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**CURRENT ECONOMIC SITUATION  
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# By Mutual Consent

What China and the United States can do together to turn crisis into opportunity

By HU YUE

**A**s the battle against the global financial storm heats up, China and the United States are increasingly finding themselves in the same boat.

In the face of looming downturns, both countries have pumped massive fiscal stimuli into various key industries to foster a turnaround. But an end to the crisis will not necessarily turn on a spigot of fresh economic growth. It is widely believed that restarting the world growth engine will require closer ties between the world's largest economy and the most vibrant emerging economy.

The high economic interdependence of China and the United States could explain why they believe cooperation with the other is essential. While U.S. consumers account for the bulk of China's growth-driven exports, China is the largest holder of U.S. government debt—a key source of financing for America's soaring deficits.

Considering the many uncertainties of the current crisis, the question many are asking is whether the two countries' economies can emerge from the downturns by working with each other and at the same time position themselves for future economic growth.

This year's China Institute Executive Summit on April 27-28 in Beijing provided a platform for economists and business leaders from both countries to plot a way out of the current economic mess. By exchanging views on further cooperation, they sent a strong signal of hope on their joint path toward economic recovery.

This was the first time that the five-year-old summit was held outside the United States. Sara Judge McCalpin, President of the China Institute, which organized the summit, told *Beijing Review* that the conference was designed to provide a bridge between business leaders from both countries and help them gain knowledge and learn best practices from each other in overcoming the crisis. The China Institute is an educational and cultural organization based in the United States, which focuses on advancing a deeper understanding of China.

## Challenges ahead

While Europe and Japan sink into deeper



**DAUNTING CHALLENGE:** Donald H. Straszheim, Managing Principal with Straszheim Global Advisors Inc., says China may face slower economic growth in the coming years because of an export collapse

recession, the world is looking to China and the United States for some confidence. With its 4-trillion-yuan (\$586 billion) stimulus package taking hold, the Chinese economy appears to be turning around. On the other side of the Pacific Ocean, a gradual stabilization is also removing a huge drag from the U.S. economy although it still has a long way to go before it can realize a full-fledged recovery. More importantly, the fiscal boost delivered by each country provides a source of confidence for the other.

But one common challenge confronting the two economies is that U.S. consumers, whose retirement accounts and home values have seen significant drops in value, will be more prone to saving money than spending it in the years to come, said Donald H. Straszheim, Managing Principal with Straszheim Global Advisors Inc., at the summit. Straszheim Global Advisors is a U.S.-based independent economic research firm

that focuses on business strategies in the two economies.

With the large amount of excess capacity built up during the past boom times yet to be digested, reduced consumer demand for products will make a dent in both economies, Straszheim said.

In response, China is widely expected to rebalance its economy away from its current dependence on exports and toward private consumption, while the United States must shore up its investments since it cannot afford another round of over-leveraged household spending.

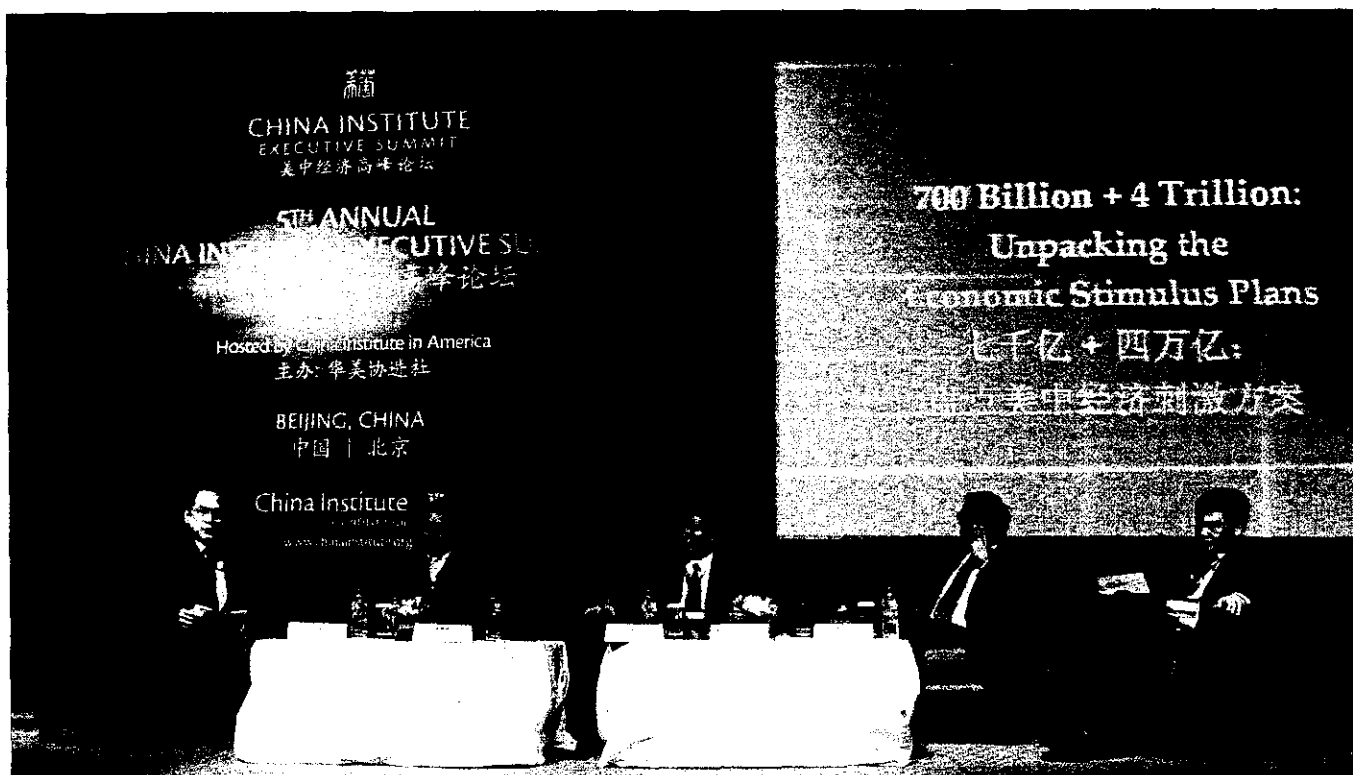
Economists at the summit welcomed China's push into innovative and high-value industries, as well as the government's efforts to build a viable social safety net that could spark a surge in domestic consumption. A higher rate of precautionary savings in the United States also would help restore the household balance sheet and provide a floor under the buckling financial system, they said. The entrenched consumption-savings imbalances between the two economies must be gradually redressed, they added.

Yet, the road to economic revitalization will not be smooth sailing. China's economic growth, without a vibrant export engine, may no longer be able to operate in high gear, because the country's consumer market still needs time to grow, Straszheim said. The United States, in turn, will have to cope with a shortage of fiscal ammunition to jumpstart the economy, he said. It also faces questions about how to address the problems of monetary, credit and asset restructuring to repair its tattered financial system, he added.

"We should join hands to evolve with a new foundation for future growth," Straszheim said. "There is a real need for continuous cooperation between us to overcome those challenges together."

Zhu Min, Vice President of Bank of China Ltd. (BOC), echoed Straszheim's opinion, citing the Sino-U.S. Strategic Economic Dialogue as an important stage for coordination.

"Never before have we been so close to each other," he said. "The first step of cooperation should be to enhance our mutual understanding and policy transparency in a concerted effort to temper the growing slack."



**JOINING HANDS:** The China Institute Executive Summit in Beijing on April 27-28 provides a forum for economists and business leaders from China and the United States to weigh their cooperation in fighting the economic crisis

Norman Yen, Board Advisor of SmithStreetSolutions Consulting Co. Ltd., a Shanghai-based knowledge process outsourcing firm, said coordination may be difficult for the two economies, which have their own preoccupations, but the dialogue serves as a good start.

### Opportunities on the horizon

Although it came as a heavy blow to the Chinese economy, the global downturn has been more of a double-edged sword whose upside has started to shine through.

Now is a good time for the country to nurture a consumption-driven growth model that is more sustainable and efficient in both economic and environmental terms, said Yen. To achieve that, more meat must be added to the bones of industrial restructuring plans, and the government must ensure that quality plans are implemented, he said.

For China's ambitious enterprises, the downturn also provides them with a rare opportunity to become more globally competitive. Through outbound organic expansion or cross-border mergers and acquisitions, they can get access to advanced technologies, raw materials, marketing and distribution channels, global brands and global management teams.

Another bright spot for both domestic and foreign investors is China's rural market

that is emerging as a potential driver for the flagging economy. Cao Yuanzheng, chief economist at BOC International Holdings Ltd., said China's numerous towns and villages would increasingly become important targets of investments. For example, the rural areas where financial services and capital are scarce may provide chances for foreign banks and private equity investors, he said.

Rural China is no longer simply a source of emigrants bound for the cities, but a hot-bed of prosperity, said Peter Rupert Lighte, Chairman of JP Morgan Chase Bank (China) Co. Ltd. But that will eventually require a dynamic integration of cities and villages, he said. For instance, the government must draw rural migrants to smaller and newer cities closer to their original homes so that the geographic and financial urban-rural divides will be diminished, he said.

### Green economy

In addressing their different economic woes, China and the United States took similar low-carbon paths to green growth. While China embarked on a spending spree on environment protection, the United States resorted to a tax cut for clean energy industries.

The "green" stimuli have the capacity to inject steam into both economies in a sustainable and efficient way, said William J. Friedman, Director of Food & Drug Asia at

Covington & Burling LLP, a renowned law firm based in the United States. The countries' enormous economic and social benefits range from higher energy efficiency and healthier agricultural products to green job creation and conservation-based enterprises, he added.

Richard J. Schulberg, Executive Director of the International Sustainable Development Foundation, agreed with Friedman.

"We are still confronting a crisis of neglect in many places around the world about the ecological system and the climate change that might be even more crippling to the world's future than the current financial crisis," he said. "The financial crisis is also mounting pressure on us to be more productive and energy-efficient. As a result, the pursuit of the green economy is not an option, but a necessity for the promising future."

Gary William Dirks, Group Vice President of BP Plc, believes that China and the United States can play a positive role in fostering the green economy by strengthening their financial support for green policies and creating standards.

The two countries have a good opportunity to cooperate in a number of areas, such as protecting the ecosystem, promoting energy-efficient vehicles and developing a smart grid that is highly efficient in power transmission and distribution, he said. ■

# Destination China

China's foreign direct investment (FDI) inflows dropped by about 20 percent year on year in the first quarter, raising questions about the country's attractiveness to foreign investors. Edgar G. Hotard, Chairman of the Monitor Group (China), sat down with *Beijing Review* reporter Hu Yue on the sidelines of the Boao Forum for Asia on April 17-19, to discuss this issue. The Monitor Group is a global provider of strategy consulting services, headquartered in the United States and with offices in China.



**STRONG CONFIDENCE:** Edgar G. Hotard believes a fast economic recovery will polish China's appeal to foreign investment

**Beijing Review:** China's appeal for foreign investment seems to be fading as reflected in the declining FDI. Do you think the decline will continue in the long term?

**Edgar G. Hotard:** There has been some decline in FDI, but this is more a result of the macro issues deriving from the global downturn and not a reflection of the inherent attractiveness of China. Foreign companies may be holding off on investments until the country's capacity imbalances are properly addressed and there is clearer visibility on growth. Also, private equity investment has seen a decline but should rebound once the economy begins to improve and valuations can be matched with market opportunities and growth.

**How are foreign companies revaluing the Chinese market during a downturn, and how are they rethinking their business strategies to match the realities?**

Foreign companies are revising their strategies based on the realities of the marketplace and their strategic goals for their business in China. If their strategic objective

was to tap into low-cost labor and export their branded goods back to the United States and Europe, they will have to revamp their strategy to address excess capacity in China as consumer demand in the West has declined precipitously.

Those companies that invested in China for growth in the domestic market also will require a strategy revamp as the economy here is continuing to grow at a faster pace than expected despite the global recession. Having achieved 6.1-percent GDP growth in the first quarter when exports plunged by a significant 25 percent means that domestic demand remains relatively strong and continues to grow. This is a positive sign that the Chinese economy might bottom out faster and lead the global recovery. As a result, foreign companies have to better understand the growing market segments and position themselves for future growth opportunities. Reviewing and updating their strategies to respond to the downturn and yet prepare for growth is what a lot of multinationals in China are doing today.

As competition heats up in China,

foreign companies need to develop a set of strategic actions to implement. Cost management consistent with strategic direction and balancing the short-term focus on cash preservation with longer-term strategic action is important, and driving innovation into their organizations will be needed in order to create profitable growth.

**What should China do to further improve its business environment for foreign investments?**

First of all, China should continue to communicate and make its investment regulations understood since there have been some significant changes in terms of attracting foreign investment, including private equity and venture capital.

Second, China should push even harder on innovation, particularly in high technology and basic science development, which is a long-term benefit. Additionally, China can provide an indication of efforts the country is making and highlight successes. Innovation in companies is very important at this time as it is usually during economic downturns that innovation occurs in market leading companies in product development, services, business models and marketing approaches. The constant commitment to becoming a more innovative society and pursuing high technologies and other areas of innovation will definitely help the domestic economy recover.

Also, it is necessary to engage with the world and continue to be a responsible global citizen as China has become.

**What do you think of the regulatory risks facing Chinese companies on their path of going global through mergers and acquisitions?**

I think there is too much attention focused on that issue. There are some Chinese companies looking to buy foreign strategic assets or technologies that might have national security implications. But that is only a small part of the total cases. There are a lot of other successful acquisition cases in manufacturing and consumer services-related sectors that have no national security issues. Foreign regulators have a reason to be careful about national security issues, but they should not label every potential acquisition under that classification. ■

# Growing Pains

As clouds gather over its economic prospects, the United States seems to still have a long way to go toward riding out the recession. In striking contrast, emerging Asian economies are becoming a stabilizing force in the global battle against the economic crisis. John Rutledge, former economic advisor to U.S. presidents Ronald Reagan and George H.W. Bush, discussed this issue in an interview with *Beijing Review* reporter Hu Yue on the sidelines of the Boao Forum for Asia on April 17-19.



**THE RIGHT STUFF:** John Rutledge says it will take more policy moves for the U.S. economy to see light at the end of tunnel

**Beijing Review:** Several U.S. economic indicators are turning around, such as the consumer confidence index and the manufacturing business index. How likely is it that the U.S. economy has entered a period of recovery?

**John Rutledge:** The economy is a very complicated sector involving 300 million Americans making a living and the stock market on top of it. So it is hard to predict an early recovery when a rising number of Americans are still worried about their jobs and housing debt.

The depth of the economic woes would defy any quick fix to turn around the deepening gloom. The demise of many established financial institutions came swiftly, and the prices of money market funds fell below \$1 for the first time in history. All those catastrophes dealt a heavy blow to both the economy and people's confidence.

To thaw the credit freeze, the U.S. Treasury Department and Federal Reserve have shoveled billions of dollars into the financial markets. I believe that is why the U.S. stock markets and international commodity prices saw a substantial rally from March to

April. But the real economy that concerns numerous jobs and paychecks also fell off the table and has not come back. I believe it will take some time for the capital market rally to work through the real sectors, perhaps one or two years.

Jobs hold the key to the broader economy because they are the source of new products and services as measured by the GDP. Most Americans have little savings and live by spending this week's paycheck. So if job losses proliferate, the economy will drift into serious trouble. The sound health of the stock market will extend some support to the real economy, but we just have to wait longer for an end to the crisis.

**What do you think are the biggest challenges confronting U.S. policy-makers in pulling the economy out of its quagmire?**

Facing the severe credit contagion, policymakers have no other choice but to pump ample liquidity into the banking system, or rather quantitative easing. But as soon as they are convinced that the growth engine is restarted, they will have to take out the

excess money in case of dollar depreciation and serious inflation.

The trick lies in when and how properly to drain the excess liquidity. There will be a second recession problem if they pull out too fast, and an inflation problem if too slowly.

Another concern is that the U.S. government's stimulus package is little weighted toward infrastructure construction, which is an efficient way to create jobs and growth for the future. Only around 4 percent of the bailout package is in construction-related investment. Obviously, China has attached importance to infrastructure spending, and is now braced for a quick recovery of its economy.

Meanwhile, U.S. government spending is taking an escalating share of the GDP, putting a heavy burden on the already fragile economy for a long time.

**Asian emerging economies are also feeling the pain of the global recession. What do you think they should do to fight the crisis?**

I believe the biggest contribution Asian countries can make to the world economy is to maintain their stability and growth as they are already doing. Asian countries still have very high savings rates and sound capital bases, which are very important to economic stability. To retain their financial health, they should take a gradual approach in opening up their capital markets so as to fend off Western speculators. Closer coordination and cooperation between them can also help regain growth momentum and foster prosperity in the region.

It is unavoidable that fast growth incurs some side effects, such as environmental pollution and energy waste. But some Asian countries such as China have been moving fast to fix them as they shift to more energy-efficient and environment-friendly growth models.

**How do you think the unprecedented financial crisis will change the business world?**

I think the business world will learn a serious lesson from this crisis. As Americans tend to save more and spend less on consumer goods, export-driven economies such as China and the southeast Asian countries will receive a hit. But as long as the change does not happen too fast, the export countries will still have time to adjust themselves.

