35th Trend/Forecasting Report

The World at a Crossroads

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Political Overview For 2007-2008:
Politics As Usual

With Congress back in session after the August recess, look for a stepped-up effort by the Democrats and breakaway Republicans to set a timetable for the drawdown of U.S. troops from Iraq.

Look also for renewed partisan infighting over just about every issue as the 2008 political election year approaches. The Democrats will try to increase spending on education and health and simultaneously increase taxes on business and the wealthy to finance these measures.

There may be some Republican support for increased domestic spending, but the party will vigorously oppose any tax hikes. This will likely spell stalemate.

After a year of campaigning, and with more than a year to go for the 2008 presidential election, the question is whether the candidates or the voters are more exhausted by the prospect of many, many more months of the same.

Expect someone, or perhaps several, to make a fatal mistake. There is just too much time and too many variables to avoid that.

Although some in both parties have dropped out, the field is still crowded. Eight Democrats and nine Republicans remain in the race for their party's nomination.

And waiting-in-the-wings are at least two possible third party candidates—New York Mayor Mike Bloomberg and Newt Gingrich, who may yet toss their hats into the ring.

This is, by all odds, one of the longest and strangest presidential campaigns in recent memory.
To begin with, the early front-runners from each party are both from New York — Democratic Senator Hillary Rodham Clinton and former Mayor Rudolph Giuliani — even though New York has not fielded a presidential nominee from either party since 1948.

While the increasingly unpopular war in Iraq is clearly the biggest issue in the minds of most Americans, the two candidates favoring an immediate U.S. withdrawal from the war—Democratic Representative Dennis Kucinich of Ohio and Republican Representative Ron Paul of Texas—barely register in the public opinion polls.

And who would have predicted after the 2004 presidential election that the candidates leading in the polls going into the 2008 election would include a woman, an African-American, a Mormon, and a twice-divorced former New York City mayor?

Although the Democrats seem satisfied with their party's field of candidates, the Republicans are so unhappy with theirs that the latest entry in the presidential sweepstakes, actor and former Tennessee Senator Fred Thompson, scored high in public opinion polls long before he exhibited any open interest in running.

The one bright spot emerging from this long campaign is that, with the recent front-loading of the presidential primaries and caucuses, the likely nominees from both major parties will be known by February 5, 2008, when almost half of the delegates to the national nominating conventions will have been chosen.

For the Democrats, the odds favor Hillary Clinton, who has led in polls among Democrats almost from the outset. Despite high negatives, her campaign has been well-organized, heavily funded, and carefully orchestrated, in part by advice from husband and helpmate, former President Bill Clinton.

Hillary's main challengers are charismatic Illinois Senator Barack Obama and former vice presidential nominee John Edwards of South Carolina. Obama and Edwards are handicapped because both are competing for support from the party's liberal wing while Clinton's centrist positions give her a broader range of support.

On the Republican side, the picture remains murkier. It's hard to believe that, given their previous positions, either Rudy Giuliani or his chief current rival, former Massachusetts Governor Mitt Romney, can be nominated to lead the party that has long championed bans on abortions, stem cell research, and same-sex unions.

With the Democrats heavily favored to win the White House and retain control of both houses of Congress in 2008, it is possible that the Republican base will end up supporting a more conventional conservative like Thompson, former Arkansas Governor Mike Huckabee, or Senator Sam Brownback of Kansas.

Whether Bloomberg will mount a third party challenge remains to be seen. Bloomberg, a Democrat turned Republican, turned Independent, is a billionaire and could easily finance an independent candidacy. But the history of third party efforts over the past 100 years is a dismal one, and it is highly unlikely that 2008 will prove to be an exception.

Implications For Business

• Don't expect much in the way of pro-business legislation from the Democratically-controlled Congress after six years of overwhelming corporate backing for the Bush Administration.

• Look for Congress to tighten trade restrictions aimed at stopping the outflow of jobs and capital investment abroad.

• Expect some kind of significant legislation broadening healthcare coverage plus a wave of "green" legislative proposals to reduce CO2 and other greenhouse gas emissions and encourage development of alternative energy sources.

• Look for a strong emphasis on ways to make the "green" movements pay off by reducing energy use through conservation efforts and investing in alternative energy sources.

Just When We Need Them, Where Are The Great Leaders?

The wars in Iraq and Afghanistan drag on and no one has a clue about how to turn them into victories. The terrorist threat grows greater while relations between the West and the Islamic world deteriorate. The economy skates on thin ice, yet policy matters in Washington and world capitals are confused and indecisive. Global warming is generally recognized as a looming threat, yet the politicians dither, not just in the U.S., but in India and China.

The list of world-class problems is long and growing, but nowhere on the horizon is there a leader, or team of leaders, with the vision, courage, and skill to tackle them.

The large crowd of presidential hopefuls illustrates the problem. Polls show that Democrats are happier with their choices than are Republicans. But even among the Democrats, none of the candidates ignites real passion. Each is flawed or carries serious baggage. None has offered a compelling and aspirational agenda for the future.

The business world fares no better. Giants like Warren Buffett and Bill Gates are aging out of the scene, and no younger counterparts seem to be emerging. Most CEOs are professionals who keep their heads down and their eyes on the bottom line, which is fine. And for many of these men and women, it is all about money.

Where is the global vision?

In the past, great challenges summoned up great leaders. Think of Washington, Lincoln, Churchill, Dr. Saulk, Adenauer, Ataturk, Sadat, FDR, and even Mao Tse-Tung. The challenges today are of even greater magnitude, yet where are men and women of such stature? Why won't men and women step up? New leaders have emerged in Europe—Gordon Brown in the U.K., Nicolas Sarkozy in France, Angela Merkel in Germany. Time will tell about their records, but so far the word "greatness" is not on anyone's lips.

Explanations for this absence of leadership do not come easily, but if the question is limited to American politics, especially the presidency, some informed analysis emerges:

• Presidential campaigns are far too long—the current one started nearly 22 months before the actual election—too costly, and too dominated by pollsters and consultants.

• Candidates are carefully rehearsed to stick to safe, general answers to tough questions to avoid offending important blocs or major donors. The campaign "speech" is a package of focus group-tested bromides that is repeated with little or no variation at every stop.

• The "gotcha" nature of media coverage and attack ads tends to rule out anyone who has taken on real challenges and make many tough decisions. Such people are usually outsized personalities who aren't afraid to make mistakes, which makes them easy targets.

• The growing power of interest groups also makes it difficult for anyone who has ever taken a controversial stand or uttered an offensive line to survive.

The result is elections that are little more than popularity contests that play out almost entirely on TV—which has the added effect of making them indistinguishable from entertainment. Presidential elections turn on personality and "character" rather than substance, and likability becomes far more important than competence.

A similar list can be developed for business.

The belief that was ushered in by Teddy Roosevelt and his fellow reformers and lasted well into the '70s that government service was one of the highest callings and could alternate with a career in the private sector has not entirely gone away. But it is deeply, and perhaps permanently, eroded. In fairness, it should be noted the financial rewards that the private sector offers today are so large and—when compared with the bruising life of the public arena—so pain-free that many good people prefer to remain in business. But even with huge rewards in many cases, men and women in business have just not stepped up.

Implications For Business

If history is shaped by the impact that great leaders have on the events of their time, then we live at a troubled and uncertain moment. Look for continued division and drift in Washington, with, at best, only incremental progress on homeland security, the economy, education, the infrastructure, and other pressing needs. Expect employees of businesses to drift, not care, and lack a supportive spirit, as they will find it difficult to rally behind those who will not leave the corner office except to play golf or otherwise consort at their exclusive country clubs.

Global Market Volatility: It's Not Over Yet

Fast and decisive action by the U.S. Federal Reserve Board and the world's central banks temporarily headed off a liquidity panic in global stock exchanges last month, but left unresolved whether the real crisis is over.

The Fed and other central banks pumped billions of dollars into the global financial markets to head off a credit crunch precipitated by a collapse in the value of untold billions of dollars in subprime mortgage notes held by banks, investment houses, hedge funds, and other investors.

While this helped to stabilize plunging stock markets around the world, the action by the Fed and foreign central banks was only a temporary fix for the wider concern over declining investor appetite for up to $1 trillion dollars in "asset-backed" instruments such as mortgages or accounts receivable.

Until investor confidence in the markets returns, investor money is likely to continue to flow out of the equity markets into safer havens like U.S.

Treasury bonds and notes. So, barring a dramatic change in the economy, look for continued investor uncertainty and market volatility for the next few months.

Meanwhile, considerable damage has already been done to the national and global economies as a result of the credit crunch. The banking system at home and abroad suffered financial losses and giants like the Goldman Sachs Group, Morgan Stanley, Merrill Lynch & Co., and Bear Stearns Cos. are expected to earn less than expected through the next year as a result of the rout in sub-prime mortgages.

The liquidity crisis had worldwide impact on equity markets and banks—in Asia as well as Europe. At the end of last month, an Australian-owned hedge fund registered in the Cayman Islands, Basis Yield Alpha Fund, which specialized in corporate and structured credit, filed for bankruptcy protection in New York citing "significant devaluation" in its asset portfolio.

