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WORLD ECONOMIC TRENDS

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EXECUTIVE SUMMARY

With the US recovery from the "growth recession" underway, the outlook for the world economy has turned both positive and confident. The outlook, say from the IMF, turns world growth up to its long run average. No m0ore than that, but it is a strong improvement from the 2.5 to 2.8 percent performance in 2001-2002.

Table 1 World Growth

	2002	2003
IMF	2.8	4.0
Merrill	2.2	3.7
Goldman	2.6	3.6
JPMorgan	1.9	3.3
Morgan Stanley	2.6	3.9

Led by the US where monetary and fiscal policy, including defense and reconstruction spending have kept demand growing, Europe, Japan and all-the export led emerging markets are expected to see an upswing. One channel is trade-- a yet further widening US current account deficit. But another more important driver spreading US growth abroad is consumer and business confidence; as US confidence turns up and translates into growth expectations, so does confidence abroad and with it spending. This channel deserves increasing attention because the trade channel is relatively small and takes time; the

confidence channel is near immediate and potentially very large. Only in that way can we understand that better performance in the US, where policy has been immensely active, translates into important growth elsewhere although nothing has happened there policy-wise.

Of course, the US expansion even though very likely remains to be seen. There are key questions such as will the consumer hold up even with higher oil prices; will investment join in time? One point is clear, if the US growth peters out rather than shifting up; the rest of the world will be in bad shape. There is little in terms of policy, little in terms of a growth story and hence what is slow growth in the US may well mean a downturn there.

In a favorable US scenario, the Fed is expected to raise rates soon -- an upward bias in the directive by May-June, actual rate hikes by August or so forward rates say. Not so, the Fed is on no rush and there are plenty of reasons, and precedent, to expect an important delay in rate hikes. Inflation is not an issue, productivity growth is stunning, capital markets are fragile, there is war -- why would the Fed raise rates?

There is also an ugly scenario which may come to happen and limit not only US expansion but also the dollar. The US is at war and, after initial success, is bogged down both on the military and diplomatic front. The increasing US involvement in the fight against terrorism, with success elusive, anti-Americanism building up in Europe and Islamic countries, and US commitments rising may come to look like Vietnam. Surely Iraq is next and what then and where is the definition of war aims and success? The analogy may not be right in terms of the size of commitments but it may well right in terms of the perception that the US is bogged down, not making headway, not being able to get out. That diminishes the view of the US as powerful beyond belief and, economically and militarily, successful and lucky. Such a situation may get to confidence and from there, in no time, to international interest in moving yet further capital to the US and that, of course, means dollar decline. This is not a foregone conclusion but is clearly becoming a realistic outlook, more so when combined with capital market malaise, large deficits and the sheer question of how the US gets out of the geopolitical swamp. In the hopeless Vietnam War situation a US Senator declared "declare victory and get out". We are nowhere there, but the US is stuck and that may take its economic toll.

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ECONOMIC OUTLOOK

With different degrees of enthusiasm, forecasters concur that 2002 is a good year and 2003 even better, even in Japan! Thew driver is the US upswing, the chief engine a gain in worldwide confidence. This is, indeed, the central scenario. Without terror-related confidence complications, and with prudent Fed policy, the US will sustain the upturn and the good news will spread via trade and psychology to Europe, Asia and even parts of Latin America. The US upturn is merely to potential output growth and hence very plausible. The upturn in Japan. Predicted every year and always failing, is harder to make a case for. And even the European upturn is a bit generous-- Euro depreciation is over,

the Central Bank faces inflation issues that it cannot wave aside, fiscal policy is not an option, so where is the big push?

Table 2 Consensus Outlook			
	2001 (IMF)	2002	2003
US	1.2	2.5	3.5
Japan	-0.4	-1.0	1.1
Euroland	1.5	1.3	2.8

United States

The US, in hindsight, never had a 2001 recession even though at the sector level and notably in manufacturing it very much looked like that. Call it a growth recession for which there is dome precedent. Very early monetary easing, long before a negative quarter, the tax cut in the summer and defense and reconstruction spending plus post-September 11 normalization all helped turn the fourth quarter into an expansion rather than the expected recession. From there, with inventories largely gone, the first quarter registered an upswing with more to come.

Table 3 US Growth Forecasts		
	2002	2003
IMF	2.3	3.4
Goldman	2.4	3.0
Merrill	3.2	4.3
JPMorgan	3.1	3.4
Morgan Stanley	2.6	3.8

Looking forward, the next 4 to five quarters can be expected to bring growth at the pace of potential output, some 3.5 percent growth. Potential output growth is made up of a 1-percent growth rate of the labor force plus some 2.5 percent growth in labor productivity.

Where is the downside to that outlook? The list of questions includes these:

- Can the households continue to spend more than their income? The answer is that household net worth is up -- housing and real estate gains dominating increased debt o that balance sheets are good. Moreover, with low interest rates and relatively low

unemployment rates more debt is more plausibly carried. Not surprisingly, households face no credit rationing and thus, if the spirit is there and oil prices don't cut to deeply in the purse, so will be spending.

- Corporate balance sheets and profit flows are, of course, a problem as is leverage and aggressively priced stocks that have discounted the recovery and wait for extra good news. The post-Enron reassessment puts a large question mark and with it *capital market malaise*, spreads, and rationing. This is not about to go away and, no question makes investment prospects more elusive. There is some offset from the Fed keeping rates low and from accelerated depreciation legislation that boosts cash flow and incentives for early investment but there is the offset of very large excess capacity. Fortunately much of defense procurement goes to the same high tech sector that is in most dire straits.

- The fiscal side is no problem. With a public debt/GDP ratio, moderate deficits are easily affordable. Indeed, the dent ratio remains stable or may even decline as the economy emerges for the slowdown. Serious debt issues from health care and social security are decades away and public finance, while possibly unwise is most definitely not a problem, as it is almost everywhere else.