It is true that people can learn something from the pain. I believe global entrepreneurs will be more careful with their strategies even after the world economy recovers its health. They will use less debt, keep more cash, and seek a stable position in competition. ■





**JOINING FORCES:** The finance ministers of China, Japan and South Korea have reached agreements on the forex pooling arrangement and how much their countries will contribute

## Asia's Commitment

East Asian countries pool foreign exchange funding to heal their economic woes

By HU YUE

**T**he global economic downturn is exposing some serious cracks in the Asian financial landscape. A batch of crisis-stricken Asian countries from Cambodia to Malaysia are feeling the pain of waning foreign capital inflows, the collapse in equity market prices, a lack of dollar liquidity and, in some cases, depreciating currency. Though their financial woes do not appear acute enough to justify deep concern, East Asian countries have started flexing their collective financial muscles for self-rescue.

On the sidelines of the Asian

Development Bank (ADB) annual meeting, finance ministers from China, Japan, South Korea and the 10 members of ASEAN (Association of Southeast Asian Nations) announced on May 3 their plans to set up a \$120-billion foreign exchange liquidity fund by the end of this year to provide a regional backstop against the credit contagion. The fund will offer a contingency credit line should any of the member countries come under speculative attack, as they did in the 1997 Asian financial crisis.

According to the announcement, Japan and China will each contribute 32 percent of the funding while South Korea will contrib-

ute 16 percent. The rest will come from the 10 ASEAN countries. Under the terms of the scheme, smaller Asian economies are allowed to borrow larger amounts of money in proportion to their contributions than the more developed ones.

Moreover, the fund will also come up with an independent surveillance organization with the help of the ADB and the ASEAN Secretariat as soon as possible to monitor economies in the region.

The forex pooling program is the first and strongest such financial alliance to be launched and managed by the region to fight off the deepening gloom. It is part of the Chiang Mai Initiative, which encourages bilateral currency swap arrangements among the 13 countries. In May 2008, finance ministers agreed to strengthen the loose currency swap network by building an \$80-billion forex reservoir to support member countries saddled with short-term liquidity shortages. In February 2009, they decided to increase the funding to \$160 billion as the financial distress intensified.

### Glimmer of hope

Despite having avoided following the Western world into the abyss of recession, emerging Asian economies are reeling from a freefall in demand for their toys, electronics and other exports. The ripple effect has triggered widespread investment stagnation, factory closures

and painful layoffs. The World Bank even forecast that emerging East Asian countries, excluding China, will see a minimum 1.2-percent GDP growth in 2009, reflecting the worse-than-expected unfolding of the financial crisis.

Economists believe that the liquidity fund will provide a floor under the buckling East Asian economies while they get back on their feet. At the very least, it has sent out a strong signal that Asia is well positioned to ward off a repeat of the financial crisis that gripped the region a decade ago, they said.

Zhao Changhui, a senior economist

with the Export-Import Bank of China (China EXIM Bank), told *Beijing Review* that the arrangement will deliver a boost to the region's financial resilience as liquidity risks loom large. By participating in the fund, China can also play a bigger role in regional revitalization efforts and decision-making in East Asian economic affairs, he added.

Although the fund marks a step up for economic cooperation in East Asia, the region still has a long way to go toward building a vibrant and healthy financial market, Finance Minister Xie Xuren said in a statement.

China has spared no effort in extending financial assistance to needy countries in the region and will continue to be a firm advocate of East Asian financial integration, he added.

As part of its commitment to regional economic integration, China has been pushing to establish a China-ASEAN free trade area, as well as encouraging more cooperation on bond markets and currencies.

Economists say the fund will also help diversify the use of some Asian countries' massive forex reserves, which have far more than what these countries need to cover their short-term debts and stabilize their currencies. China alone had amassed nearly \$2 trillion in foreign exchange reserves by the end of 2008. The bulk of it, however, is parked in low-yielding U.S. treasury bonds, stoking complaints about low returns and a lack of diversity. The weakness of the U.S. dollar in recent years has further added to the concerns. Analysts believe the liquidity pool will provide emergency insurance to financially distressed economies in the region and at the same time take some pressure off the region's management of idle reserves.

### A challenge to the IMF?

As the Asian emergency fund comes under the global spotlight, speculation is swirling—will it overlap with the International Monetary Fund (IMF), which has the same functions, or even marginalize the global fund in Asia?

This idea is not unfounded. The IMF itself had been financially strapped before receiving a boost from the G20 countries this April and now faces a complete restructuring to improve the representation of emerging economies. The painful memories of the

1997 financial crisis may have also made Asian countries less willing to seek help from a global fund dominated by the United States and Europe. In return for its financial bailouts 10 years ago, the IMF imposed harsh economic and social policies on a number of Asian borrowers, including fiscal retrenchment that worsened their economic troubles. In recent years, no Asian country except Pakistan has turned to the IMF for

the fund as a challenger to the IMF. The East Asian forex fund will be an effective complement to existing global financial institutions and an important part of the world's financial system, he said. It also represents an innovative approach to improving and reforming the global financial landscape, he added.

### Hurdles ahead

Although there is no doubt that the fund will generate a measure of common good, a handful of uncertainties still linger over its viability and growth prospects. The huge economic and social gulfs within the ASEAN-Plus-Three mechanism may undermine its ability to find a community response to emergencies. For example, Singapore, the richest country in the region, has a per-capita GDP 150 times that of Myanmar, the poorest.

The member nations of the fund are at different stages in developing their financial markets and regulations. He Fan, Associate Director of the Institute of World Economics and Politics under the Chinese Academy of Social Sciences, said in a statement. They also have sharp differences in their economic preoccupations amid the downturn.

Moreover, the lack of a powerful rule enforcer in the fund may hinder the timely arrangement of financing when a crisis strikes, he added.

Zhuang Jian, a senior economist with the ADB, added that the participating countries have yet to add flesh to the bones of the fund, including appropriately defining an emergency that allows use of the financing and making clear the repayment terms for borrowers. Details about its organization and financial management will determine how effectively it can ensure regional financial security, he said.

However, it enjoys greater flexibility in negotiations between the participants compared with the IMF, which is based on an annual conference, he said.

Xie Xuren also stressed that vigorous efforts are still needed to establish and improve the forex fund as the crisis creates new challenges for the region.

"In the next step, we should further enrich regional cooperation in various forms to edge closer toward economic integration," he said. ■



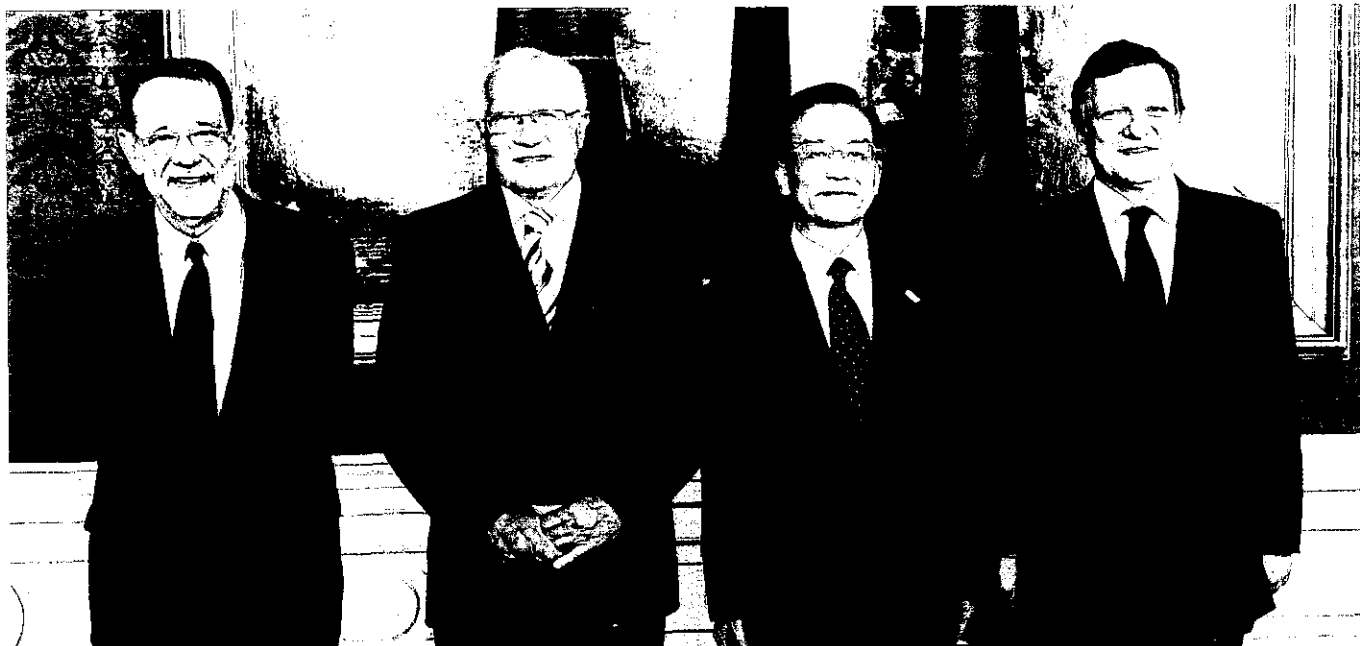
**ECONOMIC INTEGRATION:** Economists believe the regional liquidity fund is set to tighten economic ties between East Asian countries

financing aid.

"The IMF provided too little money with too many strings attached, which hurt its credibility as a reliable rescuer in the region," said Zhao Changhui of the China EXIM Bank.

In the wake of the 1997 financial crisis, Asia learned that it must depend on itself during downturns. Ten years of growth have rendered the region more able to erect its own safeguards against any crisis, he added.

Xie Xuren played down the idea of



**CHINA-EUROPE AFFAIR:** Chinese Premier Wen Jiabao (second right) poses with Czech President Vaclav Klaus (second left), European Commission President José Manuel Barroso (right) and Javier Solana (left), Secretary General of the Council of the European Union and High Representative for the Common Foreign and Security Policy, before the China-EU summit in Prague on May 20

## Cooperation Across Civilizations

After a six-month delay, the 11th China-EU summit produced agreements on renewing bilateral ties

By YAN WEI

**A**t their latest summit on May 20, Chinese Premier Wen Jiabao and European leaders reached new consensus on advancing bilateral relations, including sending another Chinese buying mission to Europe and holding the next summit in Beijing in the second half of this year.

Wen attended the 11th China-European Union (EU) summit in Prague, the capital of the Czech Republic, with Czech President Vaclav Klaus and European Commission President José Manuel Barroso. The Czech Republic now holds the rotating presidency of the EU.

The development of China-EU relations embodies the mutually beneficial coopera-

tion between the biggest developing country and the biggest bloc of developed countries and the friendly exchanges between the two major ancient civilizations, Wen said, according to a news release from China's Foreign Ministry.

The China-EU summit, as a frank dialogue between countries with different social systems, benefits the Chinese and European people and the entire international community, he added.

In the face of the complex and volatile international political and economic situations, China and the EU should uphold their strategic partnership, focus on practical cooperation, keep up with the times, bolster confidence and make joint efforts to promote

the all-round, in-depth and sustainable development of bilateral relations, he said.

China and the EU announced they would establish a comprehensive strategic partnership in 2003 after the sixth China-EU summit in Beijing. The EU is China's biggest trade partner, with two-way trade totaling \$425.6 billion last year. The average annual growth of the EU's exports to China has exceeded 20 percent in the past five years, making China one of the EU's most important export markets.

Wen urged both sides to give full play to the role of the China-EU summit as well as other consultation mechanisms such as the high-level economic and trade dialogue. He also called for an early conclusion of

### Flashback

The 11th China-EU summit, originally scheduled for December last year, was postponed after French President Nicolas Sarkozy, whose country at that time held the rotating EU presidency, met with the Dalai Lama.

Chinese Premier Wen Jiabao visited Switzerland, Germany, Spain, Britain and the EU headquarters in Brussels from January 27 to February 2. At a meeting in Brussels, Wen and European Commission President José Manuel Barroso decided to hold a high-level forum on the economy and trade

and a China-EU summit in 2009.

Chinese President Hu Jintao met Sarkozy in London on April 1 on the sidelines of the G20 summit, immediately after France reiterated that it adheres to the one-China policy, recognizes that Tibet is an integral part of Chinese territory and refuses

the China-EU Partnership and Cooperation Agreement.

China and the EU began substantial negotiations on their Partnership and Cooperation Agreement in January 2007. The agreement will replace a 1985 trade and economic pact to serve as a new framework for China-EU relations.

The principles of mutual respect and non-interference in each other's internal affairs are of great importance to China-EU strategic cooperation, Wen said, adding that the two sides should take into consideration each other's core concerns and properly handle sensitive issues. Wen expressed the hope that the EU would recognize China's market economy status and lift its arms embargo against China as soon as possible.

Since they share common interests in coping with the international financial crisis, China and the EU should work together and contribute to the early recovery of the world economy, he said.

The two sides agreed to oppose trade and investment protectionism, increase mutual investment and enhance cooperation in the development of small and medium-sized enterprises, trade facilitation, science and technology, transportation and postal services. They also agreed to strengthen dialogue on macro-economic policy and finance and jointly promote the reform of the global financial system.

The Chinese side promised to send another buying mission to Europe soon. It also hoped the EU would relax its export restrictions on hi-tech products to China to create new areas of trade growth. The buying mission in February following Wen's last visit to Europe concluded some \$13 billion in purchase agreements in Germany, Switzerland, Spain and Britain.

With regard to climate change, Wen said for all the impact of the financial crisis, the international community should not waver in its determination or slacken its efforts to address climate change.

Under the principle of "common but differentiated responsibilities," China is willing to work with the EU to help bring about positive achievements at the UN climate change conference to be held in Copenhagen, Denmark, in December, he said. ■

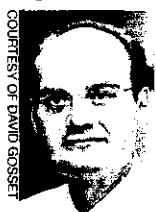
to support any form of "Tibet independence" in a joint press communiqué between China and France.

Chinese Vice Premier Wang Qishan co-chaired the China-EU High-Level Economic and Trade Dialogue with EU Trade Commissioner Catherine Ashton in Brussels on May 7-8.

# Not a G2 But a Trio

The new world order has three major players:  
Europe, China and the United States

By DAVID GOSSET



COURTESY OF DAVID GOSSET

**O**n the occasion of the London summit on April 2, the leaders of the G20 declared in their final statement: "We face the greatest challenge to the world economy in modern times."

But by questioning many of our assumptions, our ways of doing business and even some of our values, the crisis has prompted meaningful reflection and debate, generated intense consultation and triggered important reforms. From a geopolitical perspective, it underlines a rearrangement of power that was already reshaping our world system. The European Union (EU), China and the United States are the three main structuring forces of the 21st century global village, and the dynamics within this triangle as much as its interactions with the rest of the world will largely determine the foreseeable future of world politics. In this context, the idea floated by some analysts of a G2, composed of the United States and China, is a theoretical bipolarization that evacuates one fundamental dimension and misses a more nuance and complex reality.

Obviously, China is already a pillar of Asia's stability and is in a position to co-design a new world order. The Chinese renaissance modifies the world's distribution of power in a gradual and peaceful process that does not entail abrupt discontinuity or violent disruption.

Europe, another major factor in the world affairs equation, also has to cope with the decline of global economic activity. Even if the Europeans have tackled challenges mainly at the national level, the crisis exposes the need for a more integrated and potent Europe. With adequate leadership, the EU could take some initiative to put itself in a position to have a strategic role commensurate with the weight of its economy and in tune with its sui generis culture.

Although President Barack Obama's America remains a key element of the global village, the United States has lost the status of unchallenged hyperpower. The failure of Wall Street was not at the origin of the current redistribution of power, but reinforced a shift that was already under way.

The author is director of the Academia Sinica Europaea at China Europe International Business School, Shanghai, and founder of the Euro-China Forum

Confronted with the growing evidence of China's re-emergence and the increasing economic interdependence across the Pacific within "Chinamerica," some have raised the idea of a G2. In an article titled, "The Group of Two That Could Change the World," Zbigniew Brzezinski declared that the world needs an informal G2 made up of China and the United States.

Undoubtedly, the Sino-American relationship has to be taken to another level, but it does not have to be a process that would put the EU on the margin of world affairs. Sino-American and Sino-European links have to be upgraded simultaneously.

