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S and Global Economy and Financial Markets in Turmoil: What Lies Ahead?

혼돈 속의 세계경제와 금융시장: 분석과 2012년 전망

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- 현 미국 Decision Economic사 대표 겸 수석 글로벌 이코노미스트
- Michigan대 졸업, Northwestern대 경제학 박사
- 오랜 기간 월스트리트에서 경기진단의 대가로 인정받고 있을 뿐 아니라, 현재 미국 백악관뿐만 아니라 각국 정부, 금융기관, 기업 등 300여 곳에 대한 자문활동을 하고 있음.
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US and Global Economy and Financial Markets in Turmoil: What Lies Ahead?*

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There are a lot of questions and not a lot of answers regarding today's topic. I want to review the turbulent year of 2011 to set the stage for thinking about what lies ahead. 2011 was a year of turmoil, turbulence, and volatility in the US and global economies and financial markets. Political and geo-political instabilities were widespread. Equity markets fell sharply in most countries. Except for 2007, it was the worst performance of equity markets in decades. Inflation was high at the beginning of the year and later commodity prices, including oil and energy, started to move down. G7 country interest rates stayed low with the Federal Reserve in the US, the Bank of Japan, and the Bank of England expanding balance sheets through quantitative easing. Long-term interest rates for a number of countries, whose sovereign debt was in question, rose sharply and soared as eurozone's economic and financial crises worsened. European and European Central Bank (ECB) policies to stem the crises were too little, too late. Unemployment remained high in many countries. Financial institutions and financial intermediaries in most major countries remained troubled, especially in Europe where there was extraordinary financial distress for banks in a number of European countries.

2011 in Review

As for the US and world economies, by and large economic recovery and expansion continued in 2011. This was part of the world recovery that began in economic growth rate of 3% in 2011. That was down from a very robust rate of 4.3% in 2010. The line we set that divides recession and expansion of the world economy is a positive 2% of real GDP growth. A move down in global growth from well over 4% to 3% is a major slowdown. Last year was essentially the second year of recovery and expansion. Normally economic recoveries in the early stages do not tail off that fast. Our numbers, qualitatively, will probably tell the same story as World Bank or IMF forecasts.

US economic growth in 2011 was only 1.8% following 3% in 2010. Compared to other historical economic recoveries in the US 3% was already very bad, normally in the second year of a recovery it is around 5~6%. There has been recovery, but it has been anemic and subpar. It will continue to be this way in the future. Under almost any circumstance, the US is not going to grow anywhere near the pace that used to grow in the good old days. We are not a high growth country anymore—either in the short, intermediate, or longer term horizon.

We estimate that Japan's economy had a negative 0.5% growth rate last year, after a strong recovery growth rate of 4% in 2010. Of course, that was in part a result of the disasters that occurred in Japan, but we are estimating Japan to grow only 1% this year. It is more than just the disasters that has pushed the Japanese economy away from the strong initial recovery it had.

We estimate China's growth to be a little under 9%. This is down compared to 11.3% growth in 2010. South Korea grew at 3.8%, significantly under the 5% that I forecasted last year. When I discuss why the global economy faded, it will be clear why South Korea's growth rate did not meet my expectations. A nearly 4% growth rate is not bad in a year like 2011, but of course South Korea wants to grow fast and hopefully will do so. However, Korea is a very open economy that is heavily driven by exports, so Korea's growth rate depends largely on how other parts of the world do.

Over the past year, a number of countries fell back into recession. This is very unusual in the second or third year of an economic upturn. In particular the economies of Greece, Portugal, and Ireland fell sharply. Lately, Italy, Spain, Belgium, and the Netherlands have also all fallen into another recession. Growth is also much weaker in the UK, Germany, and France. China and other developing economies all weakened in growth, but they still grew very well. As a group of countries Latin America grew at 4% compared to 6% in 2010. Emerging Asia grew at 7.5% after a booming 9.3% in 2010. Emerging Europe was strong and stable with around 6% growth. The Middle East grew at about 4%.

The pattern is clear. Although there has been a slowdown in Asia and the developing world, there was very strong and positive growth. Nobody likes activity to slow down, particularly in business, but the growth has still been excellent. Even if it will fade, as it probably will in Korea, relative to the rest of the world the prospects are good.