- The widening current account associated with US growth leadership could become unfinancable, a story of more than a decade but sure to be correct one day. On the strict economics, leaving out geopolitics, the US remains the most dynamic and plausible investment location. Yet, investment returns have not been stellar recently and doubts about geopolitical success can undermine the capital inflows. If that happens, the dollar will decline. That boosts US competitiveness and growth, is unlikely to raise inflation and interest rates, creates growth problems abroad. But even for the US, a declining dollar, more so rapidly declining one, is unlikely to be an unmixed blessing. There are always spillovers to asset markets and prices that are not quite so benign.

So where is the good news to offset these concerns? The answer is continuing strong productivity growth-- even in a slowdown year, and of course no upturn in employment cost inflation.

Table 4 Employment Cost (4th qtr/4qtr) and Productivity Growth

	1997	1998	1999	2000	2001
Employment Cost	3.3	3.4	3.4	4.1	4.1
Productivity	2.0	2.6	2.3	3.3	1.9

The annual productivity growth number for 2001 might not inspire too much confidence except for two points: in the recession year 1991 it was only 1.2 percent. But more importantly, in the last quarter of 2001 productivity growth ran at an annual pace of 5.2 percent. Iff productivity growth at only half of this pace holds up, inflation is not an issue and even corporate earning growth looks brighter. Unfortunately, there are to *ff*s.

Productivity growth rates at a New Economy pace, while beneficial on the inflation front -- and hence holding the Fed at bay--, carry the risk that demand growth is not strong enough to hold unemployment down. In fact, unemployment risks slipping up and earnings growth might slow. Thus even this silver cloud has a dark lining.

What to expect from the Fed? In the 1992 recovery the Fed held rates constant at 3 percent for fully a year and a half. This was a "jobless recover" and with inflation a non-issue but banking problems, the Fed wisely let the recovery play out before moving to restraint. The present situation is much the same; little chance of an early overheating because neither wages nor employment will have much drive. And, while the banks are not in the firing line. Corporate paper and debt surely are. Without urgency for a rate hike, why would the Fed run the risk of aborting the recovery that is just emerging or put into freeze the fixed income markets? Greenspan has been there, he has seen it before and avoided the mistake. Moreover in time of war, the Fed never raises interest rates.

The Ugly Scenario: The Middle East conflict— Palestine-Israel now, Iraq to come – create serious risks for growth and for financial stability. In themselves they present quite open-ended risks to security in the world, consumers' willingness and ability to spend and hence for world growth. And the economic consequences of a growth slump make them that much worse.

It is useful to start with what will *not* happen. All the grandstanding notwithstanding, neither Iraq nor Iran will mount an effective oil embargo on the US. First, their heroism and commitment is far more limited than sacrificing essential oil sales that keep their run-down economy going. They easily recognize that what they do not sell, others will so that the embargo is ineffective and all that happens is that they will lose money. They are smarter than that but this will not stop them from grandstanding and moving oil prices a bit. To their audience, grandstanding is almost as good a proof of leadership as actually doing something.

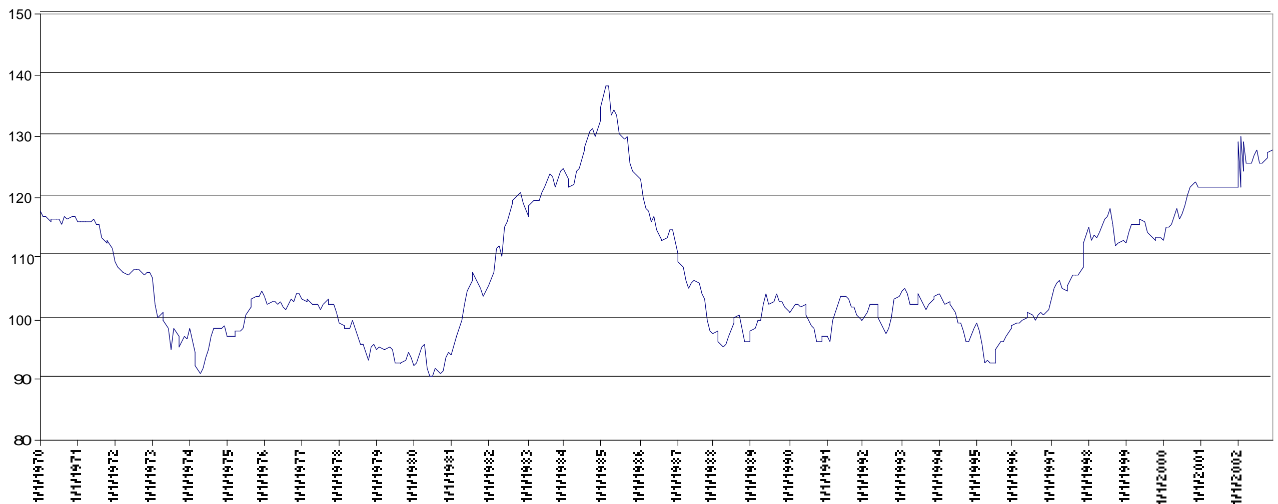
But the real risk to oil is, of course, active hostilities (or sabotage) taken close to oil installations. What matters here are pipelines, refineries, and oil ports – they influence the spot price because they govern the immediate availability of oil—and not oilfields. As we saw in the gulf war, the risk of damage to oil refineries raises the spot prices dramatically, $40 at the time, this time round surely more because the risks including sabotage are much more widespread. This would happen, almost surely, if and when the US takes on Iraq. In principle Saudi Arabia could offset the price rise by production hikes. But surely it is one thing for Saudi Arabia not to join an embargo, it's quite another to undercut oil politics by flooding the market in a pro-US move; Saudi Arabia is not stable enough to

get off the fence. Surely, using the US strategic oil reserve will dampen prices but when all is said and done oil prices will be up.

