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***LOOKING FORWARD IN WARTIME  
SOME VULNERABLE POINTS IN THE GLOBAL ECONOMY***

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**INTRODUCTION**

The purpose of this paper is to address several key economic issues facing the United States and the world at a time when war and terrorism-related activities may potentially further stress the global economy. In some ways the global economy today resembles a large truck racing down the highway at 70 miles an hour, with four or five bald tires. The odds are that the truck will make it to its destination intact. But a major accident is also possible. This paper explores some of those vulnerabilities and is based on recent conversations with political and financial leaders on five continents. Such confidential conversations are necessary in today's global economy, because what happens in one part of the globe often has major consequences, sometimes quite unexpected, in other parts of the globe. For example, a ruble crisis in Moscow seven years ago triggered a melt down of derivative positions on Wall Street that posed a threat to the U.S. financial system itself. That is just one example of the global interconnectedness of everything.

The consequences of the collapse of large segments of global equity markets in 2001 continue to plague the global economy. The vast monetary and fiscal stimuli needed to re float the U.S. economy may have led to new forms of asset inflation, a bubble in real estate and very probably also in bond markets, and not just in the United States. Vast global economic imbalances have also developed, partly as a consequence of this titanic U.S. macro economic stimulus.

These imbalances and other current global economic conditions remind us of several enduring economic lessons, with powerful future implications. Wise leadership and much good luck may be required to achieve a soft landing and a gradual shift in global trading patterns later in this decade.

**EQUITY MARKETS**

**How the Stock Market Bubble Grew and Burst**

The bursting of the U.S. stock market bubble erased at one point somewhere between 8 and 9 trillion dollars of wealth. When you add to this the immense sums that were lost in

overseas equity markets during the same period, the magnitude of liquidity destruction was simply enormous.

Students of history will remember the famous cartoon by Thomas Nast about the corrupt Tweed Ring in New York in the late 19<sup>th</sup> century. The title of the cartoon was: "Who stole the people's money?" It featured a group of well-fed men standing in a circle, each man pointing his finger at the next person in the circle.

A similar cartoon could be drawn about the great asset bubble and bust of the late 1990s. The former head of the Securities and Exchange Commission points to Congress for failure to heed his warnings. Congress points to some dishonest people on Wall Street for having misled investors. Wall Street analysts point to the Federal Reserve complaisance. The Federal Reserve points to the irrationally exuberant investors and greedy corporate leaders. The greedy corporate leaders point to their auditors. The auditors point to permitted complexities in derivative and accounting rules. And so on around the circle of blame.

The fact of the matter is the blame is widely shared. There was a massive systems failure here and a massive loss of wealth when the bubble burst, particularly for the least sophisticated members of the investment community, including the elderly, many of whom were left holding the bag. The leadership of the Federal Reserve has come in for special criticism because the Federal Reserve is, after all, the ultimate regulator of the health of the nation's financial system, and controls margin requirements and the amount of liquidity made available to the system.

The equity bubble was fuelled in part by accommodative monetary policies in the latter part of the 1990s. Indeed the world was awash in liquidity during most of the bubble years. Attractive investment opportunities grew harder and harder to find. Traditional value analysts of stocks were increasingly discredited, as market momentum confounded one after another of their bearish predictions. Available cash continued to flow into already overpriced stocks, and also into over-investment in capacity for the production of goods and services. Telecoms were a prominent example.

People running U.S. monetary policies were obviously highly competent and experienced individuals. A question now often raised is why monetary authorities did not heed the timely warnings that appeared regularly in the *Economist Magazine* and other respected publications, and tighten liquidity, or at the very least, increase margin requirements as a warning signal to dampen the raging speculative fever.

We also know from subsequently released minutes of the 1996 deliberations of the Board of Governors of the Federal Reserve, that some of the Governors, including Larry Lindsey and Chairman Greenspan himself, appeared concerned about the potential for a future catastrophic asset inflation bubble, as happened in Japan during the late 1980s.

These troubled deliberations inside the FED occurred shortly before Chairman Greenspan made his famous "Irrational Exuberance" comment at the American Enterprise Institute.

According to remarks by former Governor Kelly at a conference at CSIS in the summer of 2004, Kelly in retrospect greatly regretted the fact that, after 1996, the subject of a potential asset inflation building in U.S. equity markets never again appeared on the agenda of a single meeting of the open market committee of the Fed. One wonders why this lapse occurred.

Experienced financial leaders, such as former New York Federal Reserve official, Henry Kaufmann, later faulted U.S. monetary authorities for failure to take preemptive action

to slow the developing asset inflation. They questioned why Chairman Greenspan did not use his bully pulpit to repeat his warnings about irrational exuberance.

