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## Issue Papers For the Administration

### #11 “Looking Forward in Wartime: Vulnerable Points in the Global Economy”

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**As the costs of the war on terrorism and now the war in Iraq mount, policymakers must wisely manage a number of problems in order to prevent further global economic damage. Chief among these challenges are the legacies of the great equities bubble of the late 1990s: massive destruction of wealth and the creation of over-capacity in production; the mounting strain in the public finances of Japan, Turkey, Brazil, and a number of other countries; the lack of economic growth and dynamism in Germany and surrounding regions; the inflationary pressures from oil price increases; the strain on the dollar from massive accumulated trade deficits; the challenge of China’s export surges and over-production; the vast disproportion between the relatively trivial cost of launching terrorist attacks and the titanic damage such attacks can inflict, directly and indirectly, on advanced economies; and the proven ability of derivatives to transmit and amplify global economic instabilities.**

**Unless closely monitored and wisely managed, these and related strains may trigger cascading economic disasters, which could begin at any number of weak links in the global economy.**

In **Report to the President-Elect 2000: Triumphs and Tragedies of the Modern Presidency**, the Center analyzed Presidential leadership through the lens of more than seventy-six case studies. These **Issue Papers** are a forward looking complementary series of short, single-author papers that frame and briefly analyze key issues and policies that the Administration should address. Views expressed in these papers are those of the authors.



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

**RICHARD T. McCORMACK**

## **INTRODUCTION**

The purpose of this paper is to address several key economic issues facing the United States and the world at time when major new war and terrorism-related activities may 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. These 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 five 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.

A gaping hole from the collapse of large segments of global equity markets continues to plague the global economy. So do poor policy choices and the lack of strong political leadership in a number of key economies. However, current conditions also point us toward several important lessons, with powerful future implications.

## **EQUITY MARKETS**

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

The bursting of the U.S. stock market bubble erased 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 1990's. 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 complexities in the derivative system and the rules which allowed them to operate the way they did. 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. The FED has come in for special criticism because it is, after all, the ultimate regulator of the health of the nation's financial system, and the body that 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 warnings that appeared regularly in the *Economist Magazine* and other respected publications, and reduce the availability of liquidity, or at the very least, increase margin requirements to dampen the speculative fever.

We also know from recently released minutes of the deliberations at the Federal Reserve, that many of the Governors, including Larry Lindsey and Chairman Greenspan himself, were greatly concerned about the potential for a catastrophic asset inflation bubble as happened in Japan during the late 1980s.

These troubled deliberations inside the FED began in 1996, shortly before Chairman Greenspan made his famous "Irrational Exuberance" comment at the American Enterprise Institute.

Experienced financial leaders, such as former New York Federal Reserve official, Henry Kaufmann, 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 low consumer price inflation in the U.S. during this period would have made it difficult for him to justify to Congress the sustained increases in interest rates and squeezing of liquidity that would have been necessary to deflate the bubble. 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 and rates were cut by 75 basis points the following year.

The Russian ruble and banking crisis subsequently triggered a series of world wide 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. Creditors were also sucked into the vortex.

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 amidst widespread recriminations. There is some talk now about the possible desirability of a limit of two terms for future incumbents of the nation's second most powerful job.

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

The loss of purchasing power that accompanied the erasure of stock values, plus the excess capacity that easy money made possible, contributed to an imbalance between supply and demand in 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.

Some question now whether a new bubble in housing and real estate has been being created.

There is no easy answer to that question. While the upward trend in most U.S. real estate markets in recent years was sharp, conditions do vary regionally and in different sectors of the real estate market. At the lower end, there clearly is a demand for housing on the part of people seeking starter homes, including young immigrant families. At the upper end of the commercial real estate market, softening is already evident in places like New York City. The question is what will happen to the broad middle of the housing market and when.

It is important to remember that while interest rates are at historically low levels, rising insurance rates and local taxes are steadily adding to the cost of real estate ownership. It is also important to remember that current low interest rates will not last indefinitely, and rising

commodity and producer prices and other indicators suggest possible future inflationary pressures in sectors of the U.S. economy. Should inflation return and interest rates rise, large-scale holders of 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.

In London, where housing costs rose 25% in a single year, history suggests a possible repeat of the housing bubble that was created and burst during the tenure of former Chancellor Nigel Lawson. The London 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 left the Conservative Party in shambles from which it has not yet recovered ten years later. London real estate prices have begun to sag in the early months of 2003.

