world recession by sharply falling trade volumes notably in high tech commodities, deteriorating trade volumes as well as credit rationing. Their recovery will lag on that in the US and in Europe and hence cannot be expected in calendar 2002.

	2000	2001	2002
World	4.7	2.4	2.4
Newly Ind. Asian Economies	8.2	0.3	1.7
Developing Countries	5.8	4.0	4.4
Developing Asia	2.8	3.5	3.6
China	8.0	7.3	6.8
India	6.0	4.4	5.2
Asean 4	5.0	2.1	2.9
L.America	4.1	1.1	1.7
Brazil	4.4	2.0	2.0
Transition Economies	6.3	4.7	3.9
Russia	8.3	5.8	4.2

The only two emerging markets that look outright favorable are China and Russia (see essays). The rest is in one way or another damaged goods.

In Latin America Argentina is at the center of attention. The country has been bankrupt for a while. Unfortunate and ill-advised IOMF programs have covered up the fact and given the policy establishment for a long time leeway not to make the reforms that now are under discussion. Argentina needs urgently to reduce its debt to some 30 percent of the face value, no less. Beyond that, of course, there are massive reforms to be done in public finance and throughout the supply side – all those things President Menem refused to do or even gave back in the search for a second term and President DelaRua never dreamt of doing. The currency board has gone and it is inconceivable that it can be brought back as if nothing happened. A mega devaluation Russian style now becomes a serious option.

Brazil has elections coming. In his search for a second term, with cover from the IMF, President Cardoso failed to reform aggressively on the fiscal side and elsewhere. Vulnerability is altogether obvious, more so if the issue of debt reduction becomes a campaign issue. (Argentina is unlikely to be an inspiration, though). As a result, interest rates will remain high and stand in the way of growth. If it were not for Central Bank President Fraga, the word crisis would come very rapidly to mind. True the currency is undervalued and that helps. Whether it is enough remains to be seen, more so if the US upswing is delayed.

There is also the perennial question of Mexico. The every-6-years-collapse did not happen. But the exchange rate is meritoriously overvalued. Flexible rates are supposed to depreciate in a recession – that is the argument for a flexible rate! Yet, in Mexico it has appreciated on the dollar to reach a record high even as the economy has plunged into a deep recession. What comes next? If the US upturn takes its time, the peso will not hold up.

Asia suffers from the disappearance of the Japanese markets, the high tech recession and the lack of domestic reforms. Growth performance is extraordinarily bad and there is little prospect of a V-shaped upturn. Korea appears the only economy that practices outright stabilization and with some success; the rest is simply distressed.

In Eastern Europe convergence is the word. Imagine enlargement does not happen, contrary to EU promises that it will come in 2004. France is believed to harbor that thought, disguised as a widening of admission—an admission that is already a nightmare to many Europeans—of Rumania and Bulgaria. Anything in that direction will be profoundly destabilizing. Yet, the risks existed in the US-Mexico case (remember Perot) and it may still come to Europe, more so if the upswing is not brisk.

Emerging markets do not have a very promising immediate story. That is true not just in Latin America with Argentina and Brazil unresolved. It is also true in South Africa, it is the case in Asia until recovery and it may even hit Eastern Europe if the French have their way.

## BEYOND THE RECOVERY

Suppose all goes as expected, there is an upswing in mid-2001 and a year from now we are well on the way to recovery. What comes next? Probably the news is not good: the world economy will suffer a relatively anemic recovery, far-far away from the boom of the past few years. There are several reasons for this pessimistic view. First, the US but Europe just as much, will have relatively little dynamism: capital spending takes time because we first have to grow into the capital built during the boom phase. Consumers while not outright wobbly in their knees are certainly not in a position to wage the frontline battle for prosperity. What is precarious in Europe and the US is of course much more so in bankrupt Japan.

One might look to technology, new economy and the like as the remedy. True, they are continuing to play an important role and will be a source of growth. But this will not be at the vehement pace of the recent past. And here is another certainty: emerging markets won't help the upswing. They are all overextended and mostly damaged goods. That is clear in Latin America, that is clear in Asia. True, China and Russia make a favorable impression but they are not big enough to be locomotives for G3.

We might, of course, reconcile ourselves to somewhat weaker growth—the world has known that before. Perhaps, instead of 3.8 percent growth in the world, we might just have say 3 percent. That is certainly a lot better than the just-above-2 percent we have right now. But even that is not assured. The nasty little secret is this: if something goes wrong, as in time it almost always does, how do we get out of trouble? In the past, and today, the answer is simple: expansionary monetary and fiscal policy. But realism forces us to contemplate a situation where most countries no longer have a reservoir of policies to use, they are plain out of ammunition with which to bombard a slump or worse a recession.

In the past 50 years we have done well both by understanding the policy lessons of the Great depression – use stabilization policy, use it early and use it aggressively. As a result, each slump was readily followed by an expansion. Economic growth rarely got far away from the trend line and never for long. But today Japan, and increasingly Europe and the US must contemplate that there are no ample policy tools left. This is clear in Japan where inflation – imagine!—is elevated to the rank of a policy tool but the problem risks reaching all. It is perfectly possible that over the next half year, to finally accomplish a firm upswing, the Fed will have to give much of what it has left in interest rate cuts. And there may even have to be another fiscal package in the spring. In Europe where recession is coming on, the ECB will have to do more, like it or not. Yes, we will get a recovery in the end but by that time we may have no ammunition left to fight the next recession if and when it comes. That vulnerability would influence very negatively business confidence and stock markets.

In the past, we have enjoyed what former US Treasury Secretary Larry Summers called the “reloading of the gun” – prosperity restores budgets, cyclical upturns bring inflation

and with it a rise in interest rates which in turn are available in the next downturn to be cut again. But imagine our upswing is too weak to do much the reloading. We are not really very far away from such a situation. The US has a bit left on monetary policy and quite a bit on the fiscal side. In Europe, including ECB reluctance and Maastricht, there is at best half that; in Japan there is strictly zero. In emerging markets too much debt is already turning economies into restraint. In sum, the risks described here might well become highly plausible if the 2002 recovery is anything but very strong. That would be a world where growth is sub par, extended slumps become plausible, deep recession scenarios not impossible. And the further we go in that direction, the more difficult of course the prospect of getting back to the good world of the past 50 years.

