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Aftermath of the 'Crises': US and Global Prospects, Legacies, Policies

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- Michigan대 졸업, Northwestern대 경제학 박사
- 오랜 기간 월스트리트에서 경기진단의 대가로 인정받고 있을 뿐 아니라, 현재 미국 백악관 및 의회, 연방준비제도이사회(FRB)의 경제정책에도 중요한 자문활동을 하고 있음.
- Data Resources, Inc.(DRI) 수석 금융이코노미스트 겸 부사장, Lehman Brothers 수석 글로벌이코노미스트 등 역임. MIT, New York대, Boston대, Northwestern대에서 교수로도 활동 중임.

Aftermath of the 'Crises': US and Global Prospects, Legacies, Policies*

Allen Sinai

Today I would like to divide my remarks into three segments: the first is to give a short version of what happened in the economic financial crisis in the United States and in the World; second is to talk about the policies that have been used in the US and World; and third is to take a look at the prospects, the aftermath, the legacies, the by-products, the problems, and the picture going forward for the world.

The Crisis

The crisis itself and the US as an engine of the economic and financial crisis are over. The look ahead is very different than it was starting four or five years ago as we moved toward the crisis. In the US, for various reasons in asset markets (residential real estate and in the stock market) and in credit and debt we had huge booms long in the making. There are a lot of reasons for it, but those reasons are a subject of another day. Out of the business cycle in the United States – the globalization of economies and financial markets and the policies taken (monetary and fiscal) – came a huge boom in residential real estate as part of the expansion. The use of that asset (residential real estate) as collateral for both borrowers and lenders, leveraging up of that asset, developing a lot of businesses and institutions around the derivatives, businesses and transactions of that asset, and a boom in residential real estate and boom in housing prices – which in turn because of what we think are the natural endogenous forces of the business cycle in any country – was used as a lever for aggressive spending and

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finance in the United States all contributed to a strong stock market, tremendous growth in credit and credit businesses, and in debt held by American consumers. An unsustainable boom and unsustainably high and rising prices of two key assets for any economy are equity and real estate (commercial and residential).

Now this part is not unfamiliar. Business cycles throughout history – ups and downs in activity in financial markets and in finance, lending and borrowing – have often been accompanied by excessive booms and rising prices of assets (real assets and financial assets). Most typically it occurs in real estate. I need not to belabor this for you here in Seoul or the Asian area of the world because Hong Kong, Japan, Korea, and perhaps China now have gone through the booms and the excesses. The price rises for assets which sometimes get so excessive that they can be called "bubbles." Then something happens and the prices come tumbling down. That happened in residential real estate in the United States. Some of us picked this up early and some did not, but if you are a student of business cycles and have been studying and analyzing them and doing the kind of work that I have done for almost four decades, it was not unfamiliar. Japan had it in the 1980s and the United States had asset price bubble booms in the 1920s~1930s.

What is unusual is to have two, three or four of them at the same time. In the US, not only did we have a real estate asset bubble, but also there was the ability to fund with innovations in the financial system and to take equity out of residential real estate and then deploy that equity for spending and on investments like buying stocks and buying more real estate. The double boom in residential real estate and in stocks, and in the credit and debt that went along with the spending with those booms, created a multiple set of booms and price bubbles for those assets and liabilities in the US economic and financial system. When interest rates were raised slowly from the chairmanship of Allen Greenspan from very low numbers and got up to 5~6 percent, and the momentum of growth in the housing boom slowed, that triggered a reduction in the ascent of residential real estate prices. Then what clicked in is something we economists call the "accelerator effect." It is a change in the rate of growth which sets into motion reverse movements in activity and asset prices that occurs at the top of a boom and then sets an economy going down. Of course, along with those booms came excesses in finance, unregulated, unsupervised activities relating to housing and other derivative activities and financial businesses in the US financial system which by this time had blurred the lines between traditional banking, investment bank, and trading so that numerous non-bank financial institutions were engaged in bank-like activities.

Indeed, research is showing that the lending and deposit gathering activities were traditionally in the domain of commercial banks, but in this crisis they essentially resided in the investment banks, the venture capital, private equity, hedge funds, and the financial institutions that grew up around the boom and the price bubbles. Those financial institutions were not transparent. They were outside the net of the regulators within the banking systems. Regulators did not watch very closely. The pursuit of money, greed in the system, and materialism in US society and economy got the better of everybody and a mania turned into a bust. That decline in residential real estate prices, the first in decades, radiated through the financial system and hit and hurt the US equity market, because by that time the financial sector in the US stock market was 25 percent of the market capitalization. Those financial institution stock prices began to come down. Balance sheets of financial institutions, banks, and non-banks, contracted as asset prices came down. The leveraged expansion – debt and capital market finance expansion of the balance sheets for bank and non-bank institutions that had fed the boom – turned around.

