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What The World Needs in 2004 to Extend Our Optimism into 2005

Policy changes in the G3 can help ensure that improvements in the world economy can be sustained even after the inevitable day when the Federal Reserve raises rates

As 2004 gets underway, we project world GDP will grow at an above-trend 4.5% this year, close to the heady performance of 2000. Over the past 12 months we have become progressively more optimistic as improved financial conditions, especially in the US, have created the preconditions for rising confidence and activity.

How long can this last? What would we need to see for this improvement to turn into a durable and enduring expansion? The key is a weaker dollar. This would help reduce the dependence of the US on foreign capital inflows and provide support for the US economy as US fiscal stimulus lessens and households save a greater proportion of their incomes.

To offset a weaker dollar, other countries need to continue to stimulate their own economies. In particular, this requires the ECB to become a bit more relaxed about inflation and to forego an early tightening of monetary policy. It also requires China to accept a modest revaluation of the renminbi against the dollar, as the Chinese peg stands as an obstacle to a broad-based dollar decline and a relatively smooth unwinding of the US trade imbalance.

In 2002, we called for a significant number of policy changes that could help the world economy. These included:

- A shift away from the 'strong dollar policy' to allow market forces to take the dollar lower.
- A reversal in the timing of US fiscal policy to produce more easing earlier, with greater fiscal prudence later.

- More coordinated monetary and fiscal accommodation.
- A willingness by China to allow the renminbi to appreciate against the dollar.

As some of these began to unfold, in early 2003 we argued that five additional issues needed to be remedied. These included getting the US private sector balance back into positive territory; increasing the US household saving rate; improving the funding of corporate pension plans in the US and elsewhere; increasing the flexibility of Euroland's Stability and Growth Pact; and meaningful bad debt reduction in Japan.

A number of our suggestions have now come to fruition, and the outlook has improved markedly. The US private sector balance has moved from negative into positive territory. The imbalances caused by the US stock market bubble and investment boom have clearly lessened, and, with that, the danger to the global economy. In Europe, economic and finance ministers have sensibly given Germany and France leeway to run higher budget deficits.

To begin 2004, we call for additional policy changes to help ensure that the remaining imbalances can be unwound smoothly and in a way that ensures that the improvements in the world economy can be sustained even after the inevitable day when the US Federal Reserve tightens monetary policy.

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GS GDP and Inflation Forecasts												
% year-on-year	GDP		CPI		2004 GDP				2004 CPI			
	2004	2005	2004	2005	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	4.4	3.3	1.5	1.3	4.9	5.2	4.0	3.5	1.5	1.6	1.3	1.4
Japan	1.9	2.2	-0.8	-0.5	2.0	2.0	1.9	1.7	-0.6	-0.8	-0.9	-0.7
Euroland	2.6	2.4	1.8	2.0	1.7	2.7	3.0	3.0	1.8	1.8	1.7	1.7
China	9.5	9.2	4.0	4.3	8.5	11.9	9.1	9.1	3.5	3.9	4.4	4.0
UK	3.0	2.5	1.5	2.0	3.1	3.2	3.1	2.7	1.2	1.4	1.6	1.9
Emerging Markets	6.7	6.4	5.9	5.3	6.3	7.5	7.0	6.4	5.8	5.7	6.1	5.8
World	4.6	4.2	2.9	2.6	4.3	5.2	4.7	4.3	2.8	2.8	2.8	2.8

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Improved Financial Conditions and Smaller Imbalances

We have become much more optimistic about the global outlook for two reasons. First, over the last 12 months, financial conditions measured by our own index have improved by more than two percentage points in the US, and within the OECD by 0.7 percentage points. The mild tightening that occurred in 2001 and 2002 has been unwound, and the trend is now strongly towards easing.

Second, the imbalances in the US that threatened the global economy have clearly lessened. In 2000, the US economy was far out-of-whack. The private sector balance, which is simply the difference between private income and spending, had fallen to -5% of GDP, far from its +2% long-term average. As this happened, the global economy became overly dependent on the US economic engine to drive activity. The private sector imbalance has since lessened sharply; it is now only modestly below its long-term average.

That said, there remain two important challenges. First, it remains to be seen if the improvement in financial conditions can be sustained. In the 1990s, financial conditions improved for most of the second half of the decade. Could this be repeated?