Friends of Chairman Greenspan reply that, as in the Japanese asset bubble of the 1980s, low consumer price inflation might have made it difficult for him to justify to Wall Street and their friends in Congress the sustained increases in interest rates that would have been necessary to deflate the bubble when it was much smaller. Some critics would doubtless have accused him of gratuitously damaging capital markets. Yet this was the very policy advocated by the I.M.F., the *Economist Magazine* and others.

Several other developments that took place in the latter part of the 1990s also made it difficult to use a tight money policy to dampen the U.S. economy and financial markets. In the latter part of 1997, the Asian financial crisis unfolded with a vengeance. With the strong encouragement of the U.S. Treasury Department, monetary authorities poured high-powered liquidity into U.S. financial markets to cushion the blow from Asia. Interest rates were cut by 75 basis points the following year.

The Russian ruble and banking crisis subsequently triggered a series of worldwide repercussions that eventually undermined the highly leveraged derivative investments of a number of New York hedge funds, including the respected Long Term Capital Management firm. This particular hedge fund had leveraged few billion dollars worth of capital into over a trillion dollars worth of notional value on derivative markets. Creditors to these derivative speculators from the money center banks were also sucked into the threatening vortex, which briefly imperiled the U.S. financial system itself.

Finally, stating worries about the potential impact of the Year 2000 computer glitch, the U.S. central bank preemptively injected large amounts of liquidity into financial institutions in the fourth quarter of 1999, delaying the impact of a tightening cycle that began in July of 1999.

Chairman Greenspan later said that market warnings unaccompanied by large and sustained curbs on available liquidity would have had no more impact on raging bull markets than his original "irrational exuberance" speech.

In 2000 the Federal Reserve System resumed tightening and the enormous bubble eventually burst after the Presidential elections amidst widespread recriminations. There is some talk now about the possible desirability of limits of two terms for future incumbents of the Chairmanship of the Federal Reserve, the nation's second most powerful job. The advantage of a Chairman with four successive terms is that the incumbent accumulates valuable experience from past successes and mistakes as his tenure in office rolls on. The disadvantage is that any deep-seated biases and blind spots on the part of a powerful and influential chairman inevitably become increasingly imbedded in personnel appointments throughout the institution. The temptation potentially also may exist for a Chairman wishing successive reappointments to get too close to political authorities in a position to reappoint him. Some years from now, economists will have a clearer idea of the balance of benefits of a very long serving chairman, when they will be able to assess with the clarity of hindsight the full impact of the Greenspan legacy.

### **The Bubble's Consequences and Aftershocks**

The vast loss of wealth and purchasing power that accompanied the erasure of stock values, plus the excess capacity that easy money made possible, contributed to a threatened

imbalance between supply and demand in some key markets. Profits further weakened and the new concern became deflation and recession.

To help stimulate demand and off-set the massive loss of wealth from the collapse of the stock market, the Federal Reserve reversed itself in 2001 and progressively lowered interest rates, in part to stimulate the housing market and the borrowing power and net wealth of homeowners and consumers. Many believe that a new bubble in housing and real estate has thus been created. The question is if, how much, and how soon will overall property markets weaken?

In considering these questions, it is important to remember that while mortgage interest rates in recent years were at historically low levels, rising insurance rates, local taxes and energy bills in the United States and elsewhere have steadily added to the cost of real estate ownership. It is also important to remember that current low interest rates will not last indefinitely. Indeed, a rising cycle of interest rates is already underway. Rising commodity and producer prices and other indicators suggest possible future inflationary pressures in sectors of the U.S. economy. Should broad inflation return and interest rates rise beyond the levels that many now anticipate, large-scale holders of fixed rate mortgages and their derivatives will be vulnerable. Fanny Mae, Freddy Mac and those who hold the riskier paper hived off in massive derivative transactions are sometimes cited as weak links in such scenarios. This potential vulnerability has belatedly become apparent to U.S. regulatory authorities, some of whom are now calling for an 80% reduction in the trillion and a half dollar mortgage asset holdings of Fanny Mae and Freddy Mac.

In England, where housing costs rose 25 percent in a single recent year, history suggests a possible repeat of the housing bubble that was created and burst during the tenure of former Chancellor Nigel Lawson. This bubble, before collapse, triggered inflation and required draconian monetary retrenchment. This in turn contributed to the sour political climate that ended Margaret Thatcher's historic prime ministership, and helped leave the Conservative Party in shambles from which it has not yet recovered ten years later. Recently the latest boom in English property markets was noted with concern by the IMF, and is now the subject of close attention by the Bank of England.