Balance sheets contracted, credit contracted, the stock market fell, the decline in the equity market, in turn, took down the wealth of households massively and that, in turn, hurt consumer spending. Because the mechanism of finance for American consumers shut down, namely mortgage refinancing on rising housing prices as an easy way to get funds, we think that the financial factor hit consumption hard for two or three quarters. We had not seen declines like that since the 1930s. Those declines centered around the second half of 2008 and the first quarter of 2009. Interestingly, the economies of countries around the world also plummeted. In one of the handouts given out today you can see startling declines in GDP between the middle half of 2008 and the second quarter of 2009. Those declines at the time looked inexplicable. It is like a sickness that a doctor has never seen before. If you do not know what it is and have not seen it before like the swine flu, then it is hard to deal with that sickness.

Of course, stock markets tumbled based on that news. Ultimately, in the US we had the second biggest bear market in our history, second only to 1929 to 1933. On March 9th 2009 the US equity market was almost down 57 percent from its previous peak. For stock markets around the world similar results occurred. Then the effects of collapsed stock markets on the real economies interacted to bring the economies down some more. Credit risks became greater. Financial institutions did not want to lend to each other or to anyone outside the financial system. Events like the failure of Lehman Brothers and the AIG problem were examples of the completely uncharted waters that confronted the whole world.

Well, what I have given you is our idea of the genesis of how it arose. It is the result of years of excesses in the US. It has many causes. In my work and research in the business cycle I would say that it was endogenous; it was in the system. The role of the financial factor in the business cycle is nothing new. The financial factor, in one form or another, shows up at every business cycle upturn and downturn. It is absolutely decisive in throwing economies into downturns at the upward turning points. This financial factor was a combination of bursting price bubbles, excesses in credit and debt, excesses in highly leveraged use of debt finance by clever and innovative financial institutions doing what they thought they should do for their shareholders to maximize shareholder value and the whole thing collapsed. We will not see this kind of event again to this degree in our personal or professional lifetimes. We will see another financial crisis and another financial crunch not just in the US, but it will also happen again right here in Asia, because it happens in every business cycle. Price bubbles, bursts, the mania, the psychology around them, and the greed that all societies inherently have in pursuit for more money are all a result of the human condition and human nature.

The puzzle to me is that since it has recurred periodically and regularly in all business cycles that I have studied, and we know that it happens again and again not just in the US (Japan had a similar situation, Asia in the late 1990s had a similar crisis), then why is it that we have not figured out how to deal with it so we can take actions to make it less bad or prevent it from happening much like vaccines and medications that now have made obsolete so many of the illness that used to plague civilization? I think that is part of why, in our own forecasting analysis, we picked it up early and that is part of why policymakers around the world in other states picked it up late. They were late in recognizing what they thought was a rare and unusual event and lost valuable time in policy reactions to prevent further weaknesses and excesses. Then they had to devise policies *in extremis*, and in this case, experimental policies. Of course, there are lags in the formulation of them, the implementation of them, and in the time it takes before they actually have an impact.

By the time the US Federal Reserve, the US Treasury, the administrations in the US (the Bush administration, Congress, and the Obama administration) and policymakers around the world got around to dealing with the problems; the dynamics of the downturns and crises were way ahead of the policymakers much as if I were a medical doctor and took too long to treat a patient. Being early pays when it comes to policymaking. But, I have yet to see any country, any set of policymakers, able to do this given the nature of how policymakers get put into their jobs, because they do not stay that long, because memories are short, and because the agents in private sectors in mixed capitalistic systems will act the same way. When you throw into it a dose of mania and "herd instinct," you have a recipe for extremely volatile conditions.

