close to zero. Latin American economies would feel the brunt of the U.S. slowdown and dollar depreciation through a flattening of their exports. Monetary and fiscal policies could come into play but initial conditions are not favorable for a big expansion. In sum, a hard landing of the United States would impact most negatively Japan and Latin America and less Euro-11. World growth would clearly take a dive. One small consolation would be the much-awaited appreciation of the euro against the dollar.

The chance of a soft landing depends on the Fed and the oil price shock. If the Fed were to believe that higher oil prices would not last beyond six months and actually oil prices were to follow the Fed's prediction, monetary policy would change course and expand. Short-term interest rates would fall to compensate the adverse effects on the economy of a declining stock market and higher oil prices. Net capital inflows would slow down and the dollar would depreciate, but much less so than in the hard landing scenario. Globally, a soft landing of the U.S. economy would be relatively benign.

As to oil prices, these are bound to remain high throughout the winter. The short-term supply of oil is very inelastic to prices; the demand is also very inelastic to prices. Consequently, if the demand for heating oil were to rise in response to a harsh winter, oil prices would be bound to rise before falling. Over the medium run, the supply of oil is responsive to oil prices. Oil producers will find it profitable to extract more oil from existing wells and bring to production new wells. Experts indicate that it takes approximately six months for the supply of oil to adjust to the higher oil prices. Until then oil supply will remain relatively rigid.

Another risk of the forecast arises from the possibility that the United States may not be able to borrow approximately $400 billion a year to finance its current-account deficit. While this state of affairs cannot go on forever, it can last for quite a few years. There is no way to tell when foreign capital will turn sour on the United States. The day it will happen a hard budget constraint will be enforced on the U.S. current account, meaning that either exports will rise or imports will decline or there will be a combination of more exports and fewer imports. For exports to rise substantially, the dollar would have to depreciate significantly in the exchange markets with the obvious consequences on domestic price inflation. For imports to fall sharply, the U.S. would have to suffer a cut in income. This is what usually happens in countries that have to correct a current account deficit: unpleasant but necessary consequences. The United States is fortunate to have the largest economy and the most widely used currency in the world.

In sum, the soft landing scenario may appear a good bet should oil prices stay high or rise for a limited number of months.

# Financial Market Forecast for 2001

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It is time for us to take out the crystal ball once again. 2000 being a presidential election year we must repeat one salient truth: the 2001 forecast is not dependent upon who is in the White House.

There are three major factors in forecasting the financial markets: interest rates, earnings and the risk premiums. First, interest rates are lying on a yield curve that declines by 60 basis points in the first 15 months and is then essentially flat. This appears to indicate that the markets are looking for a slight decline in interest rates. But beneath this there is a major struggle between the forces of light and darkness.

The forces of light believe that the Fed is done tightening and the next move in interest rates, if any in the next few months, will be downward. While the forces of darkness see rising interest rates necessary to combat inflationary pressures due to the rise in the price of oil. By the way, there are two schools of thought regarding oil prices and interest rates. One is that the rising costs of crude diverts dollars out of the domestic economy and, although some may come back via the financial system, that this may actually reduce inflationary pressures in the general economy. The counter argument is the classic cost-push argument that high crude prices raise costs and

business will pass these costs through the system causing inflation. Being essentially a monetarist, I lean toward the former in that higher crude prices reduces the domestic real supply of money if we assume a constant Fed policy.

Second, earnings have been very robust for the past few years and although next year's growth may not match the recent record, corporate earning may still grow by nearly 10 percent. Corporate earnings growth will be hampered by the strong dollar and a consumer sector that is already spending at the "max". On the upside is a rate of productivity growth that does not show any signs of slowing. But the net is that earnings will grow but at a slower rate than in the recent past.

Third, will this slower growth upset investors? This is where risk premiums enter our discussion. Until this past spring we had seen risk premiums decline to the lowest level in memory. It is always difficult to separate the effects of declining risk premiums from rising expectations but it appears that over the past few years that expectations were rising and risk premiums were falling.

Since last spring the NASDAQ index has fallen sharply relative to both the Standard and Poor's 500 and the Dow Jones Industrial Average. This indicates that there has been an increase in the risk premium. It should be noted that this increase appears to have just restored the risk premium that evaporated during the speculative surge in the five months, November 1999 through March 2000. Therefore, there may be further relative erosion of the prices of the riskier part of the stock market.

There are imponderables that will worry the financial markets. The two big ones are full-fledged warfare in the Middle East with its impact on oil supply and prices and the future of the Euro. Barring any major calamities we look for a 50 to 70 basis point decline in short rates and steady long rates. The stock market will be the driven more by the nexus of risk premiums and expectations than by actual interest rates and earnings realizations. There is a real probability that the riskier part of the stock market will under perform the more defensive part of the market. Remember that valuations are still relatively high. So short term investors: "you be careful out there". But long term investors (7 years and longer): "hang on Sloopy hang on".

# Soft Landing for Housing

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Housing starts have been slowing throughout the year 2000. During the first quarter of the year housing starts were at a 1.7 million unit pace but by the third quarter the pace had slowed to about 1.5 million units. The average for 2000 will likely come in at around 1.6 million housing starts but for 2001 the rate is likely to be about 1.5 million starts. This is not a drastic decline but suggests a "soft landing" for housing as the impact of higher interest rates and perhaps lower equity prices has had an effect on housing markets. New and existing home sales are also likely to come in at a lower level for the year 2000 than the previous year and continue to decline in 2001.

At the same time, the "good news" is that the percent of Americans who own their homes hit a record high 67.7 percent in the third quarter of 2000 according to the U.S. Department of Housing and Urban Development. The relatively low mortgage rate environment and steady home prices has no doubt contributed to the ability of more people to purchase a home. In fact, the national median home price for both new and existing homes actually declined in 1999 to $133,000 from $147,000 the previous year. The deductibility of mortgage interest for the purposes of calculating federal income taxes no doubt also continues to encourage home ownership. The IRS recently reported that nearly 31.5 million federal income-tax returns for 1998 included a deduction for home-mortgage interest payments. This represents about one fourth of all tax returns and a lot of voters who are unlikely to support elimination of the home mortgage interest deduction (even though Morton Marcus has stated during past Outlook Panels that this just subsidizes rich people)!

Lower home prices in 1999 resulted in an increase in the housing affordability index to 137.8. An index of 100 indicates that the median income family can just afford to purchase the median price home