The behavior of bond markets is also a troubling phenomenon. Short and long-term yields show remarkable little differentiation, by comparison with historical standards. The same can be said for the collapse in spreads between government and corporate bonds. Markets seem to have forgotten the recent default of Argentina on its 100 billion dollar bond portfolio, and the fact that during the next serious downward move in the global business cycle, other democratically elected leaders in emerging markets will face constituent pressures to use President Kirchner's 70% write off as the standard against which to negotiate with their own bond holders. But the problems go well beyond emerging markets. What are the prospects that Japan's titanic quantity of 1% bonds will be an attractive proposition five years from now? The same can be said for other bonds, including the remarkably low spread on France's recent 50 year bond offering. Those bringing the bonds to market will pocket their commissions. Whether the long-term bond-holders will be as fortunate, is a very large question. Earlier relatively low consumer inflation meant that central banks in many countries, including the U.S., Japan, and England, had the opportunity to generate a vast amount of liquidity, big piles of which have wound up in asset markets of all kinds. The question remains about the medium and long term sustainability of these bond and other asset prices, leading to a further question about a possibly painful hang over after the party ends

In property, bond, and equity markets, as in much else, a great deal obviously depends upon the future trajectory of the U.S. business cycle. Massive fiscal and monetary stimulus has been applied in the past several years, a need anticipated by President Bush's economic advisors as he came into office. This enormous economic stimulus has, however, also contributed to a massive increase in the U.S. current account deficit and a dramatic weakening in the U.S. dollar. No one should be surprised at this latter development. The oldest rule in economics, following the law of supply and demand, is that the surest way to weaken a currency is to print too much of it. Today's dollar buys half the house, a fraction of the college costs and medical attention, and far less gasoline than it could have purchased a decade ago. As the dollar weakens on international markets, its purchasing power in other areas is also likely to erode with time.

Members of the Austrian monetary school take a grimmer view of the long-term consequences of the generous monetary policies of recent years. They believe that the subsidized interest rates, repeated bail-outs, and asset inflations they have financed since 1997 will only postpone a far larger future economic and financial crisis. The Austrian school favors a cautious monetary policy and a prevention of asset inflation, rather than the bailout model now favored by the Fed and supported by Wall Street.

Because of a lack of information, most outside observers are not yet ready to offer a definitive judgment on this dispute between the Austrian school and Greenspan policy preferences. We may all know the answer to this very large question, however, within five years, unless the tipping point trigger which sets off any future large scale crisis is in itself so dramatic that it obscures the true role of any past underlying monetary policy mistakes and vulnerabilities.

## **U.S. VULNERABILITIES**

### **Future Prospects—A Global Tour**

Should the Iraq war end soon, not spread to other neighboring countries such as Iran and Turkey, and terrorism problems remain manageable, prospects for continued growth in the American economy in 2005 appear positive at present.

A gradually weakening dollar, although a potential source of sectoral inflation and higher U.S. capital costs, should also eventually encourage more investment in manufacturing and in the production of other tradable goods in the United States. However, any rapid fall in the dollar would create many problems both domestically and abroad. Export dependent economies would face recession and financial dislocations, and the U.S. would experience both sectoral inflation and increase in the cost of capital, which would also impact housing markets and consumers here.

Should the conflict and follow up with Iraq prove longer and more expensive than anticipated, should terrorists strike key economic targets in the U.S., or sabotage impact oil shipping and production facilities beyond those damaged in Iraq itself, U.S. and global economic recovery could be derailed for a period depending on the severity and duration of the disruptions.

In 1990, the first Bush Administration delayed release of oil from the stockpile until the very eve of the Gulf war. This decision, plus the firing of the Kuwaiti oil fields and the embargo against Iraq's oil, led to an increase in oil prices and inflation in the United States and

elsewhere. At present oil markets are already tight. Should the conflict with Iraq spread to neighboring oil-producing economies, directly or indirectly through terrorism or civil unrest, the oil shortage scenario of 1990 could easily be repeated on a larger scale. Because oil prices are already very high, the impact of any further tightening of oil markets could be quite dramatic.

Other vulnerabilities in the global economy also exist.

### **Japan's Malaise**

Vast fiscal efforts to prime the pump and delay painful restructuring of the Japanese economy in the aftermath of the collapse of the Japanese asset bubble in 1990 have contributed to a massive public debt. The OECD estimates that this debt equals at present 169 percent of Japan's entire gross national product, the largest by far of any member of the industrialized world. Other well informed observers believe that Japan's actual public debt and contingent liabilities are far higher than even the OECD estimates. Japan is able to service a debt of this magnitude only because interest rates, in a deflating economy, are only about 1 percent in nominal terms. But what happens to all those 1 percent bonds when the inevitable day comes that interest rates rise to support the greater risk that this huge and growing debt entails? Who will want to buy these bonds should perceived risk and inflation mount? And what will happen to the banks and insurance companies now holding many of these 1 percent bonds as collateral and capital? Indeed, the Governor of the Bank of Japan recently worried aloud about the exposure of his own institution's balance sheet, should future inflation and interest rates undermine the value of the BOJ's vast and growing bond holdings. According to media accounts, today the Bank of Japan holds a greater percentage of Japanese Government bonds than even during the peak war year of 1944. If true, that is an astounding fact.