Much obviously depends upon the health of the U.S. economy. Massive fiscal and monetary stimulus has been applied in the past two years, a need anticipated by President Bush's economic advisors as he came into office. And while growth was sluggish in the last quarter of 2002, there were signs, such as modest increases in orders for machine and tool companies, which in the past have heralded a pick-up in capital investment. However, it is clear that many capital investment decisions are being delayed due to residual overcapacity in some sectors, and uncertainties from oil markets, terrorism, and the conflict with Iraq. Equity markets rose briefly in the opening days of the Iraqi conflict. But uncertainties abound and price earnings ratios are still unattractive by historical standards. Ultimately, profits must undergird any sustainable rise in equity prices.

## **U.S. VULNERABILITIES**

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

Should the war be brief, the damage light, and terrorism problems modest, prospects for a slow and steady growth in the American economy appears positive, albeit nowhere near the boom conditions of the 1990s.

A gradually weakening dollar, although a potential source of sectoral inflation and higher U.S. capital costs, should also encourage more investment and production in manufacturing 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 the U.S. would experience both sectoral inflation and increases in the cost of capital.

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 is likely to be delayed for another year or so, 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. This, in turn, encouraged the Federal Reserve to maintain tight monetary policies for longer than otherwise would have been the case. Ultimately, this resulted in President Bush campaigning for re-election in a weak economy in 1992. This scenario easily could be repeated in 2004, should inflation return for any reason.

Other vulnerabilities on the global economy also exist.

### **Japan's Malaise**

Fiscal efforts to prime the pump and delay painful restructuring of the Japanese economy have contributed to a massive public debt. The OECD estimates that this debt equals 140% of the 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 about 1% in nominal terms. But what happens to all those 1% bonds when the inevitable day comes that interest rates rise to support the greater risk that this huge 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 which hold many of these 1% 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 inflation undermine the value of the BOJ's vast and growing bond holdings.

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. Many so-called zombie companies, kept alive by constant transfusions of loans from banks, will eventually have to be closed. The alternative is ever more bad debt piling up in the banks. But much of Japan's political class is resistant to policies involving short-term pain, so the debt build-up continues and continues.

Recently, 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 has failed to grow the money supply sufficiently with lower interest rates alone--the money supply grew by only 2% during the past 12 months--Ito urges unconventional measures to inject money into the economy. In current circumstances, broad deflation can 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 can be put to higher and more productive uses than supporting zombie companies. The banking

system needs reform, injection of public money, nationalization in some cases, and outright closure of some weaker banks.

If a program such as this is not implemented within a relatively short time, the debt build-up in Japan will eventually trigger a crisis that may 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. Prolonged oil price increases, a war in Korea, or a double dip in the U.S. recession would of course put immense new pressure on the Japanese economy and finances. Fortunately, a highly competent man, Mr. Fukui, has just been named head of the Bank of Japan. No one should envy this man; he has inherited a massive problem now under increasingly stressful geopolitical conditions.

### **The Argentina Example**

Argentina is a good example of a country which delayed facing its problems until it was too late. Today Argentina's economy is 20% smaller than it was four years ago. Much of the banking system and a large part of the country's savings were lost. Capital flight added to the disaster. The crisis itself forced desperate last minute measures which further undermined the country's economy. Today, the political class is largely discredited. Demagoguery forms an important part of the public discourse. A key problem in Japan, as in Argentina, is that the abler parts of political class seem unable to unify behind national leadership to shape and implement a sustainable reform program. Argentina's agricultural exports, and failure to address debt defaults have kept a modicum of stability in the currency. However, underlying problems remain.

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

Brazil is another vulnerable spot. That country's large debt is mainly funded by short-term loans at nominal interest rates of 25.5% which are vulnerable to inflation indexed increases. A large long-term debt funded by short-term borrowing has no margin for error. The moment markets lose confidence in government policies, or in the broader context in which a country operates, risk premiums on borrowings can explode. Brazil today faces the common danger of a possible oil price induced inflation, and the urgent need for pension and tax reforms, both of which are controversial. The new Brazilian President is doing his utmost to achieve these reforms and has made a good beginning. He knows that failure to achieve these fiscal reforms could easily force a renegotiation of Brazil's public debt within 18 months. Recently, neighboring Uruguay and Paraguay were driven to renegotiate their own large debt, victims of regional contagion and past policy weakness.