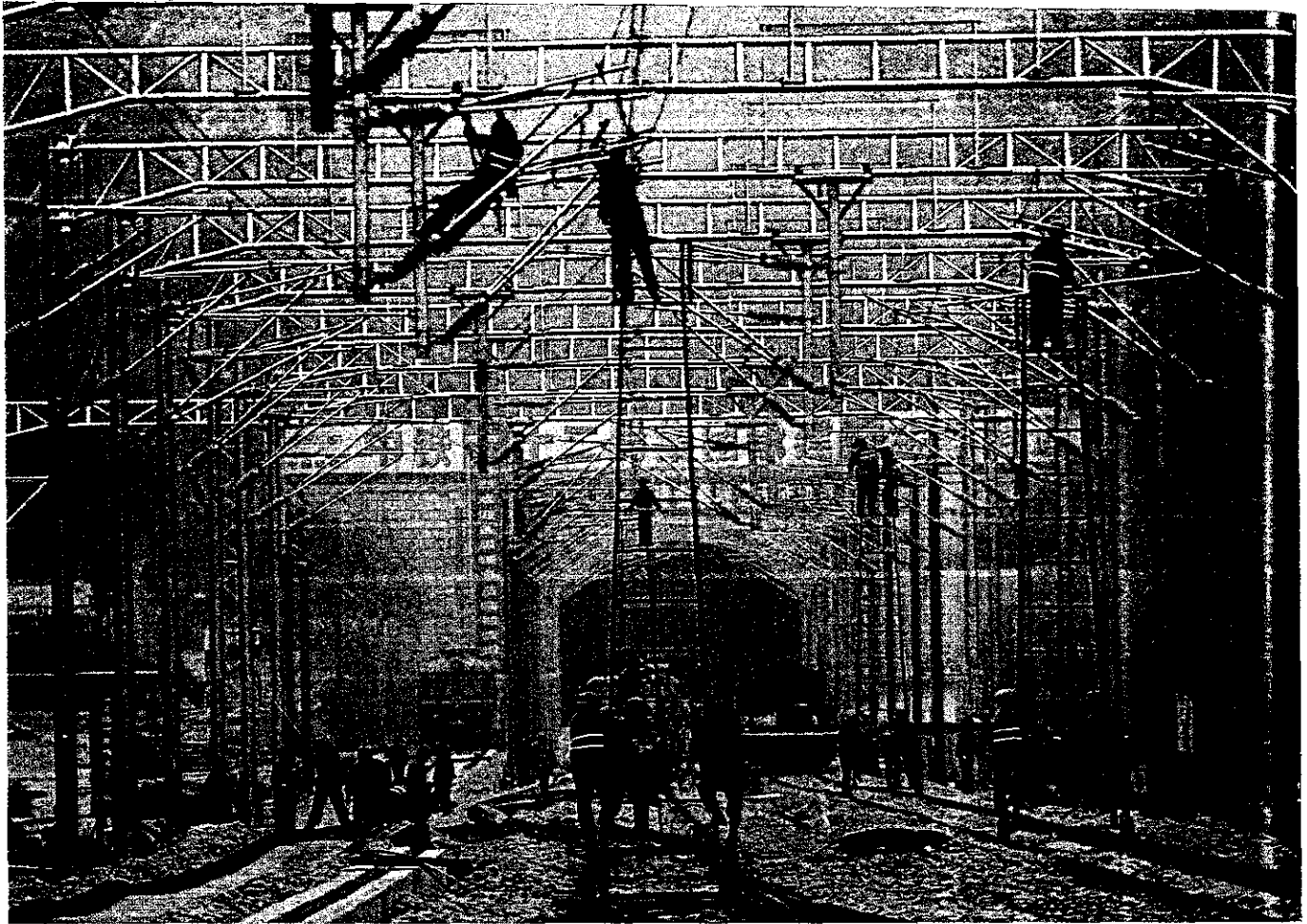
Only a trio and not a G2 can contribute to solving the world's social, economic and political problems. A constructive triangulation between Beijing, Washington and Brussels requires an open China, a cooperative America and a cohesive EU, but would also depend on actors free of past ideological barriers and able to conceive cooperation where all the potential synergy could flourish.

Instead of speculating on a G2, the time has come to initiate a strategic dialogue, a process that would bring together top Chinese, American and European leaders. A trio is not a triumvirate in the sense that it does not aim to subordinate other poles of power. By accepting the idea of a multipolar world, the EU-China-U.S. trio can be a genuinely constructive dynamic.

In the EU-China-U.S. triangle, the link between Europe and China has a special significance. Europe and China are two civilizations with certain symmetrical characteristics at the two edges of the same continent, and by deepening their relationship they can bring prosperity and stability to the vast and complex space in the middle of Eurasia.

Various forms of excess are certainly to blame for the current tumultuous global conditions. From the temptations of neo-imperialism to irrational exuberance, hubris is too often in action. Europe and China have proved several times in their long history that they can find the path of moderation and the way of balance. The United States would benefit from two ancient civilizations capable of reinterpreting the best of their respective traditions.

The EU-China-U.S. trio has in itself the material and spiritual resources to serve the ideal of a more harmonious modernity—an era of synthesis and conciliation between present and past, man and nature and civilizations. ■



# CHINA'S STIMULUS GOES TO WORK

Funds from Beijing are pouring into projects all over the country. Will that slow economic reforms?

By Dexter Roberts



TIANJIN, CHINA

For a glimpse of China's economic stimulus plan at work, stroll the factory grounds of Tianjin Baocheng Group. Sales of its giant cylindrical boilers for commercial buildings and small power plants are on track to grow 40% this year, to more than \$25 million, as government funds fuel a construction boom. With demand soaring, Baocheng is building a huge new factory that will more than double annual production. "The Chinese economy has hit bottom," says

Chai Baocheng, a former soldier who founded the company 25 years ago. Thanks to the stimulus, he says, "from now on, it will only keep going up."

Government money is coursing through this sprawling industrial city of 12 million. A historic port 80 miles east of Beijing, the Tianjin area is currently China's fastest-growing region. Not far from century-old banks built by the

French and British, a cavernous new station serves as the terminus for a bullet train that takes just 30 minutes to reach Beijing. Stimulus money will help pay for an even bigger station and an extension of the high-speed line to Shanghai by 2012. There's also a new port and a second runway at the airport, plus wastewater-treatment plants and hospitals—all helped by funding from Beijing. "Government companies, private firms, and foreign enterprises are all benefiting from the stimulus," says Yang Weidong, vice-chairman of the Tianjin Chamber of Commerce & Industry.

One of many infrastructure jobs: an electric railway linking east and central China

It's a similar story across China. Despite three decades of quasi-capitalism, the biggest companies and banks remain under state control, making it relatively easy for Beijing to dump money into the economy. The building binge drove a

**\$676**  
billion

New bank lending in China in the first quarter

Data: People's Bank of China

29% surge in fixed-asset investment in the first quarter, compared with 25% last year. And even though exports are off by 20%, manufacturing expanded in April for the first time in nine months. Economists now think China will hit its 8% target for gross domestic product growth this year, despite a decade-low GDP of 6.1% in the first quarter. "China's rapid reaction in rolling out the stimulus package has resolved some prominent problems in the economy, strengthened market confidence, and stabilized people's expectations," Premier Wen Jiabao said in April.

#### ECONOMIC CURE-ALL?

While the \$586 billion package made headlines in November for its size, actual investment is already far higher. In the first quarter, new bank lending soared to \$676 billion, close to Beijing's full-year target and more than total lending in 2007. While some of those loans are also counted as part of the stimulus, it still amounts to a big boost for fresh infrastructure initiatives not included in the official plan. "Thousands of [additional] projects are being undertaken by local governments, and that's stimulus too," says Stephen Green, head of China research at Standard Chartered Bank. Boiler manufacturer Baocheng, for instance, got a hefty loan from the Agricultural Bank of China to fund its expansion.

Some observers are queasy over the speed at which China has unleashed spending. They fear money will be dumped into questionable pet projects of local governments or even used for speculation in stocks and real estate. More critically, economists say the initial success with stimulus may convince officials that government largesse is an economic cure-all. That could slow reforms such as opening the state-dominated services sector to more competition. "As long as the government is allocating resources, there is going to be waste and corruption," says economist Xu Xiaonian at the China Europe International Business School in Shanghai. "What we need is a further opening of the economy, not more government spending." | BW |

# A CASH INFUSION FOR MUNICIPALITIES

Investors are buying up Build America Bonds—popular new issues from state and local governments



By Ben Levisohn

Last year, Joseph G. Zegers, the finance director of De Pere, Wis., learned the true cost of the credit crisis. To raise money, the suburban community of 22,000 sold municipal bonds with an interest rate of 5.6%, up from 4.15% in 2006. Facing a higher debt bill, Zegers figured he would have to postpone plans to upgrade roads, sewers, and buildings, hurting local construction. Now, thanks to a new federal program, De Pere is selling munis at 3.3%, saving the city around \$200,000. "Without the bonds some projects might not be done," says Zegers. "There would be less employment."

Cash-strapped states and municipalities may have a fix for some of their financial problems: Build America Bonds, a new type of municipal debt that's the financial crisis equivalent of war bonds. Interest rates on the taxable debt, created as part of the \$787 billion stimulus package, are higher than typical munis. But Washington foots part of the bill, which in the end makes them cheaper for municipalities.

By some estimates this market could

swell by \$50 billion this year and another \$100 billion in 2010. The funds are good news for states and local governments, whose economies account for 13% of the gross domestic product. Local officials can use the proceeds to build bridges, fix roads, and spruce

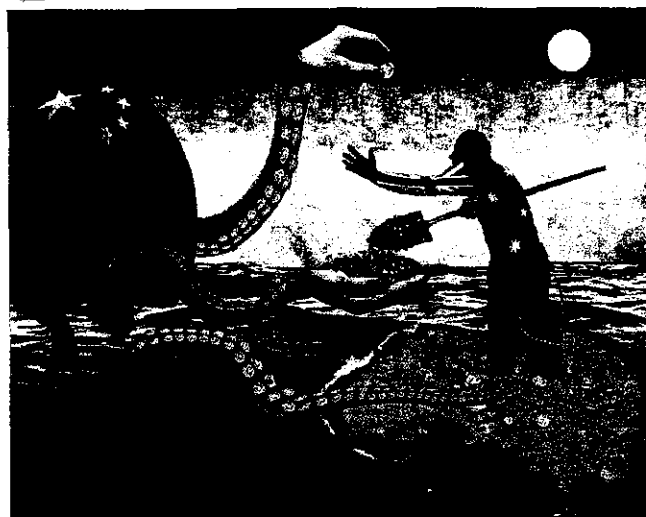
up schools—the sort of infrastructure projects the Obama Administration is counting on to rev up the U.S. economy and job growth.

Pension funds, university endowments, insurers, and other big investors can't get enough of the debt, which hit the market in late April. The New Jersey Turnpike Authority, the agency that oversees the 148-mile highway, planned to offer roughly \$250 million of Build America Bonds. But investor appetite was so great that the agency actually sold \$1.4 billion, and it plans to plow that money into road work. The New York Metropolitan Transit Authority, which runs the city's subway system, issued \$250 million more in bonds than expected.

California officials, who have just sold \$5 billion of the new debt, estimate that the bond deal will translate into 90,000 jobs. Says Tom Dresslar, a spokesman for the California State Treasurer's Office: "The sale of these bonds creates or preserves jobs, pumps millions in revenues into companies that depend on the projects, and bolsters the state coffers." | BW |

## Banyan | Australia's Chinese entanglement

For all China's commercial charms, Australia still looks to America as Asia's sheriff



**N**O COUNTRY in Asia or the Pacific is more clearly a beneficiary of China's industrial revolution than is Australia. Its coal fuels the power stations that keep that revolution churning. Its iron is in the steel for every other new building. Chinese demand for Australia's mineral riches drove the long boom that ended last year. It still provides Australia's best hope of avoiding the worst of the slump that has followed.

Last November, when China announced its first big, 4 trillion yuan (\$586 billion) economic stimulus in response to the downturn, Kevin Rudd, Australia's prime minister, was among the foreigners cheering loudest, calling it "very good news". The sense of relief was understandable. Taking goods and services together, China is now Australia's biggest trading partner. The slump may slow this trend down, but not change its direction.

Yet on a recent visit to Canberra, a capital whose eerily empty streets and subterranean parliament suggest a Pyongyang without the dystopia, Banyan found politicians and policy pundits in a quandary over how to handle both China and the recent upwelling of popular Australian antipathy towards the Chinese government. For all that China is Australia's second-biggest export market, with huge potential for growth, it is also a dictatorial power whose policies anger many Australians. Moreover, its commercial expansionism is accompanied by growing military strength. Defence strategists, who are paid to think the worst, now see the biggest potential threat to Australian security not as an unstoppable influx of Indonesian boat people, but as China.

One by-product of the slump, a rash of Chinese companies snapping up stakes in Australian mining enterprises in response to tumbling share and commodity prices, has provoked a popular backlash. To the mining companies, the colour of China's money is dazzling. But, though the Chinese onslaught looks fractious and pell-mell, conspiracy theorists smell a state-driven attack on the commanding heights of Australia's economy. They have succeeded in whipping up an anti-China mood. In March Australia blocked China Minmetals' acquisition of OZ Minerals, a copper and gold producer, on security grounds. A ruling over an even bigger deal is pending, having been delayed until mid-June. This will cover the \$19.5 billion bid by Chinalco, an aluminium company, for nearly 20% of cash-strapped Rio Tinto.

The government's decision, on whether national security is at stake in this transaction, may be the hardest it has had to make since coming to power in late 2007. It seems certain that the prime minister wants the purchase to go through. If it does, it will lead to renewed charges in Australia and around the region that he is soft on China as it seeks to extend its tentacles. After all, Mr Rudd was once posted to Beijing for the foreign service. In 2007 Chinese diplomats at a reception nearly choked on their canapés when Mr Rudd, then leader of the opposition, made a speech in faultless Mandarin. The prime minister, John Howard of the (conservative) Liberal Party, looked on with ill-disguised fury. Then, in a speech at Peking University last year, Mr Rudd described Australia as China's *zhengyou*, its "true friend". Mr Howard had nailed his colours to the mast of Australia's alliance with the United States, and after September 11th relished being America's "deputy sheriff" in the Asia-Pacific region. Mr Rudd, by contrast, has urged world leaders to accept a greater role for China. The opposition sneers at him as China's "roving ambassador".

There is enough force in this accusation to unsettle Mr Rudd. In Britain for the G20 summit in early April, he was caught on camera squirming in embarrassment at being seated next to Fu Ying, China's sophisticated ambassador to Britain (and, before that, Australia). Yet the slur is misplaced all the same. Mr Rudd has few illusions about China. He once wrote a thesis on Wei Jingsheng, one of China's most persecuted dissidents. Briefly out of a political job a decade ago, he trudged around China alone trying in vain to collect unpaid debts for Western firms. Last year he watched the Chinese embassy in Canberra orchestrate squads of Chinese students in Australia to smother pro-Tibet demonstrations. It was, says one of Mr Rudd's friends, a crucial moment: the first time a foreign power had denied freedom of expression to Australians in their own homeland. When Mr Rudd spoke of *zhengyou* last year, he used it in the dictionary definition of the term, as a "friend who will give forthright admonition", as over China's handling of Tibet. China prefers *lao pengyou*, "old friends", preferably sycophantic ones.

### A stake in Australia's heart

Indeed Mr Rudd appears to have a keener sense than Mr Howard of a growing strategic dilemma. On the one hand, Australia's crackerjack fit with the Chinese economy is reshaping Australia's trade and investment flows, drawing the country into a China-centred Asian orbit. On the other, Australia's security hangs on America's continued presence in the western Pacific. A long-awaited defence white paper that is soon to appear is expected to recommend heavily strengthened armed forces. A central question is what Australia should do as the primacy of the American sheriff fades and China's power grows. Worst of all for Australia would be if one day it had to choose between the United States and China—possibly over Taiwan.

The urge to avoid having to make such a choice partly explains Mr Rudd's idea of an Asia-Pacific community, a framework for regional co-operation that he mentioned last year. Misread as a vague expression of pan-Asian sentiment, this is in essence a possible plan of action. For a start, offer China a say in helping to build predictable economic and security norms for the region. As a Rudd adviser puts it of the Rio Tinto decision: what is the point of asking China to be a responsible stakeholder if it isn't offered a stake? But, if the attempt to tame China goes horribly awry, make sure America is still around to help sort out the mess. ■



dominated by alcohol and drugs.

Anyway, in Britain as in Pakistan, a plurality of ordinary South Asian Muslims follows a different form of the faith: the Barelvi tradition, which celebrates shrines, saints and music. One pioneer of Muslim education in Britain is of the Barelvi school: Musharraf Hussain, an imam who runs a school, mosque, radio station and magazine in Nottingham. He fears that among Britain's Muslim establishment, sectarian splits are becoming "entrenched and fossilised". Some Deobandis retain a deep sense of victimhood and grievance.

Clearly, some young British Muslims ignore the sectarian issues that gripped their parents. Sometimes this reflects secularisation. Sometimes it reflects the opposite: belief in a "global umma", or community, that differentiates all Muslims from all non-believers. Still, the Nottingham imam has observed one unexpected side-effect from the turmoil engulfing Pakistan. Many British Muslims, he thinks, will "move on" in a healthy way. They will give up the dream of resettling in South Asia and put down firmer roots in Britain.

A harsher message is emerging from some mosques in the north of England, especially in places like Burnley where many have roots in the war zone on Pakistan's border with Afghanistan. The plight of people fleeing the region is keenly felt. Many blame Pakistan's government, not the rebels. "People think the Pakistani government is fighting not for itself, but for American interests," says Abdul Hamid Qureshi, the chairman of the Lancashire Council of Mosques, which groups Muslims of all shades. People in an angry and defensive mood will hardly welcome Gordon Brown's pledge, on April 29th, to work with the Pakistani army to fight terror. Neither will they take too seriously the prime minister's vow to boost education and ease poverty on Pakistan's border.

British Muslims, who number at least 2m, can amaze their cousins from South Asia with their religious conservatism. One reason is the high incidence of migration from poor, rural parts of South Asia, such as Mirpur in Kashmir and Sylhet in Bangladesh. In Bangladesh the fortunes of the Islamist Jamaat-e-Islami party plummeted in last December's election. But the movement can still attract second- and third-generation youths of Sylheti origin in London, who know little of the group's record at home. Some British-based Bangladeshis are dismayed by the influence the Islamists enjoy in the diaspora.

Worry over radicalism made in Britain extends to Bangladesh, too. In March the Bangladeshi authorities raided a madrassa that was full of guns and ammunition. It emerged that this supposed school had been financed and run by a charity based in Britain. There are some institutions that no teaching material will correct. ■

The World Bank and global health

## Promising to try harder

For once, an international institution half-agrees with its critics

**Y**OU are part of a global conglomerate. Your market share has fallen from 18% to 6% in a decade. Well-financed niche-players are moving in, threatening to appropriate the most exciting areas. And now a report by your auditors has said that, even of your remaining business, a third has failed to come up to scratch. If you were a division of General Electric in Jack Welch's day ("Be first or second in a field, or get out of it"), you would probably be facing closure. Who, in these circumstances, would want to be in charge of global health at the World Bank?