European banks were also seriously impacted. Two German banks required central bank bailouts over fears of losses at Barclays, one of Great Britain's largest banking firms. The problems in those banks were linked to so-called conduits and structured investment vehicles (SIVs) that borrow money at low interest rates to invest in debt pools offering a higher return.

While the credit crunch in commercial paper isn't believed substantial enough to sink any major European banks, it could still restrict their ability to buy back stock or make additional loans. The key problem is that no one really knows where the sub-prime problems are buried, causing a loss of confidence on the part of both bank managers and investors.

At the root of the problem is the badly slumping American housing market, which precipitated the crisis and which continues to exert a drag on the U.S. economy.

The housing slump and credit tightening have brought a decline in housing values across much of the nation, and a ripple effect is being felt not only in the banking and investment industries, but in the home supply and construction industries and in auto sales as well.

Last month's financial turmoil prompted some government policy-makers and Wall Street analysts to reduce their expectations for growth in the overall economy. A respected economic forecasting firm, predicting that third quarter growth would be markedly lower this year, reduced its full-year forecast for 2007 from 2.1% to 1.9%.

The Congressional Budget Office said the market volatility would not derail economic growth, but it still reduced its previous forecast for this year from 2.3% to 2.1 % and warned that uncertainties were higher than normal.

Nonetheless, the economic slowdown could get worse, possibly triggering a recession, if mortgage foreclosures continue to mount. By the end of July, the national foreclosure rate was up 93% from a year ago. And that was before the credit crunch occurred and lending requirements for home loans were tightened considerably by most banks.

Fed Chairman Ben Bernanke has made it clear that he stands ready to take whatever action is necessary to keep the economy afloat, presumably including reducing interest rates if the situation warrants it.

But, if the economy tanks due to the ripple effect from the housing slump, reducing interest rates is likely to have little immediate impact. When consumer confidence and investor confidence are at low ebb, which is usually the case in a recession, there is much less incentive for a lender to lend or a borrower to borrow.

Implications For Business

• Be prepared for an economic slowdown and be cautious in assuming increased debt.

• If you have a healthy cash supply, look for bargains in mergers and acquisitions as troubled companies reach out for help.

• Expect Congress to push legislation to regulate hedge funds and private equity firms and to require greater transparency in derivative transactions and SIVs.

Private Equity: A Return To Sanity

Throughout the recent "Golden Age of Private Equity," fund managers knew that the run of ridiculously cheap credit fueling their boom would dry up, and their industry would be faced with some unpleasant truths. A few of the industry's titans didn't even try to hide this knowledge: Even as it was being priced, the Blackstone Group's initial public offering in June was widely recognized as Stephen Schwarzman's announcement of a market top. A few weeks later, the credit well did, indeed, run dry. It happened suddenly—faster than most experts had predicted—and it caught even the most experienced private equity managers off-guard. The sub-prime mortgage collapse awoke banks from their credit binge, and acquisition financing packages fell apart as bankers tried to reassert some sanity in their lending practices.

In trying to assess the fallout, it's interesting to note the parallels between private equity and another market brought to its knees by the 2007 summer credit crunch—the housing market. In each market, easy credit fueled an unprecedented surge in prices and transaction volume, and in both markets the sudden credit reversal brought deal flow to nearly a dead stop. Currently, both markets find themselves in a corrective, limbo-like period in which sellers are still yearning for yesterday's valuations, and buyers are pressing for terms that are often just too aggressive.

This post-Labor Day period is a critical litmus test for how the private equity industry settles out. Some $400 billion in announced LBO deals have yet to be completed.

The likely scenario: Most of the financing packages will get done at steeper rates and tighter terms; the prices paid for these companies will fall at a commensurate rate; a handful of deals will no longer make sense as the new terms fall apart; a small number of private equity firms will take fatal hits; returns for the industry as a whole will fall sharply for 2007.

But the top 10-15% of private equity managers will still notch double-digit returns and, finally, deal flow will begin to pick up again—albeit at a severely reduced rate—as financial and strategic acquirers take advantage of a perceived buying opportunity.

Implications For Business

Although the last few months have been rough ones for private equity, it's important to bear in mind that the industry operates over multi-year cycles. Even if returns for funds deployed in 2007 fall sharply, most funds will still be posting respectable—and in the case of the industry's top 10% of mangers, impressive—returns on their multi-year portfolios. Funds raised after 2005 will also benefit from attractive buying opportunities created by the reduced prices in coming months—a dynamic that will also benefit strategic buyers.

Conclusion: If you have exposure to private equity in your corporate pension fund or individual investment portfolio, stay the course. Yes, the "Golden Age," as such, is over, but…

Final note: In our view, the proposed tax increase on PE firms is likely to go nowhere. The movement, given impetus by the Blackstone IPO, whose stock price has now fallen on hard times, as have prospects for KKR's IPO—both reflections of the industry's current period of dislocation. The keen sense of Blackstone-generated outrage is being diffused.

Hedge Funds: Old Truths In A New Reality

The financial turmoil sparked by the U.S. subprime mortgage crisis will continue into 2008. A growing number of investors—including wealthy individuals and corporate and public pension plan sponsors—will learn some hard lessons about the risks of hedge fund investing. As one banker we know put it recently: "Up to the summer of 2007, people had started to think that investment risk meant volatility. But they've been reminded that it can also mean capital loss."

Despite some significant hedge fund investment losses and some high-profile meltdowns—some of which are yet to come—hedge funds will remain a central plank in the investment strategies of institutions and individuals, and they will remain important liquidity providers in the global financial markets.

Investors in 2008 should be on guard against the many less-than-obvious risks associated with hedge funds:

Imaginary Returns and Survivor Bias: Because managers report performance to hedge fund indices on a voluntary basis, general assumptions about hedge fund performance are unrealistically high. Managers report performance in good quarters and opt out in bad. Hedge funds with the worst performance—those that crater and close—never report performance in their waning days.

• **Inadequate Allocations:** Most investment experts contend that an asset class must represent at least 5% of an investor's portfolio in order to have a real impact on performance and diversification. This is especially true for hedge funds, which have such high fees and require an inordinate amount of time to select, understand, and monitor. Many investors that dabble in hedge funds for more than a year or two while getting their feet wet are wasting time and money.

• **Style Drift:** When a long-term boom in convertible bonds came to an end in 2004, many convertible arbitrage shops decided, rather than close their doors, they would switch to new strategies. One such fund: Amaranth Advisors, moved into energy trading. In the midst of the current market upheaval, smart investors will keep close tabs on their hedge funds to ensure that managers aren't seeking out easier returns in strategies in which they have no particular expertise or competitive advantage.

• **Leveraged Beta:** Hedge funds generally market themselves as generators of alpha (above-market returns) and as diversification tools. This is not always true. Hedge fund returns often consist of market returns x leverage. The correlation between the most widely used hedge fund and global equity indices has at times topped 0.90. Investors can protect themselves in their own portfolios by seeking out managers that consistently generate real alpha. They will have a more difficult time avoiding the systemic risks arising from these high levels of correlation, which are now so powerfully on display.

Implications For Business

This is an arcane, secretive, and very risky place to be.

Think About This

The human brain, researchers say, has about 400 parts. We know how several dozen of these parts function, but know nothing of the rest.

Credit Markets: The Return Of Relationship Banking

Alan Greenspan said in late summer that the turmoil that first hit global financial markets in July is "identical" to what occurred during the stock market collapse of 1987 and in past market crashes. While equity investors might say that pronouncement is premature, bond traders may well be accusing the former Fed chairman of understatement.

Trading in many fixed-income products ground to a near complete halt in the third quarter of 2007. With losses mounting, banks have become nervous about lending even to each other, and many of the sophisticated financial vehicles hailed as historic innovations in engineering just months earlier are teetering on the brink of collapse.

All over the world investors have lost faith in seemingly every fixed-income instrument save U.S. Treasury bonds, rates on which dropped 2.5% due to frenetic late-summer buying—the fastest drop in the history of the government securities market.

The ongoing "credit crunch" is every bit as powerful and painful as the '87 stock market crash, but it remains to be seen to what extent the consequences will spread into the broad economy. In many ways, 2008 will provide a definitive test of the 21st century financial infrastructure. Over the past five years, prevailing wisdom had it that global markets have been made more robust by a new financial architecture in which borrowers can access credit provided through a host of capital markets vehicles.

Risk, rather being borne by a handful of banks, is spread across thousands or even millions of investors and counter-parties around the world. As the thinking goes, because losses in any major credit event will now be incurred not just by a few huge lending organizations, but by a multitude of investors ranging from hedge funds and pension funds to structured investment vehicles, the impact of future market downturns should be diluted.

Now that hypothesis is being put to an acid test. Since the collapse of the sub-prime mortgage market in the United States, sub-prime exposure has turned up in such unlikely spots as money market accounts with sterling credit ratings and the previously sleepy German Landesbank sector. By this time next year we will know how successful—or delusional—this dispersal of risk was in helping to contain a potentially catastrophic market event. Even on a best-case basis, the future will hold some nasty surprises for at least some of the investors who have helped shoulder these newly dispersed risks.

Implications For Business

For many companies, the well of credit previously filled by capital from "alternative sources" has run completely dry—at least for the time being. To these and all companies, we offer one bit of advice: Do what business owners and corporate executives for the past 100 years have done when they needed financing: Put on your best suit, polish your shoes, and go ask your local banker for a loan. Expect plain old relationship banking to regain some of its former stature.