The essence, though, of this set of crises came from the US and it was centered around the American consumer. This is how it spread: consumption in the US on average for 45 years up to 2005 had risen inflation-adjusted 3.5 percent a year. That is Asia like in the growth rate. That is a big number, a lot of consumption. By 2006~2007 consumption in the United States was 71 percent of GDP. When the financial factor in the business cycle centered on the consumer and consumer spending collapsed, that was 71 percent of GDP going down. China alone, among the countries that export to the United States, had increased its export exposure to the US as a percent of its total exports at the time to about 20 percent of total Chinese exports. The housing industry does not buy a lot of stuff from China, American consumers do. American consumers buy a lot from South Korea and Japan. Yet, over the last 10~15 years the proportion of total exports from South Korea and Japan to the United States has gone down while the proportion of South Korean and Japanese exports to China has gone up. When American consumer spending went down so did those exports. Then the purchases of China from Japan and South Korea, the purchases of South Korea from Japan and China, and the purchases of Japan from South Korea and China tumbled. Trade fell and levered down the economies all over Asia. Something similar to this happened in the eurozone through Germany and to Canada as well. These along with the financial crisis intensified the downturn and the entire world economy went down.

Now, we think that the American consumer will not spend aggressively for a long time. Last year, I talked to you about the seismic shift of American consumers spending a lot less for a lot longer than ever before in our memory and saving a lot more for a lot longer than ever before. That is the process that goes on now. In the last three and a half years consumer spending in aggregate has grown about 1.25 percent per year. That is nowhere near the historical 3.5 percent a year. For any country exporting to the United States, and particularly the American consumer, the whole business climate changes. What I said last year I will say again now is that that is the way it is going to be for a long time. Consumer spending going forward will be positive but its trend rate of growth will be far below what it was historically. That means the exporters to the American consumer, businesses in the US that sell to the American consumer, commercial real estate that used to have retail consumer space will be much worse business than ever before. It is a very big effect. In the long run, perhaps, it might be healthy because we in America spent too much, borrowed too much, and did not save enough. That has changed immensely and goes on now as we speak. Why do we think it? The six major fundamentals of consumer spending in the US that we watch continue to say negative things about the pace of American consumption. In Washington DC, the policies that are being taken are not consumer-centric and so we do not think that the fundamentals are yet right for American consumers to move back toward the aggressive pace of spending and borrowing that characterized the American economy and society for the past 4~5 decades. Since it has never been that way in any of our memories, it takes time for it to be impressed upon countries and people in the consumer business but it is still going on and it is still a major theme for us.

Policy Reactions

The policy reactions, when they finally came in the United States, were on the monetary policy side aggressive reductions on interest rates by the Federal Reserve. By the time that came, it was too late. The dynamics of the downturn were well in place and the lags in response to those lower interest rates have not even yet begun to run out. In addition, the US Federal Reserve turned to quantitative easing, previously used only by Japan, in a situation of extreme distress. It was first lent to the financial institutions to relieve the crunch within the financial sector and then lent to the corporate sectors, because the financial sector was not putting any money out and markets had shut down, and then finally ended up being the lender of last resort, not just for banks, but for parts of the private sector of the American economy and for the US mortgage market. In addition, the Central Bank and Federal Reserve decided to try to prevent the major US financial institutions from collapsing.

The record is spotty on this: Bear Sterns was a managed bankruptcy, Lehman Brothers was probably an accident and AIG was saved. All of this was at the expense of taxpayer money. The Treasury was part of it. Hand in hand, the Federal Reserve worked with the Treasury to prevent the major US financial institutions from failing. Most of them are now doing fine. Bank of America and Citi Group are still losing money, but all of the other major financial institutions (now called banks because they applied for charters to be banks when the opportunity arose) are earning very good money. The Goldman Sachs results today were absolutely spectacular and JP Morgan Chase has had very good earnings. The funds that all of the financial institutions were given (some of them were forced to take) have been returned to the Treasury and, indeed, the US Treasury is making a little money because asset prices have gone up. "Too big to fail" is exactly what the Federal Reserve signed on to well aware of the risks of insuring that these very institutions that were being saved might again in the future engage in the very same practices that had led us to our problem.

Of the choices available, the US Federal Reserve chose to downplay moral hazard and chose not to let financial institutions fail because the overwhelming view was that what had brought about the Great Depression had been the collapse of credit and the banking system in the US. Whether right or wrong on that view, Chairman Bernanke was determined not to let that happen. There is no longer any crunch in the financial system: plenty of funds available in the overnight market and federal funds market. Banks are not lending because the credit environment tells them that they should not lend, so we still have a crunch in the private sector. We have a tremendous consolidation that is going on in the financial institutions, destination of the private equity and hedge funds. They will come back to live another day and once again seek and gain capital and be aggressive in the deployment of the capital. But, the leveraged finance and leveraged balance sheet expansion that fed the booms and the bubbles in the United States are long gone and will not be back in the US for a long time. The US has entered a recovery. Without the monetary and fiscal policies put into place, our studies say that in 2009, rather than a 2.5 percent decline in real GDP, it would have been minus 6~7 percent.