The report in question\* was prepared by the bank's Independent Evaluation Group, an internal monitoring organisation that reports to the bank's board. It looked at how effective the loans dished out for health purposes by the bank and its private-sector-promoting associate, the International Finance Corporation, have been at doing what they were meant to do.

The sums involved are not trivial. Between 1997 and 2008 the bank provided \$17 billion for government-run projects in the fields of health, nutrition and family planning. Over the same period its associate invested \$873m in health-related private-sector activity. And although the bank's market share has fallen as new sources of money have emerged, such as the Global

Fund (which deals with AIDS, malaria and tuberculosis) and PEPFAR (an anti-AIDS plan started by the Bush administration), the actual amount it lends for health each year has remained fairly constant.

The evaluators' criticism was not just that a third of the 220 projects under scrutiny had failed to achieve their goals, but that those goals were often misconceived. In particular, the bank's remit is to end poverty, but that was the specific objective of only 6% of the projects and a subsidiary objective of only another 7%. Even where poverty reduction was a stated objective, little had been done to find out whether poverty had, in fact, been reduced. If there had been any investigation, it often failed to find any reduction.

There was criticism, too, of the fact that many projects were of a kind more likely to benefit the middle and upper classes which, in poor countries as in rich ones, are often better able to take advantage of infrastructure, such as new hospitals, which the bank helps to create.

Yet another ground for self-reproach was that the failure was concentrated in Africa, the poorest part of the world. Middle-income countries did not do too badly. But in Africa three-quarters of projects were deemed not to be up to snuff.

That is not to say that things were all bad. It is, of course, good that the bank has an independent evaluation mechanism at all. It also remains to be seen whether other global-health bodies are doing better, though that may become evident soon. A report on the Global Fund's impact is to be published in May, and GAVI (the Global Alliance for Vaccines and Immunisation) is also undergoing independent scrutiny. It is also fair to say that the bank's managers have taken most of the criticism on the chin, and promised to do better in future.

What the bank needs, in a crowded market, is a niche of its own, and it is trying to carve one out. Sensibly, it is not competing hard in the fashionable area of infectious disease, which is occupied not only by the Global Fund, PEPFAR and GAVI, but also by the (American) President's Malaria Initiative, the Gates Foundation and numerous bilateral deals between governments. Instead it has, since 2007, been building up its activities in the less glamorous but equally vital area of "health systems". This means getting local bureaucracies to recruit the right staff and deliver the right drugs to the right people at the right times, and knocking the heads of aid agencies together to eliminate gaps and overlaps in coverage. That, plus an expansion of its nutritional and reproductive health work, should be enough to protect the agency from a Welch-like fate. ■



Yes, some good things happen

\*"Improving Effectiveness and Outcomes for the Poor in Health, Nutrition and Population. An Evaluation of World Bank Group Support Since 1997"



## Flu and the global economy

## The butcher's bill

LONDON AND MEXICO CITY

## Recession may dampen the economic cost of a swine-flu epidemic

THE scares over bird flu since 1997 and severe acute respiratory syndrome (SARS) in 2003 have spurred research into the economic costs of pandemics. Studies paint a grim picture of what swine flu could mean for the world economy. For example, World Bank economists estimated last year that a pandemic with death rates similar to those in the Spanish flu that swept the world in 1918-19 could shrink global GDP by 4.8%.

Although such research can help to identify the economic effects of swine flu, global recession means that some of the mechanisms it describes are already at work. The recession means, perhaps counterintuitively, that the incremental economic effect of a pandemic may be less dramatic than it would be in normal times.

Economists argue that a pandemic would affect both global demand and global supply, but that the first of these is particularly vulnerable to the uncertainty and fear surrounding even the possibility of widespread disease. That would cause consumer spending to fall and businesses to put investment plans on hold.

Asia's experience with SARS is a guide. The outbreak caused a sharp drop in private consumption in the economies it affected. People avoided going out—as they are doing in Mexico. On April 29th the country's president, Felipe Calderón, announced a national suspension of non-essential activities from May 1st to May 5th. The cancelling of sporting events and concerts, the closing of bars and nightclubs, and people's propensity to stay inside had already cost Mexico City's service and retail industries \$55m a day from April 24th, when authorities first closed schools. That sum was expected to double after a ban on restaurants seating customers.

Financial markets have reacted sharply: the peso has fallen by 5.5% against the dollar since the emergency began. Mexico's finance minister, Agustín Carstens, has said that he expects the economic cost to be 0.3-0.5% of GDP, based on Asian precedents. Luis Flores, an economist at IXE, a bank, reckons that the government's budget deficit could increase by 0.7% of GDP.

This outbreak has happened when, worldwide, consumer confidence is low. So any further drops in demand because of a swine-flu pandemic may be smaller than those caused by SARS, when airline-passenger arrivals in Hong Kong fell by nearly two-thirds in a month. But a pan-

demic would dent hopes of a rapid recovery from recession, by providing yet another reason for gloom to continue.

The uncertainty caused by a pandemic could hit investment too. Risk premiums for countries affected by the pandemic might rise. And worries about safety, justified or not, pose risks to trade. Already, China has banned Mexican pork, though there is no evidence to suggest that meat spreads flu viruses. World trade is already plummeting. Widespread reactions of this sort could steepen its dive.

## More than fear itself

The potential supply-side effects of a pandemic come mainly because people fall ill or die. Infected people cannot work, and others must take time off to care for them. This has an immediate effect on the size of the labour force, but with consequences that last many years. The future output of those who die is lost. That is especially important when people of working age are taken. The worst economic consequences of AIDS have come from death and sickness among young adults.

The worldwide costs from deaths and hospitalisation are hard to calculate in the absence of information about medical costs in each country. However, Martin Meltzer, Nancy Cox and Keiji Fukuda, now deputy director-general of the World Health Organisation, did the sums for

America in a paper in 1999. They found that a pandemic affecting 15-35% of the population would have cost between \$71.3 billion and \$166.5 billion (in 1999 dollars).

The bulk of this would come from forgoing all that the sick and the dead would have produced. In other words, it is an estimate of the effect on the potential output of the American economy. Because of the global slump, many more people are already out of work than in normal times. This probably means that the immediate cost of additional losses in output would be smaller than in the estimates made by Mr Meltzer, Ms Cox and Mr Fukuda.

Several studies have put all this together to estimate the overall impact of a pandemic on economic growth. In 2006 Warwick McKibbin and Alexandra Sidorenko found in a study for the Lowy Institute for International Policy in Sydney that even a mild pandemic could shave 0.8% off world GDP. For the worst possibility they considered, the drop would be a staggering 12.6%. They reckon a pandemic similar to the one that began in 1918 would reduce growth in the American economy by 3 percentage points and in Japan by 8.3 points. Roughly comparable numbers emerge from a study by economists at America's Congressional Budget Office (CBO), which found that a Spanish-flu-like pandemic would lower real GDP growth in America by about 5 points. Even a milder episode would lead to a 1.5-point drop.

These are large declines. The CBO notes that a severe pandemic would be like a typical post-war recession. As it happens, the worries about swine flu come when the world is already in its worst slump since the war. That would dampen the economic effects of a pandemic. But if a pandemic does occur, this would be small comfort indeed. ■



As busy as it gets

► claims to have 30 clients preparing to invest. Ford Credit, which sold \$3 billion of eligible securities in March, is planning to issue more. Ajay Rajadhyaksha, of Barclays Capital, thinks the TALF may turn out to be like America's guarantee scheme for bank debt, which began unpromisingly but took off once it reached critical mass. Dealers say demand will increase in May's third round, perhaps topping \$10 billion.

Still, there are reasons to doubt the success of the "bold expansion" of the TALF

promised by the Treasury. The idea is that this would finance not only new asset-backed debt, but also part of the public-private programme to remove toxic assets from banks' balance-sheets. This plan is beset with teething troubles. The Fed is also working to extend the TALF to commercial mortgages (and, possibly, residential mortgages too). But this market is deteriorating so fast that some officials worry about the Fed becoming saddled with hard-to-value securities if it has to take on

the collateral. And, at three years, the maturity of TALF loans is too short for most commercial-mortgage investors. There is talk of expanding it to five years.

Much rides on making the TALF work, if only in its original form. If the economy is to recover, securitisation must be revitalised; banks cannot come close to plugging the gap. If the programme is to fulfil its promise, however, investors may need more reassurance that they will not become the next target of the anti-bail-out backlash. ■

## Buttonwood

### The end of the carry trade brings a new era of complexity to currency markets

FROM 2002 to 2007, foreign-exchange trading was pretty simple. Buy the currencies with the highest yields and sell those with the lowest. This "carry trade" created high returns with low volatility.

In theory the trade made little sense. High-yielding currencies should be compensating investors for the risk of depreciation, and low yields have been a characteristic of strong currencies like the Swiss franc. But who cared about the theory when, for a long time, the carry trade produced bumper returns?

Then came the credit crunch and some carry trades broke down spectacularly. The high yields on offer from Iceland did not compensate investors for the collapse of the krona. East European debtors are still coming to terms with the downside of one carry trade, borrowing in low-yielding currencies like the euro or Swiss franc. It saved them interest costs in the short term but it also created a nasty mismatch: their wages and revenues were in one currency and their liabilities were in another.

Now markets have reached a stage, in the biggest economies at least, where the carry trade looks hard to pull off. Thanks to the desperate efforts of central banks to revive their economies, most currencies yield virtually nothing. There is not enough of a spread between the dollar, euro and yen to reward speculators.

Although that is true in nominal terms, David Woo of Barclays Capital argues that there is still a difference in real yields. America is now officially in deflation so real yields on Treasury bonds are around 3%. That compares well with real yields in Japan, Canada and Britain and it may be attracting capital flows into the dollar.

But another possibility is that the focus has moved away from yields to other factors. This would not be the first time. In the late 1990s America's superior growth prospects were perceived to be good for



the dollar, as the country attracted portfolio flows into technology stocks. At other times, trade patterns have dominated, with deficit countries perceived to be vulnerable to currency declines.

What could be the basis for the new regime? Adam Cole of the Royal Bank of Canada reckons the answer is the credibility of economic policy. In America the authorities have shown themselves willing to try everything to boost the economy, including lower interest rates, bank rescues, fiscal stimulus and quantitative easing (expanding the money supply). In contrast, the European authorities have been more cautious. That is why the dollar has been strong against the euro recently.

This is odd. Running budget deficits and printing money tend to weaken a currency. David Bloom of HSBC argues that the currencies of those countries that have adopted quantitative easing will underperform those that have not.

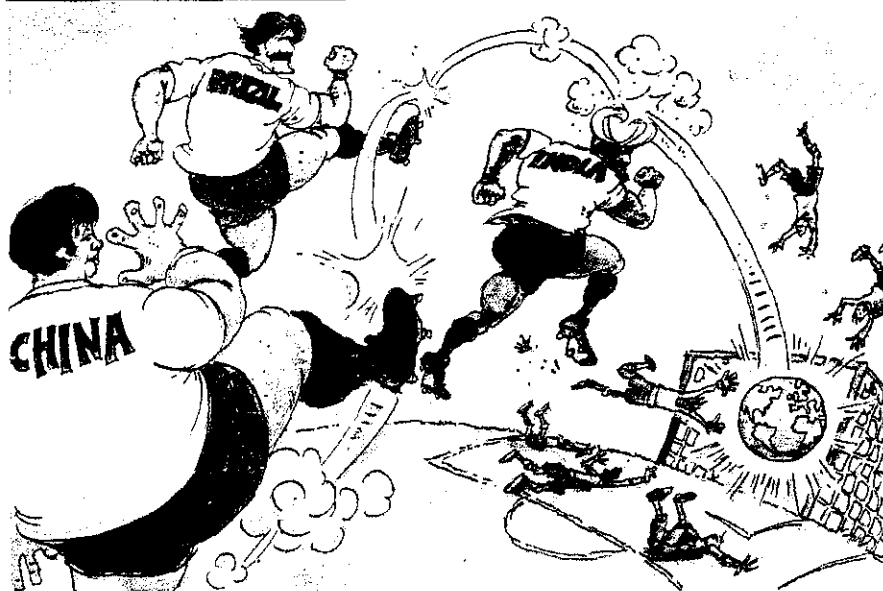
But it may be a sign of the severity of the crisis that currency traders are willing to ignore their misgivings about such unorthodox tactics. As Ajay Kapur of Mirae Asset Management puts it: "In a debt deflation, the currency of the least responsible country benefits."

Another possibility is that currencies are being driven by risk appetite. That seems to be true in developing countries: emerging-market currencies have rallied alongside equity markets in recent weeks. And it makes a certain amount of sense. If rising stockmarkets are a sign that the world economy is stabilising, then export-driven emerging markets should be the first to benefit.

When investors turn risk-averse, they seem to favour the dollar, as was illustrated yet again on April 27th when the outbreak of swine flu caused the greenback to gain ground. A further reason why the dollar may be benefiting during stock-market sell-offs is because American investors, who piled money into foreign shares in recent years, are bringing their money back home.

And the dollar may also be gaining a following from those who focus on trade deficits as an important agent in foreign-exchange markets. For years, the size of the American current-account deficit was seen as bearish for the buck. But the global slowdown, and in particular the falling oil price, have caused the deficit to shrink dramatically.

The new world of foreign exchange may thus be much more complicated than the old. But for the moment most factors seem to be favouring the dollar. Ironically, the greatest danger for the greenback might result from the success of the efforts of the Treasury and the Federal Reserve to revive the global economy. Not only might investors start to chase high yields again, but they might also start to worry about how the bill for all those unorthodox policies is going to be paid.



Emerging markets and the credit crunch

## Whom can we rely on?

Poor countries are not fretting about the boundaries between state and market. Instead, they are debating whether to rely on domestic or foreign demand

A STRIKING feature of the worldwide economic crash is what hasn't happened. While rich countries agonise about whether Anglo-Saxon capitalism should be replaced by the French version (and the French flirt with revolutionary socialism), emerging markets have stayed angst-free. Arvind Subramanian, an Indian economist, says there has been "no serious questioning of the role of the market."

That may sound like an exaggeration. As in rich countries, the state's role in many poor ones has increased as a result of the recent global meltdown. China's 4 trillion yuan (\$587 billion) stimulus package last year will benefit state-owned enterprises. Its sovereign-wealth funds have been buying stakes in publicly-traded companies and (as in America and Europe) state subsidies have been flowing to loss-making industries, such as carmakers.

In India, critics of liberalisation have gained ammunition. They have long cautioned against giving foreign banks freer rein or allowing pension funds to invest more money in stockmarkets, leading one prominent magazine to ask, "did the left save India?" Some economists called the central bank timid last year for resisting attempts to let international capital flows dictate the value of the rupee. It now feels vindicated. Depositors have also been shifting away from private banks—former stars of the new Indian economy—towards once-unfashionable state-owned ones.

While private banks retrench, state ones are expanding their lending vigorously.

Yet such state intervention is driven not by ideology but, mostly, by pragmatism. In China the Adam Smith-toting prime minister, Wen Jiabao, argues that his country "would rather speed up reforms" to combat the crisis and should "give full play to market forces in allocating resources". Whereas American and European countries have re-regulated business, China, set on meeting its 8% growth target, has continued to liberalise. This year, for example, it removed some barriers that curbed the yuan's use in international trade.

Few if any serious attempts have been made to restore state ownership. When Embraer, a formerly state-owned aircraft manufacturer in Brazil, laid off thousands of workers, unions demanded its renationalisation—in vain.

In other words, emerging markets have adopted different policies, as well as ignoring the rich world's philosophical agonising. But why?

The first reason is that the global crisis originated in America and Europe and inflicted itself on the rest of the world. So emerging-market governments see little reason for painful self-examination in response to other people's problems. Moreover, the largest emerging markets are beginning to see hints of recovery. China's output was 6% higher in the first quarter of this year than it had been in the same per-

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Green.view, our online column on the environment, appears on Economist.com on Mondays. The columns can be viewed at

[Economist.com/greenview](http://Economist.com/greenview)

iod in 2008. Chinese and Indian manufacturing output rose in April, pushing Asian stockmarkets up sharply. Though these are merely short-term gains, they are enough to deflect navel-gazing for the moment.

Second, in many emerging markets, the state is fairly large already, especially in banking. The current demarcation between state and market commands broad public support and the main issue, as Mr Subramanian puts it, "is how to continue reducing [the state's] role in a gradual and pragmatic manner." So even if the demarcation line shifts statewards in rich countries, emerging markets are well beyond that point already, and see little advantage in moving the line any farther.

### Tricks of the trades

Yet the global crisis has provoked anguished disagreement about an equally fundamental matter: how much to rely on exports and how much on domestic demand. At this month's annual meeting of the Asian Development Bank, minister after minister said countries should rely more on each other and less on selling to America. Thirteen Asian countries also agreed to create a \$120 billion fund—part of a nine-year-old system of swap agreements called the Chiang Mai initiative—from which they can (in theory) draw when financial pressures become acute.

How this would work in practice is uncertain. But the impetus behind it is clear: pooling risk expresses Asian fellow feeling and common Asian caution about both the International Monetary Fund and further fallout from America's crisis. Emerging countries concluded from the financial crises of the 1990s that they could not rely on fickle foreign capital. Now the collapse of international trade is causing them to wonder whether they can rely on fickle foreign customers. ■

► range during the 1980s and 1990s.

