



Election Year Politics

by Marvin Zonis
Professor of Business Administration
University of Chicago Graduate School of Business

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I have titled my forecast for 2004, "Election Year Politics." Last year, my forecast was titled, "The Year of War." A year of very poor public policy is vastly preferable to a year of war. As those of you who have heard my previous forecasts must sense, I am uncharacteristically optimistic for 2004.

The year 2004 will be dominated by four great stories:

1. The 'iron law' of democracy. In the run up to elections, public policy will always be driven by politicians wooing voters rather than by concerns for the national interest. A very large number of important countries are having elections in 2004.
2. The principal way in which the 'iron law' will be manifest in the US will be through a vast federal fiscal deficit and the imposition of barriers to free trade when those barriers will win the President more votes. Watch for other countries to retaliate with their own trade protectionism. The American people will pay and be the losers. Special interests – sugar and citrus growers, corn farmers, textile producers -- will win.
3. The 'War on Terrorism' will continue to be a major focus of many governments. Both the governments and the terrorists will score victories in 2004.
4. The war in Iraq will pre-occupy US policy makers.

Elections

Parliamentary elections will be held this coming year in the US, Iran, Spain, South Africa, India, Australia, and for the European Parliament. Presidential elections will be held in Russia, Indonesia, Taiwan, Germany, Slovakia, the Philippines, and the US. Pandering to voters will be the order of the day.

The War in Iraq

Mark Twain once went to an opera by Richard Wagner. As he was leaving the opera house, he was approached by a journalist who asked, "Mr. Twain, how did you like the opera by Wagner?" Twain thought a moment and then answered, "It wasn't as bad as it sounded." Iraq in 2004 will not be as bad as it sounds in 2003. The violence against the US and its Iraqi allies is being carried out by a very small number of people, fewer than 5,000 and some 95% of the attacks against the US have been carried out in a very small area of the entire country, the so-called 'Sunni Triangle.' In fact the Shiites, some 65% of the Iraqi population have been quiet and cooperating with the Americans – anticipating a future Iraqi democracy which they can dominate. The Kurds, another 20% of the population, have also been quiet, under the control of two powerful Kurdish governing groups. Given the small number of the 'enemy' and their geographic concentration, the US should be able to get on top of the violence and reduce its casualties. This will take a far more sophisticated intelligence operation than we have had until now. The President should immediately boost the number of troops in Iraq to compensate. But he has already ruled out that policy and military officers who believe it is crucial to increase troop

strength have been silenced. By the Spring of 2004, improved U.S. intelligence should be evident and casualties should begin to decline—although they will continue indefinitely at a lower level. President Bush will have trouble turning over power to an Iraqi Governing Council before the November 2004 elections – which would allow him to declare a great US victory. The Shiites want everything to be determined by direct elections which will give them decisive influence. But no direct elections can be held until voter rolls are compiled, a task that will take all of the year 2004. Still, count on some dramatically diminished US profile by November. Meanwhile, US nation-building in Iraq continues to be run by the US military out of the Department of Defense. The experts on nation-building in the State Department and elsewhere have been shut out of the process. Do not expect either a prosperous or democratic or stable Iraq. Democracy cannot be imposed, neither from the top nor from outside. Nor will Iraq be economically prosperous in 2004. Oil revenues will not be up significantly on account of sabotage. The major international oil companies will not begin investing their capital to expand Iraqi production, given the persistent violence and instability. Iraqis do not have the organization, the personnel, or the capital to do it on their own. Moreover, Iraq has had a socialist economy for decades. Its entrepreneurs either sided with the tyrants to make money or fled the country. Very few significant profit making enterprises have ever existed. Given the near universal failure of economies depending on ‘rental income’ – oil revenues – Iraq does not have a bright economic future. One thing is for sure, the eagerness of the US to withdraw is widely perceived in Iraq and throughout the Middle East as a sign of weakness—that the US can be forced to ‘cut and run.’ Insofar as the US attack on Iraq was meant to send a message to terrorists and Middle East governments that they needed to take us seriously, the rush to turn power to the Iraqis sends exactly the opposite message. The word for Iraq in 2004 is ‘grim.’