Forces of uneven performance

The uneven economic performance across countries and global regions can be traced to four different forces. First, there were more negative macro-economic shocks last year than any time since the shock ridden decade of the 1970s. Second, there was a hangover from the economic and financial crises from 2007 to 2009. As we all recall, it was the deepest and longest downturn for the US and world economies since the Great Depression of the 1930s. In 2011 economies and financial institutions were still in the process of healing and correcting huge excesses and imbalances that arose in the Great Recession of 2007 to 2009. Third, there were a lot of policy errors and ineffective policies, which played a large role in the ups and downs of the business cycle. It is a category of things that had a big effect on the ups and downs of economic activity and the behavior of financial markets. The last force has been political change and instability.

Later, I will go through the shocks in greater detail but for now I would like to mention a few things regarding all the shocks last year. The picture at the beginning of 2011 was very different from how things actually turned out. When I was here a year ago, the Arab Spring had not happened, oil prices had not shot up, the disasters

Federal Reserve was thinking about exiting quantitative easing, which they tossed to the side in the middle of the year because the economy underperformed.

Regarding the hangover effects and legacy of the 2007-09 crises, as the excesses and imbalances of past years were worked out there was deleveraging, or as I call it re-liquefaction. This is a cyclical process of getting household finances and balance sheets back in shape after a huge deterioration in the preceding years. Recovering financial institutions have to recapitalize and deal with a tough credit environment that is unwilling to lend because of the perceived risks.

Additionally, punitive austerity measures imposed on the sovereign debt ridden countries by lenders and the European Union led to political backlash and in turn made the situation worse. I along with some other economist, notably Professor Joseph Stiglitz, have always been critical of punitive nature of lender conditionality. In theory the conditions must be put on the debtors so that they get their fiscal situation in appropriate shape, however the conditions are too stringent and too punitive. As a result the situation gets worse before it can get better. If a political backlash occurs, as it has this time, then that becomes a problem in the business cycle because of the uncertainty of everyone in the private sector. Regardless of what the policies will be, it is a negative factor.

Sometimes, countries upon whom the austerity measures are imposed will default or devalue their currency if they can. Indeed this is more the rule than the exception. Of the choices available countries often end up reneging on their sovereign debt and devaluing their currency. It is very punishing to the people in the country when the currency is devalued. The debts that are held externally make the private sector in the country impoverished. Those debts end up being forgiven because nobody can pay them back and after lags of a couple years money begins to flow into those countries and they begin to grow again. If they are careful and do what they are supposed to, as Brazil and a number of countries in Asia have, then the future can be very bright.

There were a lot of other policy errors that existed in tandem with all of the shocks. In fact, all of the shocks made policy making more difficult. Additionally, with underperforming economies like the US and Japan and with China trying to slow down it is very difficult to design policies to keep everything going. In the case of the US and Japan, which are both financially constrained on the fiscal side, they cannot afford stimulative macro-policies any more. The policy context is very different than in the past. How can they grow the economy, lower the unemployment rate, get the budget deficit down all at the same time? It is very difficult to find the policy solutions for these problems.

In regards to policies on monetary easing, it has not just been in the US but Japan has also been aggressive in quantitative easing. The ECB may now cut rates and pour funds into the banking system to keep banks going. They will not directly buy the sovereign debt of fiscally irresponsible countries; no central bank can do that. Rather, they will provide liquidity to banks to keep them going, which is the proper function of central banks. The traditional connections between monetary policy and the economy through mortgage finances and housing has not been working. Until very recently we had not seen consumer spending pickup.

This is a predicament that is very unusual and would exist and limit US economic growth no matter what shocks occurred last year. Without the shocks the US might have grown at about 2.75%, but with all the shocks it grew at 1.8%. Actually, it is amazing that with all the shocks the world economy did stay intact and keep growing.

If we step back and look at the world we see a huge liquidity trap, characterized by consumers that are rebalancing grossly unbalanced balanced sheets, not spending much, and scared. In the US, Japan, and other areas consumers are now sitting on cash and worried about retirement. There is a reluctance to invest or spend the cash that they hold, even though returns on savings are close to zero. Additionally, financial intermediaries are hugely averse to taking risks on lending, they are holding on to their cash and excess reserves. Financial institutions are also not sure on how much capital they will need, because the regulations have not all been settled.

strong balance sheets. However, businesses are not spending much of their cash holdings. They are now just now beginning to hire some people, but they largely prefer to buy technology rather than hire people. They will keep doing that and it is a great opportunity for businesses in new information technology. That is where American businesses are spending money. Why? To make profits. They really do not want to hire new people; people are expensive. They would rather replace them with robots, PDAs, or anything else that is labor saving and that stuff is cheaper than labor. In the US we see spending in that area with some of the cash they hold, but by and large they are sitting on terrific amount of funds.