An inflection-point occurred around 2000. Income growth stagnated but debts continued to grow rapidly, from 94% of income to 133% in 2007. The share of income devoted to servicing those obligations also jumped. A study in 2007 by Karen Dynan and Donald Kohn, both of the Fed, attributed that partly to more of the population reaching home-buying age, and mostly to a rise in home prices which made it possible to borrow more.

Financial innovation also played a role as the industry devised new ways for Americans to borrow against their homes.

One manifestation was the plethora of credit-card offers to even marginal borrowers: more than 8 billion poured into Americans' mailboxes in 2006, according to Mintel Comperemedia, a consumer-research firm. From 2003 to the end of 2006, consumers borrowed almost \$2 trillion against their properties via home-equity loans and "cash-out" mortgage refinancings. A dramatic reversal is now under way. Last year household wealth fell by 18%, or by \$11 trillion. Macroeconomic Advisers, a forecasting firm, estimates the resulting negative "wealth effect" will depress consumption by 2% this year.

The financial crisis has killed off many of the loan products that had expanded access to credit during the boom. Subprime mortgages have disappeared and refinancings that deliver cash to homeowners are subject to stricter underwriting standards and higher fees. In the first quarter the credit-card industry sent out only a quarter as many solicitations as it did a year earlier (see right-hand chart on previous page).

A more enduring restraint will be the pressure on consumers to reduce their debts to more manageable levels relative both to income and to the much lower value of their homes. This effect is difficult to ►►

## Buttonwood

Investors' optimism has returned very quickly. Too quickly

**M**OST students suffer from pre-exam nerves. But the financial markets were remarkably sanguine ahead of the results of the stress tests of American banks (published after *The Economist* went to press). By the close of trading on May 4th, the S&P 500 index had regained all the losses it suffered earlier in the year.

Financial stocks have in fact been rallying ever since March, when Citigroup hinted that its trading performance in the first quarter had been better than expected. That optimism was borne out in other banks, albeit with the help of some one-off factors that may have overstated the underlying recovery in their finances. Big losses on commercial property and consumer debt are still to come. Nevertheless, the system has come a long way since the meltdown of last autumn.

That view is supported by the credit markets. The number of American banks tightening lending standards in the consumer and corporate-loan markets has fallen for two consecutive quarters. The three-month London Interbank Offered Rate (the price banks pay for borrowing in the money markets) has fallen below 1% for dollar loans, having been almost 5% in the autumn. Investors in high-yield bonds, the riskiest form of corporate debt, enjoyed returns of 11.5% in April.

In short, there seems to have been a huge shift in attitudes towards risky assets. That can be seen at the sectoral level as well as in the overall market. The rally has been led by cyclical stocks, those that are most dependent on economic growth. By the end of April mining, automobile, engineering and general-retail stocks were all up on the end of 2008, whereas defensive sectors such as food producers, pharmaceuticals and utilities were down.

This economic optimism has largely



been justified by the data, notably by the purchasing managers' surveys of both manufacturing and services. In truth, the data suggest only that the economy is contracting at a slower pace than before. Nevertheless, the figures seem to point to a deepish recession, rather than the rerun of the Depression that was feared a few months ago.

All told, this looks like a conventional rally from the depths of a recession. Stockmarkets usually advance before a downturn is over, anticipating the recovery in profits to come. Optimists point to America's first-quarter results, in which 66% of reporting companies beat expectations, according to HSBC.

The trouble with this picture is that it all seems too neat. Bear markets are normally pitted with some vigorous rallies, as investors in Japan have discovered over the past 20 years. Often these rallies result from the technical position of investors, and this may be another example. After their battering in 2008, many hedge funds entered the year either betting against the market (going short) or holding large cash positions. As the market has rallied, those

funds have had to chase it higher, thereby giving the rebound stronger impetus.

The economic data may have improved, but only from some terrible lows. It would have been amazing, given the amount of stimulus thrown at the economy in the form of lower oil prices and interest rates, quantitative easing and fiscal deficits, if there had not been some kind of rebound.

Nevertheless, an observer who had woken after sleeping for the past two years, would be alarmed at the numbers. Nominal GDP in America has fallen for two consecutive quarters for the first time in more than half a century. Industrial production is still dropping at a double-digit annual rate in America, the euro zone and much of Latin America and South-East Asia.

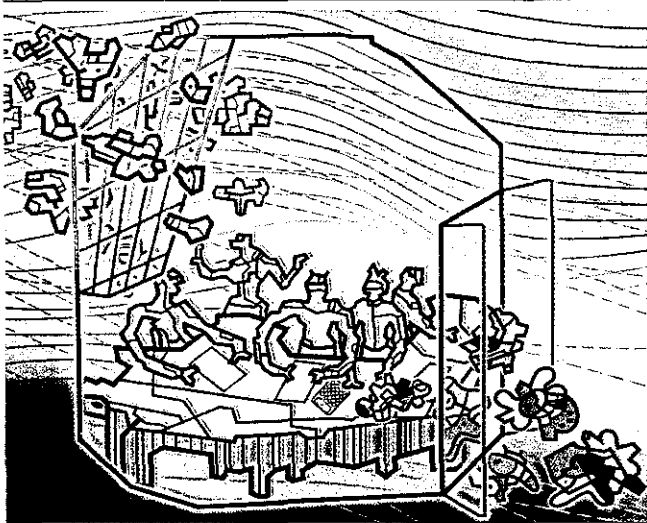
Companies are still defaulting on their debts at a steady rate; 40 issuers did so in April and Moody's expects the default rate to reach 14.3% by next March. Even the results season has been mixed. Andrew Laphorne at Société Générale points out that 62% of American companies have missed expectations for sales. That implies the profit improvement is coming from higher margins, something that it is hard to believe can persist given the economic backdrop.

The danger is that sentiment has flickered higher rather than a dissected frog's leg will twitch when an electric current is applied. The world is still drowning in debt, unemployment is still rising, wages are stagnant and the threat of higher taxes hangs over consumers. This was not a conventional downturn; it is unlikely to herald a conventional recovery.

**Award:** Philip Coggan, our Buttonwood columnist, won the title of Senior Financial Journalist of the Year at the Harold Wincott Press Awards for 2008.

## Economics focus | Opening the floodgates

Imports can be as useful to developing countries as exports are



**P**AUL KRUGMAN, who won last year's Nobel prize in economics for his work on trade, wrote in 1993: "What a country really gains from trade is the ability to import things it wants. Exports are not an objective in and of themselves; the need to export is a burden that a country must bear because its import suppliers are crass enough to demand payment."

This view does not dominate the public debate. Most are thrilled by the idea of export growth, but cower at the prospect of more imports. Such prejudice certainly prevailed in India in 1991, when the IMF foisted tariff cuts on the economy as one of the conditions attached to a \$2.5 billion bail-out package. Pessimists fretted that a flood of imports would destroy Indian industry.

For a group of American economists\*, however, that sudden trade liberalisation has provided an unusually clear lens through which to study the way that commerce affects the economy. This is precisely because it was externally imposed. That the government had to hew to the IMF's diktats and slash tariffs across the board gave industries little scope to jockey for exemptions. This made the researchers confident that tariff cuts, and not differences in industries' ability to lobby the government, were responsible for changes in India's trade patterns after liberalisation.

As part of those reforms, India slashed tariffs on imports from an average of 90% in 1991 to 30% in 1997. Not surprisingly, imports doubled in value over this period. But the effects on Indian manufacturing were not what the prophets of doom had predicted: output grew by over 50% in that time. And by looking carefully at what was imported and what it was used to make, the researchers found that cheaper and more accessible imports gave a big boost to India's domestic industrial growth in the 1990s.

This was because the tariff cuts meant more than Indian consumers being able to satisfy their cravings for imported chocolate (though they did that, too). It gave Indian manufacturers access to a variety of intermediate and capital goods which had earlier been too expensive. The rise in imports of intermediate goods was much higher, at 227%, than the 90% growth in consumer-goods imports in the 13 years to 2000.

Theory suggests several ways in which greater access to imports can improve domestic manufacturing. First, cheaper imports may allow firms to produce existing goods using the same

inputs as before, but at a lower cost. They could also open up new ways of producing existing goods, and even allow entirely new goods to be made. All this seemed to hold in India. For example, its prolific film industry had continued to make some black-and-white films into the 1970s, in part because of the difficulty of importing enough supplies of colour film. But proving whether the theory applies in practice requires more detailed data, not just about how much firms produced but what they produced, and how all this changed over time.

Most attempts at addressing these questions have foundered because such information is not available. But with India, the researchers were helped, perversely enough, by highly restrictive industrial policies that the country had introduced in the 1950s. These included rules that required companies to report to the authorities every little tweak to their product mix—a burden for firms, but a gold mine for researchers. Happily, the economists found that the data backed up the theory: lower import tariffs did lead to an expansion in product variety through access to new inputs. They found that about 66% of the growth in India's imports of intermediate goods after liberalisation came from goods the country had simply not bought when its trade regime was more restrictive. These new inputs caused the price of intermediate goods to fall by 4.7% per year after 1989. And detailed data linking inputs to final goods showed that the imports led to an explosion in the variety of products made by Indian manufacturers; the average firm made 1.4 products before liberalisation, but by 2003, this had increased to 2.3. The increases in variety were largest for industries where the input tariffs were cut most, and these industries also saw increased spending on research and development. Overall, the new products that Indian companies introduced were responsible for 25% of the growth in the country's manufacturing output between 1991 and 1997.

### Slash and churn

But one aspect of India's experience after trade liberalisation did not conform to what the researchers had expected. Normally, as new products are introduced, some older ones stop being made. This "churn" in the market is part of what makes people uncomfortable about lower trade barriers, because it may cause difficult adjustments for some workers or companies. But the Indian variant of creative destruction seemed unusually benign. The researchers found that firms rarely dropped products. One reason for this may be the diversity of India's economy: there is always a segment lower down the economic pecking order which is happy to buy products that richer consumers scoff at.

This may be unique to countries like India where many levels of development co-exist. But Penny Goldberg, one of the authors, thinks that the methods used in the studies on India can be applied to many other countries where trade has been similarly liberalised and which have good data on firms, such as Colombia and Indonesia. She notes that one of her co-authors, Amit Khandelwal, visited a Coca-Cola bottling plant in China, and noticed that all the machinery was either Japanese or German. China, of course, is known as a big exporter. But it may never have achieved this success without access to a range of imports. ■

\*"Multi-product firms and Product Turnover in the Developing World: Evidence from India", by Penny Goldberg, Amit Khandelwal, Nina Pavcnik and Petia Topalova. (Forthcoming in the Review of Economics and Statistics.) Other papers available at <http://www.princeton.edu/~pennykg/>

# Three trillion dollars later...

There is no single big remedy for the banks' flaws. But better rules—and more capital—could help



**C**OULD there be a better time to be a bank? If you have capital and courage, the markets are packed with opportunities—as they well understand at Goldman Sachs, which is once again filling its boots with risk. Governments are endorsing

high leverage and guaranteeing huge parts of the financial system, so you get to keep the profits and palm off the losses on the taxpayer. The threat of nationalisation has receded, reinvigorating the banks' share prices. Money is cheap, deposits plentiful and borrowers desperate, so new lending promises handsome margins. Back before the crash, banks' profits just looked big; today they might even be real.

The bonanza is intentional. Governments and regulators want the banks to make profits so that they regain their health faster after roughly \$3 trillion of write-downs. It is part of the monstrous bargain that bankers have extracted from the state (see our special report this week). Taxpayers have poured trillions of dollars into institutions that most never knew they were guaranteeing. In return, economies look as if they have been spared a collapse in payment systems and credit flows that would probably have caused a depression.

In an ideal world any government would vow that, next time, it will let the devil take the hindmost. But promises to leave finance to fail tomorrow are undermined by today's vast rescue. Because the market has seen the state step in when the worst happens, it will again let financiers take on too much risk. Because taxpayers will be subsidising banks' funding costs, they will also be subsidising the dividends of their shareholders and the bonuses of their staff.

It should be obvious by now that in banking and finance the twin evils of excessive risk and excessive reward can poison capitalism and ravage the economy. Yet the price of saving finance has been to create a system that is more vulnerable and more dangerous than ever before.

## The great purge

Some argue that only draconian re-regulation can spare taxpayers from the next crisis. The structure must be changed. Governments should purge banks that are big enough to hold the system to ransom. Or they should seek to slice through the entanglements, cordoning off the dangerous bits. New "narrow" banks would be guaranteed a seat in the lifeboat by the state and heavily regulated for the privilege. The rest of the industry would be free to swim—and to sink.

Yet this search for a big, structural answer runs into two problems. One is that the reform is not as neat as it first appears. Nobody wants to have banks that are so big that they stifle competition (itself a source of stability), but breaking big banks up into tiny bits that pose no systemic risk would be a horribly complex and lengthy task. As for narrow banks, precisely which bit is too important to fail? People's idea of a systemic risk can change quickly. Today's rescues have included investment banks and insurers, neither of which used to be re-

garded as system-threatening.

The second drawback is inefficiency. Limiting banks' size could stop them from attaining the scale and scope to finance global business. Confronted with restrictions, financiers innovate—in recent years, for instance, risk was shifted to non-banks such as money-market funds, which then needed rescuing. Regulators can stop innovation, some of which has indeed been abused, but Luddites in finance would do as much harm to the economy as Luddites in anything else.

## Capital solution

Instead, it is better to focus on two more fiddly things that could produce fairly radical results: regulation and capital. By any measure, regulators need help. That help does not mean creating a new global authority to match the global scope of finance: the money for bail-outs ultimately comes from nation states. But there is plenty of sensible reorganisation to be done—America's system is a chaotic rivalry of conflicting fiefs, Britain's an ambiguous "tripartite" regime—and there is a useful general principle to enforce. Regulators should focus on function: if an outfit behaves like a bank, it should be regulated as one, whatever it says on the brass plate. Ideally each jurisdiction will incorporate a set of broad global principles, which establish a benchmark of prudent finance.

Regulators can also use markets. Banks' solvency depends on a bedrock of capital. Regulators could monitor how this trades, or use markets that gauge the risk of insolvency, to help decide when banks must raise more capital (see page 79). Regulators could get managers to watch for systemic risks by linking their bonuses to the bank's bonds. If managers identify with shareholders, as they do now, then they worry only about shareholders' losses. Catastrophic losses bigger than that are all the same to them. Incentives matter: with higher risk charges on banks' trading books, bankers would become more discerning about how they put their money to work, and less prone to make dangerous bets in pursuit of huge bonuses.

Smarter regulators and better rules would help. But sadly, as the crisis has brutally shown, regulators are fallible. In time, financiers tend to gain the advantage over their overseers. They are better paid, better qualified and more influential than the regulators. Legislators are easily seduced by booms and lobbies. Voters are ignorant of and bored by regulation. The more a financial system depends on the wisdom of regulators, the more likely it is to fail catastrophically.

Hence the overwhelming importance of capital. Banks should be forced to fund themselves with a lot more equity and other risk capital—possibly using bonds that automatically convert to equity when trouble strikes. Higher capital requirements would put more of the shareholders' money at risk and, crucially, enable banks to absorb more losses in bad times. Think of it as a margin for regulatory error.

Regulation cannot prevent financial crises altogether, but it can minimise the devastation. Loading banks with equity slows the creation of credit, but the reward for a healthy financial system is faster growth over the long term. There are three trillion reasons to think that the trade-off is worth it. ■



# Rebuilding the banks

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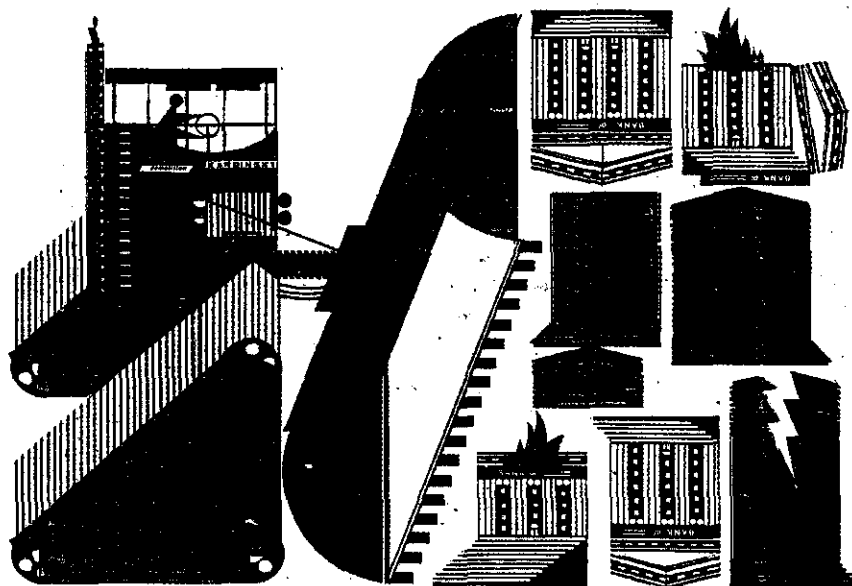
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A tamer banking industry is already emerging from the debris of the old, failed one, says Andrew Palmer

**B**ANKING is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently; instead, they ladled credit to anyone who wanted it. Banks are supposed to make money by skilfully managing the risk of transforming short-term debt into long-term loans; instead, they were undone by it. They are supposed to expedite the flow of credit through economies; instead, they ended up blocking it.