Israel-Palestine

Israeli oppression of the Palestinians will continue in 2004. The solution is obvious to everyone – two independent states. But both Israel and the Palestinians need to make politically painful concessions to get there. Israel must shut down settlements; must alter the borders of Jerusalem to allow the Palestinian capital to be established in the city; and must be flexible on the question of sovereignty on the Temple Mount. The Palestinians must also make important concessions. They must rebuild their security forces and confront the rejectionists; must accept territorial adjustments; and must also be flexible on Temple Mount sovereignty. It appears to be the case that Arafat would prefer to die as father of his people than accept these painful concessions. There is a high probability he will get his wish in 2004. But in the meanwhile, the US will make some effort to move Israel to concessions. President Bush has heard the message coming out of the region, the message that terrorism and Iraqi resistance is stimulated by the unwavering support he has given to the State of Israel. So he has begun to communicate his dissatisfaction to Prime Minister Sharon. But no meaningful US pressure on Israel can be expected in the run up to the US elections. Too many in President Bush’s Born Again/Evangelical Christian base reject such pressure as do US Jews whom the President seeks to woo to the Republican Party. Israeli politics will be stable with Prime Minister Sharon remaining in

power, but without a clue as to a useful Israeli general strategy other than more repression. The violence will continue to scare off investors to Israel. Its economy will continue to falter and the emigration of its most educated and skilled people will continue to rise.

Saudi Arabia

King Fahd--on his last legs since suffering a stroke a decade ago—will die. Crown Prince Abdallah will succeed to the throne. Defense Minister Sultan will become Crown Prince. The new King will push reforms more quickly than others in the royal family would like. Islamic clerics, more political than religious, will be removed from their pulpits. Terrorist financing will be better controlled. Terrorists will be pursued with uncharacteristic vigor. The deal between Saudi Arabia and the US – Saudi oil for US support -- will be strengthened in 2004. But the succession formula which has brought the Kingdom 50 years of stability has come to an end. So has the regime's unstinting support for the most conservative Islamic clerics. The Kingdom is entering a period of unusual instability in a dangerous and unstable neighborhood.

Iran

Elections in February 2004 will return a new conservative majority to the parliament. The reformists have been utterly demoralized by the failure of their president, Mohammad Khatami, to initiate meaningful reforms or challenge the hardliners who control the country and its economy. Rather than vote in what they consider a hopeless cause, many will stay home. The newly invigorated hardliners — in better control of Iran -- will then make meaningful overtures to the US to establish a new relationship that will get Iran out of President Bush's 'Axis of Evil' and diminish US pressures on their regime. Iran will show its new spirit of cooperation by reigning in Hizbollah attacks against Israel and using its influence to restrain the Shiites in Iraq. Iran will not resume its nuclear enrichment or plutonium processing programs in 2004. High oil prices will keep the economy growing and diminish popular discontent. The US response to Iran will be a function of the relative strength of the 'hardliners' versus 'reformists' in the Bush administration. No change in the dominating role of hardliners in the US should be expected until after the US elections. The US will not respond usefully to the coming Iranian political overtures.