So how likely is it that this course of events comes anytime soon? It is clear that the US is committed: Iraq's leadership meets the 3 criteria set out by US policy thinkers as unacceptable: promoting regional instability, pursuing control of means of mass destruction, and suppression of its own people. Thus, Saddam Hussein will go, and it does not matter much whether Europe cooperates or not. The problem, of course just as in 1991, is the absence of a suitable government to fill the vacuum, be acceptable to the region and to the US. That issue and the unresolved Palestine-Israel debacle hold off action. But, and here is the point, that means oil prices will remain high and possibly quite a bit higher; there is simply no Middle East –wide peace in sight.

There are immediate implications running from high oil and the possibility, if not outright likelihood, of US ground troops in the Middle East. Consumers in the US, but also in Europe and Asia, will directly be hit by an oil shock. They will have less spending power for other things, demand will fall and growth will slow, just as during the Gulf War. This is more likely, the earlier the events unfold before even a recovery is fully underway. A slowdown of the US and world economy, in turn, is bad news for asset markets and it puts central banks in the awkward position to decide whether to accommodate by easier money or fight the inflation blip by tightening. And if tightening is the rule, *sayonara* to stocks. It is true that oil is far less important in the economy today than it was in the past, but an extra 10 dollars still makes for a huge shock and to say it won't last doesn't mean much until it's over.

US: REAL EFFECTIVE EXCHANGE RATE
(JPMORGAN INDEX 1990=100)



Suppose all this happens, what about the dollar? So far it is both true that the dollar is strong relative to Europe—not very strong, a rate of $1.20 for the Euro was never an equilibrium rate—but it was sustained by US relative growth performance and by the image of a US as the superstar. The superstar role is enforced by military prowess but it is seriously damaged by getting bogged down by worldwide disapproval, from greens, anti-globalizers and peaceniks around the world, European disenchantment to outright hatred of the youth throughout the Arab and Islamic world. With an economy that will not do decidedly better than Europe in this adverse scenario, and with an image issue that is easily widened to all things economic, the dollar is at risk. The only thing that might hold it is the sheer misperformance of Europe in every conceivable dimension. But suddenly the argument is stability rather than being cool and suddenly the US is no longer on top.

Of course, once the Us comes into question, the reasons for a decline become many: overvaluation close to 1985 levels (see chart), vast and seemingly unending current account deficits, poor and risky investment returns and more.

Euroland

While Europe has avoided much of the high-octane US excesses, on both sides, its growth performance has not been much better than in the US. True, the US has a lot of spare capacity, but in time that will go. By contrast, Europe has a lot of unemployment and that, most definitely, will not go. Little productivity growth, restrained investment, widening anti-market politics all give a negative outlook for supply side growth. And, without supply side growth and with unions riding the upswing, the Central Bank is never far away. Fiscal policy is gone. Most US market participants, including workers, would surely opt for the American model-- they have done well with it; most European's would do the opposite, they behold the status quo and have given their politicians strict marching orders not to rock the boat. There is harmony in all this, choices of a different model.

Table 5 Euroland Growth

	2002	2003
IMF	1.4	2.9
Consensus	1.3	2.8
Merrill	1.5	3.7
Goldman	1.2	2.4
Morgan Stanley	1.4	3.1
JPMorgan	1.3	3.1

The forecast of 3 percent growth or so-- Merrill is an exuberant outlier as it is in the US view-- may well be optimistic. First, it is strictly essential that the Us upturn happens; that is likely, that has not happened yet. Next, it is essential that the confidence-upturn-is-in-the-air atmosphere actually prevails so that domestic European spending gets on the roll. Again, that is likely, but it has not quite happened yet. Two ifs that might easily translate into just 2 percent and not quite 3. Of course, 2 percent means more budget trouble, more unemployment, and a story well known by now.

On the policy front, barring a dollar decline, not much can be expected. Oil will mean more inflation, as will the upswing. Difficult to see how the ECB can remain on the sidelines for a long time. This looks more and more like British stop-go of the old days, not an extended expansion much like a virtuous cycle with productivity growth, decentralization, innovation as the drivers. Europe's supply side has been taken prisoner and will serve a long sentence. Europe is rich, Europe is stable, it can easily afford to neglect the supply side without early signs of distress coming to haunt those in charge of misgovernment.

Does it make a difference that wins in the elections? Not in France, -- the right does not support market economics; in fact, the whole idea of a free market economy is anathema to the brightest minds in France and most surely to the right and left. The right might not be statist, but it certainly has an agenda far away from what the Anglo-Saxon world would view as a market economy.

In Germany, what would Stoiber as a winner do? With the Parliament dominated by teachers and bureaucrats, he would find out quickly that he is in much the same position as Koizumi. Reform is a non-no and a non-starter. He would turn to foreign policy or the like. And if Schroeder won, would Oscar Lafontaine have a come back? Probably not, but surely Schroeder has gone in that direction for a quite while and if that is necessary to win an election, why should he not go further?

Japan

As always, the year ahead outlook for Japan is favorable. US recovery and with it Asian recovery will bring the increase in demand that revives the economy. Much of the upturn is to come from a resumption of investment, government consumption, exports and a minor contribution from consumption. The budget deficit will stay upward of 8 percent.

It is immediately clear that if the US has an accident, or just a disappointment, the Japanese story falls to pieces. What are the chances of that? Surely upward of 30 percent. But, more optimistically, let the trade linkages play out and give Japan some growth in the US market, and second-hand, some Asian market expansion. Of course that will help, of course that will increase demand and stem the negative forces. But it is probably premature to expect very much of an investment upturn. Companies are still struggling to restructure, raise asset returns, and downsize jobs. There are now success stories, including of foreign participation. But the Tankan outlook does not support the view that

firms are on the verge of spending serious investment money. Hence skepticism remains appropriate. Growth, assuming a favorable Us scenario, is likely to be 1 percent, a lot more would be a surprise.

Table 6 Japan Growth

	2002	2003
Consensus	-1.1	1.0
IMF	-1.0	0.8
Daiwa	0.0	1.2
Nomura	-1.0	0.2
JPMorgan	-0.8	1.7
Morgan Stanley	-1.0	0.8
Merrill	-1.0	1.5
Goldman	-1.4	0.8

As always, it is helpful to look at long-term visions of what will happen in Japan. Here is the latest 25-year view of the Japan Economic Research Center (JERC), Japan's prestige economic think-tank. It involves a dramatic reform strategy as the cornerstone as well as a weak Yen.