Second, the US economy is still not in balance. Although the private sector

balance has corrected, this obscures the fact that the bulk of the adjustment has been concentrated in the corporate sector. The household private balance is still at around -2% of GDP, far below its long-term average of about +3%. Moreover, both the fiscal and current account balances remain skewed. The federal budget deficit is likely to climb to more than 4% of GDP this year, and the current account deficit appears poised to exceed 5% of GDP, an all-time record.

How Can Financial Conditions Remain Accommodative?

Our financial conditions indices are made up of short-term interest rates, reflecting the monetary policy stance; 10-year corporate bond yields; broad equity market indices; and for individual national indices, the trade-weighted value of the currency. Broadly speaking, therefore, to keep buoyant financial conditions, interest rates need to stay low and equity markets firm. Globally, of course, currency moves are a zero-sum game that do not have any meaningful impact on global financial conditions.

At a time when many financial market participants believe that interest rates are below their long term equilibrium and equity markets above theirs, keeping rates low and equities firm is not an easy challenge. It does underscore our view that the Fed's approach to keeping short-term rates low until inflation climbs is indeed warranted.

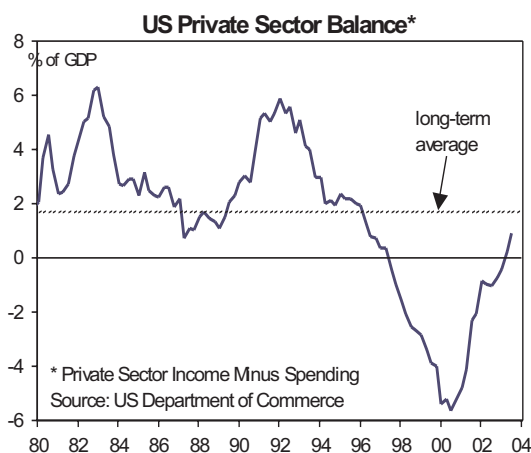
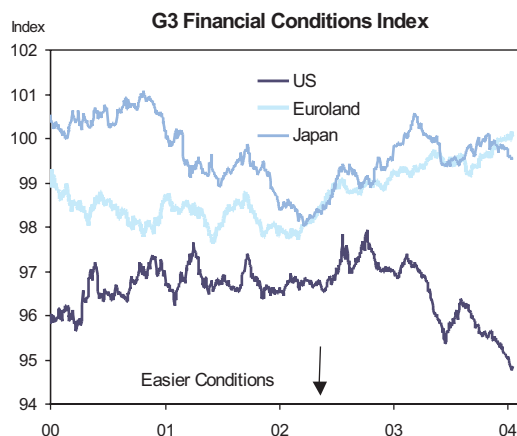
What Should Be Done in 2005?

So how can the US economy get back into balance? Over time, the household saving rate needs to rise and the twin federal and current account deficits need to shrink. The trick will be for these adjustments to occur in a way that does not destabilize the US or the global economy.

The risk to the US economy, of course, is that the adjustment upward in the household balance starts sooner than the narrowing of the current account deficit. To avoid this, we recommend:

- In the US, the Federal Reserve Board should persist with its appropriate easy monetary policy stance for a 'considerable period,' perhaps making it somewhat clearer that a rise in core inflation towards 2% will be a prerequisite for a tightening of monetary policy. Low short-term rates should sustain financial conditions, slowing the pace of adjustment by the household sector.

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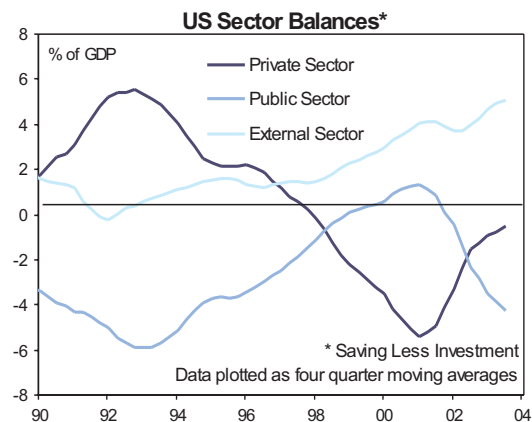
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- US and G7 policymakers should continue to preside over a declining dollar. While the high absolute level of the euro against the dollar may be troubling to some, in the context of the US imbalances, its rise is to be welcomed. Indeed, perhaps the biggest need in foreign exchange markets is for broader dollar weakness to emerge—particularly against many Asian currencies. The G7 meeting on 6-7 February will provide an opportunity for a strong statement calling for more flexibility in foreign exchange policies—a stronger statement than that issued in Dubai last fall would be welcome.
- To minimize the risk that dollar weakness turns into a rout, the Bush Administration should intensify its public commitment to take steps to improve the long-term budget outlook. This could be done by reinstating the PAYGO provisions of the Budget Enforcement Act of 1990, which worked well in restraining the growth rate of spending. In addition, the Bush

