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"THE CONFLICTS AROUND GLOBALIZATION: A FRAMEWORK FOR GOING FORWARD"

I've been asked to step back and reflect on the path ahead for the global economy. That path is always uncertain, and complicated, but some times are especially uncertain, and I believe that this is one of those times.

I will divide my remarks into two portions. One will be my views as to the shorter and intermediate term outlook for the global economy, and that will focus predominately on the United States, since the United States economy will almost surely be the key to what happens globally. And, then I will discuss a set of policy issues which seem to me central to what happens globally over the longer term, as well as having impact in the shorter term.

Let me start by saying that I think the setting for this discussion is most fitting. I have read a goodly part of the memoir written by your senior minister Lee Kuan Yew, whom I've had the privilege to know for many years, on the growth of Singapore over the past fifty years, from a small, impoverished fishing and agricultural community to today's remarkable commercial and financial center, and Singapore is an outstanding example of what can be achieved with good economic policy.

Let me also start with a brief biographical comment, that relates to how I approach thinking about both the outlook for the years ahead and the policy issues we face. I spent my entire career dealing with uncertainty and trying to reduce that uncertainty to probabilities about future events, to provide a basis for action. That is the essence of the arbitrage activities where I began my career and the essence of what we in the economic team did when I was in Washington, under President Clinton's leadership, in everything from the critically important decisions to work to re-establish fiscal discipline in the United States to the excruciatingly difficult judgements about responding to financial crisis in Mexico and then later in Asia, Latin America and Russia.

My views on the shorter-term outlook of the United States and global economies are a product of that probabilistic mindset. To start, the United States had remarkable economic conditions from 1993 through the rest of the 1990s, due largely to the inter-related impact of several factors: firstly, a restoration of fiscal discipline after a long period of fiscal ill discipline, which promoted lower interest rates, increased business and consumer confidence, and a strong inflow of capital from abroad, and for all these reasons led to increased investment; secondly, the availability of new technologies and greatly increased understanding of how to apply technologies; thirdly, our own relatively open trading markets, which created competitive pressure for change and productivity improvement, and our flexible labor markets which created an incentive for increased investment because the potential benefits could be more readily realized; and finally a long-established culture of embracing change. Also, the United States government had the view that our economy could be significantly affected by what happens elsewhere in the world, and thus engaged energetically on international economic issues – promoting trade liberalization around the world, providing effective response to financial crisis in other parts of the world, and development assistance though not enough to emerging market nations.

I might add that unfortunately we also had and have economically important issues that have not been adequately addressed, such as a troubled public school system, inadequate programs to equip the poor to enter the economic mainstream, and an excessive litigation regime.

In any case, at the same time that our economy flourished, imbalances also developed – a phenomenon that seems to be inevitable whenever economic conditions are favorable for a considerable period.

These unbalances included corporate and consumer debt at very high levels of GDP, a low personal savings rate, a stock market that was high by any conventional standard, a current account deficit that was high and rising, and excess capacity. These imbalances led – I thought at the time predictably – to difficulties in both economic conditions and the markets, though the legacy of the 1990s provided strong fundamental factors to ameliorate this inevitable adjustment period including a large fiscal surplus, strong productivity, growth, low unemployment, more open markets around the world and a healthy banking system. In any case, briefly looking at how forecasters reacted to the slowdown seems to me useful in thinking about the current outlook.

Once the slowdown began, most forecasters predicted that strong action by the Federal Reserve Board to lower interest rates would relatively quickly restore healthy growth. That certainly was a real possibility, and the Federal Reserve Board is certainly an important factor in our economy. But the Federal Reserve Board is only one factor and not an all-powerful answer to all problems, and I felt that forecasters throughout this period overstated the force of this factor and greatly underweighted the impact of the imbalances. And, in fact, conditions did remain difficult, right up to the terrible attack of September 11, which added a new set of competing considerations affecting the economy. On the one hand, confidence was adversely affected and security, trade and transportation costs increased; on the other hand, government spending increased in response to September 11, providing fiscal stimulus.

Today, the great preponderance of Wall Street forecasters have for some time been projecting favorable economic conditions for this year and next. Their theory is that previous rate cuts of the Federal Reserve Board, combined with the stimulus from government spending in response to September 11 and from the small portion of the tax cut enacted in 2001 that occurs this year and next, plus favorable changes with respect to inventory accumulation and, very importantly, continued productivity improvement, will result in maintaining healthy growth in consumer demand and renewed growth in investment demand.

My own view is that the current situation is similar to the situation with respect to forecasts and the outlook at the time the slowdown began in mid-2000. The positive forecast could well turn out to be right, but many uncertainties and concerns exist that could produce more difficult conditions. Since the positives have received the bulk of the attention in most forecasts, and since I've already mentioned them, let me now elaborate on the concerns.