How to avoid getting there in the first place? Greenspan has surely been pursuing just that strategy with his vigorous interest rate cuts. But what to make of this: they have often, notably in Europe, been condemned on the ground of creating excess liquidity, moral hazard in stock markets, inflation risks down the road. Greenspan's view, quite on the contrary, has been that if we miss *this* upswing it is not so clear how we should accomplish the next attempt. If Japan can run out of policy tools, why could it not happen to us? Europe has made too little of that scenario, left the US with too much of the task and hence contributed to the risk that we might just get there. Leaving something on the shelf for next time is clearly the wrong idea; the more vigorous we work at recovery now, the more broad and deep the recovery, the better the chance of recharging policy batteries for more stable performance down the road.

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## *ESSAYS*

### *US-EUROPEAN GROWTH COMPETITION*

Revisionism is running hot; not only did the US bubble crash (or at least get some big leaks), now it even turns out that much of the miracle never happened. When it comes to performance, Europe is king, not the US.

A study of the sources of economic growth by the OECD has brought together a formidable set of data and with it a new view of who is doing well and is doing poorly. The new view ids that there is a lot less glamour to US performance than had been thought. The accompanying table captures the central fact: true, the US has had high growth in the 1990s, more than the large European economies by a long shot. But the productivity part – the US as a productivity miracle—is not correct. This is apparent at the conventional level of output per person employed. But it gets even worse when we recognize that in Europe much fewer hours are worked per person than in the US. By the time we look at output per hour worked, Europe shows a full reversal -- that is where now the productivity show is running. Suddenly a place thought dull if not worse, Germany, is

the big winner. They don't work much, but when they do, it is with unmatched productivity and the story gets better over time.

Tale 9 Growth 1990-98 (% per year, Source: OECD)			
	Actual GDP	GDP Per Employee	GDP per Hour Worked
US	3.0	1.7	1.5
Germany	1.4	2.1	2.5
France	1.4	1.3	1.8
UK	2.0	2.0	1.9

It might seem from these numbers that Europe has figured out the trick: work little, work well. In fact, not only was productivity growth better in Europe, so were the levels of productivity. West Germany or France produced absolutely more dollars worth of output per hour worked than the US and so did even Italy. By contrast, Japan with its very inefficient service sector was way below the US or Europe as was the UK.

How to interpret these facts? One possibility is this: Europe's labor market is a great problem. It is over-regulated and inflexible and, to top it, labor is very expensive even at the current levels of the Euro. Why be surprised then that European firms shy away from labor and operate in a very capital-intensive fashion. With much capital per worker, other things equal, labor is highly productive and that is the European mode. Moreover, labor intensive (i.e. low productivity) companies more readily outsource or go offshore altogether,-- in part because restructuring is hard so the whole operation goes. As a result, what is left over time gains in productivity by elimination. That model is smart, but is there a downside?

The downside is this: Europe has high unemployment because firms shy away from labor. In the US by contrast, growth involves normally relatively less capital accumulation per worker, a small productivity gain per worker or per hour, but in exchange significantly more employment creation. In fact, much of the growth in the 90s involved the absorption of the unemployed and of welfare recipients into jobs. US growth involves lots of jobs, Europe's growth, if high, keeps unemployment barely constant. Two different models, each with a downside. It would obviously be attractive for Europe to get the extra piece of massive job creation and for the US to enjoy on top of the jobs machine a better productivity performance. Is there a chance of this?

Europe does not stand much of a chance to emerge from its unemployment trap. Not in the coming year with recession and not any time soon either. The better productivity

performance on a low growth of spending Europe, the less labor demand grows simply because productivity growth is high. Europe would have to stoke up the economy with a lot of investment dynamism, cheap money and tax cuts for everyone, and maybe public works on top. No prospect of that. The story will simply remain one of good productivity; surprisingly good, considering that Europe was not thought to be part of the “new economy” area.

In the US there is immediately the issue of recession and hence rising unemployment. And then there is the problem of modest recovery, not strong enough, to outpace productivity. Next year, accordingly, Europe and the US will look much alike. On the productivity side the news may become somewhat better. This is the first time the US shows productivity growth in a recession where normally it is negative. If this holds up and strengthens into the recovery, as Chairman Greenspan seems to think, the US may soon have the European dilemma. It does well on productivity, very well indeed and possibly better than Europe, but it can't get the unemployment rate down. Comparing pre and post-recession, it's not clear which to like better.

## **TWO BIG RISKS FOR THE WORLD ECONOMY**

The discussion of the day is the depth of the present world recession. True, there are serious questions whether the upturn is around the corner—in the second quarter and V-shaped-- or whether we should prepare for worse with a shallow outrun. And much of 2002 spent in the doldrums, a scenario in which Europe and not just the US would be in recession. But there are good reasons to be confident that in the end monetary and fiscal policy will get us out of trouble with a downturn far milder than the 1982 recession, the worst since the great depression. But while we are worrying, we might as well look to the really serious risks for the world economy. Of these one can easily imagine two: a Japanese financial meltdown and the fall of the Saudi royalty. Both are events quite sure to happen, either one could happen any day, either would be enough to bring a deep shock to world prosperity, far bigger than what us just happening.