As mentioned, the last few years, and 2011 in particular, were marked by significant political instability throughout the world. We saw changes in the old guard of the leaders in the Middle East due to the Arab Spring, six heads of Japan in five years, the inability of Washington to function and make decisions, and big changes from the elections of 2008 and 2010. In Europe one leader after another has left—some for the better and some not. In the case of Italy, the current leader of Italy Mario Monti is a massive improvement over Berlusconi. The new government gives hope for Italy, but there is concern that Italy is now so deep into its crisis that it will be difficult to climb out.

Eventually a real upturn should take hold, but the developing world will far outperform developed economies. When the risks subside sufficiently, equity market performance should reflect the fundamental decoupling of the developing and developed worlds. We think the developing world can sustain the level of high growth relative to the developed world. At some point if the decoupling of performance continues, then the stock markets of the emerging world will soar. This includes the South Korean stock market, although Korea is already an advanced economy.

Shocks in 2011

I will go over the negative shocks from last year and what to make of them now. First, the Arab Spring and the political upheavals in the Middle East gave rise to a speculative move up of crude oil and energy cost on the fear that oil supplies would be interrupted. When oil prices shot up the US sentiment went way down and it definitely took 0.5~0.75% of growth out of the US economy. Oil price increases, like what occurred last year, are both inflationary and recessionary. As central banks tightened in response to inflation, which happened a lot in Asia, interest rates went up. That hurts and is recessionary.

The turbulence in the Middle East definitely affected the outcome of 2011. However, it is now a stable outside shock and is not a factor, even though the Arab Spring goes on unsettled. There have been changes of leaders in a number of countries, with one more to go. I would venture to say that Assad will no longer be in charge of Syria at the end of this year. The risk is of course with Iran and the potential for conflict between Iran and Israel or Iran and the US. A major conflict would center on oil supplies and lead to sharp rises in oil and energy costs causing inflation around the world. Depending on how long the conflict lasts and how it is resolved there will be strong inflationary and recessionary forces. Oil shocks are always bad when they happen, but right now we are not at that point.

The Japanese disaster is something that nobody had to analyze before. The earthquakes, floods, and nuclear disaster were all horrible tragedies. They damaged the Japanese psychology and created huge problems for policy makers to deal with. They dealt with the problem by running bigger deficits, so now Japan's debt-to-GDP ratio is about 200%. I was just in Japan talking to senior level policy makers and they are extremely worried about this. They are intent on closing the gap on this potentially devastating fiscal situation. If it continues, five years from now Japan is a country that could go bankrupt, as rich as they have been. It is unsustainable.

We did our best to analyze that tragedy, and it had a big effect. Japan had negative 0.5% growth that reverberated through the supply chain. The effects were felt throughout Asia and probably damaged the global economy by a quarter of a percentage point. However, that happens once every hundred years and the shock is gone now.

booming 11% growth rate to a slower rate in the 7~8% range with an acceptable inflation rate of 4%. The growth rate for 2011 was around 9% and it will be a little lower in 2012. This is still very good growth, but it is the downward change that injects negative dynamics into economies that are touched by China. We think China's attempt to disinflate has been successful and is now over. The current rate of inflation is 4.1% compared to 6.6% five months ago. The attempts to slow it down and the effects of the European recession on exports have made the economy weak enough that the Chinese are worried that they could overshoot on the downside, and now they are starting to stimulate.

A year ago, nobody knew when China would stop disinflating and start stimulating. Now, this outside shock is a positive, provided that their inflation rate stays down and that they do not reemerge into another boom which appears unlikely. A stabilized growth rate in China is a plus for Korea and Japan. The prospect for six, twelve, or eighteen months down the road is that the Chinese economy will no longer be declining and it may turn up in growth. That is a very different backdrop for those of you who do business in China and for the South Korean economy in general than what we saw last year.