Dealing with Japan's multiple structural, financial, and economic problems must inevitably involve some short-term increase in bankruptcies and unemployment, as part of a fundamental transition. More so-called zombie companies, kept alive by constant transfusions of loans from banks, will eventually have to be closed. Alternative policy would involve ever more bad debt piling up in the banks. Much of Japan's political class was resistant to policies involving short-term adjustment pain in the interest of social and political stability, so the debt build-up continued and continued. Japanese officials were, however, remarkably skillful and successful at the management of most perceptions abroad about the actual state of the Japanese economy and finance at any given moment, despite the 15 years of stagnation and false recoveries since the bursting of the great Japanese asset bubble.

A year ago, however, former Finance Vice Minister Ito published in the *Financial Times* a credible plan for addressing some of Japan's financial and structural problems. It contained the following elements:

1. Since Japan's central bank had failed to grow the money supply sufficiently with lower interest rates alone--the money supply grew by only 2 percent during one recent 12 month period--Ito urged unconventional measures to inject money into the economy. In current circumstances, broad deflation could only be cured by a monetary expansion.
2. Japan must gradually control excesses in deficit financing to avoid a fatal debt build up, and eventual crisis in debt servicing. Ito also believes that the tax system and public spending patterns must be reconfigured to encourage greater aggregate demand.

3. The non-performing loan problem must be progressively solved, so that Japan's capital could be put to higher and more productive uses than supporting zombie companies. The banking system needed reform, injection of public money, nationalization of some banks, more mergers of others, and the outright closure of some weaker banks.

If a program such as this is not consistently implemented over the next few years, the debt build-up in Japan may eventually trigger a crisis that could shake the nation to its roots, destroy an immense amount of wealth, require a massive use of the printing press at the Central Bank that will be highly inflationary, and force Japan to face its problems with a vastly reduced capital and savings base. Even with interest rates at slightly over 1%, government debt service charges already absorb more than one fifth of Japan's annual budget.

Prolonged oil price increases, a war in Korea, or a deep future U.S. recession would of course put immense new pressure on the Japanese economy and finances. Fortunately, a highly competent man, Mr. Fukui, has recently been named head of the Bank of Japan and has begun a reform effort. No one should envy this man. He has inherited a massive problem now under increasingly stressful geopolitical conditions: The dollar weakens. The competition from China intensifies. Aging Japan's demographic trends accelerate. The public debt mounts.

### **The Argentina Example**

Argentina is an example of a country which delayed facing its problems until it was too late. The Argentine economy eventually shrank by 25 percent over a four year period. The banking system and a large part of the country's domestically held savings were lost. Capital flight added to the disaster. The crisis itself accompanied desperate last minute measures by Finance Minister Cavallo, which further undermined the country's capital base and economy. The political class was largely discredited. Demagoguery and finger pointing formed an important part of the public discourse. A key problem in Argentina, as in Japan, was that the abler parts of political class were unable for years to implement a sustainable reform program. In the end, foreign holders of a hundred billion dollars worth of Argentine bonds were left holding the bag in one of history's largest defaults. After an excruciating two years, soaring global prices for Argentina's agricultural and commodity exports and the default on Argentina's foreign creditors, allowed growth to resume in Argentina, but at the cost of Argentina's long term creditworthiness and foreign investment prospects.

The most expensive bill from the Argentina default may be the new precedent for other future bond defaulters in emerging markets. Which future democratically elected leader with debt service problems will be able to demand less than President Kirchner extracted and received from his defaulted bond holders? This is likely to become a very live issue during the next serious downturn in the global business cycle.

### **Brazil's High Wire Act**

The high ratio of debt to GDP of Brazil is a major source of concern. International institutions consider that ratios above 50 percent in emerging markets could expose countries to crisis. Such high ratios may not seem threatening in Europe and the United States because of higher capacity of raising government revenue. Theory and data do not provide a reliable

measurement of the sustainable debt/GDP ratio for any country. The internal debt of Brazil was 55.5 percent of GDP in 2002, increased to 57.2 percent in 2003 and declined to 51.1 percent in 2004. Vulnerability exists at the point when investors may not be willing to purchase government securities at a "reasonable" cost, forcing default. It may not be feasible empirically to measure such a point. In order to reduce the debt/GDP ratio, Brazil must continue its prudential fiscal management of primary budget surplus, which is now close to 5 percent of GDP. Simultaneously, Brazil converted a current account deficit into a current account surplus of close to 2 percent of GDP by reversing a trade deficit into a trade surplus of more than \$30 billion. Simultaneously, the economy is growing again. There are still many challenges in Brazil, in particular, tax and labor reform, which would modernize the country, allowing better control of its own destinies.

Similar problems exist in other major Latin American nations. Much of the work done in the 1980s to encourage the adoption of market based economic reforms in Latin America has been undermined by policy failure, some corrupt and discredited privatizations, and similar mistakes. But as the former President of Bolivia stated two years ago: "The hangover facing our region is not due to the reforms we have made, but to the reforms which we have not yet made."