Table 7 JERC Japan Scenario	
Population peak 2004	
Revival by 2004	
End of supply/demand gap: 2010	
Yen: 170	
Primary Surplus by 2011	
2010-2020	2.3% growth
2020s	1.5 % growth

All this might happen, but of course it won't come without reforms. And reforms in a fragile economy-- fragile on the side of consumers and of finance-- is a very risky strategy in a recession. Moreover, it has absolutely no support in the Diet as Koizumi found out very quickly. All that Japan has to offer is an extraordinary prowess in high tech. But it is far step from there to move out of the macro swamp and translate it into a driver for the economy at large.

There is no sign that Japanese policy makers, or indeed the overwhelming majority of the public, perceive an atmosphere of outright crisis. Never mind the credit downgrades as long as the US has Enron crises and Europe has ABB-- Japan might even look comfortable. Without a crisis, Japan will procrastinate, and if procrastinates visions for 2025 are a moving, harder to attain target.

The vision includes as part of the package a Yen at 170/$. Here is a delicate issue: the expectation of a significant Yen depreciation risks a flight from Japanese assets both by US investors who dominate movements in stocks, but also in the JGB market. This is, of course, very touchy. Expected depreciation and money getting footloose is just what is completely incompatible with stability and an ability to hang in for a long time, waiting for a better policy environment. The same risk flows, of course, from an overly generous monetization by the central bank. Setting off a currency rout is risky, pushing up the stock market, in a determined big way is a much better macro strategy to try and get out of the slump.

Emerging Markets

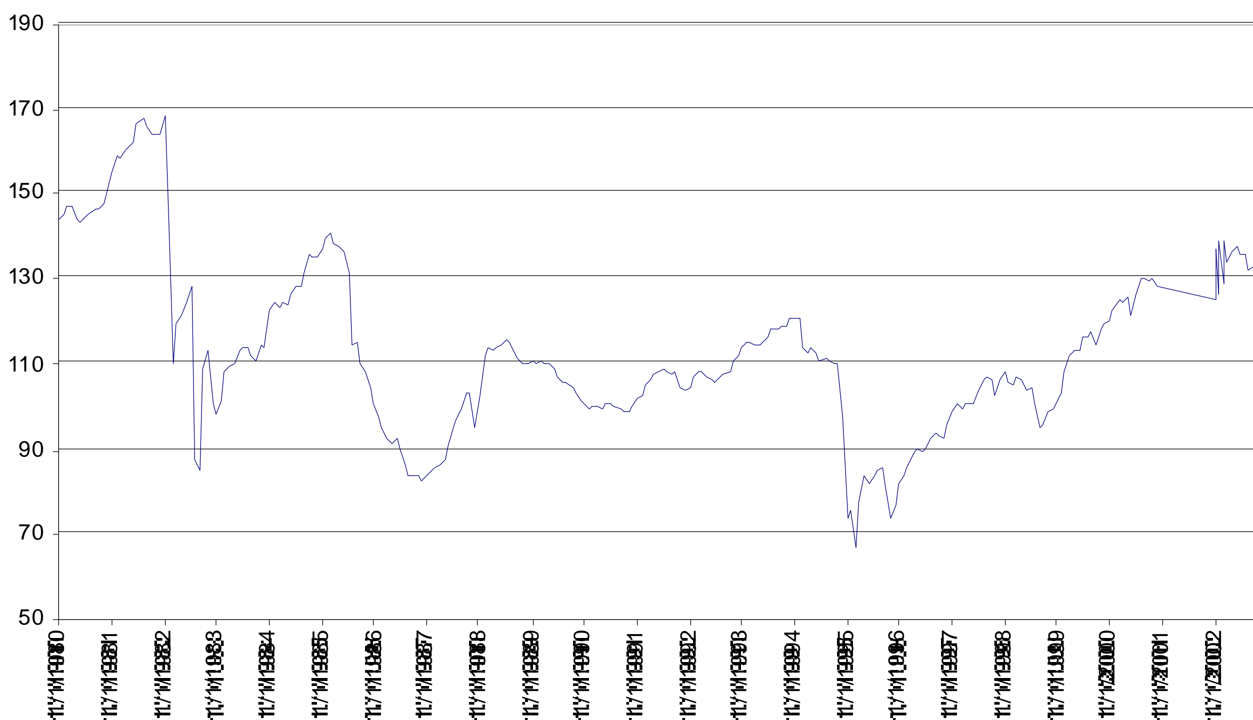
The IMF's outlook for emerging markets reflects the strengthening of the world economy but with lot of extra trimmings: oil is down, commodity prices will rise 7 percent, interest rates just rise 100 basis point, long real rates fall; imports by advanced economies expand at a rapid 6.6 percent, almost twice their growth rate. With all that good news, the periphery benefits from the normalization at the center. Everybody picks up-- the Asian export economies, the transition economies and even Latin America whose problems are more nearly self-inflicted.

Table 8 IMF Outlook for Emerging Economies

	2001	2002	2003
Newly Ind. Asian Countries	0.8	3.6	5.1
Developing Countries	4.0	4.3	5.5
Africa	3.7	3.4	4.2
Dev'g Asia	5.6	5.9	6.4
China	7.3	7.0	7.4
India	4.3	5.5	5.8
Asean-4	2.6	3.3	4.1
M.East & Turkey	2.1	3.3	4.5
Latin America	0.7	0.7	3.7
Brazil	1.5	2.5	3.5
Central and E.Europe	3.1	3.9	4.4
Russia	5.0	4.4	4.9

The developing world has a huge amount at stake, and at risk, in what regards the US economy. If the US does not have a very successful-low interest upturn, these growth hopes will not only fail to materialize but many economies will fall flat once again. Performance and credit ratings are not stellar and a bad world turnout will dry up not only trade but also capital. It helps to favor the economies that are more stable: China and Russia certainly.