The Chinese policy is about the only policy in the world that I can point to and say that they roughly got it right. None of us know enough about China, because the country is not transparent. We are all suspicious of the real estate market, the financial institutions, the way the government works, and even the data that comes from China. That being said, at the moment it looks like the policy makers in China got it right. A soft landing of 7~8% growth or even a harder landing of 6% growth is better than most other countries do on policy when they are faced with a similar situation. We will watch it to see if it will hold in that range.

The eurozone crisis is economic, financial, political, and societal. It is a moment of truth in the history of Europe. We are living through a momentous period in history and we do not know how it is going to turn out. It continues to be an ongoing macro risk.

We were worried about the American consumer at the beginning of last year. That is no longer a concern. The American consumer is getting lively. It is not like the good old days, but aggregate consumption is picking up. This is a big plus for South Korea, Japan, and the business that export into the United States. We are projecting for the US 2.5~3% growth this year. Historically that is small compared to past recoveries in their fourth of fifth years, but compared to 1.8% it is an improvement. Businesses that are directly and indirectly tied to the United States will feel this.

In the US there is also the fiscal problem and the 2012 election. Last year, Washington's dysfunction was a macro shock to the economy. The policies dealing with the long run deficit problems and short term stimulus were totally unpredictable and could not be figured out. Americans now look at the executive branch and the congressional bodies with disgust and distaste. A business could not possibly be run the way Washington is. Americans increasingly feel that way about their representatives in Washington. We do not know how this will play out in the election of 2012. Certainly the fiscal situation is a big deal. There was the debt ceiling crisis last year. Two commissions were created to work on the long term problems of the deficit and the president ignored the finding of both, despite the fact that he appointed one of them. Congress went home fighting about a temporary extension of unemployment insurance benefits and social security tax cuts. It is an embarrassment that I have to talk about this. On top of all that, the performance of the stock market was terrible and that had an effect on the psychology in the economy.

Looking Ahead

The big picture here at the beginning of 2012 is that two of the three big global regions look pretty good. We did not see that a year ago. The US had fourth quarter growth of 3.5%, motivated by some liveliness in consumption. This has happened because American consumers have cut debt way down. They have not fully deleveraged, but they have moved in the direction of better finances and now they are able to spend more. There is evidence of this in consumer sentiment, retail sales, uplift that is fundamentally driven by consumption which makes up 70% of the US economy. The US consumer in aggregate is a very big deal for Korea, Japan, and China but less so for Europe. We trace much of the waves of economic growth around the world in the last eight years to big shifts in consumer spending. However, I am not talking about a big shift here. It is about a 2.5% increase in consumption for the year in real terms. Historically, the rate of growth for the American consumer was 3.5%, but 2.5% is a lot better than 0% or 1% which we saw previously and it is that positive motion that matters.

The other region that looks good is Asia, minus Japan. We have no doubt that the numbers that come out of China will continue to deteriorate for the first half of this year. However, from a market point of view, the handwriting is on the wall that they will make their economy better now that they have inflation under control and have started to stimulate the economy. Stock markets will react quickly in anticipation, but businesses need to wait until they see better sales and better prospects coming from Asia. The government of Japan and the People's Bank of China are trying to stimulate and that is very different from what they did last year.

This year's growth for all the regions around the world will reflect the problems of last year. There are now a lot of bad numbers. The global growth figure we forecast for 2012 is 2.5~2.75% growth, which is down from 3% growth last year and 4.3% in 2010. That is not far from recession territory for the global economy, which by our definition would be under 2%. This means the global economy is vulnerable. Where are the biggest weaknesses? One is Japan, but the major one is of course the eurozone which we forecast to have negative 1% growth.

For the eurozone we will see depression, bankruptcy, and probably default for Greece. There will be recessions in Portugal, Ireland, Italy, and Spain. There will be slower growth in Germany and France. Germany had negative growth in the fourth quarter last year, we do not expect that to continue, but it is possible. There will be a recession in the eurozone. The questions are how big and how long it will be.

The forecast is that the recession that started in fourth quarter last year will last until the third quarter of 2012. If we are wrong, then it will probably be worse than we are predicting, not better. There are a lot of questions about what Europe will look like after the recession. Will there be a euro with fewer countries? Will the euro even survive? How many countries will leave? Will they leave voluntarily? How many national defaults and bankruptcies will there be? How bad will it be for financial institutions that hold that debt? How severe will an ongoing credit crunch be? How much money can the ECB pour into this? How will the eurozone downturn affect the rest of the world?