The costs of this failure are massive. Frantic efforts by governments to save their financial systems and buoy their economies will do long-term damage to public finances. The IMF reckons that average government debt for the richer G20 countries will exceed 100% of GDP in 2014, up from 70% in 2000 and just 40% in 1980.

Despite public rage over bank bail-outs, the industry has also comprehensively failed its owners. The scale of wealth destruction for shareholders has been breathtaking. The total market capitalisation of the industry fell by more than half in 2008, erasing all the gains it had made since 2003 (see chart 1, next page).

Employees have scarcely done better. The popular perception of bankers as Porsche-driving sociopaths obscures the fact that many of the industry's staff are modestly paid and sit in branches, information-technology departments and call-centres. Job losses in the industry have been savage. "Being done" used to refer to

hearing about your annual bonus. Now it means getting fired. America's financial-services firms have shed almost half a million jobs since the peak in December 2006, more than half of them in the past seven months. Many have gone for good.

The pain is nowhere near over. The credit crunch has been a series of multiple crises, starting with subprime mortgages in America and progressively sweeping through asset classes and geographies. There are now some glimmers of optimism in the investment-banking world, where trading books have already been marked down ferociously and credit exposures to the real economy are more limited. But most banks are hunkering down for more misery, as defaults among consumers and companies spiral. In its latest *Global Financial Stability Report*, the IMF estimates that the total bill for financial institutions will come to \$4.1 trillion.

With so much red ink still to be spilled, it may seem premature to ask, as this special report does, what the future of banking looks like. For most industries, failure on this scale would mean destruction, after all. Banks, notoriously, are different. The most seismic event of the crisis to date, the bankruptcy of Lehman Brothers last September, demonstrated the costs of letting a big financial institution collapse. Trust evaporated and credit dried up. "October was the most uncomfortable moment in my career," recalls Gordon Nixon, ►►

### Acknowledgments

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A list of sources is at

[Economist.com/specialreports](http://Economist.com/specialreports)

An audio interview with the author is at

[Economist.com/audiovideo](http://Economist.com/audiovideo)

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► the boss of Royal Bank of Canada (RBC). "There was a possibility that the entire global banking system could go under."

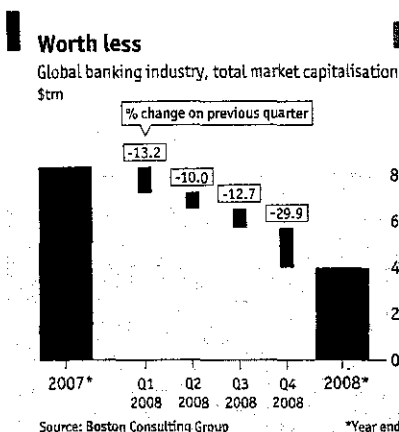
Concerted actions by governments since then, first in the form of capital injections and liability guarantees, and more recently via schemes to buy or guarantee loans, have signalled their determination to stabilise and clean up their big banks.

Politics notwithstanding, the commitment of governments to defend their banking systems removes the existential threat to the biggest institutions (or, more precisely, transfers it to sovereign borrowers). Bank bosses have learnt not to pronounce too confidently about the future. If the IMF's loss predictions turn out to be accurate, there is still too little capital in the system. But most think that the chance of another Lehman-style blow-up has been greatly reduced.

There is still great uncertainty about the nature and extent of the support that governments will end up offering to their banks. But governments are now deeply embedded in banking systems. They are guaranteeing far more retail deposits than before the crisis. They are guaranteeing the issuance of new debt. They own preferred shares in many banks, common equity in others and stand ready to inject capital in others still. Banks that have not taken a scrap of government money still benefit from their stabilising presence. "We all exist at the largesse of the government right now," says a bank boss.

The types of losses that banks now face have also changed. The huge writedowns on trading-book assets that defined the first phase of the crisis were horribly unpredictable. The complexity of structured finance made it difficult to know how losses would cascade down the ladder of investors in securitised assets. The patchy credit histories of subprime and low-documentation borrowers made it hard to model default rates accurately. And mark-to-market accounting meant that banks were valuing illiquid assets at prices which reflected a lack of buyers as much as underlying credit quality (accounting standards bodies have since been bullied into allowing bankers to exercise more judgment in how they classify and value such assets).

Although the losses that banks face in their loan books are ugly, they should be more predictable. Shocks are still likely: for instance, the size of the bubble and scale of the bust may overturn historic relationships such as that between unemployment rates and credit-card losses. But losses on loans can be recognised in the ac-



counts more slowly. And the assets that are now under scrutiny may be much bigger than their subprime predecessors but they are also better understood. "The scale of the recession is unprecedented but it is more familiar terrain," says John Varley, the chief executive of Barclays.

### The forgotten art

With government backing assured and impending losses somewhat more predictable, the big banks are slowly starting to lift their heads from the floor. Meetings with investors have been dominated for the past 18 months by discussions about banks' balance-sheets and, in particular, the amount of capital that banks had. "This is my first experience of the quarterly-earnings game where no one has cared about earnings," says Bob Kelly, the boss of Bank of New York Mellon.

That is changing. Even the biggest victims of the crisis expect to return to profitability this year. Galling as it may be to contemplate the returns that will once again accrue to banks, the rest of us badly need them to make money. Just as the prospect of continuing losses is what has stopped private capital from entering the system, the prospect of future profits is what will lure investors back in to replace governments. Profitability is also critical to the ability of banks to cover future losses without calling on further government cash. The situation is fluid but analysts at Barclays Capital reckoned in March that cumulative pre-tax and pre-provision income at the top 20 American banks for this year, 2010 and 2011 will be \$575 billion, just enough to cover their estimates of losses in that period of \$415 billion-\$560 billion.

Profits need to be sustainable, of course. They may be the first line of defence against trouble but they disappeared all

too quickly during this crisis, wiped out by writedowns and by the implosion of business models. "The discounted future profit streams of financial institutions went from quite something to almost nothing in an instant," says Andy Haldane, head of financial stability at the Bank of England.

Banks recognise this as much as regulators do. There is a striking degree of convergence between the thrust of planned regulatory reforms and the new strategic thinking of many institutions. Greater resilience is a shared objective. Banks are reducing their dependence on wholesale funding and increasing their reliance on "stickier" deposits. They are reducing the amount of risk they take, which means reducing their proprietary trading and concentrating more on clients and activities that consume less capital. They are rapidly shrinking their balance-sheets. "The banking industry got it so wrong and destroyed so much value that it is difficult to sit in front of investors and say we are going to carry on as before," says Richard Ramsden, an analyst at Goldman Sachs.

The future looks different to different types of banks. For smaller ones that fall outside the comforting embrace of the state or have less diversified loan portfolios, the outlook is bleaker. American regional banks and Spanish savings banks, or *cajas*, are among those coming under increasing pressure as commercial-property portfolios suffer. Mike Poulos of Oliver Wyman, a consultancy, expects the number of banks in America, currently some 8,000 or so, to drop by 2,000 or more as a result of the crisis.

Banks in many emerging markets will suffer as the economic climate deteriorates but they need to deleverage less. There is also less need for regulatory change. The Asian banks kept their exposure to cross-border funding flows under control, for example, unlike their peers in eastern Europe. The scale of structural change that these institutions face is relatively limited.

But for those banks at the heart of the crisis, the household names of Western finance, the landscape is different. Their future is secure enough for them to be able to plan beyond survival. Their failures have been big enough for them to know that everything they do, from the way they manage their balance-sheets to the way they pay their managers, has to change. But in seeking to work out what the new normality will be for banks, the first question to ask is how quickly and on what terms governments will disentangle themselves from the industry. ■



## Too big to swallow

The future of securitisation is the industry's most pressing question

ONE of the canards of the credit crisis, trotted out regularly by politicians and pundits, is that banks have stopped lending. It is a charge that bankers vehemently reject and the data largely back them up. It is true that overall flows of credit have fallen steeply. Yet analysis by Oliver Wyman, a consultancy, suggests that net lending by American banks, for example, has contracted by amounts that are broadly in line with previous recessions, when demand for credit naturally diminishes and lending standards inevitably tighten. Indeed the worry of some observers, given that easy credit got us into this mess, is that banks are still lending too much.

The really precipitous contraction in credit has come from non-bank lenders—the array of money-market funds, hedge funds, former investment banks, exchange-traded funds and the like that is sometimes called the “shadow banking system”. These capital-market lenders are especially important in America—banks have supplied only 20% of total net lending in the country since 1993 (see chart 7, left-hand side)—but they play an increasingly important role elsewhere too.

In particular, non-bank lenders have been buyers of securitised products, loans that are bundled together into securities and sold on to investors. An estimated \$8.7 trillion of assets worldwide are funded by securitisation. More than half of the credit cards and student loans originated in America in 2007 were securitised. Many European banks used securitisation to fund the expansion of their loan books in the boom (see chart 7, right-hand side).

There is a stylised model of what is meant to happen when the shadow banking system contracts, in which banks act as “lenders of second-to-last resort”. Borrowers who can no longer get money from capital markets can call instead on contingent funding commitments made by the banks. And banks can fund their expanded asset base because at the same time deposits are attracted into the banks by the comfort of deposit insurance. A 2005 paper from Evan Gatev and Philip Strahan of Boston College and Til Schuermann of the Federal Reserve Bank of New York showed how this flight to traditional banking operated



when the Long-Term Capital Management hedge fund failed in 1998.

Some of these things happened this time too. Liquidity lines from banks to off-balance-sheet entities such as conduits and structured investment vehicles (SIVs) were activated as securitisation markets evaporated. Bank executives report heavy loan demand as a result of the collapse in non-bank credit. Some savings flowed into banks too. The problem is that the amount of money needed from the banks this time around is so vast. Oliver Wyman calculates that in the first three quarters of 2008, lending via capital markets in America shrank (on an annualised basis) by \$950 billion. In contrast, banks' total net lending

in 2007 was just \$850 billion.

Supposing for a moment that the banks actually wanted to take on the credit risk associated with these assets, the sums simply do not add up for two reasons. First, taking securitised assets back on to bank balance-sheets implies extra demand for capital that would be very hard for banks to meet in benign circumstances, let alone these ones.

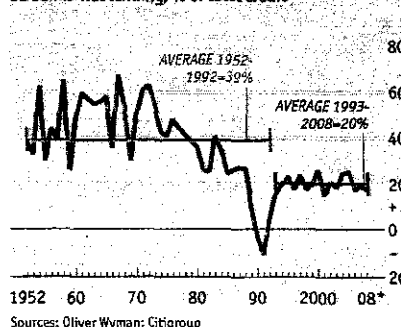
Second, plenty of banks depend on securitisation for a big chunk of their own funding, so they would have to replace this source of finance with deposits. In most mature markets, savings penetration is already relatively deep, so there are limited options for driving deposits higher still. There is greater capacity to increase deposits in emerging markets, where there is more cash under the mattress (see chart 8, next page), but doing so takes years. “You cannot be disintermediated over ten years and then reintermediated in a month,” says Mr Nixon of RBC. Hence the near-universal agreement that securitisation needs to be revived.

### Resuscitation procedures

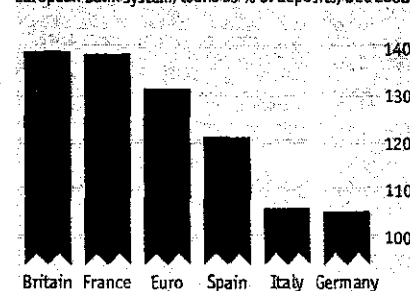
If only it were that simple. The intellectual case for securitisation certainly remains strong, and not just because without it, deleveraging will be even more painful. Banks that have concentrations of risk in their portfolios can reduce them by selling assets to other investors. Those investors who cannot extend credit directly to individuals or small businesses can get expo- ▶▶

### Out of the shadows

US banks' net lending, % of total credit



European bank system, loans as % of deposits, Dec 2008



sure to these assets via securitisation. "We didn't come out of the internet bubble and say that we should give up on venture capital," says a regulator.

Optimists point out that some of the worst excesses of the market have already gone. Ludicrously complex securitised products, the CDO-squareds and -cubeds, have gone forever. Greater emphasis on the quality of borrowers will mean that risk should become more predictable. "The problem comes when you start securitising things for which you cannot compute the odds of default," says Stephen Cecchetti, chief economist at the Bank for International Settlements. Even if those predicted default rates are high, the risk can be mitigated by techniques such as overcollateralisation, where there is an excess of loans to cover losses.

There is also an emerging consensus on how to fix securitisation's biggest flaw, the moral hazard which meant that originators had less incentive to care about the quality of the business they wrote because they thought the risks were someone else's problem. By making issuers take the first loss on any defaults in the securitised pool of assets (and stipulating that they cannot hedge that exposure away), regulators will give them a clear incentive to think about asset quality.

This goal of aligning the interests of issuers and investors also explains official enthusiasm for covered bonds, a type of secured-funding instrument in which creditors have recourse to both assets and the issuing bank. By keeping all the assets on the balance-sheet, however, a surge in covered bonds would still require banks to find a lot of additional capital. That cost is more manageable if banks keep some exposure but sell most of the securities to other investors who have no recourse. Assume a risk-weighting of 20% on a portfolio of high-quality mortgages, calculates Jamie Dimon, JPMorgan Chase's boss, and retaining a 10% slice of a \$50 billion pool of mortgages would imply a capital charge of \$80m. "That's doable," he says.

There is broad agreement on how a revived securitisation market would work (high-quality assets, simple products, some retained risk on the part of the issuer). But big worries remain. First, regulators may impose higher capital charges on banks for the contingent risks they run as a result of securitisation. Banks were not just undercharged for the formal liquidity lines they offered to conduits and SVs; they were also undercharged for reputational risk, the informal obligation to reabsorb

troubled off-balance-sheet assets to help their clients. That reputational exposure will surely attract a more explicit cost in future. Coming changes to FAS140, an American accounting rule for off-balance-sheet assets, will also mean that banks can no longer claim capital relief by securitising assets through special-purpose vehicles.

Second, many buyers of securitised products are also likely to be more constrained in future. Leveraged investors, such as some hedge funds, are going to find it harder to gear up, making the returns on securitised products less attractive.

Banks themselves, also important buyers of securitised products, will have less room for manoeuvre too. Matt King, an analyst at Citigroup, believes that the surge in securitisation during the bubble can partly be explained by a massive mismatch between the regulatory regimes of American and European banks. Those American banks whose regulator imposed a leverage ratio had an incentive to move assets off

their balance-sheets. European banks which operated only under a risk-weighted capital regime were able to buy those very same assets because they attracted a low capital charge. With risk weightings on the rise, and leverage ratios all the rage, the capacity of European banks to purchase these assets is shrinking.

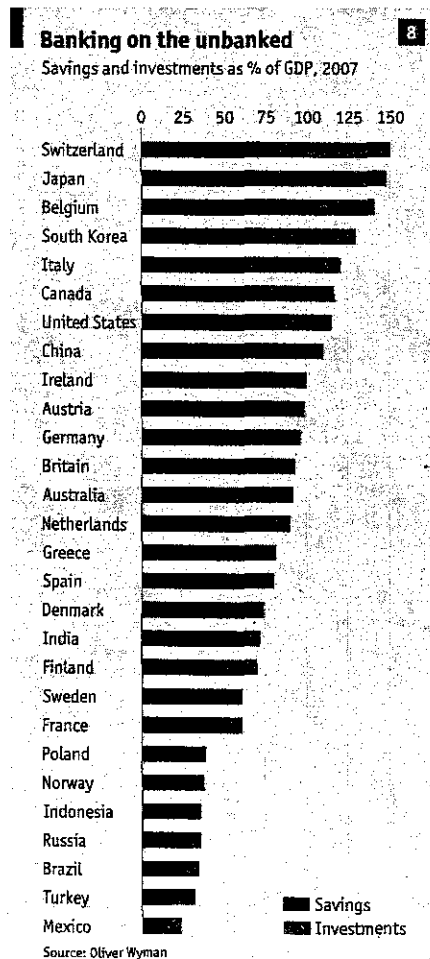
Money-market funds, which invested heavily in securitised products, will also be more constrained. One of the most unnerving moments of the crisis was the massive outflow of cash from these funds after the announcement by one of them last September that it had "broken the buck", meaning that its net asset value had fallen below \$1 a share and investors were going to get less back than they had put in. With \$3.4 trillion of assets under management, allowing a run on money-market funds was unthinkable. The American government stabilised the market with a temporary guarantee that investors would not lose money.

The issue is what kind of quid pro quo money-market funds will now face. There is a particular focus on their break-the-buck commitment, which means that they mimic a bank by engaging in maturity transformation while promising shareholders that they can get all their money back whenever they want it. A choice is looming for the industry—either to keep this commitment and submit to greater regulatory oversight, potentially including capital charges, or to drop it and make shareholders understand the risk.

Neither outcome is great for securitisers. If money-market funds keep the break-the-buck promise, they are likely to move into more liquid asset classes than securitised products. If they abandon it, they will demand even higher yields on securitised assets or even greater amounts of credit enhancement, which inevitably means higher borrowing costs for issuers. (On the flip side, if funds produce lower yields or more risk in future, that could lead investors to keep more of their money in banks).

Even for long-term investors—think of pension funds and insurers with long-dated liabilities of their own—likely levels of demand for securitisation are horribly murky. Rating agencies are going to be far more wary of giving AAA ratings for structured products. Since many of these investors have to put their money into top-rated products, that implies a smaller market.