The oil scenario has a simple story. Today, with world recession underway, falling oil prices are a welcome offset to the slump – they put more money into consumer's pockets, they lower inflation and make central banks more willing to cut rates and stimulate demand. But play the story in reverse, let them explode. In a recent issue of the *New Yorker*, Seymour Hersh has documented the loss of legitimacy of the Royal Family. They have now lost the support of the conservative Islamic community and have even been declared *infidels* where before they were protectors of the holy sites and the conservative faith. That leaves them just distinction of 5000 princes many of whom have the image of being corrupt. All too many are seen as spending their time cultivating a life style that while impoverishing the population offends the faith; they have lost any plausible claim to the riches. Too late for reform; just as with the dubious attempt of the Shah in Iran at the time, they will fall like ripe peaches. They rather resemble the Central American dictators, invariably supported by the US, whose security is the palace guard

and no more. They never last. Nor will the house of Fad with its expatriate protection force. Indeed, who is to say that the anti-US terrorism with its Palestinian motivation is not predominantly a side-play for a seizing of the Middle East by fundamentalist forces? After what we have seen on September 11th, nothing is far etched, nothing is impossible!

George Perry of the Brookings Institution has developed scenarios of a serious contraction of oil supplies—in the course of a mere disruption or a lasting reduction in supplies. With good economics and without drama, he finds that a contraction of just 1 million barrels per day would raise prices to \$32; an extreme cut of 7.5 million barrels—a cut equal to 10% of world production--would raise prices to \$161. And that would mean a recession like we have not seen in 50 years. Of course, there would be geopolitical responses but even if that gets the oil flowing again, it carries the seeds of worse to come.

Fostering alternative, moderate government in the Middle East. Like deflating gradually a bubble, the latter may not be plausible option and for that reason the risks are that much moiré serious.

The second mega-risk scenario involves a Japanese financial meltdown. This, too, is something that is ripe to happen but may still be a few years off. The ingredients are two: an economy that stubbornly refuses to turn up—and nobody having a clue of how to change that, and a financial superstructure that is out-and-out bankrupt. This is not just the banks and the insurance companies, and retailers and other parts of the private sector. Importantly, the government is bankrupt. Its debt is larger than that of the US – a country much larger than Japan—or that of all of Europe, again and economy much larger than Japan. Growing out of debt is the usual answer but if the economy shrinks year How to respond to this vulnerability? There are four areas: Foremost, fostering competing oil supplies from Kazakhstan and Russia to Mexico and Venezuela, increasing strategic reserves, even beyond their current levels, reducing particularly in the US oil consumption and by year that simply means things are getting worse.

Japan's finances are mostly stable as long as households wake up every morning and support the status quo by rolling the debt or buying even more in the mistaken belief that this is a plausible investment. Having lost on all their investments, it is not surprising that they hang on to their government's liabilities as the last straw of hope; ironically, it is the least straw of hope. One day there will be a creditors strike, the investors leave for foreign assets (just as any delinquent emerging market--, the currency crashes, the debt crashes, confidence falls and with it consumption. Japanese will be overnight in the Great Depression. And with Japan goes much of Asia and that means the world will have the single largest shock in 50 years. Far from bottled up in Japan, it will spread everywhere just as was the case in the 1930s. Policy responses might be better and we know better than have trade wars in response to a Yen crash, but who is to know?

Yes, there might be a moment of enlightenment in Saudi Arabia that rapidly and just in the nick of time restores stable government; yes, it is barely conceivable that some inflation strategy might get Japan off the hook just before midnight. But it is in the nature

of the beast that when the damage has gone too far, damage control opens the door to all-out collapse.

Doomsayers have forever talked of the political risks in the Middle East or the financial risk in Japan; true these have never come to fruition. Yet! But surely anyone barely aware must concede that they have moved sharply closer and that there is no good prevention strategy in place. Both have dramatic macroeconomic implications, neither is of the scope of an IMF intervention or a Gulf War as the solution.

## **THE EURO CONTROVERSY**

Surely one of the great financial surprises of the past year is that the Euro has failed to recover – US current account deficits and the lack of saving, a high tech crash, US recession, US stock correction, terrorism in America notwithstanding. Is there nothing bad enough in the US to give the Euro a second chance? Maybe there is a message here; maybe the Euro is approximately valued right. After all, a currency is only as good as the people who manage it. And the economy that it backs it. If it were true that you can make a first impression only once. The Euro could only be called a disappointment, a challenge to the dollar that went nowhere. That view is surely thoroughly wrong; creating good money is a long distance race and Europe is barely at the outset with many rounds to come. There is every reason to believe that with the creation of the Euro an important step has been taken both for the economic restructuring of Europe and the broadening of world finance to a second lead currency. In matters of money there have never been instant results, at least not on the positive side.

To warm up, lets review the run up to the Euro and the early experience

*It Can't Happen* The political decision to move to narrow exchange rate bands, and from there to fixed rates and a single currency left economists by and large speechless. How could so diverse economic, financial and monetary experiences and cultures be blended into one. How could the German saver be held save against the Italian spender; How could exchange rates be given away without some other mechanism to create flexibility – after all, in the local labor markets there was no flexibility to speak of whether the argument was political – no German government can afford to put this over on its savers or just economic, widespread suspicion and disbelief greeted the decision. And, indeed, the early test run failed: Italy and the UK just could not make it. True, France increasingly looked like a German monetary occupation zone, but convergence seemed a far distant and elusive goal.

But the fact is, it did happen. The Maastricht criteria were a forceful mechanism to give governments a fresh argument against procrastination on fiscal laxness and casualness in anti-inflation policy. It worked and there was not even much cheating at the end. Those who said “impossible” (including this writer) were embarrassed by those who did it.

*It's A Bad Idea* There was another line of argument, less oriented toward the economic and political feasibility and rather focusing on just how good an idea all this was. Harvard's Martin Feldstein is perhaps the central voice in this camp. Disregarding that much of Europe had practiced fixed exchange rates already for almost a decade, he expressed doubt in a Europe without exchange rate flexibility. Indeed, he painted a ghastly picture of things to come as a result of lost flexibility, including even the eccentric idea of cross border hostilities. Not much is heard from that camp just now. Their focus on exchange rates being a substitute for flexibility and reform was deeply misguided.