The US is not very exposed to recession in Europe. About 13.5% of our exports go to the eurozone and the export-to-GDP ratio is about 13%, so the exposure to the eurozone is fairly small. In the case of Korea the export-to-GDP ratio is around 50%. The exposure to Europe, including Korea's exposure to Europe through China, is quite significant.

The US can help the world. The US sells and buys a lot from Canada and Mexico. Canada and Mexico are not touched very much by Asia or Europe in terms of trade. The US is in a bit of a self-contained igloo and relatively protected. If the US economy revives, then the demand will flow back to other countries that are more open to Europe. To be clear, if there is a severe long term downturn in Europe, then the 3.5~3.75% growth forecast we have for Korea will be too high. If the US surprises us on the upside, which is one of our scenarios, then maybe our forecast will be too low, but 4% looks to be out of the question.

As we get through all of this we can expect to see stronger growth. I am not a close student of the Korean domestic economy. I am talking about the macro picture as it affects Korea through trade. Of course financial markets affect Korea as well. Overall, we regard the Korean picture as positive.

The rest of Asia, except for Japan, also looks positive. We advise our clients to be overweight in this part of the world. We have a positive view on the currencies in Asia. The Korean won has actually gone down against a couple of major currencies, and I can tell you Japan is not happy about that. However, we still expect some

Asian currencies. It is very competitive area for exports and it is not
countries to have policies that favor exchange rate differentials that will benefit their exports, especially if they are very open economies.

In Latin America we expect 3.5~3.75% growth compared to 4.25% last year. We anticipate the Middle East to be steady at 3.5~4%. Canada will be about the same as last year and better next year. The UK will barely grow this year or next year. The G7 countries are showing unenviable slow growth and recession.

With that kind of global picture we expect inflation rates in most countries to tend down and central banks to be supportive. Where 0% interest rates are in place they will stay in place. Countries like Japan, the US, and the UK might do more quantitative easing. Monetary policy will be on hold and cheap money will be everywhere. Eventually there will be a business cycle upturn.

Scenarios for the eurozone

At this point the macro-economic exposure around the world to the eurozone crisis is too big to ignore and it is the number one potential source for a global recession. We have three scenarios for the future of the eurozone and I cannot tell you today which one will happen.

The first scenario is that they continue to muddle though. Currently, the policy makers observe a problem and deal with it after it happens. Their rescue efforts are almost always too little, too late, and they do not set up mechanisms that analysts feel they should. By the time the policy makers come around to the problem the dynamics of the situation have changed and they are way behind. There are repeated examples of this behavior in the case of the eurozone crisis. The first fundamental mistake was to not let Greece go. Look at them now. It is now obvious that Greece cannot pay their debt and they will eat up most of the pie that has been gathered to fund these troubled countries and Greece is still not making the reforms that the lenders want them to do. It is a waste of money.

Anything could happen at any time, but my view is that one way or another Greece will default. You do not want to hold any Portugal debt because they are next. You also do not want to hold any Spanish debt. Be careful about Italian debt, because the eurozone has not established a mechanism to provide funds to help Italy get over its refinancing for this year. Italy is solvent, but it has the third largest sovereign debt in the world and a huge amount of refinancing to do.

Muddling through is what they have been doing and look at the results. There is tremendous volatility, recessions are getting worse, country after country misses their debt-to-GDP target, and then the enforced austerity hurts the economy leading to a financial crunch. People cannot get funds so the economy weakens and GDP goes down. Then even when the deficit is cut, the deficit-to-GDP ratio does not go down. The only option for the country in this situation is to leave the eurozone.

Another scenario is for the eurozone to break apart. A lot of people believe that one way or another Greece will leave. Portugal, which is moving towards default, would follow. In this scenario there will be a thinned down eurozone, but still have the euro and European Union with the laudatory view of history and a mission to make sure tragedies and conflicts like in the past do not happen. If this is the outcome, other than the initial chaos, the euro would be much stronger and I would be a buyer. There would be fewer countries that are in a better shape. If all the bad economies were out, it would be much stronger. If Greece leaves and creates a new currency, then as a speculation I would invest in the Greek stock market after things settle. A lot of money can be made in Greece, even if they leave the euro. With their own currency they can freely fluctuate and move their currency down to lower levels, which will help their exports. I personally think that they would be better off leaving the eurozone.