Our Crumbling Infrastructure: A Marshall Plan For The U.s.

That the nation's sorely neglected, aging, critical infrastructure has been deteriorating for many decades is not exactly news. But it may have taken the Katrina disaster or the spectacular bridge collapse in the Twin Cities last July to galvanize public and private action and focus the attention of policy-makers—both, long overdue wake-up calls.

The facts are stark: Some 33 percent of our major roads are in poor or mediocre condition. Since 1966, about 1,500 bridges have collapsed in the U.S. The American Society of Civil Engineers gives the nation's overall transit system a lowly D+ rating. At least 3,500 U.S. dams have been assessed as unsafe. The depressing list goes on and on.

The U.S. Transportation Department estimates the costs of repairing the nation's highways and bridges at some $495 billion. When you factor in rail lines and ports, the American Society of Civil Engineers puts the tab at $1.6 trillion—and that doesn't include airports or water and energy systems.

Those numbers are astronomic, but no policymaker should put a dollar figure on the safety of our citizens. A bold vision that will mobilize the nation is what is required.

Expect large-scale, out-of-the-box thinking about this genuine crisis that may lead to a workable, comprehensive strategy—perhaps a domestic Marshall Plan for the 21st century—to address the problem while simultaneously jump-starting the economy, creating millions of new jobs, and assuring that the U.S. continues to enjoy the competitive advantages derived from the infrastructure investments made by our forbears.

Today, private financing and investment must also be a significant part of that project with the business community leading the effort.

Look for a truly massive public-private commitment to come into play. Both liberals and conservatives will come together on this highest priority issue and forget past obstructionist positions. Knee-jerk opposition by the environmental movement to highway and bridge construction projects will be put aside.

The right has to jettison its mantra of tax and spending cuts when it comes to fixing the U.S. infrastructure. Federal spending for infrastructure has declined by as much as 50 percent since 1980. It currently totals less than two percent of GDP contrasted to a surging China, for example, where the figure stands at nine percent.

Yes, a new domestic Marshall Plan will be costly, but the benefits are indisputable. And there is no alternative.

Implications For Business

Major expenditures will be a huge factor driving economic growth and development across the country. An efficient transportation system may be also one of the nation's most important economic assets, providing businesses with freedom of location and the ability to quickly reach customers.

Think About This

What happened to Y2K?

Iraq—is There A Solution?

The short answer is no. President Bush's "Surge" and "New Way Forward" have brought about minor reductions in violence in Baghdad and Anbar Province, but the sectarian killing goes on unabated throughout the rest of the country. Most importantly, the central government has made no substantial progress on arriving at a political settlement, without which the civil war will continue.

Meanwhile, expect President Bush to try to change things and to prevail, and probably make troop reductions as we move toward November, 2008. The Congress simply does not have the votes to force a major course change. If Congress advises a change, it cannot muster the 68 votes to override the Bush veto. So, the Iraqi quagmire will be left for the new administration to resolve.

Implications For Business

• Do not count on a peace dividend in the federal budget any time soon.

• The defense industry can count on a continuation of high levels of spending on military equipment and weaponry for the coming year.

• Democrats in Congress will push very hard to close tax loopholes to free up funds for domestic spending on health, education, and welfare programs.

• Budget constraints will rule out any new major domestic initiatives.

Tribalism Vs. Nation-building: Who's Winning?

The lofty intention often invoked by the Western politicians, having for the most part overlooked tribalism as they drive the concept of nation-building and democracy in all parts of the world, is the high-minded mission of spreading democracy and freedom. Often overlooked and rarely understood in the West is tribalism, which reaches most of the Middle East, large potions of South and Southwest Asia, and Africa.

The simple reality is that the populations of many countries in those regions identify, not with their nation states, but with their tribes.

Many of today's "nations" are artificial entities created in the 19th and early 20th centuries by the colonial powers. Rival tribes (or clans, as some prefer to call them) were thrown together by map-makers in Europe and given identities that they tolerated only because they had no power to resist colonial authority. But the old tribal loyalties remained intact.

While nationhood was widely celebrated when it came after WW II, real patriotism of the kind the West is accustomed to was weak or non-existent.

Africans know this, which is why they adamantly insist on honoring national boundaries set by the European powers and refuse to recognize breakaway states. They know that if one tribe succeeds in breaking free, centrifugal forces on the continent could kick in and Africa could wind up as thousands of tiny tribal enclaves.

Even Turkey, which appears to be a large, stable nation, faces this dilemma. That is one reason the Turks are so determined to prevent the creation of an independent Kurdistan. If their own Kurds break away, the many other tribal groups in Turkey will demand the same right and the country could fall apart.

Not much of this has been apparent to Western eyes during the 50 or so years since the end of the colonial empires because most of the African and Asian nations seemed to be holding together and we assumed the citizens were national patriots just like us.

More often, the "nation" was held together because a strong man, or a ruling elite, enforced unity. Remove the strong man, as we did in Iraq, and the old loyalties pull everything apart. Somalia is a prime African example. A general, who seized power in a coup soon after independence, was toppled in 1991. No one was powerful enough to replace him and most of the country has been embroiled in lethal tribal warfare, like so many other African nations, ever since.

Today, tribalism trumps nationalism in much of the post-colonial world—witness the civil wars in Lebanon, Nigeria, the Congo, and Rwanda, to name only a few embattled nations. The West, in general, and the U.S., in particular, have been slow to recognize the underlying cause of these conflicts because we continue to identify the conflicts in national terms involving legitimate nation-states rather than dysfunctional aggregations of tribal groups.

Implications For Business

Diplomatic and strategic business thinkers need to figure this out. Until they do, undemocratic, often corrupt nations, driven by tribal rivalries where the rule of law does not exist, are risky environments in which to do business.

Iran—the Start Of A Mullah-driven Effort To Dominate The World

Iran has been a problem for the West since the Shah was deposed. Expect nothing to change in the near-term.

The mullahs are in charge, and murder, torture, imprisonment, ostracism and worse are the rules of this land—all done in the name of Islam and purity.

Since July, more than 120 people have been executed—four were stoned to death—and there are 150 awaiting execution in the next five months. Much of this is not happening in public. Notwithstanding, we believe the majority of Iranian people want a rapprochement with the West. The mullahs, however, will not let this happen as they seek a bigger goal—the start of Islamic domination of the world.

The U.S. has sent message after message that Iran should not be involved in and meddle in Iraq. The word has not penetrated Iranian leadership and matters are getting worse.

But the mullahs are vulnerable and they know it:
• Their approach is despised all across the Arab Middle East; no Sunni wants to see a foreign Shia, or Persian, gain hegemony in the region;

• Groups like Hamas in Palestine and Hezbollah in Lebanon accept Iran's leadership only reluctantly. If the mullahs have a problem, expect the terrorists to abandon them;

• Ninety percent of Iran's oil production and facilities sit in, or near, the Gulf. Losing this access will cause irreparable harm to Iran's leadership;

• Nearly one million men and women have been arrested for violation of the Islamic dress code. Most spend just a few hours in custody, but as of the end of August, 20,363 Iranians are in one of the country's 130 prisons for this alleged offense;

• The mullahs must work carefully to keep the Iranian army—450,000 strong—on their side and to protect the country's admitted 3,000 centrifuges that can be processed into military-grade uranium.

Implications For Business

Keep a close watch on developments here as everything from the price of oil to peace in many parts of the world and terrorism will be impacted by what happens in Iran—most, in a negative way. Expect nothing good in the short-term.

Afghanistan:
What Went Wrong, What's Ahead?

Assessing the current situation in Afghanistan, there is little doubt we are witnessing a very troubling reversal of fortune since December, 2001, when U.S. forces, leading an international effort, routed the Taliban, declared it "a spent force," and Hamid Karzai assumed the presidency of the newly-liberated nation.

Nearly six years later, after a period of relative calm, a re-grouped Taliban and even stronger al Qaeda, operating from their sanctuary in the friendly border regions of Pakistan, are staging a comeback as suicide attacks and roadside bombings wreak havoc in southern Afghanistan and warlords still control large parts of the country.

• Terrorist attacks more than tripled from 2002 to 2007 in the provinces surrounding Kabul and those close to the Pakistani border;

• The Helmand, Oruzgan, and Kandahar provinces are the scenes of intense fighting;

• Record levels of opium will be produced in 2007 for the second straight year, with a staggering 45 percent increase in the Taliban stronghold of Helmand Province. The poppy economy is apparently run and developed by the Taliban—estimated to be worth over $3 billion annually.

Critics pin the blame for this resurgence squarely on the Administration for taking the eye off the Afghanistan ball. They charge the U.S. with largely abandoning Afghanistan after the fall of the Taliban in order to divert significant intelligence, military, and reconstruction resources to the invasion of Iraq, which was already on the drawing board. After securing the capital of Kabul, U.S. forces left most of the rest of the country to the local warlords. Those critics also charge that the Administration, ostensibly in hot pursuit of Osama bin Laden, had him literally cornered in Tora Bora and then allowed the terror mastermind to escape.