Similar problems exist in other Latin American nations. Except for Chile, it is hard to find a bright spot in South America. Much of the work done in the 1980s to encourage the adoption of market based economic reforms has been undermined by policy failure, a few corrupt and discredited privatizations, and similar mistakes. But as the embattled President of Bolivia recently stated: "The hangover facing our region is not due to the reforms we have made, but to the reforms which we have not yet made."

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 reviving economic growth is also high in other parts of the globe.

### **Turkey and South Korea**

Turkey's massive public debt, which has been sustained only with large scale U.S. supported IMF assistance, will become even more difficult to service in the immediate aftermath of any conflict with Iraq, particularly if terrorism continues. Weakened tourist revenues, depressed regional trade, and higher oil bills all weigh heavily on Turkey's staggering public finances. But with public opposition to the war running high, Turkey's political leaders were unable to pressure the legislature to endorse policies that would have produced billions of U.S. aid. Turkey's financial problems are not going to disappear. There are also problems, albeit less intense, in South Korea, which are made potentially dangerous by the risk of war and other instabilities.

### **The Euro Dilemma**

In Europe, Germany's key economy is weakening, and major reforms in labor markets and other aspects of the German economy are urgently needed. Prime Minister Schroeder has just proposed a modest increase in labor market flexibility. Politics impedes a broader assault which may not happen until Germany's two large parties join in a broad coalition to force through needed legislation. Other serious problems exist elsewhere within the Euro zone, recently worsened by the European Union's strengthening currency, global economic weakness, an Enron type debacle impacting one of Holland's largest corporate giants, and pressing concerns about the financial health of some of Europe's banks, insurance companies and conglomerates.

### **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 state-owned factories, burdened with antiquated facilities and heavy benefit programs for their workers, are 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--as much as 30% per year. According to *The Economist* magazine, export industries and international commerce now contribute directly and indirectly more than 40% of China's entire two tiered national economy. This trend in export growth rates can not continue indefinitely without major consequences for China and for the global trading system as a whole.

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

This brings us full circle to the United States, where we have a net debt from accumulated trade deficits now exceeding two trillion dollars, a debt that must be serviced with interest and profit remittances. This year the U.S. trade deficit is projected to increase by another \$50 billion, to a yearly total of \$550 billion. (China alone contributes \$100 billion to this figure.) This unsustainable trend has already helped drive the dollar down by 20% against the Euro and 13% on a trade-weighted basis.

Predicting short-term currency trends in today's volatile conditions is difficult, 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. debt and soft financial markets, leave the dollar extremely vulnerable. 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 aimed at advancing trade liberalization. This trade round however, is imperiled by an impasse over agriculture. There is also a powerful macroeconomic element involved here. If we do not succeed in creating opportunities for the U.S. to reduce its trade deficit--which continued at record levels even during recession--the dollar may continue to fall, and this will have consequences.

Moreover, 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. This could have long-term implications for Boeing and other big-ticket U.S. exporters, which now contribute importantly to our balance of payments, and create long-term strategic commercial opportunities for U.S. competitors in Europe and Asia.

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

As we consider the economic developments of the past century, and longer, 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, inflation, and over investment in capacity, have taken their toll in blighted lives, recessions, and a major depression during the past century. Now we understand, better than before, how to cope with fundamental economic problems. But while we can learn from the past, it is important to recognize that each major economic accident impacting national and regional economies 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, still 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. Leaders will not always be totally candid with their followers and their creditors. Politics itself is an unpredictable factor. People also make honest mistakes.

Painful old lessons about such dangers as asset inflation 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.

Three other issues now 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, large-scale capital transfers, etc. Competitive currency devaluations thus added to tariffs and other non-tariff barriers as an important regulator of the terms of trade.

Over the long term, floating exchange rates have proven their value to most countries which adopted them. But in the short term, currency interventions of various kinds have greatly complicated international trade, and contributed to the large sustained U.S. trade deficit.

China is a special case now because it retains an exchange rate firmly linked to the dollar that is highly advantageous to China's export industries. The problem comes when China's huge trade surplus with the U.S. helps push the dollar down against the Euro, the yen, and other floating currencies. This greatly disadvantages other trading partners of the U.S with floating exchange rates, and will tend to concentrate greater global manufacturing in one country, namely China.