When AAA ratings are awarded, investors will in any case derive less comfort from them. That is partly because of the high-profile failures of rating agencies and



partly because investors are rethinking their assumptions about the supposed diversification benefits of securitised products. A large portfolio of securities clearly offers greater protection against idiosyncratic risk—the chance that a particular borrower will get into trouble—than buying a single-name corporate bond, say. But as a paper by Joshua Coval and Erik Stafford of Harvard Business School and Jakob Jurek of Princeton University argues, a diversified portfolio offers far less protection against systemic risk such as a general economic downturn. The chance of losses on securitised products increases as the economy worsens; for single-borrower bonds, firm-specific factors are more important than the economic climate. Growing awareness of this disproportionate exposure to systemic risk may reduce investors' appetite for securitised products.

The uncertainties do not end there.

Government intervention in America and elsewhere to ease homeowners' repayment difficulties will shake investor confidence in future income streams. The prospect of court-ordered reductions in mortgage principal—or "cramdowns"—is particularly alarming. According to Anna Pinedo of Morrison & Foerster, a law firm, there is also foggy around the tax status of securitisation trusts, the entities into which securitised assets are placed. For tax purposes, they are structured as "pass-through" entities, meaning that the servicing firms that administer mortgage payments have little scope to modify the terms of loans if borrowers get into difficulty. With servicers now given greater leeway to intervene, questions about how far they can go without compromising trusts' tax status hang over the industry.

How these various uncertainties resolve themselves will not be known for

years but two assertions look pretty safe. The first is that the market for securitisation will shrink substantially. Borrowers are scaling back, buyers are thinner on the ground, risk aversion is up and banks are in any case under pressure to improve their loan-to-deposit ratios. The second is that the extent of banks' continued deleveraging depends to a large extent on the scale of that drop.

The wild card, of course, is the degree of long-term support that governments are willing to provide to buttress the market, whether through guarantees, loan programmes for investors or future incarnations of government-sponsored enterprises such as Freddie Mac and Fannie Mae. Whisper it softly, but one of the lasting effects of this crisis could end up being institutionalised guarantees for buyers of securitised assets to sit alongside guarantees for retail depositors. ■

## Opportunity gently knocks

Who will gain from the crisis?

**D**ESTRUCTIVE? Absolutely. But will the financial crisis also be creative? When incumbents disappear and established business models no longer work, that is usually good news for up-and-comers. The massive disruption in banking has members of the industry's fringe rubbing their hands. They include:

**Advisory boutiques.** "Like gnats" is how an executive at a big investment bank describes boutiques. Without financing capacity, a global presence or big capital-markets businesses, they lack the firepower of bigger rivals. But the crisis has nevertheless increased their capacity to irritate the giants. Clients' faith in the advice of the industry's big names has been badly dented by their conspicuous inability to manage their own businesses. Many banks have damaged client relationships more directly, by skimping on credit as they slim their balance-sheets. Conflicts of interest for large banks are also more common now that their ranks have thinned. And boutiques have lots of high-quality job-hunters to choose from.

**Peer-to-peer lending platforms.** These websites, through which savers pool money and lend to borrowers, have also been boosted by the crisis. Derisory

interest rates are encouraging savers to seek better returns elsewhere. Zopa, a British website that pioneered the concept, says the number of lenders joining it has soared. For borrowers spurned by their banks, low-cost and unleveraged social lenders are an attractive alternative. Zopa's boss, Giles Andrews, says new entrants like his should gain from how the crisis has undermined customers' faith in banks' solidity and intensified their doubts about whether the banks have customers' best interests at heart.

**Islamic finance.** This was booming before the crisis, thanks to oil-fuelled liquidity in the Gulf, rising devoutness among Muslims and a fast-developing market infrastructure. But its emphasis on risk-sharing and prohibition of speculation has a fresh resonance given the failures of Western finance. Its backers stress the ethical side of *sharia*-compliant finance. However, the Middle East is suffering its own economic headwinds and the industry's fundamental problems, including an over-reliance on short-term funding, have yet to be solved.

**Supermarkets.** They see the crisis as an opportunity to push further into financial services. Their costs of acquiring cus-

tomers are low, because they already have millions of shoppers passing through their stores. Their brands are trusted. And those who have seen how retailers work with banks in joint ventures consistently note how much more focused grocers are on the customer's needs. "Retailers think first about the customer, banks about the profit," says an executive. Britain's Tesco announced an ambitious expansion of its banking activities in March.

Just how capable in March are of taking big chunks of the market is unclear. The downturn is hitting most institutions, retailers included. Regulators will also have a big say. The rules may have been tweaked to make it more attractive for private-equity firms to invest in American banks, for example, but Douglas Landy of Allen & Overy, a law firm, expects continuing hostility to the idea of non-banks owning banks. And serious questions hover about whether it makes sense to encourage more competition in banking. "Anything that smacks of loosening regulatory standards is going to be politically hard," says Andrew Schwedel of Bain, a consultancy. There are great opportunities lying among the debris of the banking industry but reaching them may be tricky.

## The revolution within

The way banks manage risk—including how they reward managers for taking it—will change greatly

THE changes to the environment in which banks operate—tougher regulation, higher capital requirements and scarcer funding—will have a dramatic impact on the way that banks are managed. But banks are also reflecting hard on some fundamental internal questions, such as how to manage risk, compensation and growth itself. Too many bosses and shareholders accepted years of double-digit returns without probing the sources and sustainability of those profits. “No one was asking the ‘Columbo’ questions,” says Toos Daruvala of McKinsey, a consultancy.

The most basic of these questions, particularly for banks with large wholesale operations, is what kind of businesses they want to be. The bubble was characterised by a game of copycat, in which banks strove to match the returns of their most profitable rivals by piling headlong into asset classes where they were lagging, irrespective of the risks. “The securities industry was based on revenue, not on risk-adjusted returns,” says a bank boss.

Consultants armed with league tables and presentations full of “gap analysis” increased the pressure on sluggards to catch up. Mr Winters of JPMorgan Chase recalls how executives at the bank worried about its underperformance in fixed-income markets. “We used to beat ourselves to death about it and wonder ‘what aren’t we getting right?’ Now we know.” For the foreseeable future, managers will think harder about where they have a competitive advantage over rivals, not where they don’t.

Besides working out what they are good at, banks must decide how much risk they want to take. Helped along by the ratcheting-up of capital charges in trading books and other planned regulatory changes, a sweeping shift in risk appetite is already under way. There are obviously distinctions between firms: Goldman Sachs has maintained a stronger bias towards risk exposure than Morgan Stanley, for example. But in general proprietary risk-taking is being scaled back drastically. Risk capital will reside outside the banking system, in hedge funds and private-equity firms, much more than before.

The likes of Deutsche Bank, UBS and Credit Suisse have all unveiled strategies to

cut their proprietary activities in illiquid markets and focus on high-volume “flow” businesses: for example, helping clients to manage exchange-rate and interest-rate risk. That means leaving some money-making opportunities on the table, a most unbubble-like thing to do. “We could have held on to certain assets and made money now but we cannot have this kind of risk irrespective of future potential,” says Josef Ackermann, the boss of Deutsche Bank.

### Fireproofing

Banks are also taking measures to ensure that a poor year in more volatile businesses cannot overwhelm a decent year in steadier ones. And they are reviewing the appropriate mix of earnings between divisions, given the capital-intensity and risk profile of some activities. The firewalls between businesses are being fortified, too, so that managers have a clearer idea of the standalone profitability of each division.

UBS was especially guilty of underpricing its internal funding, letting its investment bank take advantage of the bank’s cheap overall cost of funds without paying an appropriate premium for the risks it was taking. The Swiss bank has reorganised itself to ensure that businesses are more autonomous and are funded at market rates. Such changes arguably have more impact than any regulatory reforms. “The real revolution will be within the businesses,” says Charles Roxburgh of

McKinsey, “as managers see real detail on who is making money and how.”

The mechanics of risk management are also in upheaval. Articulating how much risk to take or deciding how much to charge internally for a certain activity is less clear now that many banks’ risk models have proved unreliable. (The impression of additional uncertainty is itself partly illusory: the clarity models provided during the bubble was misleading.)

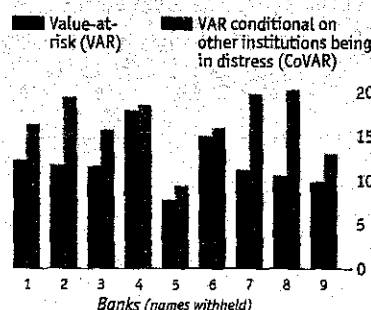
In truth, the crisis will make models more useful. They will be using data from a whole economic cycle rather than looking myopically at a period of exceptionally high returns. The improved risk profile of banks’ borrowers also means they will have better data to work with. Methodological improvements will capture the relationships between institutions—the effect on its peers of Lehman Brothers going bust, say—as well as their independent risk profiles, which are commonly assessed by a measure called “value at risk” (VAR). Tobias Adrian of the Federal Reserve Bank of New York and Markus Brunnermeier of Princeton University have proposed a measure called COVAR, or “conditional value at risk”, which tries to capture the risk of loss in a portfolio due to other institutions being in trouble. Taking account of such spillover effects greatly increases some banks’ value at risk (see chart 9).

Despite such improvements, risk managers are well aware of the need to beef up their qualitative controls too. Stress tests, designed to think through how institutions cope with periods of pressure, will become more important to boards as they seek to define institutions’ risk appetite. They will also become more important to shareholders. Bank of New York Mellon has started to include figures in its earnings statements showing what could happen to its capital under various scenarios.

Stress tests will also become more demanding. Take the assumptions about how long liquidity can disappear for. Measures such as VAR seek to capture the effects of a single explosive event within a relatively short period. This crisis, says Koos Timmermans, chief risk officer of ING, a Dutch bank, has been “more like slow death by torture”. Peter Neu of the

### Even more at risk

Selected British banks, post-2007 crisis, %\*



\*The return on the bank's share price relative to the risk-free return has a 10% chance of suffering a fall at least this great

Sources: Bank of England; Bloomberg

► Boston Consulting Group says stress tests must also become more "coherent". Too many banks defined stress events in isolation—asking what kind of losses they might sustain in the event of, say, a 20% stockmarket fall without asking what sorts of changes in the economic climate would prompt a fall that big.

Even Goldman Sachs, widely regarded as the best manager of risk in the industry, did not foresee quite how bad things could get. The bank's most demanding pre-crisis stress test—known as the "wow", or worst of the worst, test—took the most negative events to have happened in each market since 1998 and assumed that they got 30% worse and all happened at the same time. That still wasn't pessimistic enough.

Banks must revisit their assumptions about how effective their defences are against multiple risks. The crisis will live long in the collective memory for showing that all markets can become illiquid and all risks are correlated, removing many of the benefits of diversification. "The fourth quarter of last year was remarkable for showing how fragile the system has actually turned out to be," says Wilson Ervin, chief risk officer of Credit Suisse.

The inadequacy of specific hedges, something known as "basis risk", also came as a shock to many. A corporate bond and a cash-collateralised credit-default swap written on the same company ought to offset each other—if the company looks likely to default, the bond will fall and the swap rise. In late 2008 the system-wide evaporation of liquidity meant that banks could lose money on both.

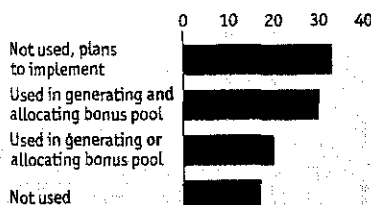
A degree of calm has returned to the markets since then, reversing some of the losses banks suffered from basis risk. The amount of counterparty risk in the system will be reduced greatly by central clearing-houses for credit-default swaps. But confidence in hedges and market liquidity as a way of mitigating risk has been badly damaged. In response, banks will use a simpler set of palliatives. They will take greater account of their gross as well as net exposures. They will charge more for taking on risk on clients' behalf. And to the extent that they continue to package and sell securitised assets to investors, they will reduce the amount of inventory they hold.

#### A game of pay sense

All of these aspects of risk management, from models to hedges, are important. But another risk-related question—bankers' pay—has dominated the public debate on the industry's failures. Pay has been the

#### Risk-free returns

Banks' use of risk adjustment in bonus calculations  
% of total respondents



Source: Institute of International Finance, survey

touchstone issue of the financial crisis, vilified both as the incentive that drove bankers to take foolish risks as well as the most inequitable feature of an industry that makes obscene profits in the good times and comes crawling to the taxpayer when it gets into trouble. From the bonuses paid to executives at AIG, a monumentally failed insurer, to the expensive tastes of John Thain, a former head of Merrill Lynch, and the huge pension granted to Sir Fred Goodwin, a former boss of RBS, pay has captured the public's attention, far more than the banks' many other failings.

Managers admit privately that things got way out of line. "It was better to be an employee than a shareholder," says a bank's chief executive. The traditional argument against changing pay structures has been that no institution could move unilaterally without competitors poaching its best people. Now, no bank can fail to alter its compensation policy without having its executives publicly humiliated by politicians and the news media, and frowned upon by regulators.

The broad thrust of the coming changes on pay is clear. Banks will tie compensation more closely to performance and spread rewards over longer periods. It should be said that neither idea is foreign to the industry. Bonus pools based on profits (though not revenues, an indefensible practice) may be seen as a problem now but are clearly more closely tied to performance than a fixed base salary. Awards of shares were common within the industry before the crisis and caused employees, those of Lehman Brothers included, to suffer vast losses when share prices dropped. What the industry as a whole did not do well enough was to design pay so that it better reflected long-term risk.

According to a survey of industry practices published by the Institute of International Finance (IIF) in March, many banks still fail to use risk-adjusted measures ei-

ther to calculate the size of their bonus pool or to allocate it. That will change (see chart 10). Economic-capital models, which calculate the use of capital based on assumptions about expected losses, will be more widely used to set bankers' pay in future. The bonus/malus structure introduced by UBS in 2008, whereby a cash portion of a bonus award is held back at the end of a financial year and reduced if targets are not met in subsequent years, will also become more common as institutions seek to track and reward the performance of senior managers over time.

Some banks will be more sophisticated still. With costs and capital under so much pressure, the incentive for executives to identify those who add genuine value to a bank has rocketed. A few banks already try to adjust, when calculating bonuses, for franchise value—the advantage derived by employees from the bank's brand value, league-table positions and other institutional strengths. An industry veteran says that more managers of big banks will come to realise that they do not need to pay twice over for the same bit of business, first by building a global infrastructure and then by rewarding an investment banker. "They would get one in five calls for big projects anyway," he says.

Other ideas in the vanguard of designing pay structures include "s-curves", which pay less below a certain threshold of profit so as not to reward employees for market conditions and franchise value, but also pay out less above a certain threshold, to discourage excessive risk-taking. These types of thinking are likely to become more prevalent.

Many of these changes are welcome, with two caveats. First, no system can be foolproof. Risk-adjusted measures of compensation work only if risk is being measured properly, for example, and the industry has proved how unsafe an assumption that is. And attempts to control pay in one area tend to inflate it in another. As bonuses fall, pressure on banks to increase basic pay is already rising. That pressure will grow as the industry recovers and competition for the best staff increases. "At some point in the next few years, the industry is going to have an absolutely stellar year," says a pay consultant who predicts that firms with clawback policies will have to offer more in upfront pay to attract recruits. The second caveat is that some employees really are worth lots of money. Asked to defend levels of pay prior to the crisis, many in the industry would reach for the analogy of film or sport, two other indus-►

## Back at the branch X

**I**F A bank posts record results during the worst quarter in living memory for financial markets, it could be a quirk. When the same bank has produced higher-than-average returns on equity compared with its peers for a number of years, it deserves a closer look. And when it has a business model that appears to answer some of the main governance concerns afflicting the industry, it repays much wider attention.

The bank is Sweden's Svenska Handelsbanken, a retail bank with operations in Scandinavia, Britain and elsewhere. Handelsbanken posted a 39% quarter-on-quarter jump in operating profits in the fourth quarter of 2008. It has gobbled up great chunks of market share in deposits and new lending in the past year. The worst of the economic downturn is yet to come in Sweden but the bank has good reason to believe it can navigate stormy waters, since it sailed through the country's 1990s banking collapse unscathed.

The bank's managers put its success down to an extremely decentralised management model, introduced in 1972 after a period when Handelsbanken had got into trouble. Branch managers are the bank's main decision-makers, following what is known internally as the "church-tower

principle"—namely, that you should do business only as far you can see from the local church tower. Responsibility for all credit decisions rests with the branches. No loans can be extended over the heads of branch managers (larger sums also require approval from higher up).

The bank is unimpressed by the idea of selling loans on to other investors. Ulf Riese, the bank's chief financial officer, says 30% of credit losses can be traced to the initial decision to extend credit but 70% come from changes in borrowers' circumstances and the way banks respond to them. Banks need to have deep customer relationships to spot and respond to these changes, he says. If loans do sour, Handelsbanken has no specialist central workout team, like those at many other banks, to come in and sort out the mess. The job is left to branches, which similarly have responsibility for cost management, salary levels and product offerings. A tier of regional management makes the decisions on where to open new branches.

The effects of making branches responsible for their own fate run deep. The bank's credit culture is consistent throughout the cycle, meaning that it loses market share in boom times and wins business in

## More Swedish lessons for the banking industry

environments like this one. There are no formal budgets or projections for the year ahead, on the principle that customer needs, not product targets, should determine growth. Handelsbanken eschews bonuses too, on the grounds that they work against long-term relationships with customers and employees. If the bank meets its return-on-equity goals, however, a portion of the profits goes into the bank's pension scheme, which is its largest shareholder.