*It Can't Last* The third camp was the voice of George Soros and Wall Street. Sure it is happening, they said, but hold your breath – before long this intrinsically unstable Arrangement will break up; it just is against nature to have rigidly fixed rates, a single money. It won't last. That camp, too, has not been heard of recently. Surely they recognize, good idea or bad idea, the Euro is here to stay. Their discussion now focuses on whether the central bank can stay truly independent, a discussion nourished by such freak appearances on the scene such as Oskar Lafontaine or the occasional French rumblings for democratic control. Enough said, the new central bank understands that democratic money is bad money.

*Unfortunate Bargain* The creation of a common money could not happen without utmost concern for institutions that assured not only political independence of the central bank but also a clear and undivided commitment to price stability. True, the Buba was a good precedent but here clearly things went overboard. Adopting monetary aggregate targets just because the Buba pretended it followed them obscured policy. Appointing Duisenberg because he projected rectitude was a big mistake. Delaying the introduction of currency, leaving the Euro as a demi-fait accompli was another. Crowding the ECB with staff whose dominant claim was in many cases national origin rather than sheer recognized competence and excellence was yet another error. Proliferating the board membership to a large number made for an unwieldy group which will get even worse in years to come. Awful public communications, at the level of bumbling, yet further enhanced the impression that Europe had an amateur central bank. Not a good start, not good even now. But these are not necessarily lasting mistakes; the US experience with very underachieving central bankers (such as Mr. Miller in Jimmy Carter's days) is readily forgotten—in the long run the record of low inflation and financial stability counts. No reason to believe that Europe won't have that.

*Excessive Expectations* It would not be right to overlook the great expectations for the Euro, at its creation, and the profound disappointment that followed. Since its inception, the Euro has crashed, no less than that – a 25 percent depreciation of a currency that was even muttered to displace US hegemony and the dominance of the dollar in world finance. Certainly there will be times where the Euro will do just that, but whatever possessed European policy makers and the public to hold these utterly unrealistic beliefs?

The arrival of the Euro was inauspicious. Like Nasdaq stocks, it had its best day on its first day or in the gray market before. The Euro came in the midst of the American boom, the money of an economy that had anything but – slow and ossified, unwilling to reform, indeed unwilling to boom. No surprise that the Euro was the anti-bubble, displaced by US bravura and performance. The Euro's day will come, but only when Europe offers distinctly more favorable economic prospects than the US. At this point that situation is not imminent, in part because Europe does not want to be like the US – and why should they, life is good, the model has a history to be proud of and if it is affordable who is the politician to upset the applecart? Not a Schroeder, not a Jospin. Their mind was absorbed by statism, hostility to decentralization, absorption with disrupting finance and its benefits. The currency cannot fail to reflect the economic leadership just as a corporation's stock reflects its management.

*Challenges & Opportunities* In the year's ahead, the Euro will bring great benefits. It is a forceful driving engine for deeper European integration and reform – a capital market, increasing market transparency, increasing flexibility and competitive reforms across the now no longer existing borders. None of this is fast, all of it is certain. That is the good side and it is all the more welcome in that governments are reluctant to front-run these changes. They talk, but the market is driving the events.

There is also the challenge of the widening of Europe. At the present, the obsession is that Eastern European accession candidates must not imagine early participation in the Euro. But why—many of them have a more convincing central bank experience under more challenging conditions than most of the present EMU members; many of the central bankers have far more distinguished combat experience than members in place today. Just as EMU gave Italy credibility and solvency, Eastern Europe should be given that bonus rather than be put on the workfare roster. Early monetary integration, unilateral or better as full membership, is a big bonus that comes at no cost to the present membership.

And then there is the much harder question of Britain. Would it not be just wonderful to have an accomplished monetary leader like Governor Edy George of the Bank of England run the ECB? That would resolve the all-too difficult question of how to replace the current President.

*Europe and America* Europe's profound expression of sympathy in the aftermath of the September bombings moved America profoundly; it has shifted the entire country back to internationalism. Now shift to the Euro and the festivities celebrating the introduction of the Euro. Imagine Europe had had the grace to invite the US Treasury secretary and the Chairman of the Federal Reserve; imagine the gesture was to say what you started with the Marshall Plan – bringing Europe together—we just widened with a giant step toward common money. Thank you. The people celebrating were just too petty, too concerned to make history all by themselves. They forgot all too eagerly how the US had started them off.

## ALMOST NORMAL: RUSSIA'S ECONOMY ON THE MEND

Only three years ago, Russia's economy blew up in the most spectacular fashion. The ruble-dollar rate went through the ceiling and the value of debts through the floor; Russia's financial superstructure was plain blown away. Few would have thought – and none is on record—that all this was for the better, that it would initiate a normalization in Russia and with that the emergence of financial stability, reforms, growth. But that is, indeed, what has been happening. In today's stressed world of emerging market finance, Russia is one of the exceptions with good growth, a budget surplus, a current account surplus and a content public. Putin has done it and the longer he maintains this calm state of affairs the greater his political power; in other words, he has opened a virtuous cycle in a country where before all roads led to destitution, lawlessness, economic as well as social collapse.

	1990-2000	2000	2001	2002
Growth	-4.8	8.3	4.9	4.0
Inflation	162.0	21	22	12

Source: World Bank, Consensus and JP Morgan

The end of empires invariably involves an economic collapse and a dramatic redistribution. It is said that more money was made in the few years of the collapse of the Roman Empire than in the centuries of its existence. Likewise, after World War I, the collapse of imperial Germany or the Austro-Hungarian Empire brought hyperinflation, political breakup and collapse of economic activity. The disintegration of the communist block was different only in one respect; it was the collapse of both a political order and of an economic model. Not surprisingly, the economic and political fallout was even more extreme. Fortunately, except for Chechnya, making war did not become one of the results. In the economic area the change toward a market economy was no less turbulent than it had been in other imperial transitions. If in Germany the Krupps emerged from hyperinflation as the great winners, Russia had its counterparts in Guzinsky or Beresovsky and a handful of others who, coming from nowhere, understood to seize the moment, plunder the state and come out smiling. Moreover, the young could adapt and welcome the change. The old with their plastic shopping bags looking for scarce, underpriced and shoddy goods of the Soviet era never understood that now there was unaffordable plenty. They were left destitute and futilely protesting for Restoration.