One particular problem with overproduction in whole sectors of manufacturing in China is that tradable goods prices are set at the margin. Small imbalances between supply and demand, whether computer chips or petroleum, have disproportionately large impact on prices in the world market, and on the competition in places without weak currencies, hidden subsidies, or other market distorting practices.

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. At Davos, recent efforts were made to persuade China to allow its currency to appreciate, following quiet appeals from the U.S. Secretary of the Treasury and others. These appeals were utterly rejected. If this situation continues for several more years, it is likely to result in efforts by some of China's competitors to weaken their own currencies. This can lead to an ugly race to the bottom, and instabilities in the global economy.

If internal problems do not brake China's pace, there may be pressure at some point from abroad to slow down the expansion of China's export juggernaut to allow time and space for competing 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, and an intense national ambition to achieve U.S. standards.

### **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 these constantly evolving derivative markets and understand where the ever-shifting vulnerabilities lie. This can not be done 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**

Today, however, the greatest uncertainty facing the American economy undoubtedly has to do with the unpredictable costs of war, reconstruction, occupation of Iraq, possible 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.

Recently economists at the IMF have calculated that geo-political uncertainties, including the war in Iraq, would cut projected global economic growth to 3.2% and cited many downside risks that could further weaken that estimate.

One of the reasons for this heavy impact beyond oil price pressure is the vast disproportion between the costs of mounting terrorist attacks and the damage that they can inflict on advanced, open, and vulnerable economies like ours. This past summer, one of Washington's major think tanks 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 the Pentagon, 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.

Knowledge that terrorists have targeted civilian aircraft with cheap anti-aircraft missiles, has recently generated proposals to equip these 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 \$100 billion dollars or more before it is over, plus the large sums our allies are asking to secure their cooperation. If there is a deeper oil crisis, or terrorist-related economic disruptions, this cost will multiply. Each thousand point decline in the Dow Jones costs share holders roughly a trillion dollars. Inflation and other instabilities have the potential to jolt bond and derivative markets.

Unless we shift budget priorities, the U.S. economy does not have a limitless ability to absorb the costs from war and terrorism without 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 and subsequent monetary restraint.

We obviously have no choice but to defend ourselves 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 the 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 we 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 problems brutally and move on. 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 orientated, and with a heavy emphasis on quality education. As long as we continue to master these basic requirements, we'll drive over any bumps in the road, and continue to lead the world.

## **OPERATIVE LESSONS FOR POLICYMAKERS**

Even during the distraction from the current war, policymakers must remember basic economic principles:

1. It is better to prevent an inflation than to have to control it, once unleashed. This is also true of serious asset inflation, which produces bubbles that, in a sense borrow economic growth from the future as momentum builds and tend to trap the least sophisticated investors when the bubbles unexpectedly burst.
2. Conditions which produce asset inflation also tend to produce excess investment in capacity. This ultimately undermines profits and stock values, and can hang over markets for years before a combination of liquidation of excess capacity and new growth allows markets to clear.
3. Wars destroy and waste wealth, and policies aimed at financing past wars often generated inflation, unless policymakers were vigilant.
4. Stimulating the housing market in an effort to ease the wealth destructive consequences of a burst asset bubble can either kill or cure the patient, depending on how long the medicine is applied.
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 weakening of the nation's currency, contributing to sectoral inflationary pressures and increasing the cost of capital.
7. As Argentina demonstrates, delay in addressing an underlying national economic imbalance can cause the economy to contract severely when problems have to be addressed in the middle of an urgent crisis.
8. As in Brazil, funding a large long-term debt with short-term borrowings can be dangerous if, for any reason, markets lose confidence in the borrower's ability to service the debt.
9. Floating exchange rates have proven their value over the long-term for most countries which deploy them, but can cause short-term competitiveness problems if trading partners engage in competitive devaluations. Major countries like China with fixed exchange rates

and large pools of savings and labor can rig some sections of global markets for years, but only at a high risk of future financial and banking instabilities.

10. Past models of disaster are seldom good tools for predicting future financial debacles. There are several reasons for this. 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 can not 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.
11. 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.
12. The world is filled with vulnerable economies, including our own. Policymakers and economists need to continue to monitor and address individual problems to lessen the risks of a cascading global debacle in the years ahead.