To begin, the imbalances, which I discussed a few moments ago, that developed over the eight remarkable years, are far from having fully unwound. More specifically, consumer and corporate debt have continued to be very high, excess capacity has diminished – except in telecommunications – but is still significant, and the current account deficit has worsened. The stock market has fallen substantially, and most analysts view the market as undervalued, but a thoughtful case can be made that valuation is unclear and remains a question. Morever, current market psychology is clearly affected by accounting and corporate governance issues, by terrorism and geopolitical concerns, and by the fall of the stock market itself. How much the decline so far will affect consumption and investment, if at all, and how much impact any further decline would have, is an important uncertainty. So far, increasing housing prices have maintained consumer net worth, and with mortgage refinancing have helped maintain consumption, but will that dynamic continue? Stock market analysts have relatively favorable expectations about future profits – a key to renewed investment – while most business people are uncertain about profit prospects. More generally, most economic forecasters are relatively positive, and most business people are more concerned.

To digress just for a moment, let me comment briefly on accounting and corporate governance, which is presently receiving enormous focus. Clearly, a spate of problems have developed, as has happened before after extended good times, and systemic issues have been revealed that need to be addressed. Various proposals are in process that seem to me, on the whole, constructive, for example, the so-called Sarbanes bill that was just passed in the Senate and many of the NYSE proposals on directors. In addition, the expensing of options seems worthy of serious consideration and the conflicts between research and investment banking need a dispositive, industry-wide solution. And, enforcement actions should be brought, where appropriate.

However, these responses should be balanced and sensible. Our system, in my view, has served our country's economy very well for a long time, and has great strengths - in being conducive to decisive management decisions, rapid change and agility, experimentation, and risk-taking - and hopefully those strengths will not be unwisely eroded even as strong and effective action is taken to deal with the problems before us.

Now to return to the concerns and uncertainties about factors that could affect consumption or investment and thus the economy.

That list could go on, but let me mention just three more. First, the projected long-term fiscal position of the United States government has deteriorated enormously over the past year, with significant likely adverse effects on interest rates, confidence and the ability to attract capital from abroad over the long run and almost surely some effect even now. Secondly is the backlash against globalization and the spread of market-based economics, but I want to save that for my comments on policy. And, thirdly and most importantly, future terrorist acts, or political instability and conflict in important areas around the world, certainly seem a realistic possibility.

Interestingly, if you read Wall Street economic forecasts, remarkably little is said about geopolitical risks. On the other hand, the many people I know who have been in national security jobs in prior administrations are all deeply concerned about these risks.

When you put all this together, my conclusion is that the most realistic and useful way to look at the shorter and intermediate outlook is not as a single point forecast – which is what almost all forecasters provide – but rather as a wide range of possibilities. In that context, I think there is a significant probability of either favorable or unfavorable conditions occurring and I don't think it is possible to estimate the respective likelihood of either other than to say, as I just did, that the likelihood of either is significant. I recognize that that kind of "on the one hand, on the other hand" type of view is what economists – and I am not an economist – are often criticized for, but, in this instance, I think it provides the most realistic perspective on the time ahead.

Let me also add - and this is very important in evaluating business decisions or investment decisions - that, at least in my view, the long-term potential of the United States' economy is very favorable, due to great underlying strengths, such as flexible labor and capital markets, a societal pre-disposition towards change, a dynamic and economically oriented culture, and the size and existing investment base of the economy. However, realizing that potential will require meeting many challenges, including repair of our federal government's long-term fiscal position, providing quality public education, more effective measures to equip the poor to join the economic mainstream, dealing effectively with terrorism and geopolitical issues, the many matters around globalization which I'll discuss in a few moments, and much else. These challenges are substantively and politically difficult, but our history suggests, in my view, a good likelihood that they will be met.

Looking at both uncertainty about the shorter term, and the likely but not certain favorable prospects for the long term, I think for both large corporate enterprises and investors, a sensible balance is the wisest approach. For the corporate enterprise, that means being strategically and operationally energetic, within the limits imposed by being highly disciplined on expenses and maintaining a strong balance sheet and strong liquidity, and for an investor, that means equity exposure for the positive possibilities within the context of a total asset allocation that can comfortably weather difficult conditions should they occur.

Let me now turn briefly from the U.S. economy to the two other major areas in the global economy.

Japan could experience some cyclical upturn, assuming that the global economic conditions are reasonable, but the enormously complicated structural and fiscal problems Japan faces have in large measure not yet been effectively addressed. My personal view is that a nation and a culture that had the remarkable economic success experienced in post-World War II Japan, is likely to once again do what is needed to get on a successful economic track. However, that will require exceedingly difficult actions on banking, trade restrictions, labor laws, regulations, informal rigidities, and a severe fiscal and government debt problem made all the more serious by Japan’s rapidly aging population. Addressing these issues will itself create economic difficulty during an extended adjustment period, and thus the prospect of a robust Japanese economy lending strength to the global economy – though I believe likely in the long run – is not a shorter-term prospect.

As to Europe, I think the common currency is proving to be a real success for the European Economy. On the other hand, Europe still has not effectively addressed the structural reforms that are requisite to achieving increased European productivity growth, and in my view, until that happens, Europe is likely to have relatively moderate growth even in good times.