A series of miscalculations have, in fact, dogged the U.S.'s entire Afghanistan adventure from the very start including the inadequate financial commitments made to that beleaguered nation compared to the outlays for Iraq.

There have, to be sure, been substantial improvements in the economy, education, and healthcare in Afghanistan's cities—especially Kabul. The economy grew by 14 percent last year. Telecommunications are booming. New TV channels are opening. Afghanistan now has three private airlines. But an apparent failure to win the hearts and minds of enough Afghans with country-wide, effective reconstruction efforts has enabled the Taliban to find new support among the tribal populace—especially from Pashtoons, who have always been their biggest allies.

Still, as in Iran, the jihadists and terrorists do not have broad support. They carry the day with fear.

More recently, the U.S., after cutting assistance in 2006, took a positive step when it significantly increased its financial aid to Afghanistan, which will reach $9 billion by the end of the year. The British are also spending $60 million to promote legal crops in the province, and the U.S. Agency for International Development is mounting a $160 million alternative livelihoods program across southern Afghanistan, most of it in Helmand.

At the same time, security has now devolved upon NATO with some 35,000 peace-keeping troops on the ground. Nonetheless, there is friction here, too, since NATO and American commanders disagree about the strategies to be employed against the Taliban and al Quada.

Implications For Business

All this said, kidnapping, murder, executions, and terror are a way of life in this country.
Western businesspeople have already slowed doing business in this part of the world and that has emboldened both the Taliban and al Qaeda.

Extraordinary amounts of money and effort are now being poured into this country to stabilize it. The question: What will it lead to and what action will the Bush Administration and Western Europe take? The prognosis is not good.

Expect violent deaths to accelerate this Fall as the West sends in operatives to gauge Taliban and al Qaeda plans for 2008, which will certainly be a strong offensive.

The consequences of failure in Afghanistan may be just as serious as that in Iraq since its border regions with Pakistan now appear to be the real epicenter of Islamic terrorism.

Turkey, A Buffer For The West: Islamic Or Secular?

Because Turkey is a powerful, strategically located, secular state of Islam, it is critical that the country remains a strong ally of the U.S.

The nation's July 22nd elections convincingly returned the ruling conservative Justice and Development Party (AKP) to power, demonstrating, for the time being at least, that Islam and democracy can co-exist. Nonetheless, the issue of mosque vs. state still looms.

Last spring, when the AKP nominated a very devout Muslim, Foreign Minister Abdullah Gul, to be president, secularist protests broke out around the country and the military hinted at a coup. (In Turkey, the president is also commander-in-chief of the Armed Forces.)

On August 28, Gul, a 54-year-old economist was elected president by successive votes of the mostly Islamist new parliament. His victory broke, for the first time in the 84 years since the modern state was founded by Ataturk, the dominance of Turkish politics by secularism. Gul had, however, previously stated that "secularism is one of the basic principles of the Turkish Constitution and I will work to protect it." But his election has still raised hackles in many quarters—especially the opposition Republic People's Party (CHP).

Although Turks have become increasingly devout during the past five years, the country continues to be an open society committed to the rule of law. A very significant percentage of the electorate did not, in fact, vote for the AKP. Yet, Prime Minister Recep Tayyip Erdogan is committed to relaxing the secularism that has characterized the nation. Many fear his party has a secret agenda to gradually Islamize Turkey. That is the Turkish dilemma.

The country's fast-growing middle class is strongly conservative and rapidly overtaking the die-hard, secular elite, who have ruled Turkey since 1923. Anti-American sentiment is also pervasive on the Turkish "street", stemming directly from the Iraq war and a growing Turkish ultranationalist movement continues to opposes close ties with the U.S.

Although Turkey has long been a member of NATO, its bid to enter the European Union has encountered considerable resistance—another sore point that hasn't helped U.S.-Turkish relations. Gul has vowed to re-invigorate the stalled Turkish efforts to join the EU, but he will face formidable opposition—notably, from France and Austria. The instability of Iraq hasn't helped either since that embattled nation sits on Turkey's southeast border, offering easy entry to Kurdish terrorists.

Turkey's role in Iraq is potentially very troublesome. Current U.S. strategy will be seriously undermined should Turkey intervene militarily by crossing the border to put down the militant anti-Turk PKK terrorists or block oil-rich Kirkuk from becoming part of the Kurdish Federation—all very real possibilities.

No less critical is the need to make sure that Turkey aligns itself with Washington against Iran, a major trading partner of Turkey and its ally fighting the PKK in the north. The Turks might easily elect to join with Russia and oppose very tough, meaningful sanctions against Iran. Recognizing Turkey's substantial influence in the Muslim world, especially with the Sunnis, Washington needs Turkish support for U.S. policy initiatives in the Middle East.

There is much speculation, too, that Turkey's future dealings with Russia could also be another hot-button issue that will impact U.S.-Turkish relations, centering around the largely undeveloped oil and gas resources of the former Soviet Central Asia region. Thanks to its strategic location, Turkey will surely evolve into one of the world's premier energy hubs with major pipelines snaking across its terrain. Both the U.S. and Russia will compete for Turkey's favor in determining where those valuable lines will run and whose products they will carry.

In short, Turkey is a very valuable ally the U.S. can't take for granted and can't afford to lose, but it will require some very astute diplomacy to sustain good relations.

Implications For Business

Although the political allegiances of the current Islamist regime continue to be problematic, there is no argument that the Turkish economy has been booming under the pro-business AKP. Many state-owned enterprises have been privatized as Turkey has evolved into a choice market for foreign investment. In 2006, it attracted over $20 billion from foreign investors, a whopping 20-fold increase in only three years. That trend will likely continue.

Abu Dhabi—a Middle East El Dorado

A fundamental premise of modern-day nation building is this: A country's wealth, especially accruing from its natural resources, must be put in the service of economic growth. On the face of it, that premise seems to capture the obvious, especially in the Middle East where more than 75 percent of the population of more than 300 million is below 30 years of age.

Not all of the Middle East's 16 countries possess great natural wealth, to be sure, but what about those that do? What else would a country—in this case, the United Arab Emirates—do with its enormous revenues from pumping out 2.1 million barrels of crude oil a day, confident in the knowledge that its proven oil reserves of nearly 100 billion barrels should last another 150 years. The U.A.E.'s oil reserves constitute 10 percent of the world's known supply. And natural gas? The country has some 60 percent of it.

By "country" one means, in this case, the Emirate of Abu Dhabi—when it comes to oil and gas. It is by far the biggest oil producer in the U.A.E., controlling more than 85 percent of total oil-output capacity, and possessing more than 90 percent of its crude reserves. Nearly 92 percent of the country's gas reserves are also located in Abu Dhabi and the Khuff reservoir beneath the oil fields of Umm Shaif and Abu al-Bukhoosh rank among the largest single gas reservoirs in the world.

Notwithstanding, the premise of contemporary nation-building has an important predicate—a blessed country needs strong investment vehicles for channeling its wealth. And in this age of galloping globalization, it isn't enough simply to invest. It is important to invest wisely. It is equally important to invest widely.

That is clearly what the Emirate of Abu Dhabi is doing. One has only to look around. There are vast residential developments being raised. There are commercial plazas on the horizon. There are new shopping malls sprouting. There is Abu Al Shuoom Island, the site of a proposed $10 billion project featuring homes, offices, parks and entertainment facilities.

And there are enormous areas of greenery all over the capital. Abu Dhabi is quite possibly the greenest city in the region. This is no accident or happenstance. City planners, taking their cue from the nation's founding father, His Highness Sheikh Zayed, have sought to expand verdant zones.

They have also sought to expand Abu Dhabi's cultural dimensions. Saadiyat Island will be home to the $400 million outpost of New York's fabled Guggenheim Museum. The Los Angeles-based architect, Frank Gehry, is designing.

Also on Saadiyat Island, Zaha Hadid is creating the Abu Dhabi Performing Arts Center. It will be part of a five-structure complex, the others being the Guggenheim; the Classical Art Museum; the Maritime Museum; and the Sheikh Zayed National Museum. Even the Louvre wants in. Negotiations are under way for that French icon to have a presence in Abu Dhabi.

The Higher Colleges of Technology, which recently marked the 20th anniversary of the system's founding by His Highness Sheikh Nahayan Mabarak Al Nahayan, is particularly on an expansion path. HCT is opening its 16th campus soon, and the undergraduate enrollment will rise past 20,000. Some 32,000 Emiratis have already graduated, and now many hold top-level jobs, especially in the corporate sector. The Oxford-educated Sheikh Nahayan, who is the U.A.E.'s Minister for Higher Education and Scientific Research, is seeking to establish more strategic alliances with educational institutions abroad, particularly in the United States. HCT's partners already include the Massachusetts Institute of Technology and Stanford University.

Implications For Business

• Many top U.A.E. decision-makers want more American businesses to compete for contracts in education, construction, and technology.

• U.A.E. officials want to encourage the professional training by American companies of young Emiratis, especially in the United States.

• Because Abu Dhabi has more than $500 billion in cash reserves, it is open to investment possibilities.

• Abu Dhabi prides itself on being one of the most environmentally friendly cities in the world.

Therefore, companies dealing in environmental or “clean” technology will find receptive audiences here.