The third scenario is a political and fiscal union. That is what the leaders of Europe have always wanted. Do any of us really think that it can happen in Europe? I wish that I thought it could. Chancellor Merkel, President Sarkozy, and the former president of the ECB, Jean-Claude Trichet, were working very hard to achieve this goal. They have made some progress on the fiscal union, but it is taking so long that

There is a very interesting situation in Washing that I do not think many people are aware of. Unless the laws are changed, there is $6 trillion in planned deficit reduction over ten years beginning in 2013. In August last year, a deal was struck to cut $900 billion in government spending. A super committee was also created to negotiate at least $1.2 trillion in further deficit reducing measures with a stipulation that if they could not find a compromise there would be an automatic $1.2 trillion cut in government outlays, with half coming from defense spending and the other half from domestic spending. The super committee failed to come to a deal, so on the law right now there is $2.1 trillion of spending reductions extending over ten years. The Bush tax cuts are also set to expire at the end of 2012 which would raise $3.5 trillion in revenue over ten years. An additional $500 billion from the alternative minimum tax will hit families unless Congress decides to alter the tax as they have every year since the problem first arose.

The composition of the deficit reduction is over 60% tax increases with less than 40% of outlay cuts. Nobody has suggested this mix to reduce the budget deficit. The commissions that have studied this for many months argued for every three dollars of outlay decrease there should be one dollar of revenue increase. It is amazing that this is what is on the books right now. If 60% of deficit reduction comes from tax increases, then our models show a recession. They have come to this result even though the biggest deficit reduction that anybody has proposed is $4 trillion. It is unbelievable that the American government has done this by accident. I do not think that Washington will actually let these laws stand, but I cannot promise that they will not do something stupid.

As for the 2012 presidential elections, President Obama will campaign on extending the Bush tax cuts and preferential rates of capital gains tax for middle and lower income families. He will argue that the Bush tax cuts should expire for the wealthy—families with income over $250,000. He will also call for corporate tax reduction, corporate tax reform including closing a lot of the loopholes, and broadening the base. There is a broad consensus in both parties that this has to be done to be more competitive in the world.

On the Republican side, it appears that Mitt Romney will likely be the nominee. He is a competent technocrat and has been successful in business. He was a Republican governor in the predominantly Democratic state of Massachusetts.

Obama and Romney have the potential to give us an articulate and enlightened discussion of the big issues including the role and size of government, the amount and kind of regulation, how to deal with the debt, the role of the US in the world, and what the trade policy should be.

At this point I am cautiously optimistic. I think the US can work its way through these problems and end up dealing with many of these issues in a reasonable way. When I back away I see a lot of agreement between the Republicans and Democrats. There is a lot of consensus on a lot of issues. Looking beyond the election, for the first time in years, we have the US slightly overweight against the MSCI Index. That means you can buy stocks in the US.

Concluding perspectives

I think there will many fewer shocks in the coming year, and that is a cause for optimism. However, as last year has taught us, tail risks and unexpected events may come out of nowhere. As for the shocks that are still around from last year, we have a better idea what their impact will be.

We have seen the worst of the problems and shocks in this economic cycle. Looking ahead compared to last year it looks much brighter. What happened in 2011 was really a very sorry state of affairs in so many ways. We are optimistic and overweight on stocks and somewhat underweight on fixed income. We are bullish to the tune of 10~20% up on oil. We continue to be overweight and hold gold in our portfolios and I recommend it as a currency alternative.

The uncertainty over the future of the US, the eurozone, and Japan is so great that although I am cautiously optimistic I cannot put my money where my optimism

dollar, the euro, or the yen. In terms of the basket of currencies
that are an alternative to these currencies, we would be buyers of the South Korean won, the Singapore dollar, the Chinese yuan, and the Canadian and Australian dollars.

For Korea moving ahead things look bright. Korean should be happy that they are not dealing with the problems that the US is dealing with. Make sure that you do not let the Korean government borrow too much money so that Korea does not end up like one of the countries I talked about today.

Questions & Answers

Q What are the chances that the euro breaks apart and countries return to their original currencies? And if that happens what will be the impact on the global economy?