Administration is committed to make permanent the tax cuts that now are scheduled to sunset. It might be better to precondition this on budgetary improvement occurring first. In this manner, policymakers would be penalized if they were unable to behave in a more fiscally prudent fashion. Among the side benefits of such a shift in the stance of fiscal policy would be that the Fed's job became easier. If the fiscal path is sustainable, that will surely put less pressure on monetary policy when tightening ultimately becomes necessary.

- An early move by the Chinese authorities to move to a more flexible foreign exchange system is highly necessary. The rise in Chinese inflation which we feared would be a consequence of the 'stable' FX policy to the dollar is now a reality; we see it as a welcome boost to stronger personal consumption in China at the expense of a further excessive build up in investment. We hope—and expect—that China will allow its currency to appreciate against



the dollar before the spring, with a shift to a basket peg now the most likely option. We will applaud such a move if and when it comes.

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The risk to the global economy is that the adjustment in the US dollar and current account deficit contributes to economic weakness outside the US.

With this in mind, we recommend:

- In Europe, rather than complaining about the strength of the euro, policymakers should build on their previous welcome shifts in monetary and fiscal policy practices. In particular, monetary and fiscal policies should be applied not to halt dollar weakness, but to help stimulate and sustain stronger Eurozone domestic demand.
- In this context, the ECB should further redefine its inflation target from 'close to, but below 2%' to a symmetric target around 2%, or perhaps even a bit higher. Such a move would allow for persistently stimulative monetary policy despite the strong euro, helping to maintain friendly OECD financial conditions.
- As far as fiscal policy is concerned, we encourage a further shift in the Stability and Growth Pact. The EU should formally adopt a program in which each country is encouraged to make full use of the automatic fiscal stabilizers. Medium-term budget deficit targets need to be set to keep ratios of government debt to GDP on a sustainable path, rather than to aim for balanced budgets. As we have long argued, such a policy would allow Euroland governments more necessary flexibility to cope with cyclical challenges while ensuring that persistent debt issuers are penalized and limited from dangerous policy choices.
- In addition to all the above macro policies, we also call on each of the G3 governments to renew their efforts at micro reform, including their commitment to supporting free trade, improvement in the operation of labor markets, support of much needed pension reform, and, especially in the cases of Japan and Europe, stronger steps to boost immigration.

Japan remains a bit of a special case. Excessive yen appreciation needs to be resisted because the Japanese authorities do not have the option of following more stimulative monetary and fiscal policies, unlike Europe. Moreover, the persistence of extremely large FX intervention by the Japanese authorities is understandable in view of the relative strength of the yen compared to other Asian currencies, as well as the persistence of deflationary pressures. However, as the Japanese economy recovers further, and on the assumption of greater flexibility of Asian currencies, i.e. strength against the dollar, the monetary authorities in Japan should be able to reduce their intervention activities.

The Key Wildcard: Inflation

The ride in financial markets is likely to become bumpier when we eventually do get sufficient pressure on resources to generate inflation. We do not know exactly when this will happen, but it will make the financial market environment much more challenging for two reasons.

- Monetary policy tightening will be a shock to the US financial system. Market participants know that when the FOMC begins the tightening process, it is likely to be a long and arduous one. Markets will reprice quickly even if the first move is only a very small one.
- Inflation will change the attitudes of China, Japan, and other Asian countries about keeping their currencies undervalued and recycling the dollars back into US Treasuries. Global bond markets could get an additional jolt if the central bank appetite for bonds lessens.

This is why it is important to implement the changes suggested above promptly—before inflation starts to become a problem. It will be more difficult later to both unwind global imbalances and try to restrain inflation.

If all the above policy changes can be enacted in the coming year, then there is a strong case for suggesting that our optimism for 2004 can be extended into 2005 and 2006. As we suggested earlier, this is not the easiest challenge facing policymakers and we do not assume that these steps will be as easy to implement as

those successfully undertaken in the last 12 months or so. Consequently, 2005 and 2006 currently look to be more challenging than 2004, but we can only live in hope! ■