Pakistan—more Than Meets The Eye

There are no less than five Pakistans within the territory that covers some 803,000 square kilometers, sitting in that geopolitically strategic zone to the west of India, east of Afghanistan, and south of China and Russia. The question is: Which Pakistan will survive, let alone prevail? Stability in Pakistan, with its nuclear arsenal, is critical for U.S. security.

There is the Pakistan of Pervez Musharraf, the military general who seized power in 1999 and made himself president. It is a Pakistan over which Musharraf has tenuous control. It is a Pakistan characterized by increasing violence and lawlessness, especially in the remote North-West Frontier Province and Baluchistan, from where fiercely anti-American tribal groups are spreading their message of militant Islam.

There have been two assassination attempts against Musharraf by suicide bombers and, reportedly, several others have been foiled by the shadowy Inter-Services Intelligence (ISI), a state organization of fiefdoms over which the president by no means exerts total control. Musharraf’s enemies resent his close ties with the United States, to whom he has pledged partnership in Washington’s global war against terrorism.

Musharraf shows no signs of yielding power, and it’s a reasonable bet he will leave office only when he’s deposed by Pakistan’s next military strongman or by a bullet or a bomb—or a combination of all three.

There is the Pakistan of the Westernized elites, the middle classes that savor luxury brands, dress well, and scorn veils and the traditions of rigid Islam that right-wing religious parties want to impose throughout the country. Pakistan is a constitutionally Islamic state contrasted to neighboring India, which is secular and whose 225 million Muslims outnumber Pakistan’s entire population of 175 million, making India, in effect, the world’s second largest Muslim nation, after Indonesia—where alcohol, gambling, and extramarital sex are prohibited.

But the country’s Westernized elite—which consist of the middle classes as well as the landowning class—live outside such prohibitions. The joke is that more malt is consumed in Pakistan than is produced in Scotland. The middle classes, who live primarily in big cities such as Lahore, Karachi, and Islamabad, do not necessarily support Musharraf. The landowning classes are the ones who put up candidates for a bicameral parliament, and for regional councils in the country’s four major provinces and seven tribal sub-provinces.

There is the Pakistan of Islamic militancy and constant political intrigue. The main political parties are the Pakistan Muslim League (PML); Pakistan People’s Party (PPP); Muttahid Majlis-e-Amal (the umbrella group generally known as MMA); Muttahida Qaumi Movement (MQM); and Pakistan Muslim League-Nawaz (PML-N). Musharraf reportedly invited former prime minister Nawaz Sharif to return home from luxurious exile in Dubai and London, but when Sharif landed home, he was quickly arrested and deported.

Now another former prime minister, Benazir Bhutto, is said to be in private talks with Musharraf in order to form a quiet pro-Washington alliance that would involve power-sharing between the general and the Harvard-educated Bhutto.

Her father, Prime Minister Zulfikar Ali Bhutto, was hanged by one of Musharraf’s military predecessors, General Zia ul-Haq, who was himself blown up in an airplane. Nawaz Sharif’s recent experience may be sobering for Benazir Bhutto as she contemplates a return to domestic politics in Pakistan, where there are lingering suspicions that her family—and most particularly her husband, Asif Zardari, known as “Mister Ten

Percent"—misappropriated billions of dollars of public funds.

There is also the Pakistan that seeks to sustain confrontation with India over the disputed Himalayan territory of Kashmir, which both nations claim. This is the same Pakistan that covertly supplies arms and training to guerrillas in Kashmir. It is the same Pakistan that supplies arms and training to members of the anti-U.S. Taliban in Afghanistan, much to the distress of President Bush. It is the same Pakistan whose troops and weapons prop up the Saudi royal family and several other despots in the Middle East in exchange for handsome subsidies that are largely pocketed by its military chieftains. Political scientist Ayesha Siddiqa said in a recent book that Pakistan's military has business assets of more than $20 billion, and owns 12 million acres of land.

The fifth Pakistan is one that has steadily registered an annual economic growth rate of nearly 7 percent. The consumer market is thriving, as is the manufacturing sector. Foreign direct investment is pouring into telecommunications.

Only a few months ago, the Abu Dhabi Group of the United Arab Emirates—which has the lion's share in Pakistan's WaridTel—arranged for a massive partnership with Singapore's Singtel. Pakistan's economic progress can be largely attributed to the will and wiliness of Prime Minister Shawkat Aziz, formerly a top executive at Citibank. He has proved to be a reassuring figure for Western investors, many of whom hope that he—and not Musharraf or Bhutto or Sharif—should be formally running not just Pakistan's economy but all five Pakistans. Aziz lacks a political base, and his personal life is said to be quite colorful. But it may well be that he would be the best bet to integrate the five Pakistans into one.

Implications For Business

• The telecommunications industry is booming. More investments are being sought.

• Investments are also being sought to build more roads and railways, especially in the remote provinces. American contractors traditionally are looked upon favorably in Pakistan.

• The political uncertainty aside, economic growth will continue at a high rate. That means a continuing boom in commercial and residential construction, and in shopping malls.

• Purveyors of luxury brands, and of electronics, are being sought. Pakistan wants to strengthen its power grid and streamline its ports and airports. There are also plenty of timely opportunities here.

India—booming, But...

There is so much hype about economic growth in India in this, the subcontinental giant's 60th anniversary year, that one could be forgiven for believing the world's foreign direct investment (FDI) is cascading exclusively into the Asian country of 1.2 billion people. But India gets barely $18 billion, or less than one-fifteenth of what rich countries invest overseas annually. Its neighboring political and economic rival, China, gets nearly $70 billion. And supposing FDI were to miraculously quadruple—what then?

India lacks what economists call absorptive capacity. Its infrastructure is antediluvian—ports are in disrepair, airports lack the capacity to handle increasing passenger and trade traffic, and the highway system is not good.

This is not to say that the economy isn't growing. Depending on which source you believe, the annual growth this year is likely to be around 9.5 percent; it has averaged around 7 percent for the last decade. Some officials of the government who financed India Brand Equity Foundation—which was set up by the Confederation of Indian Industries—even opine that the annual growth rate may exceed 10 percent.

The key question, however, concerns just where this growth is occurring. It should be in the manufacturing and agro-business sectors. But it's mostly in the telecommunications and technology-services sectors. These aren't sectors that generate the kind of large-scale employment that India desperately needs to address the expectations of an estimated 250 million who are jobless. Because the infrastructure is poor, foreign investors and domestic companies, too, are reluctant to build factories or to develop production facilities in the rural hinterland, where more than 60 percent of the country's population lives.

With no economic progress in sight, there's an understandable outflow of people from India's 575,000 villages into its six or seven largest cities. These cities—Mumbai, Kolkata, New Delhi, and Chennai, among them—are already bursting at the seams, their municipal services already shoddy and their governance inadequate. This has resulted in the expansion of slums: Mumbai's Dharavi slum is a city within a city; its population would make it the country's third or fourth biggest urban center.

What, then, is preventing the development and strengthening of India's infrastructure? For one, politics. The previous national government, led by the Bharatiya Janata Party, put into place an ambitious "Golden Quadrangle" highway plan linking India's four corners. But the current Congress Party-led 14-party coalition, the United Progressive Alliance, has dragged its feet—not the least on account of pressure from the Communist parties, whose support the coalition needs to survive in India's Westminster parliamentary system.

Then there's corruption. For example, New York representatives of some of India's top federal cabinet ministers demand outrageous sums from U.S. companies merely for access to officials in New Delhi. While Prime Minister Manmohan Singh has made an honest effort to streamline the bureaucracy, it's far too entrenched.

The U.S. Foreign Corrupt Practices Act makes it difficult for American companies to engage in the time-honored tradition of "baksheesh." European, Japanese and Asian companies have fewer limitations on what they can do to "win" contracts.

With nearly 850 million people still living on less than the equivalent of a dollar a day, poverty is pervasive. But that also means that if wise investment is made in manufacturing and agri-business, the consumer market has the potential of growing exponentially.

Implications For Business

• Huge opportunities exist in infrastructure sectors such as airports, roads and ports. The Indian government wants to spend nearly $500 billion in the next decade to strengthen the infrastructure.

• Strategic alliances with small-to-medium size companies, especially those that produce consumer goods will bring huge benefits. The companies need capital, and are most open to innovation.

• India is one of the few countries where newspaper and magazine readership is growing rapidly. Media companies are looking for partners. Conde Nast has just started an Indian edition of Vogue. Television networks are mushrooming. Plenty of advertising money is available to make investment in media companies worthwhile.

• Indians like Americans. Hollywood movies are nearly always money- spinners. India's production and post-production facilities are world-class.

• The telecommunications sector will continue to grow. More than 250 million cell phones are currently in use, but India needs another 600 million handsets to satisfy current demand—and demand is rising by the month.

Think About This

Scientists estimate that every four years the lifetime of those being born is extended one year.

Beyond The Middle East

Everyone is focusing on how to get our troops out of Iraq and whether Iran will be the next flash point the West must deal with.

Appropriate concerns, for sure.

But what about the Kashmir, Muslim-Christian fighting in Indonesia and the Philippines, Muslim-Buddhist problems in Thailand, Muslim-Christian violence in the Sudan, Muslim-Igbo violence in Nigeria, Muslim-Russian violence in Chechnya, violence between Muslim moderates and Islamists, between Sunnis and Shiites? Not to mention the "smaller" wars and battles in South America and Africa.