Robespierre in the French revolution understood that the only way to achieve lasting change (and, unsuccessfully, to save his neck) was to eradicate the aristocracy altogether; the guillotine was doing overtime. The young Russian reformers – Gaidar and Chubais above all--used that same model in the economic area; removing price control buried away the planned economy, privatizing– creating owners and moving assets out of the public sector at literally any price and with just about any process and not much care for niceties – meant communism was de facto gone. That this was controversial beyond belief, that it created an oligarchy with great wealth and political power to match was only to reveal itself a few years later. Christy Freeland in her extraordinary book *The Sale of the Century* has documented all that. In hindsight many argue that that this might have been done better.

Yet it worked. Where gradualism, circumspection, a plan and rules might have led is very open to question. After all, there was no consensus, democracy was owned by the communists, institutions were plain absent, and this was the country that had just failed spectacularly at planning. This was not a Czech republic or a Poland detaching itself from occupation for an early return to democracy. Radical change just does not come that way and history is very forgiving to those who succeed. Now, little more than a decade later, Russia quite clearly will never go back and it is far better equipped, and indeed has started, to deliver a growing standard of living. Ultimately that is what counts.

For much of the first post-communist decade, Russia was an unmitigated mess: collapsing state production, immiserization of much of the population – remember the subway corridors full of old women – and they probably were not much more than 40!—selling off their home-knitted gloves or some belonging, state firm managers organizing spontaneous privatization into their own pockets, gangsterism, the discovery that opening a bank is the first step to great wealth. There was hyperinflation, currency collapse, dollarization, vulgar display of extravagant wealth of the *New Russians* , desperate poverty, and vodka everywhere. The young learnt English and commerce, the old were left by the side. Yeltsin misruled and everybody followed his model.

The past few years have ushered in an entirely different world. Russia is normalizing. Broad-based growth and financial stability are the outward signs of the normalization. But the roots run much deeper. Several factors seem important in that transformation. It is useful to highlight them in order to judge whether they make for a lasting change. First and foremost, Yeltsin is out, Putin is in. The change could not be more dramatic. Yeltsin when not drunk was redistributing state assets to his favorites, buying political support for an extra term against an increasingly mobilized opposition. Putin by contrast understands that the broad public wants stability and growth and will reward with their votes anyone who delivers just that. Never mind Putin’s KGB background, he delivers what the public wants and his power is on the rise. And he does so with great skill as we witnessed in his courageous use—against domestic opposition, notably from the military- of the Terrorist crisis to become one of “us”.

A second key ingredient for the newfound stability and growth is, of course, oil. For the past few years, until the current world recession just emerging, oil prices have been high

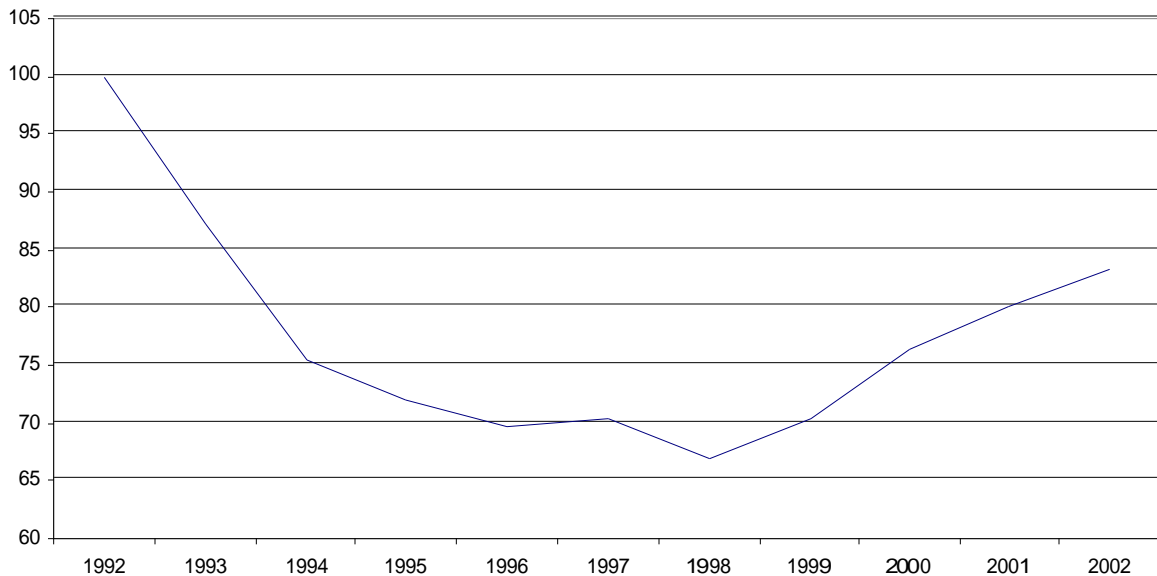
and that has favored oil-producing Russia on the two key fronts: budget revenues and external surpluses; both, of course, are keys to financial stability. The high oil prices came just in time to help Putin put in place his financial responsibility policy and his reform strategies. Now that oil prices are falling off underworld recession pressures, some of the sheen is going out of Russian policies. But it is surely right to argue that we are miles away from printing money and a return of capital flight and currency collapse.

The third element in normalization is the sheer fact of running out of bad ideas. In Russia, bad economics, populism, anti-market policies—all of the above, have been tried without exception. Their failure has come at a steep price and, as a result, have been discredited. As in every country that has gone through hyperinflation and economic collapse, an unusual respect for soundness and economic conservatism evolves. Even the communists learn that they can't win support advocating economic experiments. This is reinforced by the fact that past cumulative policy reform could not show its merits in the midst of extreme inflation and dislocation but becomes far more evident and productive once the economy is stabilized. In addition, of course, the massive privatization and restructuring of state enterprises is paying off. The initial phase, because of poor existing productivity, is always dramatic but by now—with reduced debts, less overstaffing and a gain in flexibility-- the fruits are starting to show.