As in Argentina, however, soaring world commodity prices have boosted economic growth in many parts of Latin America to levels not seen since the commodity boom of 1980, a boom which ended in tears in 1982, and a lost subsequent decade of economic growth for the whole continent. There is no substitute for getting overall policies right for sustainable balanced economic development. Otherwise heavily indebted commodity dependent economies will continue to be hostage to the full impact of the booms and busts that accompany the global business cycles.

The United States has a very large stake in the outcome of the intensifying struggle between the demagogues and the sound economists in many parts of Latin America. Our stake in economic growth is equally high in other parts of the globe. Unsustainable U.S. trade deficits cannot be corrected without a major global recession unless growth and demand elsewhere contribute to the solution.. This plus other measures would then help permit an orderly shifting of global trading patterns.

### **The Euro Dilemma**

In Europe, Germany's key economy is weakening with core unemployment exceeding 10 percent. Major structural reforms in labor markets, pension systems, and other aspects of the German economy are urgently needed. Prime Minister Schroeder has accomplished a modest increase in labor market flexibility. Politics impedes a broader assault on imbedded problems, which may not be resolved until Germany's two large parties join in a broad coalition to force through needed legislation. Other serious structural problems exist elsewhere within the Euro zone, recently worsened by the European Union's strengthening currency against the dollar zone. Because of the internal trade within the expanding European Union, and because of favorable relative energy prices in Euros, the impact on Europe's economy of the latest currency shift is less dramatic than some predicted. Still, Europe depends upon exports to the dollar zone for millions of jobs, and reduced competitiveness because of its strengthening currency may encourage some European leaders to turn even more heavily to high profile global politics in controversial areas to secure export markets. The Middle East and China are

only two of several such theaters where international politics heavily impact local procurement and mineral concession decisions. This then could create more strain on Europe's ties with the United States, and potentially more strain on the economic side of the relationship in future discussions of trade and technology across the Atlantic.

### **The China Question**

China's intense national ambition rapidly to become the dominant Asian power, its low wages and its undervalued currency have unleashed trends that threaten to turn that country into an engine of deflation in sectors of manufacturing. Over supply of goods continues to cause profit problems for competitors both within China and abroad. Many of China's 150,000 state-owned enterprises, burdened with antiquated facilities and heavy benefit programs for their workers, remain in business only because banks are required to provide "loans" to subsidize their operations and prevent unemployment. This is contributing to a bad loan problem that may rival that of Japan in its size and potential implications for the future.

Indeed, mismanagement of banking and finance has been the traditional Achilles heel of the Asian development model, and China is not likely to prove a long-term exception to this rule. But in the meantime, China's exports are expanding at a frantic pace—more than 30 percent per year on a compound basis. According to *The Economist* magazine, export industries and international commerce now contribute directly and indirectly more than 50 percent of China's entire two tiered national economy. This soaring trend in export growth can not continue indefinitely without major consequences for the stability of China, China's trading partners, and for the global trading system as a whole.

### **The U.S. Deficit**

This brings us full circle to the United States, where we have a net debt from accumulated trade deficits now approaching three trillion dollars, a debt that must be serviced with interest and profit remittances. This year the U.S. trade deficit is projected to increase to a yearly total of over 700 billion dollars. (China alone contributes \$135 billion to this figure.) This unsustainable trend has already helped drive the dollar down against the Euro and other floating currencies.

Predicting short-term currency trends in today's volatile conditions is difficult, partly because of massive intervention in Asia, and partly because the dollar's competitors, the yen and the Euro, are based on economies that are themselves deeply troubled. Nevertheless, the massive, growing U.S. current account problems leave the dollar extremely vulnerable in the short and medium term. Should the dollar continue to fall, the U.S. market will be less available to overseas exporters, regardless of our trade and tariff policies.

Past U.S. trade policy concentrated on opening U.S. and global markets. We are now engaged in a new round of trade negotiations aimed at further trade liberalizations. But if we do not succeed in creating opportunities for the U.S. to reduce its trade deficit--which continued at record levels even during a past recession--the dollar may continue to fall and this will have consequences.

Moreover, persistent global ill-will toward, or misunderstanding of, U.S. foreign policies could trigger a *de facto* overseas boycott of U.S. goods and services far beyond Macdonald's currently flagging sales in the Arab world, or the disappearance of the

Marlborough cowboy from many of its earlier marketing sites throughout Europe, as a now negative symbol. Such attitudes overseas could have long-term implications for Boeing and other big-ticket U.S. exporters, which now contribute importantly to our balance of payments. They could also create long-term strategic commercial opportunities for U.S. competitors in Europe, the Middle East, Latin America, and Asia.