A The odds of some kind of breakup of the eurozone are high. However, I do not think that all countries will go back to their individual currencies. The original political reasons for the eurozone are so entrenched in the leaders that the most likely breakup scenario is a eurozone with eight to ten countries. If there is a breakup, we hope that they plan it in an orderly fashion. There are some contingency plans, certainly in the private sector, for this eventuality. I have always thought that the system as it was originally set up could not endure. Ultimately there will be break up, one way or another.

How do I plan for this? I cut my investments in Europe down. We have moved our asset allocations out of Europe. If you are in business there, then it is not that easy and you will be stuck with the chaos of a breakup and the problems of a downturn. I encourage all of you to look at this and take action to minimize the risks to your bottom line.

There is no orderly way to default or break apart in this kind of situation. It will be chaotic and the markets will go wild for a few days and at that time we will look for potential bargains.

If Greece leaves the eurozone, then we have to look at what is going on in Portugal, Ireland, and Italy. The big question right now is how Italy will finance all of its debt. The EU would be well advised to save their money, let Greece go, set up a transitional currency, give Greece some aid money to get up and running again, and let the drachma fall. Then they could take the money they saved to help Italy refinance its debt. If this is done, then Italy might get through the huge amount of refinancing that it has to do. At least they would have more time to get their fiscal never behave like business people.

Q In light of the recent problems in Italy, do you think we are now at a point where the rating agencies are becoming something more than that of an external observer and they are now a factor affecting the decisions that are made? Is it time to think about this aspect on the future of the world economy?

A I side with the Europeans on the issue of credit rating agencies for a couple of reasons. What I saw in the process that led to the downfall of my former company, Lehmann Bothers, and the demise of intermediary finance in the US was the dynamics and interaction between traders in the market selling short and the rating agencies down grading. We all knew about the markets and that if a stock price went down the rating agency would say they needed more capital. Investors and traders sold on the expectation and of course that made things worse and they knew it would make things worse. They knew that this would then cause the balance sheets to contract and the rating agencies would come back and downgrade again. That was expected, so the stocks were sold. Where does it all end up? It is really a road to nowhere.

Now we have the same process going on again in the eurozone. The role of the rating agencies and their active participation and even the timing of their announcements really need to be questioned and probably changed. They are profit making organizations, not public utilities. It is a negative part of the dynamic, just as the lending conditionality is negative part of the dynamic. It is far too punishing in terms of the conditions it lays upon a country, and people are justifiably so unhappy that they rebel.

I talk with the Italian press a fair amount and recently I had a conversation with them about what the Italians think about all of this. They are doing all they can do, and look where they are. They are very frustrated and the rating agencies contribute to it being worse. Of course the government plays a role and my view is the Mr.

Monti really will do a better job than Mr. Berlusconi. However, the helplessness of the situation that rating agencies are involved invites an examination of their role in all of this. In the US we did do it fully with the Dodd-Frank Act. I encourage the governments and policy makers of Europe to continue to chastise the rating agencies.

Notice the markets though. They are the ultimate answer. What has happened since the downgrades? The downgrades were irrelevant. We all know what is going on. Governments need to know that they cannot fool analysts. Governments need to know that and be transparent. Mr. Berlusconi, for all of his appeal on a social level, was not very appealing to investors thinking about investing in Italy. Mr. Monti is a different story. The markets are very smart; there is too much money on the line for too many people. They can downgrade the debt more, but ultimately the markets call the tune. Look at the US. Our long-term yields are down fifty basis points because of the downgrades, but look at the auction after the downgrades. It was a one day event in the financial markets.

Q What are your thoughts on the desirability of the Korean won becoming convertible in the global exchange market? To this end, should Korea further deregulate its capital markets?

A As a holder of $300 billion in foreign exchange reserves with a good budget and a strong tradable goods sector, Korea ought to be more open on capital flows and capital markets. In turn, that would increase the attractiveness of the won as a currency to hold and it would get a larger role in currencies that are used in trade. The Korean won is small in the world of foreign exchange reserves and I would side with the small group of economists that want to see a bigger role for it. It is one of the currencies that we go to as part of a basket of currencies and commodities as an alternative to the dollar, yen, or euro. There is no single currency that can replace the big three, but we use baskets of currencies and commodities, including gold, to face the difficult situation that undermine the major reserve currencies.