We did a retrospective look at all the policies that were used in the Great Recession of 2007~2009 asking what would have happened to the US economy if the government or Federal Reserve had done nothing. The results are very interesting. If we had taken all of those out (all of the monetary easing, interest rates, quantitative easing, fiscal stimulus program in 2008, and the Obama $800 billion program in 2009), the US economy would have been in 2009 4~5 percentage points worse. That would not have merely been a Great Recession; it would have been a mini-depression. The 2010 forecast, if nothing had been done, would have been down 2~3 percent in real GDP growth. In the US we are now forecasting plus 2.5 percent in 2010. That is not so good, but it is better than minus 4~4.5 percent. Think about the whole world economy if the US economy had gone down 6~7 percent last year, where would the stock market be today? What would that mean to financial institutions and your businesses here in Asia? Surely, if we had done nothing, China would have been damaged, trade flows would not be as good as they are emerging here now, there would be stress on the financial systems, and Japan would probably be in a depression (Japan is in a contained depression now). These policies and the policies taken in other countries all over the world (fiscal stimulus in China, Korea, Japan, and German; monetary and quantitative easing in Japan; zero interest rates in the UK and Canada; and the support of the financial system and institutions around the world) have helped these patients get back on their feet. There may have been overkill and we could have done better, but with all that was going on in such a short period of time, the world has come through quite well.

The Aftermath, The Future

The side effects and the by-products of the medicine used in the US and around the world are part of the legacy and the look ahead in the future of what might happen. The initial conditions of the countries coming out of the economic crisis, how spry the patient is after recovering from that cardiac arrest, is important. Of course, the policies going forward that are applied, the use of the medicines, are also very important.

In the US we see a decent recovery, a little bit stronger than the recovery after the recession of 2001 and 1991 but nothing like the V-like recoveries that the United States has typically had after a deep recession. This recession in the US, properly called "the Great Recession," was the deepest and longest since the 1930s. After deep recessions in the US, the first year of recovery is typically real GDP growth of 6.5~7 percent. We are forecasting 2.5~3 percent. It is better than nothing and better than minus 4 percent.

With that growth rate goes a legacy of high unemployment rate. Now, in the US the unemployment rate is 10 percent. When you add up the unemployed, the underemployed, and discouraged workers, it is around 17 million workers. In addition, with all that slack in the labor market, businesses are pushing wages down. US Businesses, in order to maximize profits, do not really want to rehire people because they are really expensive. Out of this crisis situation, we have a so-called "upturn" that is not great with high unemployment. High unemployment is a huge economic, societal, and political problem in the United States. Washington has to, and is trying to, figure out what to do about it.

Moreover, the US comes out of this with huge deficits. In the fourth quarter of 2009, the deficit was 11 percent of GDP. A gross public debt to GDP growth ratio does not look like it will be very strong. We think it will go over 100 percent in the next 3~4 years given policies as they now exist and the budget plans of the Obama administration. The health care reform, we think, will cost the government more money than they will be able to fund. The US comes out of this with still a large current account deficit. It is better than before: exports are firmer and imports have been down. The supply of treasuries is massive on the deficits, \$1.5 trillion this past fiscal year. This coming year we are estimating \$1.4 trillion. We have \$125 billion dollars of foreign exchange reserves. We are deeply in debt and politically the US is having its difficulties. That is how we come out of this.

When we look at Asia and Asia's performance during the crisis what we see is that China has now become the third largest economy in the world surpassing Germany. According to our numbers, China will be the second largest economy in the world in 2010. China's GDP is six times what it was 12 years ago. Japan's GDP is lower than it was 12 years ago. Yet, Japan has been number two because the gap was that large. The US has a much higher GDP than Japan, China and Germany, but it really is not going anywhere. Where is the dynamism? Where is the growth? Where is the momentum? They are in China. China had what we call a growth recession. At the low, their GDP grew at 6.1 percent year over year. China responded with massive fiscal stimulus, with very easy monetary policy, and guiding lending and investing. We think that the Chinese economy is going to grow 10~11 percent. We think that is too strong, and China is beginning to reign that in. Even though we do not believe those GDP numbers, they are nothing worse than a growth recession. India will have a little slower growth than China with 8~9 percent. As for growth in South Korea, we estimate around 6 percent GDP growth this year and next.