But the Us recovery aside, there are also a bit of the usual problems notably in Latin America. Mexico's currency is once again crassly overvalued. The recession may have a lot to do with the US, but just how much. If the US upturn does not deliver some 3 percent growth in Mexico, the exchange rate will move to the center of the discussion.



The other trouble spot is Brazil. Suppose the winner in the election is not Serra-- the sober and sound manager ambitious enough to want a second term and hence immediately attentive to the fiscal issues that will greet him on day one? Another candidate, and they include quite extravagant possibilities of whom Lula might be one of the more sober ones, would be unlikely to have the stamina to do what Cardoso-Malan cautiously postponed beyond their term. That means a Brazilian domestic debt situation that might easily reach crisis level. Add to that the fact that Arminio Fraga, the brilliant central banker has been denied independence of the central bank. Surely he would resign rather than attempt to check the excesses of an untutored new President. The double shock could put Brazil back on the front page.

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ESSAYS

US: HERE WE GO AGAIN

After a year in the doldrums—not actually a recession, but a pretty bad slump—the US economy is once again off to the races. The first quarter may show an annualized growth rate of as much as 5 percent. Prospects for the coming year run as high as 3.5 percent. The notion of a house of cards ready to collapse, a bubble that must be paid for with tears has, once again, proven wrong. At this point it is useful to ask three questions: to what do we owe the strong and early turnaround, when will the Fed start raising rates, where are the big risks to this upturn in the US (and hence in the world)?

Every US business cycle is much the same and we have had already 10 of them in the postwar period: The Fed faced with an expansion gone too far raises rates – too late, too little often, though not this time. Demand quickly cools, inventories pile up, production is cut, and inflation cools off as unemployment rises. At this point monetary and fiscal policy come in to stimulate, inventories sell off and soon production resumes. That is the juncture we are at now. Timely and massive Fed rate cuts as well as fiscal stimulus from tax cuts and defense spending have put the economy back on the road, just as every other time. No big surprise here.

True, the consumer has shown great spending stamina but that is not surprising since they have good balance sheets and hence are good credit risks. True, too, that so far investment spending has not shown itself and remains low key in view of mega unused capacity. But even that will, in time, have its answer. The cost of capital is radically low as a result of the large Fed cuts and the Congress just added a very substantial 3-year incentive of accelerated depreciation, which amounts to a hard-to-resist incentive to invest *now*. Add to this defense spending, heavily oriented toward high-tech, which had been hard hit by the downturn, and we have a good story for the expansion ahead.

With a strong pace of expansion, all eyes turn on the Fed. Having cut rates last year to record low levels, seeing the payoff today, how long before the Fed starts tightening from current zero real interest rates? One view is that as early as June rates will rise. But that is a far-out prediction.

There are a number of reasons to believe that the Fed will take its time. First, to give a perspective, in the 1992 recovery the Fed held rates constant for almost a year and a half. That should set the pattern for this time round. Just as then, the recovery is very likely to be “jobless”- productivity growth is high and that means unemployment will not fall below 5 percent in the coming year; indeed, it may not fall at all. In addition, of course, unemployment, productivity growth and large excess capacity together with a weak world economy keep off any significant rebound of inflation. Lastly, the Fed must be concerned about the fragile commercial paper market where the fall-out of unexpected

risk developments—Enron and more—lead to large spreads and even rationing. One more reason to keep rates stable so that the market can find a stable footing. All this is to say that the Fed is not in a rush, that it is unlikely to extrapolate the current high growth and that rates will stay largely flat for the remainder of the year. There is no risk at this point that the Fed uis behind the curve, feeding a boom; on the contrary, we are just escaping from an economy where a lack of profits offered a dismal recovery picture.

The central scenario for the US economy is benign-- and, indeed, enviable compared to Europe and Japan—growth at the pace of potential output, stable finance, growing out of excess capacity and a continuation of the New Economy productivity bonuses. But there are risks, too.

The dominant risk is geopolitical. US involvement with ground troops in the Middle East would, no doubt, be quickly seen as Vietnam all over again. And that would mean a fall in consumer confidence undermining the expansion. In fact, even Afghanistan starts looking like that as more and more troops are on the ground and digging their way through caves. War aims are unclear, progress is open-ended, and a rapid return to a post-terrorism normality is elusive if not an outright illusion. But if this is the central risk, surely the Administration must be aware and avoid that outcome with great effort. Not so easy! Europe's failure to help in pushing for aggressive inspection in Iraq leaves with few options. Giving up on limiting Sadam Hussein is unacceptable more so as terrorism and Middle East instability has the upper hand. Perhaps the Barak-Saudi peace plan and a bit more European maturity on cooperating with the US can come to rescue the situation. But we can't take that for granted, Of course, Europe would do well to remember that if the US stumbles, so will the world, including the European economies.

THE CURRENCY QUANDARY

Two exchange rate views exist, an overvalued dollar that ultimately must and a Yen that needs a deep depreciation. The implication of the two is an upward explosion of the Euro. Could Europe deal with such a shock? And how would the US look in such a scenario?

Now that the US recovery is turning up, from a slump *not* a recession, the current account deficit will widen even further and in no time the discussion of the unsustainable dollar will become fashionable once again. Yet, the very fact of a US upswing, bigger, sooner, better than anywhere else—Europe has growth cramps and policy-kabuki in Japan is going nowhere—surely supports and even strengthens the dollar. All those who have predicted the collapse of the "house of cards" must surely be getting tired. There is no dollar fall around the corner, and even less a collapse. Financial stability, strong productivity performance, flexibility and dynamism make the US one of the choice places for capital and that looks after the financing of the large current account deficits. And it will continue doing so until, at the end of the rainbow, Japan or Europe compare favorably with the US investment climate. Don't hold your breath for that day, don't wait for the $1.20 per Euro that is touted as the "equilibrium" rate.