Estimates are that there are 42 significant conflicts taking place in the world today.

Implications For Business

What is now happening in Iraq can well occur elsewhere, with huge profits for some and major distress and anxieties for others. The challenges for the next group of diplomats and the next U.S. Secretary of State will be huge.

Holdings Of U.s. Treasury Securities

Foreign buying of U.S. financial assets continues to accelerate.

Of the $2.2 trillion of U.S. securities held by foreign nations, nearly half—Japan ($615 billion) and China ($405 billion)—are held by those two nations, potentially giving them remarkable economic clout.

Implications For Business

A sell-off is possible, but not likely. Nonetheless, the threat gives Japan and China a potent bargaining weapon.

Muslim Nations Do Not Support Terror

Data show that 15 of the 16 majority-Muslim nations are showing increasingly less enthusiasm for terrorism and, more specifically, suicide terrorism.

In Lebanon, 74 percent of the public said in 2002 that suicide bombings were justified. Only 34 percent feel that way today. Pakistan and Jordan have seen a similar trend.

Only in Palestine, where 70% say suicide bombing can be justified, has the trend not reversed. Almost all Muslims have lost confidence in Osama bin Laden.

However, fear of, and hostility toward, the United States remains high in Muslim nations. Indeed, 93% of Bangladesh citizens, 92% of Moroccans, and 81% of Malaysians are worried about the U.S.

Implications For Business

It is still risky to do business in many Muslim nations, but a turn could be coming. If it does occur, there will be huge rewards for those in a position to take them.

Are We Out Of Control?

More than 65,000 new videos are being posted on websites every day, and many of them are negative and often worthless in nature. This year more than 12,000 highlight video reels, from hate-rock concerts, pseudo-documentaries on Holocaust denial, and the history of the Ku Klux Klan were readily available on websites.

Some had been watched up to 132,000 times. To monitor them all is not feasible, so material is removed only if a user complains. YouTube (owned by Google) has guidelines to ban this type of material, but the sheer volume appearing every day makes policing it all virtually impossible.

Implications For Business

This trend augers badly for business and society. But checking this phenomenon flies in the face of the constitutional guarantee of free speech and the traditional American dislike of censorship. Business leaders will need to keep a close eye on what, if anything, is being said about their organizations and counter-attack any distortions with their own postings and blogs.

Putin's Russia—what Happens Next?

The future Russian political climate remains explosive and problematic. As we send this, President Vladimir Putin dropped a bombshell with the announcement that Prime Minister Mikhail Fradkov and his government had resigned and would be replaced by the relatively-unknown Viktor Zubkov, one of Russia's chief finance gurus, and a Putin confidante, who may be his choice as a successor.

Putin, 54, has promised to step down when his current term ends in March, as prescribed by Russian law. Many Russian observers are reading the appointment of Zubkov, who is no youngster, as a signal that Putin intends to continue to wield power behind the scenes while paving the way for a comeback. Hearing the news, a leading Russian banking official, commented: "This move lends credence to the speculation that the next president could be a one-term place-holder before the return of Mr. Putin." Divining the meaning of moves behind the Kremlin's walls is always a difficult game, however, and there is a way to go until the election.

Meanwhile, many believe Russia is, in fact, in decline. That is just not so.

To be sure, Russia still has major problems—crime, human rights abuses, huge pockets of poverty, no significant dissent, and a controlled media.

But Russia is, today, the world's eighth largest economy and the second largest energy exporter, ahead of most Arab states. GDP has been averaging a soaring 7% per year.

Mr. Putin, who came to power on New Year's Eve in 1999, is the person who has made much of this happen.

The oligarchs, despite their immense wealth, are now under control. Mikhail Kodorovsky, once Russia's richest person, went to jail in a process that demonstrated to all that Putin is the man in charge and their free rein under Yeltsin is ancient history.

The next "election" will clearly be decided by a handful of men close to Mr. Putin, all of them probably from St. Petersburg.

Among this group are Igor Sechin, who officially controls the flow of documents, but also oversees the economy, and Viktor Ivanov, who is responsible for personnel in the Kremlin and beyond. Then comes Nikolai Patrushev, leader of the FBS (successor to the KGB), and Sergei Ivanov, a former defense minister and now the first deputy prime minister. Each man has very substantial cash resources. Sechin is the chairman of Roseneft, Russia's state-run oil company. Ivanov leads Almaz-Antei, the country's main producer of rockets, and Aeroflot, the national airline. Ivanov is in charge of the aircraft industry. Today, over 75 percent of senior Russian officials come from the KGB or military.

Implications For Business

Russia remains a highly volatile and unpredictable part of the world and a place to approach very carefully. Russia's leadership clearly intends to return the nation to its former status and stature as a dominant global power no matter the cost.

Did You Know?

As-Sahab (not Al Jazeera): is al Qaeda's Propaganda Arm

**Skilled American Workers:
Where Are They?...what Is Happening?**

This month, almost 23 million young men and women are matriculating at college campuses across the nation in search of the American Dream.

At the same time, millions of jobs that require skilled workers in America go unfulfilled—computer technicians, welders, machinists, and medical technicians.

Compounding the problem, the high school dropout ratio in cities across America is astounding. In cities like New York, Philadelphia, Chicago, Detroit, and elsewhere, 40 percent or more of students do not complete high school. Administrators and educators are battling this phenomenon in every city, but the trend continues to spiral downward.

Although more than half a million associates (two-year) degrees are awarded each year, it has become something of a stigma to not attend a four-year college.

Meanwhile, young people immigrating into the U.S. are largely unskilled and frequently unprepared to even enter the nation's school system.

Implications For Business

Basic jobs that have served as the underpinning and strength of the American economy go unfilled or are taken by individuals with little or no experience or training. Tasks once considered routine are poorly performed or not addressed at all. This situation does not bode well for the economy going forward. Remedies are mandatory.

Think About This

Approximately 22,000 genes make up the human body, and 60-70% of these can be found in every other living organism from monkeys to trees. Ninety-eight percent of the genes in humans are also found in monkeys.

Seeds Of Discontent

Europeans, at virtually every level of society, are unhappy at the growing numbers of Muslims in countries like the United Kingdom, France, Germany, Belgium, the Netherlands, and elsewhere.

The worst-case scenario is an upward spiral of violence in which angry Europeans begin repressing Muslim populations, leading to violence by resentful Muslims, leading to still more repression. France was convulsed by such violent outbursts just two years ago. The U.K. has suffered them off and on for many years, and smaller eruptions have occurred sporadically in Belgium, Germany, and other European nations.

Here are the Muslim populations of key European countries (all figures are from 2006):

Belgium	Population, 10.5 million. Muslims, 380,000 (0.38%).
France	Population, 60.7 million. Muslims, 6.12 million (9.9%).
Germany	Population, 82.5 million. Muslims, 3.05 million (3.7%).
Netherlands	Population, 16.3 million. Muslims, 890,000 (5.4%).
United Kingdom	Population, 60.1 million. Muslims, 1.51 million (2.5%)

To Americans long accustomed to a mixed society, those numbers may not appear all that significant. But Europeans are accustomed to keeping immigrants out. That's how they built their national identities over the centuries. They generally think of themselves as the ones who should be imposing their superior culture on others, not accepting newcomers, who speak a different language, practice a different religion, and subscribe to different values. Resentments run especially high in the working-class and marginal communities where Muslim immigrants compete for housing and jobs.

History also teaches that when resentment against minorities reaches a boiling point, some Europeans have been extremely efficient and brutal in their reactions. Consider the many centuries of suppression, expulsion, and murder of Jews, culminating in the Holocaust. Think, too, of the murderous ethnic cleansing in the former Yugoslavia during the 1990s.

Implications For Business

Europe needs to figure out how to accommodate many cultures and nationalities just as the U.S. has. As long as the resentment and unrest continues, anxiety and uncertainty about investment in European companies and nations will put something of a damper on commitments.

Think About This

A search of the literature and discussions with more than a dozen economists shows that 18 months ago, nobody was talking about the subprime and related matters which focus our attention today.

That in mind, what can we expect in the next 18 months? Do our best economic thinkers believe there is danger ahead?

European Economies In Free Fall

In 1990, per capita income in Europe was 85% that of the U.S. It is now only 66% of the U.S. Old Europe is challenged economically.
There are exceptions, including London (not the entire United Kingdom) and Switzerland, which are big players in global finance. Ireland—which has virtually eliminated taxes, leading to unprecedented wealth—has gone from nearly last place in the EU to No. 2 in per capita income in only a decade. Eastern Europe is enjoying high growth thanks to low taxes although from a low base. Even high-growth Russia has substantially lower taxes than the U.S., though part of that is attributable to revenues from high oil prices (Russia is now the world's No. 2 energy exporter).
Overall, however, conditions outside of the continent's financial centers and vacation resorts confirm the relative impoverishment of average Europeans. The outlook is troubling.

Implications For Business

Economic prospects for average Europeans, especially the immigrants who continue to flock to the continent, are not good. Look for negative reactions against governments, agitation over trade issues, and general turbulence.