What we are seeing in the high frequency data is quite a rebound in the trade flows around "the Asian loop." It is much the reverse of how the US took Asia down through the American consumer. Once again, trade flows are very tightly knit in the Asian region. Export propensities to one another, import propensities from one another, and the businesses of open economies around one another suggest that those trade flows will begin to move up sharply. That lifts the Asian economies into what I have in the past called "orbit," they lift off because trade is such a big deal and the interactions are so tight. The interactions are tighter now, relatively speaking, than they used to be with the United States. There is a decoupling going on. Business people in this part of the world understand where the dynamics of business and finance is going to be. They are living it and breathing it everyday. Business people go where they can make money, where they can sell goods, and where they can produce at lower costs. So, when we look at the prospect for 2010~2011 we see a V-recovery in much of the Asian world, except Japan. Business here is vibrantly strong and very different in performance from the US, the UK, the eurozone, and the G-7 world.

When we look at the initial conditions of China coming out of the crisis and what do we see? China has $2.4 trillion of foreign exchange reserves. The US has $125 billion of foreign exchange reserves. The US does not have enough foreign exchange to intervene on behalf of the dollar if it should collapse for more than a week or two. China can fix its exchange rate to the third decimal point for 18 months with all of those foreign exchange reserves. The Chinese deficit to GDP ratio, even after the fiscal stimulus, is something like 3 or 4 percent and debt to GDP is stable. Chinese consumer spending as a proportion of the Chinese economy is approximately 40 percent. There is a lot of room to rise to 50~60 percent. I believe that will happen as China, understanding that it no longer can sell into the US the way it used to, will take measures to induce its consumers to spend more and to become more consumer-driven. As that happens the standard of living for the Chinese consumer, which is very low in per capita terms, will rise and wealth and well-being will rise in China.

China is not simply an emerging country. There is no way I could describe a country that is about to become the second largest in the world, although still by western standards it is somewhat lawless and a little bit totalitarian in the centralization of some of the functions of what goes on, an emerging country. China, an increasingly responsible global citizen, is part of the G-20. It used to be G-2 and then G-3. G-20 makes more sense. South Korea is the 15th largest economy in the world and it is going to grow very fast. It is changing.

The next 5~10 years is not the decade of America or Japan, it is the decade of Asia. The initial conditions put Asian countries in a much better shape. They have been more resilient. We have a view of the world that I had before the crisis hit, the economic geography is shifting and changing under our very feet. It is the decade of China and Asia. Japan, in our view, is left out of that. It is suffering from a significant deflation and there is no easy answer for Japan in terms of the current deflation. Hopefully, Japan can ride the wave of the upturn in Asian economies. So, the outlook for this year in terms of GDP growth is the following: China 10.5 percent, Korea 6 percent, India 8~9 percent, Australia very strong, and Singapore 7~8 percent. This is a return to the dynamic world that Asia has known before. We saw this in the 90's and then we had the Asian crisis, but in the 90's so many exchanges were fixed, the prosperity was false. That is, indeed, a problem for China: a fixed currency, exports doing well, a flood of money coming into the country, and a bidding up of asset prices. The risk is that when someday they let that currency go, they will not be able to manage it and China will undergo a boom-bust and that, in turn, will radiate through Asia and produce difficult times. It is not all hunky-dory. There are plenty of risks out there, but frankly this part of the world is in much better shape than the United States.

Well, for markets, we, in this stage of the upturn in the world recovery, are overweight. In all equity of the global portfolio we certainly would be overweight in non-US, particularly in Asia, and some of the other emerging countries. We do know this is a year of rising interest rates. A number of central banks will start to withdraw the artificial support. We are expecting to see South Korea raise interest rates this year. After all, we have a strong growth forecast for this country, probably stronger than the government. Inflation is beginning to tick up here. Year over year it is about 4 percent – that is a little high. The Korean won is also strong and should be strong with this view that we have on this part of the world. For global investors in the currencies, the economic performance and growth is dominant in Asia except for Japan. Interest rates are likely to rise. China is already starting to tighten its monetary policy. Australia has already been doing it for a while. India will likely do it. That will tend to strengthen the Asian currencies against the US where we are not expecting the interest rates to go up anytime soon. The eurozone will keep its 1 percent rate for a while. In Japan, with deflation, the zero-rate policy looks like it will have to be there forever. On growth and relative interest rates there will be a tendency for Asian currencies to rise. Governments will have to decide on whether to sell Asian currencies because of competitive reasons on trade, not wanting their currencies to get too strong. I think that even if they intervene and sell, they will not be able to stop the movement. Asian international travelers, buyers, and business people will find that their real purchasing power, currency adjusted, is going to get very strong.