## **THE PROMISE—AND LIMITS—OF ECONOMIC PROSPECTS**

As we consider the economic developments of the past century, the trends are overwhelmingly positive. Technology, science, democracy, education, and productivity have improved the quality of life for billions of people on this planet. Ancient illnesses have been fought and defeated. Drudgery in daily life and work has been dramatically reduced. These trends will certainly continue and intensify in our present century.

But there have also been bumps in the road of progress. Debt problems, demagogues, wars, asset and consumer price inflation, and over investment in capacity, have taken their toll in blighted lives, recessions, and a major depression during the past century. We believe we understand now, better than before, how to cope with fundamental economic problems. While we can learn from the past, it is important, however, to recognize that each major economic accident impacting the national, regional, and global economy has been unique. Attempting to build precise models based on past situations has thus far not been very successful in predicting the next economic crisis. In this sense, notwithstanding all the advanced mathematics and powerful computers, economics is still a young science, still learning, still attempting to build paradigms that will allow us all to peer into the future with more confidence to avoid costly debacles. In the meantime we have to look beyond our computers to assess deeper vulnerabilities.

This is not going to be easy. Human nature, with all of its complexity and vulnerabilities, operates on the basis of emotions, values, drives and ambitions the impact of which is difficult to quantify. Statistics will continue to be flawed by false data fed into powerful computers. Confidence will suddenly collapse from time to time, triggering runs on banks and countries. Poorly supervised rogue traders in banks and hedge funds will periodically trigger vast losses to shareholders and investors. Political leaders will not always be totally candid with their followers and their countries' creditors. Politics itself is an unpredictable factor, as is war. People also make honest mistakes.

Painful old lessons about such dangers as asset inflation and over concentration in the financial industry will have to be relearned. As each generation dies off with its deeply imbedded memories of booms and busts, the snake oil salesmen will again appear in force, together with their witting and unwitting accomplices in corporate and public life. There will always be a powerful lobby for a major redistribution of wealth, whether through taxes or monetary policy measures.

Three other issues deserving special attention are problems in the global exchange rate system, some aspects of the derivatives industry, and any underestimation of strain on public finances that could produce renewed inflation.

### **Global Exchange Rates**

When floating exchange rates were adopted after the collapse of the Bretton Woods system, policymakers expected the new system to trigger automatic adjustments in the balance of payments.

Reality proved more complicated. Some mercantilist countries endeavor to influence currency directions with interventions, dirty floats, fixed arrangements, and large-scale capital transfers of various kinds. Competitive currency devaluations can substitute for tariffs and other non-tariff barriers as an important regulator of the terms of international trade.

Over the long term, floating exchange rates have proven their value to most countries with sound regulatory systems. But in the short term, currency interventions by those with fixed exchange rates of various kinds have greatly complicated international trade, and contributed to the large sustained U.S. trade deficit. Such undervalued currencies disadvantage competing manufacturers in the U.S. and elsewhere. The export-favorable currency of China also encourages more investment in local manufacturing than the global market can absorb without producing future deflationary pressures and broader dislocations.

China's economic development is a good thing, not a bad thing. But some of China's policies to jump-start a once moribund state run economy can be dangerous to China and others if continued too long. Recent international efforts were made to persuade China to allow its currency to appreciate. This is because the undervaluation of China's currency does not involve only China, but the whole East Asian production complex. None of the neighboring countries that form China's hub and spokes trading system can afford to revalue its own currency unless China leads the way.

Appeals for an immediate currency revaluation have been rejected. China cites concerns for its strained banking and political system if growth and export rates taper off for any reason.

Therein lies the great dilemma. China says that it cannot afford to slow down its titanic export drive, and the U.S. simply cannot afford to accumulate current account debts at the accelerating pace of the past few years.

Thus, if internal problems with China's banking system, energy supplies, politics, and environmental conditions do not ease China's torrid pace of export expansion, China's competitors abroad will surely seek ways to slow down the juggernaut. This would allow time and space for other economies, including those in the Western Hemisphere, to grow and adjust. This is what happened in the mid 1980s to blunt Japan's massive export drive, which also was fueled in part by state capitalism, an undervalued currency, multiple non-tariff barriers, rampant theft of intellectual property and an intense national ambition by the country's leadership to achieve U.S. standards. The fact remains that the U.S. cannot continue to accumulate debt via its collapsing current account position at this pace much longer without undermining the dollar as a reserve currency, radicalizing its domestic politics, and eventually compromising its global strategic position.

Although China has accumulated more than 600 billion dollars worth of foreign exchange reserves to cushion any future problems, China's fears about its own vulnerabilities should not be ignored. China's economy faces serious problems, problems not always fully captured by released official statistics. Although China's economy is stated to be growing at a 9% annual pace, China's stock market is at a six year low, as of early 2005. Presumably the companies listed on the stock exchange are among China's best. Their sagging value may say a great deal about the financial health of the other building blocks of the Chinese economy,

namely the individual companies. Stock markets tend to be leading, not lagging, economic indicators.