One more point deserves great emphasis: Russia's normalization owes much to the change in the political landscape: the oligarchs, their power and their conspiracy to steal the remaining pieces of Russia is out. Now tax collection from organizations such as Gazprom are considered normal where a few years back it was inconceivable. Where oligarchs are still at work in Russia, they have learnt that a fair distance from politics and a focus on normal business is in their interest. That shifts the focus to entrepreneurship and making money in Western ways which in turn translates into economic growth and a wider spread of prosperity.

It is futile to identify which of these factors deserves most credit for Russia's performance. Indeed, one would add further factors such as the benefits of a deep real depreciation of the currency. It is clear though that in combination they have created a virtuous cycle that restores credibility to a market-based economy and an open society. Putin rides that wave and he rides it well. As the rest of the world learns to accept the fact of Russian normalization, direct investment will soon become an extra driver of growth.

**RUSSIAN GDP**  
(Index 1992=100, Source: IMF and Consensus Forecast)



Even though Russia is now doing so much better, we should not lose sight of where Russia is; a few years of growth are good news but they don't change the fact that Russia is a developing country, far behind and not dramatically dynamic. To calibrate, Russia is certainly more like Brazil or Mexico, say, than high income countries. Russia is large but that, on the economic front, is most of the story. It is a developing economy, warts and all, with a pervasive lack of institutions. Its income level (in purchasing power dollars) is between Mexico and Brazil, its population growth is negative, its investment rate is astoundingly low for an emerging economy.

<i>Table 11 Russia in Comparative Perspective</i>			
	Russia	Brazil	Mexico
Population	146	170	98
Population Growth (% , 90-00)	1.4	-0.2	1.6
PPP GDP (\$)	8,030	7,320	8,810
Debt/GDP(%)	48	37	72
Investment/GDP(%)	14	23	23

The recent stabilization gives us reason to be optimistic, but lets not expect a powerhouse. Nor should we believe that there are not important complications in the wings: Russian income distribution is extremely unequal and, unless economic growth is high, that will become a political issue and a counterweight to further moves toward a

market economy. On the positive side, with Middle East oil precarious, Russia can make itself a critical supplier and indeed partner of the West.

Low oil prices just now, and world recession, test Russia's staying power as will many more tests down the road. What is new is that Russia – rather than being an implausible adventure, finally looks like it has a chance for being a somewhat promising developing country, no more, no less.

### **EUROPE'S RELUCTANT RESPONSE TO WORLD RECESSION**

The creation of the Euro was, politically and economically, a dramatic success. It is time for even the last skeptic to admit that, it is time for all of us to see the benefits ripen over the next decade as the new currency creates a driving force for integration, for the creation of a capital market, and indeed for structural reform. Quick results cannot be expected, short term disappointments (not failures!) such as the sell-off of the Euro in currency markets are not a big or lasting deal. Like many great and lasting ideas in high tech, the Euro too was a bit of a failed IPO, crashing like many of the Nasdaq stocks. But that has more to do with the initial exaggerated currency value and exaggerated claims than with basic unsoundness.

But with all the positive things that can and must be said about the Euro, we can't overlook that there are also disappointments. Most of these emerge from the difficult initial decision – how to sell to German bondholders who were accustomed to sound finance and stable money the idea of going to bed with the Italians known for just the opposite. The expedient strategy was to model the ECB on the Bundesbank and to draw a firm line against run-away bad public finance. And it is in these areas that too much of a price was paid or, at least that the full price became only clear later. The first issue is the Buba model. Most unfortunately, the new ECB hang on to some of the quaint Buba strategies, in particular retaining an attachment to monetary aggregates as guiding posts for policy. Nowhere in the civilized world is still happening, not even at the level of lip service; unfortunately at the ECB it still exerts a powerful influence.

At the Buba monetary aggregates were important in the rhetoric but in their time Buba Presidents Poehl and Tietmeyer were consummate pragmatists and as such could creatively circumvent the targets whenever they sent the wrong signals. The ECB, perhaps because it is new and surely because its President has neither much experience nor skill in communication, is a display of confusion, indecision, incompetence. That is a luxury; backed by one of the leading economies in the world no dramatic consequences flow from it but surely that is a minimal test. Europe deserves more professionalism in the management of its money. With inflation falling rapidly and a world recession unfolding, with Europe going into a slump, with monetary policy having long lags and therefore little short-run influence on reserving adverse developments, should the ECB not have moved more aggressively much earlier? Should it not, at the least, do so now?

The other price of monetary union was a tight control on budgets and the development of public debt. It is probably wrong to say “price”; indeed, to many politicians Maastricht was a heaven-sent excuse to mount a defense against an out-of-control course of European public finance. And, indeed, it has worked – deficits are in line, debt ratios came off while euro-depreciation stimulus raised growth rates. But now, with a European slump or worse, the setting of public finance becomes more of a question. President Hoover became famous when in the face of the Great Depression he ran on the platform of a balanced budget! Europe is not quite there, Maastricht does allow for *some* cyclical deficits provide they do not get out of line too much. But here is a very grave concern: suppose the world recession gets to be very deep, say like 1982 – unlikely at this point but far from impossible—what comes then. Surely the worst possible scenario is extended committee meetings to deviate how bad the situation is, how difficult it is to choose accept deviation for the rule. In this respect Maastricht is a threat to world stability simply because it limits the timely and effective stabilization of demand in the way the US is applying just now, and has successfully applied in the past 10 recessions.