To summarize, it is terrific to give an upbeat outlook after many years of being so gloomy when talking to audiences. That is the nature of the world economy in the US: recovery and expansion with risks depending on the part of the world. It follows that earnings and stock prices will rise. We all feel better when stock markets go up than when they go down. Interest rates are going to rise, but they are still going to be pretty low unless inflation gets out of hand. In some countries there are hints that it may come back sooner and get out of hand. Some central banks may be ahead of that and may surprise us with the hikes in interest rates. But even that, in the early stages of recovery, do not really stop the good times from rolling.

It is also a delight to be in the part of the world where the wave is best. I am a fair weather friend. I cannot really do much about the US. I have advised various Republicans and Democrats on policy. 20~25 percent of the time they do some of things that I say but 70~75 percent of the time they do not. I go to Japan and tell them as well what I think they should do. This time I told them to take their currency down. If you have deflation, you need a lower currency. They seem very confused about that, so I do not think that they will do it. I am used to having my advice on policy 75 percent of the time not being taken. On markets and economy, I have a higher batting average. But, it is really a pleasure to be in front of an audience in a country where the future to me looks very bright and is part of the world that is going to dominate in economics and the creation of wealth in the coming years. As an investor, it does not matter where I live, I know I cannot do anything about policy because I am not god. Even if I were, my test-tube results might not be the right results. All economists think that they can solve the problems in their laboratory. As an investor, I can make money anywhere as long as I know the scoop on what is going on roughly speaking. I can invest, move my investments around, sell real estate, buy stocks, and throw a little money out to hedge funds. On that cheery note, let me close and open up the floor to some questions.

Questions & Answers

Q I want to ask a question about the long-term outlook of the Chinese economy. Some people say that China's GDP will be bigger than the United States in 15~20 years. However, other economists say that under China's current regime, China's development will be inhibited and eventually slow down. I would like to hear your thoughts on this.

A First, we think that China's GDP will come to or surpass the US GDP sooner than 15~20 years. There will be ups and downs and cycles in the growth rate. But, prospects for future growth in the US suggest, at best, 3 percent a year. Asia, as a geographical unit, will surpass the eurozone and the US. The countries in this part of the world are relatively rich, not in terms of consumer standards of living but as countries they are rich. They do not have the same levels of debt. Those initial conditions could carry Asian countries a long way. But, there could be vicious cycles. The Chinese currency is unsustainably low. We have learned in the past that the longer a currency is fixed, the greater the chance for excesses and imbalances to develop. No matter how a country tries to exit from that fixed rate currency – typically they are forced to exit because they get runaway inflation – the central bank has to raise interest rates and that creates a lot of problems for the economy. They are then forced to let that currency go and that creates even more problems. So, the longer China waits before it starts to adjust the currency and help it get back to where it should be, the more risky it is for a boom-bust scenario in China. That, I think, is not unlikely to happen in China in the next few years. The exchange rate has been fixed for too long in China.

Q What do you think China's political system will look like after such economic development? Do you think it will maintain its one-party rule? Or do you think that China will adopt a more Western style democracy?

A My guess would be, short of political conflict, that China will be more Western capitalistic like, very influential, and a responsible global citizen. I do not share the view that it is a one-party rule or totalitarian government. It is just too big of an economy not to have a tremendous amount of decentralization. But, on very key policy issues and what is important to the future of China, the Chinese government does step in and tell its people what to do. It just told Google what Google could not do. Now, Google is planning on leaving China. It fixes the currency and nobody can change its mind. It is mixed in the sense that it is not totalitarian or a dominating government. It is an aggressive guider. It is a different kind of system. My guess is the material way of life for a society like that will dominate and they will be more Western like.