As to emerging market countries, obviously conditions will be very much affected by what happens in the United States. In addition, a number of countries have difficulties of their own, while others – such as Korea – seem to be doing very well.

Having now completed a brief tour of the global economic outlook for the shorter term, let me turn to touching on a set of underlying policy issues which I believe are centrally important to the long-term outlook for the global economy.

The economic environment of the 1990s was greatly affected by enormous forces of change that had been at work for some time, but reached new levels during this period: increased integration of trade and capital markets across the world, new technologies and advances in applying existing technologies, the spread of market-based economics throughout the globe, and real economic progress in many emerging market and developing economies. These great forces of change on balance brought much economic benefit, though unevenly distributed, including to many emerging market countries; for example, in Asia, over recent decades and the past decade. And I believe these great forces of change provide the potential for favorable long-term economic conditions, for the United States and the global economy if – and this is a big if – the challenges to realizing that potential, in economic policy, geopolitics, environmental protection, and much else, are met. I want to now focus on one aspect of that set of challenges.

The real progress in growth stemming from the great forces of change I've just mentioned has also been accompanied by serious costs: economic and social dislocation for some people, adverse environmental impacts, a sense of uncertainty and insecurity even amongst many who were doing well as an environment of change diminished reliability and certainty, and two financial crises – Mexico in 1995 and global in 1997-1998 – that undermined tens of millions of lives. Moreover, far too little progress has been made in combating global poverty or increasing broad-based sharing of growth; half of the world's population still lives on less than $2 a day.

The pendulum had swung powerfully toward the forces of change during the 1990s, but now there is a backlash, also very powerful, and a real danger for the future economic well being of the globe that the pendulum may swing back to restraints on trade and capital market integration, labor market rigidities, greater regulation, and the like.

In my view, the realities – which most political people don't want to acknowledge – are that change is key to growth; that restraining change restrains growth; and change inevitably creates winners and losers and dislocations. That hard set of realities underlies the policy decisions around globalization and market-based economics.

President Clinton, having given great thought to this central dilemma of our economic era, brought the two perspectives together into what seems to me overwhelmingly the best path forward. That path is continued trade liberalization and continued movement towards market based economics, reduction of rigidities, and embrace of change, to best promote growth, combined with an equally important parallel agenda of combating poverty, broad-based public education, program to help those dislocated by change, appropriate social safety nets, environmental protection and much else, to respond to the concerns underlying the backlash.

Making this parallel agenda work globally would require greatly increased assistance from the industrial countries for the developing world, and I can tell you from my own experience when I was at Treasury that political support for increasing foreign assistance is exceedingly difficult to garner, and requires increased awareness amongst the industrial nations' citizens - especially in the United States - of their imperative self-interest in such assistance. Even for the most wealthy nations, economic, environmental, national security and public health conditions can be greatly affected by what happens in the poorer and poorest parts of the world.

I believe that the politics and the policy of all of this – moving forward with change, the backlash against change, a parallel agenda, and foreign assistance – will be at the center of the political and policy debate throughout the globe for many years.

And that debate will include the issues of prevention, and response with respect to financial crises. I am not going to deal with those issues in these remarks, but let me make four brief observations: 1) the economic and national security interests of the industrial countries can be greatly affected by emerging market financial crisis, and thus the industrial countries have a great stake in effective prevention and response; 2) the messy reality of a crisis is far different from the purity of conceptual views; the key to avoiding far worse and far deeper crisis is reestablishing confidence through policy and financial support; 3) in the face of unprecedented and rapidly moving events, in my view, the international community on balance made sensible decisions during the Mexican and then the so-called Asian financial crises that enabled the countries that took ownership of reform to recover and that avoided what I think at several points cold have been an all-encompassing global crisis; and 4) important changes in the global financial architecture have been made, but the search for improvement must be on-going.

Let me conclude by saying again that, in my view, the longer-term economic potential of the global economy is great, but so are the challenges to realizing that potential. In law school, I remember learning that bad facts make bad law. A great danger now is that a time of global economic uncertainty could lead to counterproductive policy; for example, protectionist trade decisions, more restrictive labor measures, or other movement away from the growth maximizing regime of embracing change coupled with a parallel agenda for the problems created by change or not adequately addressed by change. Instead, we need to move forward. In Europe and Japan, for example, little if any progress has been made in recent years on the structural reforms absolutely requisite for strong growth on a sustained basis, and in the United States much need to be done on the issues I discussed a while ago. The politics of all of this is very difficult, and, as I learned during by 6-1/2 years in Washington, the politics are as important as the policy, because without effective politics, the policy will never be put in place. All of us engaged in global financial and economic matters need to commit ourselves to helping the global community and our respective countries meet the challenges ahead – policy and political – in whatever ways are available to each of us; and, at the same time, we need to deal wisely in our respective endeavors with what I believe is an uncertain shorter-term outlook and a promising but complicated longer-term outlook. And, as I said at the beginning of my remarks, the enormous accomplishments of Singapore through sensible and sound decisions over a long period of time should be an inspiration to all of us as we work to help our countries and our enterprises navigate the future effectively.

Thank you.