The War on Terrorism

The US invasion of Iraq stimulated global terrorism. It incited greater hatred in the Muslim world against the US. The terrorists, however, over reached. Recent attacks in Turkey and Saudi Arabia have turned those governments into important US allies in this War. The Turkish state is both powerful and ruthless against its domestic enemies. The Islamic oriented government of Prime Minister Erdogan has bent over backwards to demonstrate its commitment to Europe and eventual Turkish membership in the European Union. It will now bend over backwards to demonstrate its success in stamping out terrorism. The Saudis will do much of the same. But the very successes of these governments along with the work of US, Canadian, and European intelligence and police

forces has meant that the central features of the global terrorist network have been severely weakened. The result has not been that terrorists have been driven out of business but that the terrorist network has become more decentralized – *networks* is now the more appropriate term. The bombings in Turkey are the work of local networks in that country and not directly of al Qaeda. The result will be that the hard won victories against al Qaeda do not guarantee success in this new phase of the War against terrorism. Instead, 2004 will see major new terrorist attacks. But they will be outside the United States – in the UK, a principal enemy of the terrorists, and in Asia, whose governments have been less eager to take on the terrorists. The ‘War on Terrorism’ is far from over. One key issue is that US policy since 2001 has been grossly inadequate. The CIA appears to have committed the greatest intelligence failure in US history in getting Iraq so deadly wrong. The CIA was also responsible for significant intelligence failures regarding al-Qaeda and the power and longevity of the Soviet Union. Its competence to fight the ‘War on Terrorism’ is profoundly limited. Unfortunately, so is that of the US military. For decades, the US armed forces have prepared to fight against another country which fielded substantial military power. But globalization and liberalization has led to the privatization of war in the form of terrorism. And the essence of the threat of terrorism is asymmetric force—the ability of small numbers of committed terrorists with very limited financing to inflict massive damage. Intercontinental ballistic missiles, submarines, and tanks won’t do the job. The US needs massive restructuring for this War. But we won’t see the restructuring in 2004 in the run up to the elections.

Trade Protection

Karl Rove, President Bush’s political counselor, is now the chief architect of US Government policy. In 2004, he will urge the President to lift the special tariffs on steel. The President has won votes among steel workers and steel producers. But he has lost more votes from steel users. American manufacturers who use steel pay higher prices, making their products more expensive compared to foreign manufacturers who can use cheaper steel. American exports are suffering. Imports of products using steel are booming and US manufacturers are induced to move overseas. As steel users have suffered, they have organized to put pressure on the White House. The pressure has gotten to Karl Rove. But the main trade drama in 2004 will be with China whose trade surplus with the US will run over \$125 billion. China is a cheap scapegoat for US politicians. In fact, the European Union runs a trade surplus with the US nearly as large as China’s. But no US politicians are beating up on the Europeans. Furthermore, the jobs that are moving to China are not jobs that have left the United States. They are jobs that have left Mexico, the Philippines, Malaysia, and other low wage manufacturing countries. Making Chinese imports to the US more expensive by imposing duties or quotas will not return jobs to the US but may divert them to other countries – effectively subsidies to those countries paid for by US taxpayers. Moreover, China’s imports as a percent of its economy are twice as high as imports to the US. That hardly suggests that China is using trade to damage others while enriching itself. China will respond to US pressures by going on a ‘shopping spree’ in the US by buying high ticket items. (2004 will be a better year for Boeing.) The danger of all this trade protectionism is greater than

its added costs to US consumers. The danger is that if the US continues to fail to live by international trade regulations, other countries will be induced to violate those regulations when they see useful benefits from doing so. Yet the central foreign policy goal for the US ought to be to induce other countries and, in particular, China –the only dissatisfied aspiring power in the world today -- to play by the rules of the international system. We are not setting an encouraging example. Of course, if we were to integrate a rising China into the established global system, it would be very much in the interest of the US to see China become richer. A richer China would stabilize Chinese politics and create a bigger market for US goods. But President Bush's trade protection threatens the entire global trading system. The international trading system is vulnerable and the World Trade Organization could collapse. Many neo-cons in the Bush administration seek its demise because it is the only international organization that actually has the power to impose sanctions on the US. The WTO will not collapse in 2004 but the US is a threat to the global trading system.