The dollar issue is not the only one. There is another strongly held belief—which Japan cannot recover without a steep decline of the Yen. For those who hold this view, the Yen would have to decline to160 or even 200 Yen/$. Without monetary policy, fiscal policy or supply side reforms, how else can Japan return to growth except by a depreciation-driven export boom? And, because the export sector is so small, barely 10 percent of GDP, the depreciation would have to be so large.

Suppose we put the two propositions together, the yen depreciates say 30 percent the dollar while the dollar in turn depreciates 30 percent on the euro. These numbers are large but they are in everyday discussion. The implication, of course, is a huge appreciation euro in terms of everybody else. Japan might get some growth lift though not even a full percentage point of GDP. For the US the story is mostly neutral, -- a gain in competitiveness toward Europe, a loss relative to Japan—with no net gain in or loss in competitiveness or trade, no inflation effects to speak off, no interest rate hikes or stock declines, nothing to get excited about.

Of course that is not the story of Europe where there is a huge Yen depreciation and a very sizeable dollar decline on top. European competitiveness is knocked hard and quite a bit of growth is lost within a year. In fact, empirical models that try to quantify the impact of exchange rate changes suggest that without an aggressive monetary policy response, a say 40 percent Euro appreciation would cost upward of 2.5 percent growth. This number is not at all surprising if we remember that growth in the past few years was substantially due to the Euro weakening; this time round, the Euro strengthening would take it all back. Even as European growth would turn down, sharply lower import prices would also bring down inflation. That opens the door for a dampening of the damage if the ECB vigorously responds by cutting rates. "Vigorous' is not a word one would use in describing the ECB and hence there is a serious problem. There is a clear message here: Europe must hope that the dollar remains strong because, without domestic dynamism, the cheap euro is its only growth ticket; payback of the Euro depreciation of the past years would be very costly. In countries like Germany that are on the ropes of Maastricht, a continuation of stagnation or outright recession would, more deeply strain budgets and credibility. But don't worry, it is just not going to happen.

The big Euro appreciation is nowhere in the cards. European lead countries like Germany are a fiscal embarrassment and the no to reform, indeed the hostility to capital, leaves an impression of *eurosclerosis* in a way that simply will not attract capital. The Euro was a great idea, but what backs it is an economy that is distinctly dull; no way that this will become the magnet for world capital flows anytime soon. The Euro will stay around 90 and may not even pay a weekend visit to $1/euro. There won't be much European growth even so, but at least no outright growth crisis. Europe will keep talking about the American house of cards but increasingly with a sense of nostalgia that maybe this flexible dynamic economy has a trick that the ageing Europe can't get itself to perform.

Suppose all this is wrong, suppose suddenly the US cannot attract capital anymore. Nobody shows up at the Treasury auction to buy US bonds, nobody is buying stocks or companies and real estate. What would happen? Of course the dollar would be down in

no time, and substantially – enough to shrink the deficits or bring in capital to take advantage of a now undervalued dollar. But there is very little pain in that—inflation won't rise, stocks won't fall, manufactures would cheer. Because the US has low inflation and is financially stable, the exchange rate is not a risk factor quite unlike in the late 1970s. The situation is well-characterized by a line from John Connolly, treasury Secretary for Nixon, "*the dollar is our money and their problem*!"

Argentina: A Rescue Plan That Works [1]

Argentina is waiting for the next bailout, yet another a shipment from the IMF that won't help resolve the myriad unresolved issues in economics, politics and the social area. Of course, everybody knows that this is not the answer but it is easier than taking the unconventional path of radical reform. The truth is that Argentina is bankrupt, bankrupt economically, politically and socially. Its institutions are dysfunctional, its government disreputable, its social cohesion collapsed. Having fallen that deep, it comes as no surprise that reconstruction rather than quick-fix financial support has to be the answer. Argentina today is like the European economies in the early 1920s, not a country with a liquidity issue that needs a tough year and is back on its feet like say Korea, Mexico or Brazil.

It is time to get radical. Any plausible reconstruction program must be built around three points:

- The recognition that this will be an effort of a decade, not of a few years. Argentina's productive economy, its credit and its institutions have been destroyed. Both its physical and moral capital will have to be built up and that takes a very long time.
- Because Argentine polity has become overburdened, it must temporarily surrender its sovereignty on all financial issues. Financial soundness is the key area where a beachhead of stability must be created to even start thinking about sound public finance, saving and investment.
- The rest of the world should provide financial support to Argentina. But it must do so only upon Argentina's acceptance of radical reform and foreign hands-on control and supervision of fiscal spending, money printing and tax administration. Any external loan is to bridge the gap between immediate fiscal needs and the day, a year or two down the road, where radical reform creates sustainable finance.

Argentina today is bankrupt and slipping further. On the current course of events, money printing will cover up unresolved claims only so long. Before the resulting financial and public chaos further destroy the bases for a reconstruction. A wasteful distributional battle is taking place, a battle between workers and the wealthy; between those who are trapped by the bank closure and those who have their money in Miami; between provinces and Buenos Aires, between unions and businesses, between foreign investors

[1] With Ricardo Caballero.

or creditors and a nation that wants to shed obligations in a vain effort to maintain some normalcy. Argentina is being cannibalized by this strife. Further IMF money without a deeply intrusive change of the rules won't prevent self-destruction.

Argentineans must humbly acknowledge that without massive external support and intrusion they can't get out of the mess. What kind of external support? It goes well beyond funding. At the heart of Argentina's problems is a crisis of trust as a society and confidence in the future of the economy. No one group is willing to concede the power to resolve the claims and fix the country to any other local group. Somebody has to run the country with a tight grip; dictatorship is neither likely nor desirable. But since everybody thinks ---often correctly --- that everybody else is selfish and corrupt, there is no social pact that can be reached. Without this social pact, day-to-day cannibalization of social and economic capital will continue. Ever more gruesome outcomes are on the horizon.