### **The Problem with Derivatives**

In our time, derivatives have added vast new areas of uncertainty. There is somewhere between 100 and 125 trillion dollars worth of those useful instruments outstanding today. While derivatives do reduce risk to individuals and companies, they also spread that risk, often in highly leveraged form, to other individuals, institutions, and in extreme form to the financial system itself--as we saw with the Long-Term Capital Management hedge fund debacle. Some large money-center banks, which are creditors to major derivative issuers, are thought by some to be at risk under some possible scenarios.

It requires a high degree of technical skill, and unusual dedication and effort for outsiders to penetrate constantly evolving derivative markets and understand where the ever-shifting vulnerabilities lie. This cannot be accomplished by the average investor, who is likely to have no idea what recent gambles a firm's management may have made on derivative markets until the bad news of a massive loss suddenly hits the street. Many have urged greater transparency in derivative reporting. Even Warren Buffett and his skilled associates threw up their hands after attempting to penetrate the explanatory footnotes on the potential derivative related liabilities of some money-center banks.

### **Fighting Terrorism: Balancing Short-Term Costs and Long-Term Goals**

Beyond the problem of finding a solution to the global imbalances, the greatest uncertainty facing the American economy undoubtedly has to do with the unpredictable elements of war and terrorism, and the potential for disruption of economic targets, including energy related production and transportation facilities. The Venezuelan and Nigerian oil production disruptions have complicated all this.

Each year since 9/11, economists at the IMF have attempted to calculate the potential economic impact of perceived geo-political uncertainties that could cut projected global economic growth.

One of the reasons for this effort is the vast disproportion between the costs of mounting terrorist attacks and the damage that such attacks can inflict on advanced, open and vulnerable economies like ours. A year after the 9/11 attack, one of Washington's major public policy institutes assembled a group of economists to assess these relative costs. At that time, they concluded that the 9/11 attacks on the Twin Towers and Pentagon had cost Al-Qaeda about \$250,000 to mount. The assembled economists calculated that the net cost to the American economy of this attack, direct and indirect, exceeded \$800 billion dollars. This included the damage to financial markets, transportation industry, insurance industry, hotel industry, the buildings themselves and the titanic costs of striking back at terrorists and protecting the country from future attacks. In the meantime, new costs have arisen as pressure for more domestic defensive measures has developed.

Knowledge that terrorists have targeted civilian aircraft with cheap anti-aircraft missiles, for example, generated proposals to equip civilian planes with anti-missile systems at a cost of \$10 billion dollars. The war with Iraq, partly aimed at avoiding possible future Iraqi cooperation with terrorists, will certainly cost many hundreds of billions of dollars before it is

over, plus the large sums our allies asked to secure their cooperation. Since 9/11 the price of oil has doubled. If there is a deeper oil crisis, or terrorist-related economic disruption, this cost will increase. It should be remembered that each thousand point decline in the Dow Jones costs share holders roughly a trillion dollars. It should also be remembered that inflation and other financial instabilities have the potential to jolt bond and derivative markets.

Unless the U.S. successfully shifts budget priorities, the American economy does not have a limitless ability to absorb the costs from war and terrorism without eventually returning to a sharper cycle of inflation and recession.

The Federal Reserve can indeed cushion massive unexpected blows to the American economy and financial markets, but only at a high risk of future inflation, subsequent monetary restraint, and recession.

The U.S. obviously had no choice but to defend itself from evil. We have moved vigorously to strike at Al-Qaeda and their Taliban hosts and now Iraq. But we also have an obligation to look beyond the immediate issue to seek means to drain the other swamps that help spawn terrorists and recurrent regional wars. That is partly why the President's vision of a Middle East settlement with a secure Israel and a democratic Palestine was so well received by diplomats. It is vital that future scenes of cooperation among the leaders of the three great faiths involved replace the constant mayhem on television throughout the Islamic world from violent events in what was once called "The Holy Land."

History suggests that the U.S. will eventually pass through today's problems and uncertainties. Unlike Japanese economic managers who tend to bury their problems for years and compound their costs, the U.S. tends to address its Enron-like problems brutally and move on. Every four years, the Presidential election provides the American people with the opportunity to change, if needed, both policies and personnel. We can also expect that new inventions and technologies will generate whole new areas of economic activity and growth, improving the lives of billions of people.

A key to this happy outcome is wise U.S. leadership and effective diplomacy, plus keeping our economy open, flexible, market oriented, and with a heavy emphasis on quality education. We must also successfully address certain problems in the global trading system that contribute to our current account problem. As long as we continue to master these basic requirements, we will drive over any bumps in the road and continue to lead the world.

## **OPERATIVE LESSONS FOR POLICY MAKERS**

Based on the key conclusions from this brief review of potential global economic vulnerabilities, a list follows of some key principles that should be noted by policy makers even during the distractions and turmoil of war-time.