Russia

President Putin is up for reelection in 2004 and as surely as President Yeltsin bought his reelection in 1996 (with the help of many of the same 'oligarchs' that President Putin is now driving out of the country or into jail) so will Putin insure his reelection, although, like Yeltsin, it will take two rounds of voting for him to win. With his reelection will come another important milestone in post-Communist Russian history—the return of the state. The key question in Russia has been, “What will play the larger role in organizing society and economy – state or market?” President Putin's reelection will guarantee that the state and not the market will be the dominant force in Russia. The state will win great wealth through its taxes on oil and mineral exports. It will control the economy and business and the judiciary. It will favor its allies and punish its enemies. Russia will be a place where Russians can amass great wealth. But it is not a place where foreign investors will feel secure in 2004. Russia will be a democracy, but a highly centralized, state dominated democracy. It will be a market economy as well, but a state dominated and rental income based economy. With oil prices likely to remain high through 2004, watch for continued robust growth. But its longer term prospects are not bright.

China

The law of business cycles has not been repealed for China. The China conundrum is whether and when China will fly apart from its massive credit expansion and robust economic growth. My sense is not in 2004. But China cannot go on like this for very much longer. The statistics are staggering. The country's GDP will expand by as much as 10% in 2003. Some areas of the country will experience growth closer to 20%. The high savings rate of the Chinese people coupled with currency controls and the power of the state owned banks means that credit is expanding rapidly. (Debt in China increased by 23 percent in the first six months of 2003 alone and banks' bad loans have reached a staggering 50% of the national GDP.) A huge capacity bubble is being created. For example, some 200 companies are now making automobiles in China. Total auto production capacity in 5 years is likely to be twice the most optimistic demand figures.

China boasts 130 aluminum plants with 47 new aluminum plants under production or being planned. Neither China nor the world will be able to absorb this output; nor the output from China's massive expansion of its steel making capacity. When the downturn hits – not in 2004, but not long after -- watch for the political unrest to skyrocket. Then the government will look for scapegoats and there are none better than 'foreigners,' especially the US. But for the time being, expect the government of China to be unusually accommodating to US foreign policy in order to keep US market open to Chinese exports and US investments flowing into China.

Japan

Japan will disappoint again. True, its banks' balance sheets are improving. The Tokyo Stock Exchange is up. So are corporate profits. But the fundamental sclerosis of the country's politics and business remains. The Japanese mind set is deeply rooted and conservative, discouraging reform. Japanese corporations have moved to China, depressing employment. The savings of the Japanese people are depleted, discouraging consumption. The country will see some growth but the world's second largest economy will remain export dependent.

Oil

China's demand for petroleum has been increasing at 7 to 10 percent per year. The US will enjoy substantial economic growth in 2004. Overall world economic growth will be 50% higher than in 2003. That means substantial increases in global demand for oil. But Iraqi production will not increase substantially by the end of 2004 because political instability and sabotage limit the willingness of oil companies to invest or the government to increase oil production or exports. The immediately available excess capacity in the Persian Gulf is somewhere around 2 mmb/d, a small margin in an 80 mmb/d world wide market. Watch for rising oil prices in 2004.

Europe

Europe next year will be challenged by four great issues. First, ten states—Cyprus and Malta, Poland, Hungary, and the Czech Republic, Latvia, Lithuania, and Estonia, Slovenia and Slovakia will all formally become members of the EU. The year 2004 will be a honeymoon year as the new members will be on their best behavior. But the new members are far poorer than the old and their peoples will not be allowed free migration to the richer states for many more years. Instead, the new members will come to demand greater subsidies. But regional and agricultural subsidies already make up 80% of the EU budget and the big net donor of subsidies, Germany, is wallowing in economic difficulties. Tensions will build as the new states demand subsidies comparable to those received by the established member states and even use their voting power to block EU legislation as a way to pressure for a better deal. Second, the adoption of a new constitution will require ratification by the member states. National referendums on the constitution will give EU opponents a platform to set out their objections. Citizens of several states may vote to reject the constitution, launching a governing crisis. Third, France and Germany have demonstrated their disdain for the stability and growth pact