Argentina now must give up much of its monetary, fiscal, regulatory and asset management sovereignty for an extended period, say five years. After World War I, the League of Nations recognized the fundamental problem of a dysfunctional society in Austria. It resolved that issue, along with financial support, by having—with the consent of parliament-- a resident Commissioner General, appointed by and responsible to The League of Nations. The CG had to sign off on every spending bill, supervise the central bank and monitor reform. Here is the tough language of the League report. "*But the successful accomplishment of the reform program, on which Austria's prosperity and the value of her assets depend, would necessarily be a difficult and painful task. The scheme therefore included the appointment of a Commissioner General, whose duty was to ensure, in collaboration with the Austrian government, that the program of reforms was carried out and to supervise its execution. He would derive power from his control of the disposal of the loan.*"

It worked! And here is what Argentina must accept to do in exchange for new loans. Commissioners should come from distant, disinterested small countries (Finland, the Netherlands, Ireland for example) where people have understood that economic institutions safeguard stability and are the foundation of prosperity.

Specifically, a board of experienced foreign central bankers should take control of Argentina's monetary policy. This solution would have many of the reputation-virtues of a currency board, without the costs of having to adopt a monetary policy tailored to somebody else's needs. The new pesos should not be printed in Argentina's soil.

Another foreign agent is needed to verify fiscal performance and sign the checks from the nation to the provinces. Much of the fiscal problem has to do with fiscal federalism in designing and enforcing a sharing of responsibilities and resources in a way that is financially affordable. Tax evasion and corruption—and the government's acceptance of this state of affairs-- has to be suppressed in the most radical fashion. Foreign micromanagement is not feasible but agreed incentive mechanisms and a sharing of experience are. Argentina is not the first country to experience tax collection issues, effective answers are available and must be imposed. A reformed, more professional civil

service will be particularly helpful. Involvement of the provinces in the effort – with a lower basic co-participation share to 30% or so, but steep incentives for local tax collection and revenue improvements are part of the answer. Proportional is not enough – perhaps go as high as giving the provinces more than a peso for each extra peso of revenue above certain threshold. Also, because tax enforcement benefits from a simple tax structure, there is no space for a cumbersome tax code. It must be simplified to the bare basics --- flat, flat, flat.

Argentina's economy has been run down; it now needs an immediate productivity boost, pending a resumption of long neglected investment, and an eradication of corruption as a way of life. The incentive mechanism in the new tax-code should help controlling corruption at the province-level. Workers must become equity holders, enter into profit sharing agreements. Aside from the flexibility advantages of such system, it adds an extra layer of profit monitoring and of tax-evasion control to the system.

A massive privatization campaign of ports, customs, and other key obstacles to productivity must now take place. Deregulation of the wholesale and distribution sectors is essential. Another experienced foreign agent should control these processes, as well as make sure that the proceeds end up somewhere safe for all present and future Argentineans to share.

With the commitment to a clear and radical plan, Argentina would suddenly offer a fresh and encouraging new look. An awfully dark short run scenario would suddenly have a reasonable chance of a successful ending. As the foreign monetary board is setup, move quickly ---yesterday--- to a new *temporary* convertibility plan, say two pesos on the dollar just because it is the next simple number after one-on-one. Release the frozen bank deposits (the "corralito") and let the IMF and other IFIs decide which banks to support and how-- it is their money after all. Foreign capital is quick to change its mind; there can be hope again, but that won't happen without fundamental change rather than more unkept promises.

It is worth recording what the League said on the eve of the Austria program: "*At the best, the conditions of life in Austria must be worse next year, when she is painfully reestablishing her position, than last year when she was devoting loans intended for that purpose to current consumption. The alternative is not between continuing the conditions of life of last year or improving them. It is between enduring a period of perhaps greater hardship .. (but with the prospect of real improvement thereafter—the happier alternative) or collapsing into a chaos of destitution and starvation to which there is no modern analogy outside Russia. There is no hope for Austria unless she is prepared to endure and support an authority which must enforce reforms entailing harder conditions than those at present prevailing…*" Let there be no doubt, this is the situation of Argentina today; let there be no doubt, IMF money as usual would be a dramatic error.

THREE CHEERS FOR MARTIN EBNER

The investor's world is in turmoil; serious issues of corporate governance have gotten an overlay of soap opera only rivaled by Monica Levinsky's time on the stage. This is not just a question of a good set of accounting rules; it is much more a question of recognizing conflicts of interest and a good answer to the resulting problem for investors/ Surely there are lessons from and responses to the unsatisfactory experience of stockholders. Reforms of corporate governance -- tighter rules for boards, accountants, managers, more transparency and better reporting all are around the corner. But we fool ourselves in believing that this is the full answer. Its just like buying a used car; the salesman is charming and the deal is made to look great, But there is no substitute for us ourselves, or a good friend who is on our side, to kick the tires. The system is rigged with conflicts of interest for accounting firms and boards that ultimately give the investor less than a level playing field. There is a need for greedy, aggressive large investors.

Capitalism cannot function without owners, people who aggressively and effectively assert their property rights and cut through the myriad of conflicts of interest that create a gray area between management's prerogatives and stock holders' interests. Often the focus is on protecting the interests of small investors. Interestingly, the best friend small investors have is an aggressive corporate raider. Three cheers to the Martin Ebners of this world. They are a pain in the neck for management; they are a blessing for all owners.

We know that the corporate structure is useful because it taps and pools a large number of investors' savings to bring them together in a significantly scale of the enterprise. It is also clear that theory can't all every day sit around and debate corporate strategy, compensation and the whole range of decisions that come up. Some mechanism must be found to strike a balance between delegation of responsibilities and safe guard of investors' interests. Our institutions for this task are accounting firms and security regulatory commissions with their supervision and insistence on transparency. And there are corporate boards, including outside directors, as a check on management and a safeguard of investors' interests.

Unfortunately and problematically, the interests of management and of owners are not fully aligned; yes they are on common ground in wanting great performance. But when it comes to sharing the pie—management pay and perks—the disagreements start. And there is more; management wants the form to get bigger, owners may prefer dividends and put their money into other ventures. Along comes the bright idea to have boards with outside directors that protect the investor interest and with it comes the next conflict of interest. Board members are paid well and they have no interest in losing the fees, the prestige, and the club membership. Except in extremis (and even then as we know from Warnaco or Enron and a few more) they are not going to be rebel rousers but rubber stamps; if they are already on the board they can only benefit just ass management from everything getting bigger. If the board memberships reflect cross holdings the back scratching goes all the way.