The same is true for India. I was recently at a conference in Aspen, Colorado. People from all walks of life were there. There were some business people from India. I got lectured on the materialism of America and how we had wrecked the world and Wall Street had done such terrible damage. I admit that I am a capitalist. And, I do not think that America is spiritual in the same way as India is. I said, "You know what? At the end of the day, you are going to be just like us because you like all those good things in life." Afterwards an Indian gentleman came up to me, who turned out to be a head of a private equity firm, and told me that he and a bunch of his friends had gone to Harvard Business School Executive Session. He said that there they were in middle of class buying and trading stocks on their Blackberries. So, what is new? In America we think that China is very much like us. In one sense I envy the Chinese and in another sense I fear them as a competitor. I do think that they will end up more Western like and responsible in order to make their way in the world and to make money for their people. The standard of living will get to them just like it gets to lots of societies around the world.

Q Given your rosy forecast for Asia and not so rosy forecast for the G-7, what can the G-20 do to address some of the imbalances that you talked about earlier and the imbalances between the developed and developing worlds?

A The glaring imbalances exist because of the fixed exchange rate in China. The G-20 should encourage China to find a mechanism by which they exit from a fixed exchange rate regime. Clearly, it cannot be a 20 percent upward revaluation.

That would be too big of a shock. A gradual movement in allowing the currency to move up is perhaps the best way to do that. That would over time do something about the trade imbalances that are so striking. There are, or course, imbalances relating to trade and currencies in Asia which is part of the reason why so many countries are selling currencies to prevent their currencies from getting too high relative to China. So that stands out as a glaring problem.

For the world as a whole, the movement toward more consumerism in China and Japan should be encouraged. Actually, the weakness of the American consumer in the long run will be healthy in my view because we spent too much and borrowed too much for too long. On imbalances, the US should be encouraged, if not lectured, on the huge deficits that we are running and the debt to GDP ratios that are going on because there are other ways out besides spending and taxing to deal with that. On the financial crisis and the aftermath, the global community, has not yet, and neither has a lot of individual countries, resolved the regulatory and supervisory framework – the rules of the game for what I call the animal spirits of the financial system.

If not set properly and delicately, those animal spirits will run amuck. I am not critical of that. These are bright, well-paid people who know how to make money, know how to get around rules, do not break the law in most cases but walk the fine edge of the line, and use government bail-outs as part of strategy to make sure that they make more money. We should know what the game is of this sector and harness it by setting the rules and regulations. We have not done that yet. I am fearful that in the US they are going to be too punitive and hurt the supply of capital that will energize our country. I have no doubt that capital will flow freely in Asia. The G-20 should get cracking on that so we come to a resolution of the rules and regulations within which the financial spirits can be pinned for good of society rather than what happened in the United States. There are others but we only have a limited amount of time.

Q I have a question about the Japanese economy. As you said, the Japanese yen has been appreciating this year despite its slow economic recovery. What do you think are the reasons for the steady appreciation of the yen?

A That is an interesting question, why is the yen so strong given the state of the Japanese economy with zero interest rates? Part of the answer, I think, is the diversification of foreign exchange reserves that has been going on all around the world away from the US dollar as a single reserve currency. With the US situation, as I described, you would not want to own only US dollars and US dollar denominated assets. It is too risky. The future of the US is in doubt. Of course, those who have investments all around the world and central banks holding foreign exchange reserves in governments have actually over time been diversifying away from the dollar which is part of the dollar decline. Since there is no other single currency to replace the US dollar as the global reserve currency, diversify toward euros, yen, dollars, and gold. This is not the only reason why we are bullish on gold. We are bullish on gold because we think that the demand will continue to be there for gold as part of a de facto basket of currencies for how counties who have foreign exchange surpluses will invest those monies. The Japanese yen is a recipient of those demands.

The other is Japanese policymaking. There is no signal from Japan that they want a lower currency. It is a puzzle. They are big exporting country. Their businesses should be complaining and pushing the Ministry of Finance. Here is the problem and here is why they do not: the Ministry of Finance, I think, does want to see a lower yen. The new Prime Minister is not clear because he has only been there a short time and the new head of the Ministry of Finance does not have a background in economics and finance. At the Ministry of Finance, the so-called "bureaucrats" do want a lower yen because it is the right economic answer. How do they do that? They can tell the Prime Minister that they think that is what should happen and then he can tell the Bank of Japan to sell yen and buy other currencies. However, no one will join them. The US does not want a stronger dollar. They have their own problems. The eurozone does not want a stronger euro because their inflation is already too low. So nobody will join Japan in intervention. It is one way to take the currency down. They have a trillion dollars in foreign exchange reserve, but they will just waste it. They are not going to do that. What is left? The Bank of Japan is not a leader on the currency. It has been an assistant on currency movements driven by the government of Japan in past years. They are not in the habit of striking out and talking about a lower currency.