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Closing Quote

"We look upon our epoch as a time of troubles, an age of anxiety. The grounds of our civilization, of our certitude, are breaking up under our feet, and familiar ideas and institutions vanish as we reach for them, like shadows in the falling dusk."

Arthur M. Schlesinger, Jr.
1948

Appendix

Current Forecast in Key Economic Areas

FORECAST TABLE

COUNTRIES		Italy		Germany		France		Spain		United Kingdom		Netherlands		Czech Republic		Austria		Ireland		European Union		EUROZONE	
Indicators / Time horizon		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
GDP	Intesa Sanpaolo																					2,6	2,3
	Capitalia	1,8	1,7					2,7	2,4	2,8	2,3											2,8	2,1
	Goldman Sachs	1,8	1,6	2,7	2,3	1,9	2,5	3,8	2,8	3,0	2,4	2,7	2,5							3,0	2,6	2,6	2,3
	Merrill Lynch	2,0	1,6	2,7	2,6	2,2	2,1	3,6	3,0	2,8	2,3	3,0	2,6	5,9	4,8	3,0	2,7	4,9	4,5			2,7	2,4
	UBS Warbug	2,0	1,9	2,8	2,5	2,2	2,5	3,9	2,5	2,9	2,4	2,9	2,9	5,5	5,3	2,6	2,9	4,0	4,9			2,7	2,2
	IMF	1,8	1,7	2,6	2,4	2,2	2,3	3,8	3,4	2,9	2,7	2,9	2,7	4,8	4,3	2,8	2,4	5,0	3,7	2,8	2,7	2,6	2,5
	European Commission	1,9	1,7	2,5	2,4	2,4	2,3	3,7	3,4	2,8	2,5	2,8	2,6	4,9	4,9	2,9	2,5	5,0	4,0	2,9	2,7	2,6	2,5
	OECD	2,0	1,7	2,9	2,2	2,2	2,2	3,6	2,7	2,7	2,5	2,9	2,9	5,5	5,0	3,2	2,6	5,5	4,1			2,7	2,3
	BNP Paribas	2,0	1,7	3,0	2,6	2,1	2,1	4,1	2,8	2,7	2,2			4,9	4,9							2,7	2,2
	UBM	2,0	1,7	2,7	2,0	2,0	2,2	3,9	3,1	2,8	2,5					3,0	2,4					2,7	2,3
	Commerzbank	1,8	1,4	2,5	1,8	1,8	1,8	3,6	1,5	2,9	2,6	2,3	1,7	6,4	6,2	3,5	2,2	5,0	4,1			2,5	1,8
	Average	***1,9***	***1,7***	***2,7***	***2,3***	***2,1***	***2,2***	***3,7***	***2,8***	***2,8***	***2,4***	***2,8***	***2,6***	***5,4***	***5,1***	***3,0***	***2,5***	***4,9***	***4,2***	***2,9***	***2,7***	***2,7***	***2,3***
Private Consumption	Intesa Sanpaolo																					1,4	2,3
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch	1,7	1,5	0,4	2,5	1,9	1,9	2,7	2,7	2,7	2,0	1,4	2,1									1,6	2,2
	UBS Warbug	1,9	1,9	0,9	2,6	2,0	2,8	3,4	3,0	2,5	1,8	1,7	2,2	4,3	4,1	2,1	2,4	4,0	5,0			1,8	2,5
	IMF	1,5	1,5	0,4	1,3	2,2	2,6	3,3	3,2	2,8	2,6											1,7	2,0
	European Commission	1,7	1,7	1,0	2,3	2,6	2,3	3,5	3,3	2,4	2,2	1,9	2,8	4,7	4,4	2,0	2,1	7,4	4,4	2,5	2,6	2,1	2,4
	OECD	1,5	1,8	0,9	1,7	2,2	2,6	3,6	2,8	2,4	2,2	2,3	2,8	5,2	4,0	2,1	2,3	6,9	5,4			2,0	2,3
	BNP Paribas	1,9	1,7	0,1	2,3	2,0	2,7	3,3	2,6	2,9	2,0											1,6	1,9
	UBM																					1,6	2,2
	Commerzbank			0,0	2,0					2,6	2,1											1,5	1,9
	Average	***1,7***	***1,7***	***0,5***	***2,1***	***2,2***	***2,5***	***3,3***	***2,9***	***2,6***	***2,1***	***1,8***	***2,5***	***4,7***	***4,2***	***2,1***	***2,3***	***6,1***	***4,9***	***2,5***	***2,6***	***1,7***	***2,2***
Investments	Intesa Sanpaolo																					5,6	3,6
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch	3,6	2,9	6,0	4,3	5,5	5,0	6,0	4,2	6,4	3,0	7,3	3,9									5,5	4,1
	UBS Warbug	2,8	2,5	7,8	4,1	4,4	3,7	5,0	0,5	6,7	3,8	7,8	4,4	5,8	5,6	2,5	3,0	4,0	6,0			5,7	3,2
	IMF	2,4	2,2	4,7	4,1	3,0	3,2	5,6	4,8	7,0	3,6											4,1	3,6
	European Commission	3,1	2,5	4,9	3,7	3,7	3,4	6,0	5,0	5,5	3,8	4,2	3,6	7,6	7,8	5,2	3,2	5,0	3,5	5,2	4,2	4,4	3,6
	OECD	3,2	2,8	4,9	2,7	3,9	2,0	4,8	2,7	7,6	5,3	6,0	5,0	7,4	8,0	4,1	2,7	2,8	2,7			4,3	3,0
	BNP Paribas	3,7	2,6	9,1	3,4	4,2	3,2	6,7	3,8	7,5	5,0											6,4	3,0
	UBM																					5,1	3,3
	Commerzbank			4,9	1,7					6,6	3,9											4,7	1,4
	Average	***3,1***	***2,6***	***6,0***	***3,4***	***4,1***	***3,4***	***5,7***	***3,5***	***6,8***	***4,1***	***6,3***	***4,2***	***6,9***	***7,1***	***3,9***	***3,0***	***3,9***	***4,1***	***5,2***	***4,2***	***5,1***	***3,2***

FORECAST TABLE

COUNTRIES		Italy		Germany		France		Spain		United Kingdom		Netherlands		Czech Republic		Austria		Ireland		European Union		EUROZONE	
Indicators / Time horizon		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Imports	Intesa Sanpaolo																					6,1	5,6
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch	2,6	4,4	7,7	7,2	4,6	5,6	6,1	4,9	-3,4	5,2	6,1	4,5									5,9	5,4
	UBS Warbug	2,6	4,7	7,5	8,6	2,9	4,5	5,2	3,3	-4,8	4,6	6,8	6,4	9,5	10,6	3,0	3,0	5,5	6,5			5,5	5,9
	IMF	4,2	3,8	5,7	5,0	4,4	7,0	7,3	6,9	-2,0	5,0											5,6	5,5
	European Commission	4,6	4,5	8,5	7,6	6,0	5,6	7,6	7,0	5,7	5,1	6,3	6,2	11,0	10,0	7,3	6,7	5,8	5,1	7,2	6,6	6,7	6,2
	OECD	4,7	5,5	7,7	7,5	3,5	5,8	7,9	6,5	-1,1	7,0	6,6	6,5	12,0	11,4	5,2	7,7	7,5	6,8				
	BNP Paribas	4,0	3,9	9,8	7,9	4,5	6,4	7,1	6,1	-3,5	4,6											6,7	5,8
	UBM																					6,0	6,1
	Commerzbank			6,2	8,0					-6,2	4,5												
	Average	*3,8*	*4,5*	*7,6*	*7,4*	*4,3*	*5,8*	*6,9*	*5,8*	*-2,2*	*5,1*	*6,5*	*5,9*	*10,8*	*10,7*	*5,2*	*5,8*	*6,3*	*6,1*	*7,2*	*6,6*	*6,1*	*5,8*
Exports	Intesa Sanpaolo																					6,1	5,7
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch	4,4	4,4	8,2	7,0	4,2	5,1	5,9	4,2	-4,6	5,5	5,9	4,5									6,4	5,4
	UBS Warbug	4,1	5,2	6,5	8,5	3,0	4,6	5,9	5,1	-4,9	4,9	6,1	6,2	10,0	11,3	4,0	4,0	5,5	6,0			5,0	6,2
	IMF	4,9	4,1	6,2	4,7	3,8	6,5	6,2	6,2	-3,4	5,1											5,7	5,3
	European Commission	4,9	4,5	8,7	7,1	5,5	5,6	5,8	5,4	5,8	5,4	6,0	5,5	12,1	10,4	7,4	6,9	5,3	4,9	7,0	6,2	6,7	6,0
	OECD	4,0	5,1	9,4	7,2	4,0	5,9	6,3	6,3	-2,1	6,6	6,1	6,1	13,2	12,0	7,0	7,7	6,1	6,0				
	BNP Paribas	4,5	4,2	9,7	7,8	3,3	4,6	7,5	5,6	-5,5	2,6											6,3	6,0
	UBM																					6,4	5,8
	Commerzbank			8,1	7,6					-6,4	4,9												
	Average	*4,5*	*4,6*	*8,1*	*7,1*	*4,0*	*5,4*	*6,3*	*5,5*	*-3,0*	*5,0*	*6,0*	*5,6*	*11,8*	*11,2*	*6,1*	*6,2*	*5,6*	*5,6*	*7,0*	*6,2*	*6,1*	*5,8*
Unemployment rate	Intesa Sanpaolo																					7,1	6,8
	Capitalia							9,2	9,4														
	Goldman Sachs																						
	Merrill Lynch	6,4	6,2	7,0	6,6	8,6	8,4	8,1	7,9	5,5	5,3	3,3	3,0									7,0	6,7
	UBS Warbug	6,0	5,6	9,2	8,7	8,5	8,3	8,4	8,7	2,7	2,9	4,6	4,3	7,5	7,2	5,2	5,0	4,6	4,4			7,2	6,9
	IMF	6,8	6,8	7,8	7,6	8,3	7,8	7,8	7,7	5,3	5,1	3,2	3,1			4,5	4,3	4,5	4,7			7,3	7,1
	European Commission	6,6	6,4	7,3	6,5	8,9	8,5	8,1	7,8	5,0	4,9	3,2	2,7	6,4	6,1	4,4	4,3	4,5	4,6	7,2	6,7	7,3	6,9
	OECD	6,3	6,0	6,9	6,3	8,4	8,0	8,2	8,1	5,5	5,5	3,7	2,8	6,5	6,1	5,3	5,3	4,3	4,3			7,1	6,7
	BNP Paribas	6,4	6,2	9,0	8,3	8,1	7,5	8,1	8,2	5,4	5,6											7,0	6,6
	UBM																					6,9	6,6
	Commerzbank			9,0	8,2					5,4	5,1											6,9	6,6
	Average	*6,4*	*6,2*	*8,0*	*7,5*	*8,5*	*8,1*	*8,3*	*8,3*	*5,0*	*4,9*	*3,6*	*3,2*	*6,8*	*6,5*	*4,9*	*4,7*	*4,5*	*4,6*	*7,2*	*6,7*	*7,1*	*6,8*