Boards to a first approximation are a waste of investors' money; they create an expensive illusion of an effective representation of investor interests. They are anything but. And even if investors could sue the directors for not doing their job, out comes directors insurance and the stockholders lose even more by paying the insurance premia for the malfunctioning board. And accounting firms that are there to give is arm's length reports on the state of earnings and balance sheets have a divided loyalty. Their renewal of lucrative business encourages them to take an as aggressively benign view of sharp practices as is barely within the law and on occasion not even that.

Ebner is no Robin Hood; he believes in capitalism being more effective the more sharply it is focused on the interest of owners. He is simply obsessed, yes obsessed, with the simple principle that stock holders are entitled to insist on good performance and to have a say in getting it. He shook up sleepy Swiss banks by forcing mergers and the ouster of clubby Swiss army managers; he discovered persistently poor returns in corporations and shook up management, and he sniffed out obscene perks and under the table diamond parachutes at ABB. If he is so unpopular with managers it's because he is looking hard over their shoulders to demand performance for pay. Europe would do well with more Ebners. It won't solve all problems, but it will greatly increase the return to stock holders and reduce the present plundering of the pot and the acceptance of poor management results.

ESCOLA DO BRASIL

The idea of doing away with the *Banco do Brasil* is among the reform projects that are always on the table and never actually implemented. Once in government, a president finds the extra purse and outlet for patronage just too helpful, and he surely finds the resistance very powerful. The Banco do Brasil is everywhere, from 5th Ave in NY to the tiniest village of Brazil. It is staffed by an elite corps that has passed stiff competitive exams; it has tradition and size on its side. Yet, it is totally obvious that it is redundant, that it uses scarce resources, not in the least its staff, that could be useful deployed elsewhere. So why not bite the bullet? Will Ms. Roseana Sarney with her Collor-style be the one to do it, or Jose Serra who is the capable manager, or might it just be a welcome parting gift of President Cardoso?

The immediate argument against abolishing the Banco do Brasil is, of course, that it serves places of Brazil where no other bank finds it profitable to be -- an argument often made for the public administration of mail or transport. Of course, subsidies for private banks could easily make up the difference and surely it does not take a full-fledged parallel banking system. But it does not even take subsidies, imagination and technology point in another direction.

The experience in Mexico has shown that gas stations function perfect well both to receive deposits and handle disbursements simply because they are in the cash business. And this is handled privately and is an all-out success. In Peru, similarly, remote areas are served by ATM machines that handle deposits and withdrawals with scheduled visits by

the helicopter to keep up a fully functioning service. Hence, in a country that certainly has a better scope than Peru to handle the issue, service to remote areas is just gone as a sensible argument. Surely, if anything, the government would be better off to place a nurse than a banker in these places. Outside the remote areas there is, of course, even less of an issue in supplying effective banking services.

The chief remaining issue then is what to do with a complete organization -- at the least, leaving out the political pain; there is the sheer cost of terminating all the skilled staff. One intriguing answer might be not to terminate the organization but rather, to use the jargon of the day, to "reinvent" it. Why not ask how the organization and Brazil's elite corps could be used to so something else. In Argentina this happened in the course of privatizing the post office. Mail workers became tourist agents or insurance clerks on the same premises. With this in mind, the two striking features of the Banco do Brasil are on one hand locations everywhere and secondly a highly skilled -- literate and numerate, exam-approved staff). Would it not be natural to change the sign over the door and call all these offices *Escola do Brasil.* Employees could choose to become teachers, the branch manager would become the principal. They would keep their high pay and favorable employment contracts. Instead of standing behind the counter they would stand in front of the class. They would teach the very skills that they have been tested on, reading and writing, adding and subtracting and they would do so with discipline and excellence. And, of course, the big lobby of the bank makes for an ideal classroom.

Overnight, the country would have gotten rid of an albatross and put a very precious organization to a valuable national purpose. Brazil would be a leader in innovative restructuring of government, in giving education priority over patronage and inertia. And while we are at it, why not use one of the spare offices for a nurse. In remote locations, that takes care of a large part of preventive medicine

The natural response to such a scheme is to call it utopia, unrealistic and top rule it out as just too far out. Of course, that is a mode of thinking that is no longer accepted in a world where governments are held accountable for social performance, where their creativity in effecting change is watched by the day around the world. Brazil has done well distancing itself from the Argentine crash and, in succeeding, has stopped worldwide contagion. That was nothing short of an accomplishment. But Brazil is long on financial accomplishments and short on social progress. That issue is more dramatic given Brazil's extremely poor income distribution. Why not pick a project that overnight makes a dramatic contribution to social growth?

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APPENDIX: FORECASTS AND DATA

Table A-1 Inflation and Growth						
	Growth			***Inflation***		
	2001	2002	2003	2001	2002	2003
US	1.1	2.5	3.5	2.9	1.4	2.2
Japan	-0.5	-1.0	1.1	-0.7	-0.8	-0.5
Euroland	1.5	1.3	2.8	2.6	1.7	1.7
					1.4	
Germany	0.7	0.9	2.5	2.4	1.4	1.4
France	2.1	1.5	2.9	1.7	1.9	1.5
Italy	1.8	1.3	2.9	2.5	2.1	1.9
UK	2.4	1.9	2.9	1.9	2.3	2.5
Spain	2.6	2.0	3.2	3.6	1.3	2.4
Canada	1.4	2.3	3.5	2.6		2.1
Source: *Economist* Consensus Forecast						

Table A-2 Stock Market Capitalization (% of GDP, Source Bank of England)					
	France	Germany	Italy	US	UK
1991	28.1	20.2	12.7	68.5	89.9
2000	110.5	58.4	70.8	154.1	185.6