1. It is better to prevent inflation than to have to control it, once unleashed. This is also true of serious asset inflation, which produces bubbles that tend to trap the least sophisticated investors.
2. Excessively loose monetary policy which subsequently generates asset inflation also tends to produce excess investment in capacity, including real estate. In effect, such monetary policies borrow economic growth from the future. This resultant excess

capacity ultimately weakens profits, banks, and stock values, and can hang over markets for years before a combination of liquidation of excess capacity and new economic growth allows markets to clear.

3. Wars destroy and waste wealth. Financing by governments of past wars has often generated inflation, unless policymakers were vigilant.
4. Stimulating the housing market in an effort to ease the wealth destructive consequences of a burst stock market asset bubble can either kill or cure the patient, depending on how long the medicine is applied. The same can also be said about bond markets, where serious questions have arisen about the sustainability of current bond market trends.
5. During inflationary times, low fixed rate mortgages on housing can generate serious problems for those institutions holding large portfolios of mortgages or higher risk housing derivatives. Future higher interest rates will tend to make it more difficult for potential buyers to qualify for mortgages when people want to sell their houses. Higher local taxes, which are often indexed, and rising insurance costs are adding to the cost of home ownership, and will tend to reduce the pool of people able to afford such housing at existing prices.
6. The large-scale debt accumulations, via balance of payment deficits, cannot continue indefinitely without triggering a further weakening of the nation's currency, contributing to sectoral inflationary pressures and increasing the cost of capital. U.S. trade deficits are not merely a macroeconomic phenomenon involving the U.S. budget deficit and monetary aggregates, important though that is, but also and powerfully an accumulation of many micro economic problems. These include currency misalignments, failure to enforce successfully past trade opening deals, including China's WTO agreements, subtle but powerful non tariff barriers involving such things as local standards, the European VAT rebate system for exports, poorly negotiated past trade deals such as the 1992 airbus agreement which allowed subsidized and risk free financing of new aircraft, wholesale theft of U.S. intellectual property and trademarks in many parts of the world, etc, etc. Viewed individually, the impact of some of the micro economic obstacles to U.S. exports and competitiveness may seem modest. The collective impact of all the micro economic obstacles on American competitiveness and exports, however, is titanic and strategic. U.S. trade deficits have increased steadily since 1990, regardless of the fluctuating U.S. budget position, suggesting that we must look beyond the fiscal macro issue to help address our current account problems.
7. It is nevertheless essential that projected U.S. fiscal deficits be brought under control. They contribute to excess U.S. demand, cause confidence problems at home and abroad, and will otherwise lead to higher future U.S. interest rates.
8. Foreign policy rationales for trade policy measures need to be considered from time to time, but only if the collective impact of generous trade policies conducted on this basis do not collectively generate potentially disastrous current account problems.

9. Encouraging more economic growth abroad is the painless textbook solution to a global imbalance problem in trade. Realism compels us to consider the political obstacles likely to delay such growth in Europe and Japan, and understand as well that more export led growth in places like China will only compound our problems. We also need to remember the catastrophic results of efforts in the mid 1980s to encourage Japan to engage in expansionary monetary policies aimed stimulating more domestic demand. In short, we may need to look beyond this textbook solution to help ease our pressing current account problem.
10. As Argentina demonstrates, delay in addressing an underlying national economic imbalance can cause an economy to contract severely when problems have to be addressed in the middle of an urgent crisis. If this happens to the American economy, the consequences will be massive and global.
11. As in Brazil, funding a large public debt with short-term borrowings can be dangerous if, for any reason, markets lose confidence in the borrower's ability to service the debt.
12. Floating exchange rates have proven their value over the long-term for most countries with sound regulatory systems, but such countries can suffer short-term competitiveness problems against trade sold with fixed and undervalued currencies. Major countries like China with such fixed exchange rates and large pools of savings and inexpensive labor can dominate some sections of global markets for years, but at a risk of future financial, banking and political instabilities for themselves and for their trading partners.
13. Past models of financial disasters are imperfect guides for predicting future financial debacles. There are several reasons for this. One key problem is a lack of transparency in information. Political and business leaders with financial problems are seldom candid. Political responses to crises are unpredictable. Part of modern finance relies heavily on opaque derivative operations whose individual and collective impact during a crisis cannot be quantified in advance. Human nature itself is volatile, subject on occasion to credulity, panic, and the other manifestations of "the madness of crowds." Relying wholly on computers and the statistics in them can dangerously mislead policymakers who fail to understand the limitations of their economic models.
14. Allowing the economy to operate on the basis of market signals remains the best available means of running a modern economy. Rapid advances in science and technology will continue to place a tremendous premium on flexibility, quality education, and on the optimum use of capital and labor that a market driven process makes most likely.
15. Notwithstanding current overall global economic growth, today's world is filled with economic vulnerabilities, large and small. Policymakers and economists need to monitor and address the more obvious individual problems to lessen potential future systemic risks.

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