FORECAST TABLE																							
COUNTRIES		Italy		Germany		France		Spain		United Kingdom		Netherlands		Czech Republic		Austria		Ireland		European Union		EUROZONE	
Time horizon / Indicators		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Unit Labour Costs	Intesa Sanpaolo																						
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch																						
	UBS Warbug	0,5	1,9	0,7	1,8	1,7	1,6	2,5	3,1	1,5	2,7	1,6	2,0									1,1	2,0
	IMF	2,6	2,4	-2,4	-0,9	-0,5	-0,5	0,2	0,7	0,1	0,4											-0,1	0,4
	European Commission	1,6	2,3	-0,1	0,6	1,6	1,6	2,3	1,8	2,4	2,6	1,6	2,2	0,0	-0,4	0,7	0,7	3,0	2,6	1,5	1,8	1,2	1,6
	OECD	1,3	2,1	-0,5	1,1	1,7	1,9	2,6	2,9	2,6	2,8	0,9	2,4	2,2	2,2	0,4	1,1	2,8	3,0			1,0	1,8
	BNP Paribas																					1,4	1,8
	UBM																					1,2	1,5
	Commerzbank																						
	Average	***1,5***	***2,2***	***-0,6***	***0,7***	***1,1***	***1,2***	***1,9***	***2,1***	***1,7***	***2,1***	***1,4***	***2,2***	***1,1***	***0,9***	***0,6***	***0,9***	***2,9***	***2,8***	***1,5***	***1,8***	***1,0***	***1,5***
Consumer prices	Intesa Sanpaolo																					2,1	2,1
	Capitalia	1,9	1,9					2,7	2,5	2,4	2,1											2,1	2,1
	Goldman Sachs	2,0	2,0	2,1	1,5	1,4	1,8	2,8	3,1	2,3	1,7	1,7	1,6							2,2	2,0	2,0	1,9
	Merrill Lynch	1,9	1,8	2,0	1,7	1,4	1,8	2,7	3,3	2,4	2,0	2,0	2,6	2,3	3,0	2,1	2,1	2,9	3,0			2,0	2,2
	UBS Warbug	1,9	1,8	2,1	1,7	1,6	1,7	2,7	2,9	2,4	1,9	1,9	2,1	2,1	3,4	1,8	2,0	3,0	3,0			2,1	2,0
	IMF	1,7	2,3	2,2	1,6	2,7	0,8	2,9	2,6	2,0	2,0			2,9	3,0			2,0	2,0	2,2	2,2	2,0	2,0
	European Commission	1,9	2,0	1,9	1,7	1,5	1,7	2,4	2,6	2,3	2,0	1,5	2,1	2,4	2,9	1,8	1,7	2,6	2,2	2,2	2,1	1,9	1,9
	OECD	2,0	2,1	1,8	1,7	1,3	1,7	2,5	2,7	2,4	2,0	1,4	1,8	2,5	3,4	1,6	1,9	2,4	2,8			1,8	2,0
	BNP Paribas	1,9	2,0	2,0	1,5	1,4	1,6	2,6	2,9	2,4	2,2			2,4	2,9							2,0	2,0
	UBM	1,7	1,9	2,0	1,8	1,4	1,7	2,6	2,8	2,4	2,0					1,9	1,9					2,0	2,1
	Commerzbank	1,8	2,1	1,8	1,3	1,6	1,9	2,5	2,2	2,4	2,1	1,6	1,6	2,2	3,2	2,0	1,9	5,0	3,2			2,0	1,7
	Average	***1,9***	***2,0***	***2,0***	***1,6***	***1,6***	***1,6***	***2,6***	***2,8***	***2,3***	***2,0***	***1,7***	***2,0***	***2,4***	***3,1***	***1,9***	***1,9***	***3,0***	***2,7***	***2,2***	***2,1***	***2,0***	***2,0***
Budget Balance (% of GDP)	Intesa Sanpaolo																					-1,1	-1,0
	Capitalia							0,6	0,1														
	Goldman Sachs																						
	Merrill Lynch																						
	UBS Warbug	-3,0	-2,7	-1,2	-1,2	-2,3	-2,0	1,6	1,0	-2,5	-2,4	-0,7	0,1	-3,9	-3,0	-0,6	-0,5	2,0	2,0			-1,1	-0,9
	IMF	-2,2	-2,4	-1,3	-1,3	-2,6	-2,4	1,3	1,1	-2,4	-2,2	0,5	0,7			-1,2	-1,0	1,3	0,5			-1,2	-1,1
	European Commission																						
	OECD	-2,5	-2,5	-0,7	-0,4	-2,3	-1,7	1,5	1,5	-2,7	-2,6	-0,7	0,3	-3,7	-3,5	-0,8	-0,6	2,0	1,7			-1,0	-0,7
	BNP Paribas	-2,2	-2,0	-0,7	-0,3	-2,4	-2,4	1,5	1,1	-2,7	-2,9			-3,9	-3,6							-1,0	-0,8
	UBM																					-0,9	-0,4
	Commerzbank			-0,4	-0,5																	-1,1	-0,9
	Average	***-2,5***	***-2,4***	***-0,9***	***-0,7***	***-2,4***	***-2,1***	***1,3***	***1,0***	***-2,6***	***-2,5***	***-0,3***	***0,4***	***-3,8***	***-3,4***	***-0,9***	***-0,7***	***1,8***	***1,4***	***-***	***-***	***-1,1***	***-0,8***

FORECAST TABLE

COUNTRIES		Italy		Germany		France		Spain		United Kingdom		Netherlands		Czech Republic		Austria		Ireland		European Union		EUROZONE	
Time horizon / Indicators		2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Current account balance (% of GDP)	Intesa Sanpaolo																					0,2	0,1
	Capitalia																						
	Goldman Sachs																						
	Merrill Lynch																						
	UBS Warbug			6,5	7,2	-1,2	-1,1	-8,8	-7,9	-3,0	-2,7	8,0	8,5	-3,6	-3,0	1,2	1,2	-1,5	-1,0			-0,4	0,3
	IMF	-2,2	-2,2	5,3	5,2	-2,2	-2,3	-9,4	-9,8	-3,1	-3,1	7,7	7,6	-4,1	-4,2	1,9	1,6	-4,4	-3,0			-0,3	-0,4
	European Commission	-1,7	-1,7	5,6	5,7	-1,9	-1,8	-9,1	-9,7	-3,9	-4,1	9,2	9,0	-3,0	-2,7	3,2	3,1	-3,9	-4,4	-0,7	-0,8	0,2	0,1
	OECD	-2,5	-2,6	6,7	7,0	-1,0	-1,0	-10,1	-10,5	-3,2	-2,7	8,1	7,6	-2,9	-2,5	4,1	4,5	-1,5	-1,1			0,4	0,4
	BNP Paribas	-2,3	-2,1	5,3	5,5	-1,3	-1,3	-8,4	-8,2	-4,2	-4,6			-3,0	-2,7							0,2	0,6
	UBM																					0,0	0,2
	Commerzbank																						
	Average	***-2,2***	***-2,2***	***5,9***	***6,1***	***-1,5***	***-1,5***	***-9,2***	***-9,2***	***-3,5***	***-3,4***	***8,3***	***8,2***	***-3,3***	***-3,0***	***2,6***	***2,6***	***-2,8***	***-2,4***	***-0,7***	***-0,8***	***0,0***	***0,2***