Indeed, since Robert Rubin was US Treasury Secretary, central banks have been in the habit of staying out of currency affairs and treasuries have stayed out of central banking affairs. But, the Bank of Japan has a goal of price stability even though they do not have price stability. It is minus one percent year over year. It would be quite appropriate for the Bank of Japan to say; "We think the currency should be lower so we can achieve our goal of price stability." However, by doing so they would be wearing a different uniform. They have never done that. As we know, this is hard to do in any country. The other advice is to lower its interest rates but they cannot lower interest rates anymore. In time the currency will come down on its own. When interest rates start to go up everywhere else, the yen will come down, but it may be very late. All they have left is expanding the balance sheet and to announce that they are doing it. The market did react when they did it in December. The currency did go down some. So the markets are just waiting to take advantage of Japan when and if they decide to get behind the currency and push it down.

Beyond those explanations I cannot tell you other than there is a home bias in Japan for almost all things Japanese including their own currency and that may explain it partly.

Q I have two questions. First, like the coordinated stimulus packages throughout the world, when should countries begin exit strategies and should they be coordinated? When should Korea begin its exit strategy? Secondly, what is your view on the Tobin tax in the redesigning of the financial architecture?

A On the first question related to policy and exit strategy, this is difficult territory for policymakers. A number of countries have to deal with exiting from zero interest rate and some form of quantitative easing. In the United States, our Federal Reserve is shutting down quantitative easing in those areas where it is no longer needed. For example, in the financial sector those firms that are left are fine.

Two of them reported poor results but in a year from now Citi Group and Bank of America will be reporting profits. They are winding down some of the fund flows into the private sector, but they are not going to immediately wind down the fund flows into the asset-backed securities that go to consumers and small business.

A real problem in our case is what to do about the mortgage supply into the housing market which is now essentially a government owned operation. The Federal Reserve is ending its purchases of mortgage-backed securities, but that is still in debate because we need to have mortgage supply for housing. Then the interest rates will be raised. They will first do it on the rate on bank reserves and then the Federal Funds rate will go up. We think we will be at 0.75 of a percentage point on the Federal Funds rate at the end of this year. It is quantitative easing to be tapered first and then interest rates will still be far below what might normally be required. On the kind of forecast that I gave you for the US, they may do it, but this is very tricky territory. However, Chairman Bernanke and the Federal Reserve have been very genius in this, so I have a lot of confidence that they will invent ways to exit quantitative easing, quantity side, cleverly. Here is the problem: they need to get those excess reserves sopped up out of the banking system which if deployed in credit would lead to inflation. So, how do you sop up those reserves without selling a lot of treasuries and mortgage-backed securities and driving those interest rates up and interfering with the US economy's recovering expansion? They will invent a deposit; pay the banks some interest; the banks will buy them; and the Federal Reserve will sop them up that way. It is a clever alternative.

Exit policy on fiscal is very difficult in America because it is wrapped in politics and societal objectives of the Obama administration: for example, insuring the uninsured on health care. Socially, it is a worthy objective. Most of the world has its citizenry insured. In America, we have 30~40 million people who do not have health insurance. As a social matter, I think that is unacceptable, but now we have this healthcare program that looks very costly and can cause inflation. I think exiting from the deficit and debt, in this case, is next to impossible.

As for Korea and in general, exiting or "getting ahead of the curve" is always too late. It is better to be early and wrong and then reverse it rather than to be too late and get behind the curve. The dynamics of the business cycle overwhelm policymakers. Inherently, it is going to be late anyway. There is a recognition lag, implementation lag, and there are lags in the system. You can never be early enough. In that view, if I were in the Federal Reserve I would be raising interest rates now. Applying that to Korea, I would be arguing for higher interest rates earlier rather than waiting. Looking at our numbers for Asia, I would probably start raising interest rates now, not in big lumps but I would start early. Interest rates are not a very effective instrument in the short run unless you move them up very sharply but that is a shock. This said, I have no thought that policymakers will be preemptive.

On the Tobin tax, it is a concern if it is only done in one or two countries. Most people argue that it should be done everywhere, but I do not think the global community can agree on that. I happen to think that it could be done in a given country. It is being considered in the US Congress. I do not think that it would survive the lobbying efforts of the financial community, so I doubt it will happen. It is a very liberal economic view and I do not think politically that it can fly in our country but I am arguing for it behind closed doors in Congress.