Of course, there will be plenty of arguments against countercyclical policy. There is the immediate one that it is unaffordable and there is another one that it does not work and there is a third one that fiscal policy inevitably does the wrong thing – for some that means too much government spending, for others too much tax cuts and too little public works. And the argument gets so hot under the color that the status quo – at most built in stabilizers but surely no active countercyclical policy wins the day. Yet there are obvious rules that go far in providing front-end stimulus without endangering either public finance or a strategy of restructuring. For example this one: an immediate Europe-wide *temporary* investment tax credit worse 1 percent of GDP financed by a 3 year reduction in government spending in that amount. That provides stimulus, sound public finance and economic restructuring all in one.

It is interesting to ask why in the US, with all the differences of political views, fiscal packages do happen and do happen fast, why balanced budget amendments have had their time on the stage but never found their way into law. The answers are surely that when everything is said and done America is very pragmatic – recessions are not good for anyone, voters, workers, business and politicians alike. Fiscal policy is known to be effective and hence it is a mistake to forsake it as a matter of some ill-considered principal. And the same applies, of course, on the monetary side: no thank you to inflation, no thank you to reliance on shifting guide posts like monetary targeting; welcome to pragmatic monetary policy that assures financial stability and non-inflationary growth.

In many areas Europe has not chosen to have an active policy, but rather stand on the sidelines letting the US run policy. In the area of the world business cycle Europe is too large to take that view, more so in that Japan has already disappeared from the scene. In its own interest but also to support world stability, Europe must be concerned to have better control of monetary and fiscal policy. At this point we do not have that assurance.

## WAR AND INFLATION

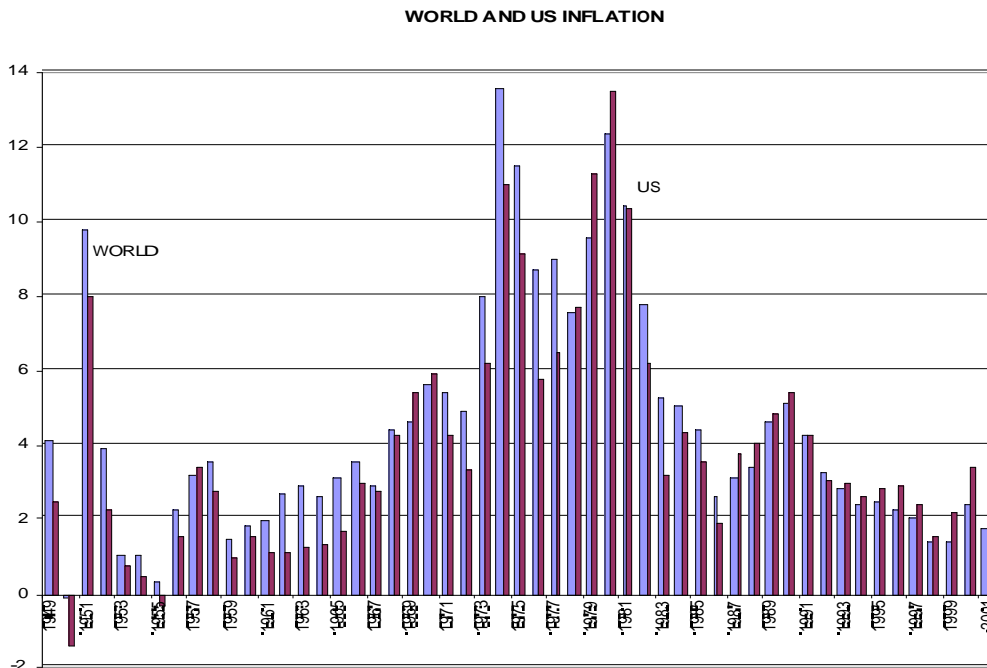
In the aftermath of the September 11<sup>th</sup> events, a broad coalition of governments has gone to war against terrorism. The immediate target was Al Qaeda and the Taliban. But it is understood that Iraq, Yemen and Sudan are on the short list in a continuing campaign. This suggests the possibility of protracted war-related expenditures. In addition, of course, there is sizeable spending on reconstruction as well as security on the home front. The question naturally arises what the inflation implications are. “War and Inflation”: has a familiar ring, just what is the evidence?

Before we get to the discussion, we need to add one critical consideration. It is not just war that brings inflation risks, it is also the postwar reconstruction and transfer payments associated with peace.

The accompanying figure shows world (IMF definition) and US inflation since the late 1940s. Three periods of wartime stand out:

- The Korean War (1950-53)
- The Vietnam War (1964-73)
- The Gulf War (1990-91)

It is apparent that the Korean War was associated with a very sharp blip in world and US inflation. But it was no more than a blip. The Vietnam War brought a period of rising inflation, ending in dollar depreciation and the oil crisis. Without war, the 1970s up to the early 1980s represented a loss of control of inflation both in the US and in the world. Lastly, the Gulf War involved once again a blip in inflation. What lessons are there for inflation risks in the present context?



What links are there between war and inflation? We can think of five considerations:

- A *demand shock*. War increases the use of resources, over and above peacetime resources. This applies as much to manpower with an impact on the supply side, extra use of commodities including oil, as well as final goods and services. This extra use of resources, other things equal, creates excess demand. Depending on the financing and the initial state of the economy, this may be a source of inflation.

To the extent that wars are now fought by downscaled professional armies and off inventories of high tech weaponry, the demand shock may be more stretched over time as it arrives in good measure at the point of replenishment of inventories rather than at the outset of war.

In the terrorist context war now must be interpreted more broadly; it does include civil defense expenditures to mitigate the risks terrorism carries at home. This involves at the front end primarily use of labor (calling up the reserve, more guards, etc.) but ultimately translates also into high-tech security development and spending.