that limits budget deficits to 3% of GDP. Both states will run larger deficits again in 2004 – a poor example when the Union is trying to win approval for the laws that will govern the behaviors of its member states. The fourth great challenge for the EU is the struggle over its proper role vis a vis the US. Belgium, Germany, and France seek an independent European Defense Force – independent of NATO and the US – and seek to diminish dependency on the US. Britain and Poland, with support from Spain and Italy, seek to deepen the Atlantic relationship and coordinate EU foreign policy more closely with the US. For the coming year, given that foreign policy decisions in the EU still require unanimous votes –giving each member state a veto over collective decisions – little progress will be made on EU foreign policy. Until Europe is able to coalesce, and it will not happen in 2004, its political weight in the world will be far less than its economic weight.

The United States

The first President Bush, in his book *A World Transformed*, had this to say about his 1991 war against Saddam: “I firmly believed that we should not march into Baghdad. To occupy Iraq would instantly shatter our coalition, turning the whole Arab world against us and make a broken tyrant into a latter day Arab hero. Assigning young soldiers to a fruitless hunt for a secretly entrenched dictator and condemning them to fight what would be an unwinnable urban guerilla war.” The son ignored the advice of his father and the advice of his father’s closest advisors. The result was a deep split in the Republican Party. With the failure to find weapons of mass destruction or any concrete ties between Saddam and al Qaeda, the rift has deepened. With the escalating attacks and casualties, the split has reached the administration itself. The President is furious at his Secretary of Defense. The Secretary of Defense is furious at the ‘neo-cons’ who sold him on the war. The rift between Secretary Rumsfeld and Secretary of State Powell is unbridgeable. National Security Adviser Condoleezza Rice never had the intellectual power or political strength to pull this fractious team together. The knives are drawn and as the poll numbers turn against the President in the summer of 2004, he will act. Vice President Cheney will move to a new post of Senior Adviser to the President. Colin Powell will be the Vice Presidential candidate.

The 2004 US election will be unusual. Victory will not go to the candidate who most convincingly promises what he can do for the country. Instead it will be a referendum on President Bush. Victory will go to President Bush

- *if US casualties are down dramatically in Iraq;
- *if Iraq has stabilized into a unified and moderate state with a secular government;
- *if the President overcomes his deepening credibility problem with the American people bred from his refusal to attend funerals and memorial services for US dead shipped back from Iraq and his refusal to allow TV coverage of the returning dead;
- *if the US economy continues its robust growth;
- *if the job numbers are improving; and, most crucially,
- *if American voters believe that Bush has moved the country in the right direction.

On the basis of my December 2003 assessment of these factors in November 2004, I predict that the President is likely to be reelected. But I wouldn't want to bet on it. If the President is reelected, he will pull back from the flood of government spending, absent the revenues to pay for the new programs. Not having to buy off the American people, the President will begin a return to fiscal sanity, but not enough sanity to raise taxes. The result will be a credit squeeze with the government beating the private sector to finance its debts and, inevitably, slower US economic growth.

Death Watch

Topping the list of leaders most likely to die in 2004 are, to my regret, the same two who headed the list in 2003. Osama bin Laden and Saddam Hussein. Osama is in the caves on the border between Pakistan and Afghanistan, protected by tribesmen who hate those governments and the United States. Saddam is living in a web of tunnels and hidden apartments in Baghdad and Tikrit, shielded by Sunni nationalists and Baath loyalists. Saudi King Fahd's death will facilitate the showdown in the Kingdom between reformers and conservatives. President Ronald Reagan's death from advanced Alzheimer's disease will remind us of the devastation of that illness and of the integrity of his conservative politics.

Conclusion

The likelihood of a major terrorist attack in 2004 remains, particularly outside the United States. But on balance, 2004 will be a year vastly more peaceful than 2003. Electoral politics will be the driving political force. Poor public policy will 'rule.' But that beats invasion, destruction, and death.