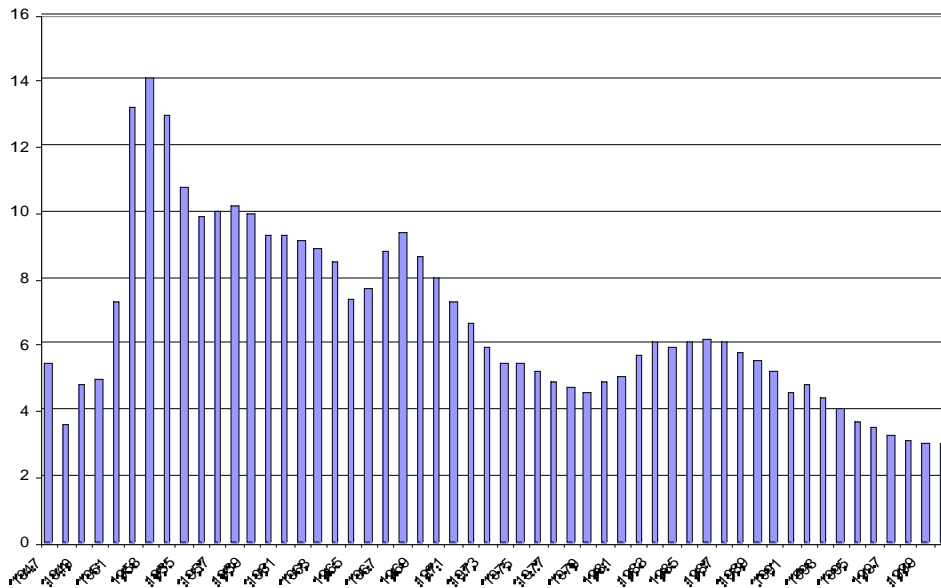
There is also, importantly, a host of spending opportunities beyond the actual hostilities. These include reconstruction but in addition rehabilitation spending such as Marshall Plan-type programs in the defeated regions.

- A war may lead to a *commodity price shock*. To the extent that a war is commodity-intensive and that leads directly to an inflation shock which, depending on the state of the world economy and financing can develop into a broader inflation picture. To the extent that the hostilities directly impact commodity supply (say oil refineries) this issue is, of course, much more pronounced.
- Because in people's mind war is associated with inflation, an outset of war creates *inflationary expectations shock* which in commodity markets but also economy-wide get to exert an actual inflationary influence. The importance of this effect, once again, depends on the absence or presence of countervailing policy effects.
- The *financing* of a war has an important impact on its inflationary consequences. At one extreme, money financed wars have the highest chance of creating an inflationary environment – any crowding out is, indeed, via inflation. At the opposite extreme is taxation which directly limits private demand. Two-thirds that way is debt finance. Here there is at least the prospect of future taxation with the possible impact of current spending reductions to finance those future tax liabilities.
- The *initial state* of the home and world economy matters critically. At one extreme there is a lasting deep recession and a pronounced output gap. In this case, the demand shock may just be plain Keynesian stimulus with little expectation of inflation, whatever the financing. At the other extreme, in a boom economy, a war financed without taxes is a major inflation shock.

The state of the economy matters not only at the world level but also its distribution as does the distribution of resource use in the world. In other words, – a deep recession in Japan does not fully make up for say a high level of demand in the US in a circumstance where the US carries much of the war effort.

The actual outcome in terms of inflation will depend on the balance between these five forces. A short and small war financed by taxation stands little chance of being a remarkable source of inflation. By contrast, a long and substantial war effort financed by debt, or worse money, in an economy that is already overheated cannot fail to become a great inflation episode. In this perspective, the 1960s are the prime example of an inflationary war – in fact, it will be remembered that the belated attempt to shift to tax finance added to the unpopularity of the Vietnam War.

US DEFENSE SPENDING (% of GDP, fiscal years)



With these considerations in mind, what is the inflationary impact of current and prospective war activity. Since the world economy is in a slump, and the US more particularly so, the inflation risks are insignificant. They are also insignificant in that the use of resources is relatively minor and presumably not very protracted.

There are three caveats to this complacent conclusion: First, risks to oil production facilities, in particular refineries, can produce immediate and pronounced price spikes. If they do last they carry a stagflation risk. Second, large reconstruction and pacification expenditures in the Islamic countries, debt financed in the West, create a more lasting impact on resource use. Third, a perception of a more lasting insecurity in the world could lead to a worldwide increase in defense budgets or civil defense outlays directed at mitigating terrorist risks. The “peace dividend” of the post communist period this might go away. (see defense expenditure budget chart)

In principle we might look to bond markets to discern what capital markets think of the changed inflation risks. The steep term structure of interest rates clearly suggests that there is an assumption of inflation risks to come back – the story is recovery and resulting rate hikes from the Fed. And we might supplement that analysis by looking at the performance of defense stocks relative to the market. Defense stocks have done well relative to the market. But that may reflect more the recession impact on the market than a prospect of lasting extra military demand. And then there are commodity prices: no indication here of lasting extra demand; on the contrary, world cyclical considerations depress demand with no commensurate offset from the war.

In summary, this is a “small” war, at a time of world recession; in its influence on the capital market it is not (yet) seen as lasting and widening. In its inflationary impact, at this time, it is not even a gulf war situation. For the time being, barring oil getting to the center or a widening of the conflict, inflation is not an important risk.

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**APPENDIX: FORECASTS AND DATA**

<b>Table A-1 Inflation and Growth</b>				
	<b>Growth</b>		<b>Inflation</b>	
	2001	2002	2001	2002
US	1.0	0.6	2.9	1.6
Japan	-0.6	-0.8	-0.7	-0.8
Euroland	1.5	1.0	2.6	1.5
Germany	0.7	1.2	2.5	1.2
France	2.0	1.3	1.7	1.2
Italy	1.8	1.1	2.7	1.6
UK	2.2	1.7	2.0	2.1
Spain	2.6	1.8	3.7	2.3
Canada	1.4	1.2	2.6	1.7

Source: *Economist* Consensus Forecast

<b>TABLE A-2 Average Annual Working Hours</b>			
	1970	2000	\$ Output Per Worker, 1998
US	1,973	1,877	100
UK	1,939	1,708	82
Italy	1,896	1,634	100
Germany	1,874	1,462	106
Japan	2,228	1,840	68

Source: OECD