Is Handelsbanken just a Scandinavian oddity or can it teach others something? Its approach works in part because it is selective about the types of customers it takes on. A mass-market bank would find it tougher to copy its model and be profitable. Mr Riese reckons that the bank's initial shift to a decentralised model was helped by the fact that lending growth was very tightly regulated in Sweden at that time. Handing full control to branches would lead to more missteps in a deregulated market. But the bank's core philosophy—a focus on customers, not products; on profitability at the level of each operating unit; and on long-term relationships, not short-term gains—is clearly of its time.

► tries where talented individuals are critical to success and are richly rewarded as a result. The trouble with this defence is that it was not just the big-name stars who got really rich in financial services; the extras did too. Lower profits and more sensitive pay structures will mean that most jobs are repriced across the industry but the best people will still be the subject of frenzied competition and will still command huge sums. That may be distasteful to many outsiders but if pay structures better reflect information about the risks such star bankers are taking and if their pay levels do not inflate the compensation of everyone around them, it ought to be defended.

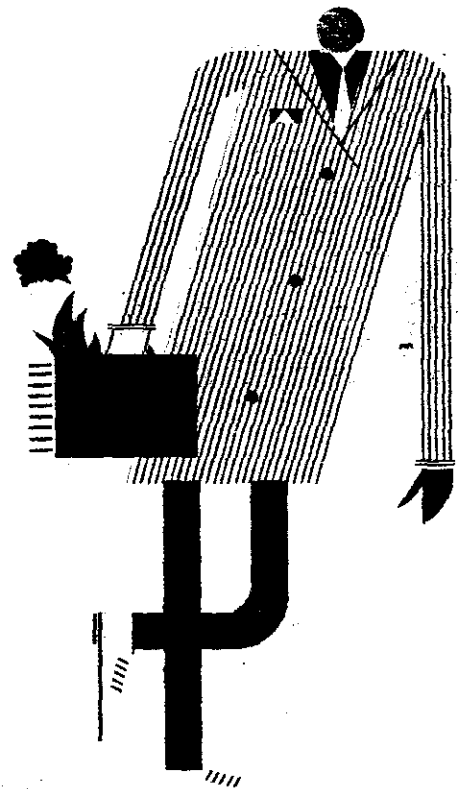
The biggest upheavals in pay and in risk management will be in wholesale banking. The assumptions that underpin the way retail banks manage risks and pay have withstood the crisis better. There are still lessons to be learned, of course. One

result, for example, will be that lenders demand more data on customers, leading borrowers to concentrate more of their business on particular institutions. But the basics of credit-risk management have been reinforced rather than overturned.

There is a problem with this picture, however. Retail banks may have less to change operationally (their funding profile is the obvious exception) yet they still got into a ton of trouble. The worst mistakes of this crisis were arguably made in relatively simple areas of retail and commercial banking—from the concentration of risk in the corporate-loan book of HBOS to Wachovia's kamikaze acquisition of Golden West, a Californian lender stuffed full of mortgage-shaped grenades. Complexity is not much of an excuse here. For many banks, the crisis reflects a simpler tale of frenetic asset growth and the inevitable turn of the credit cycle.

And that raises a bigger management question—how institutions can resist the pressure to grow when a boom is in progress. Such pressure comes from all quarters: from shareholders who want growth, from analysts who want to see higher returns on equity, from staff who want bonuses, from managers who want to keep their jobs, and from politicians who want higher employment and tax takes. One way of getting around this is to operate in markets that offer high growth without requiring great risks. "We run a boring business model in exciting markets," says Mr Sands of Standard Chartered, which is headquartered in London but operates in developing countries. "The problem was that others were running exciting business models in boring markets."

Industry bosses agree that saying "no" to opportunity is one of their most important jobs and among their most difficult. ►►



► Those who did sit out some of the boom were heartily criticised for doing so. Ed Clark, the boss of Canada's TD, recalls the heat he got from analysts for exiting the structured-products business. Ulf Riese of Svenska Handelsbanken (see box on previous page) remembers the pressure that the bank resisted to join its peers in the Baltic lending boom. Mr Timmermans, the risk chief at ING, points to the problem of getting out of positions at the right time. "It is relatively easy to get discipline into the process of putting assets on to the books. The problem is when you have held them for two years and think it may be time to offload," he says.

#### The governance gap

The memory of this most painful of episodes should make it easier for bosses to shake their heads, at least for a few years. Private capital will be more patient and managers will be more focused on sustainable growth rather than short-term returns on equity. Wrong-headed assumptions about risk dispersion will be less easily made. But there is an increasing recognition that the governance of financial institutions needs to be reviewed carefully (the British authorities have already initiated just such an exercise).

One obvious area of scrutiny will be the quality and composition of bank boards, which were found sorely wanting in many cases. That does not mean that directors should take responsibility for risk

management, a job for bank executives. "Directors do not design aeroplanes for Boeing or make the food for Taco Bell," says Mr Dimon of JPMorgan Chase.

But it does mean that they can do a better job of vetting key executive appointments—for example, the rise of Chuck Prince, a lawyer, to head Citigroup and of Andy Hornby, a youthful former retailer, to lead HBOS should have prompted more searching questions. It means dedicating more time to reviewing the business, which implies a limit to the number of directorships that board members hold. It means separating risk and audit committees. It ought to mean dividing the role of chairman and chief executive. And it means asking more robust questions around such things as "key person" risk, in which only a few employees really understand what is going on in a particular line of business.

Profound questions are also being asked about the right model of bank ownership. Some fondly remember the old days of private partnerships on Wall Street. But for banks that need lots of money to operate, that is not an option. "Capital is like heroin," says an investment banker. "Once you go down the capital-intensive route, you cannot go back." Others promote the merits of mutuals, banks that are owned by their customers. Tony Prestedge of Nationwide, a British building society that has come through the crisis relatively well so far, says that being unlisted, mutu-

als can avoid being obsessed with short-term growth targets and can live with periods of reduced profits. Then again, Nationwide has spent much of the crisis snapping up other mutuals that have got into trouble, so the model is not infallible.

With quality of management being both the best defence against bank failure and something that can change with the appointment of a new chief executive or a rush of empire-building madness (step forward the managers of Bank of America and Lloyds TSB), regulators are likely to address the problem of governance in two different ways. The first will be to cushion the impact of those bank failures that do occur by creating better resolution regimes for large institutions and for non-banks. There are also proposals for banks to buy an option on capital via a kind of disaster-insurance scheme, paying out premiums to long-term investors in return for dollops of equity when crisis strikes.

The second direction of policy will be to intervene more forcefully to prevent failures in the first place, stepping in whenever asset growth accelerates, demanding a greater say in board appointments and vetoing dodgy acquisitions on the grounds of financial stability as well as competition concerns. More daring voices are even suggesting that there may be a case for an official presence at board meetings. There is at least time to get all of these things right. It will be a long time until anyone has to worry about the next bubble. ■



## From great to good

Banks will still make money, just less of it

**F**UNDING markets are damaged. Borrowers have to recover from the biggest credit bubble in history. Bankers' reputations are mud. Regulators are not just reading riot acts, they are rewriting them. Yet many industry executives are surprisingly bouncy about the future. Investment bankers in particular have been sounding brighter, thanks to a healthy start to the year. Are banks in denial or do they have genuine cause for optimism?

The answer is obscured by a couple of big unknowns. One is the length and depth of the recession. A depressing analysis by Citigroup looks at what happened to banks in four previous episodes of extreme stress, including the Depression, Japan's "lost decade" in the 1990s and the Swedish banking crisis of the 1990s. Loan books collapsed in all cases (by 50% from peak to trough in America, 30% in Japan and 25% in Sweden), greatly reducing earnings even before credit losses were taken into account.

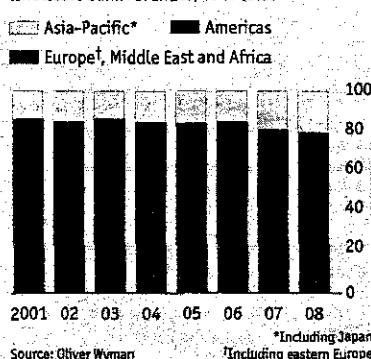
Direct comparisons are dangerous. Banks have fewer loans as a percentage of total assets nowadays (because they hold more securities) and they also have the chance to gain business that had been going to the shadow-banking system. But the dynamics that operated in earlier periods of stress are also present now—falling demand, pressure to deleverage to meet new capital rules and reduce loan-to-deposit ratios, and dipping asset values. European banks look especially leveraged in comparison with their American counterparts. If things turn out anywhere near as badly as before, says Simon Samuels of Citigroup, banks' pre-provision returns have a lot further to fall.

Another important unknown is the extent to which globalisation unravels. The threat of financial nationalism, sparked initially by political pressure on lenders to focus on domestic markets and reinforced by the likely tightening of rules on liquidity and capital for any bank operating within a country's borders, is arguably the biggest long-term worry for international banks. (Local banks, by contrast, should find it easier to win more business.)

Business volumes are likely to fall in markets that have been producing a rising

### Globalisation halted?

Wholesale bank revenues, % of total



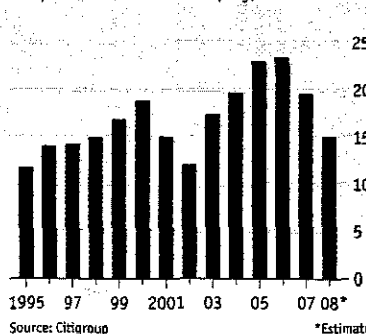
proportion of revenue at the big banks (see chart 11). Returns will drop if banks have to set aside more capital at the national level, or fund themselves from domestic deposits. Big customers may take things into their own hands if the system gets too fragmented. "If international banking gets more difficult, multinationals will end up doing things like cash management themselves," says Mr Sands of Standard Chartered.

Let us again make some non-apocalyptic assumptions: that the business of international banking is less profitable but survives broadly intact and that the recession reaches a bottom in the relatively near future. That still leaves many banks with the task of finding a new set of profit drivers to replace the old ones.

The extraordinary returns on equity

### Nice while it lasted

European banks' return on equity, %



that banks enjoyed in recent years (see chart 12) were largely created by leverage, the ability to increase the amount of assets they held relative to their equity, and by "asset velocity", which let banks reuse capital multiple times during the course of a year as assets were originated and speedily moved off balance-sheets through securitisation. The new emphasis on stability of capital and funding ensures that neither source of profits will be readily available to banks in the future. The banks' hope is that they can compensate by increasing their unleveraged returns, which means grabbing higher volumes of business and repricing their products.

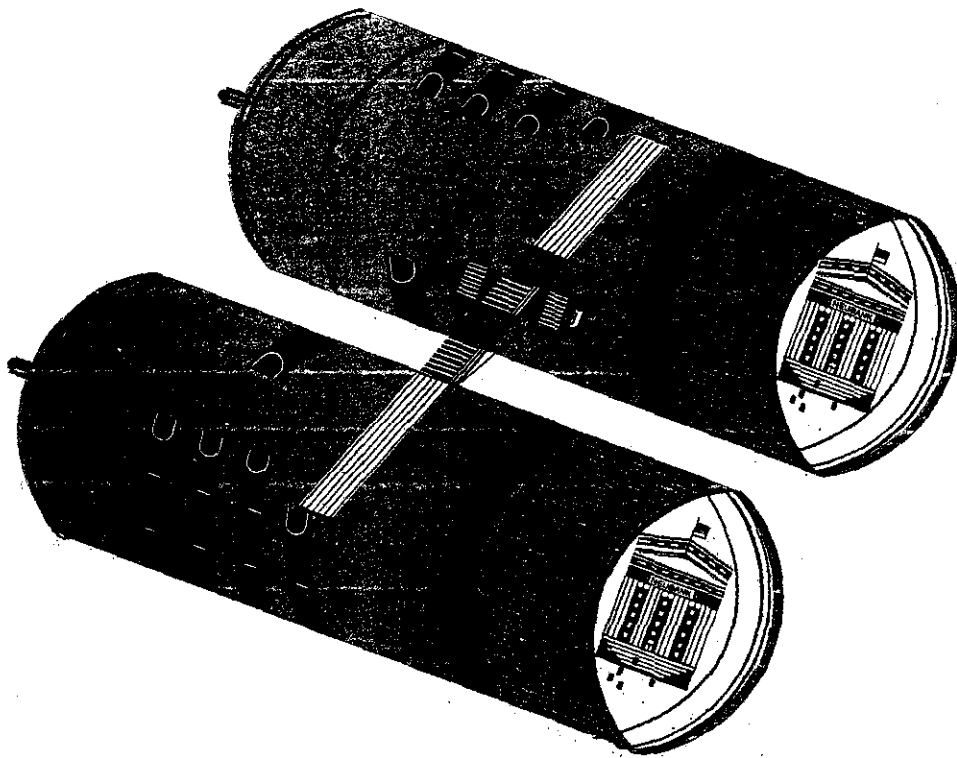
They do have some cause for optimism. The structural potential of developing markets remains intact. And in mature markets, banks' financing and risk-management capabilities are arguably in greater demand than ever. Lots of companies still need to raise capital, for example, as evidenced by the rush of bond issuance in the first two months of the year. The advisory business is ticking over too, as waves of companies seek to restructure debts.

### Still hedging

Many expect clients to demand more hedging because of the crisis. "There are companies that cannot continue operating today as a result of a failure to hedge," says Mr Winters at JPMorgan Chase, who also reckons that clients will ask for more precise, and therefore expensive, forms of protection given the inadequate performance of some hedges through recent months. "If you are exposed to real estate in the [English] Midlands it is no good being hedged with a European property index," he says.

A heightened awareness of risk will affect clients' relationships with the banks themselves. Banks are supposed to worry about borrowers going bust. Now the reverse is also true. Mergers and acquisitions mandates often require companies to pay banks a fee even if they are no longer involved at the time a deal is done, for instance. Some clients now want engagement letters for the services of banks to spell out what would happen if the banks failed in the interim. The bankruptcy of Lehman Brothers gave a harsh lesson to





► hedge funds about the dangers of doing all of their borrowing and saving with a single prime broker. Custody banks are winning lots of hedge-fund business as a result of this. Tri-party collateral management, whereby a third bank acts an intermediary between a buyer and seller, is another growth area for custodians. Bank of New York Mellon is currently servicing \$1.8 trillion of tri-party collateral a day, up from \$1.2 trillion in 2007.

#### Trend-watching

Changes in consumer behaviour can also create opportunities for retail banks. A shift towards saving is one trend to capitalise on. Retail bankers are already thinking about structured savings products that offer consumers the chance to start putting money back into shares while protecting their principal. Given worries about the stability of the dollar, says David McKay of RBC, there will also be greater demand for products denominated in other currencies such as the euro.

More important is the fact that competition has fallen sharply in many markets, either because banks have disappeared or because they are financially and politically constrained. The credit environment has changed from being demand-driven to supply-constrained, which means that market share is up for grabs and pricing power has increased markedly. A recent report on the future of wholesale banking from Morgan Stanley and Oliver Wyman reckons that bid-offer spreads have increased by anything from 50% to 300%.

"The change in the competitive landscape has been absolutely brutal but for the winners, volumes are up, margins up and market share up," says Mr Varley of Barclays.

Survivors of the crisis will also be protected by higher barriers to competition. Regulators are going to be nervier about letting new entrants into the finance industry and allowing foreign banks free rein in their markets. Many of the most important sources of earnings in the new banking landscape, such as cash-management services and flow businesses, are gigantic, technology-heavy operations that are difficult to replicate. Economies of scale will also count for more in areas such as deposit-gathering, risk analysis, cross-selling and wholesale-debt issuance. Although there is much talk about constraining banks that are too big to fail, the smallest institutions are the ones that will suffer most in this changed environment.

All of these factors help to explain why banking will continue to be a highly attractive business. But they do not make up for what has been lost. Huge swathes of the wholesale industry's product offering (including some of its most profitable areas) have disappeared. So have many of its newer customers—analysts at Morgan Stanley reckon that hedge-fund assets fell by around 40% in the second half of 2008 alone, and that a further 15-30% of assets will be redeemed this year. The contribution that prime brokerage, structured credit and private-equity activities made to profits in wholesale banking rose from approximately 20% in 2000 to around 35% in

2006, according to estimates by Oliver Wyman. These sources of revenue will not easily be replaced.

The goal of many retail customers, meanwhile, will be to deleverage. The fact that households, not businesses, have so much debt to unwind is something that marks this episode out from many previous banking crises. According to McKinsey, American consumers have accounted for more than three-quarters of the country's GDP growth since 2000 and for more than one-third of worldwide growth in private consumption since 1990. Although deleveraging can also occur through income growth, the immediate response of consumers has been to save more, depressing demand for credit (see chart 13). That is likely to continue for the foreseeable future. (The situation in emerging markets is different: assets there will probably grow rapidly again once the economic cycle turns, although the need to reduce loan-to-deposit ratios will weigh on several eastern European markets.)

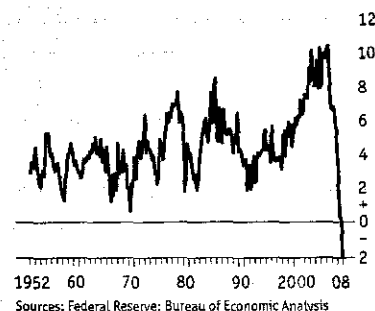
The ability of retail banks to make money from those customers who do still need to borrow is also more constrained than it may appear. The politics of ramping up lending rates to taxpayers is sensitive, to say the least. As Andy Maguire of the Boston Consulting Group points out, there is also an adverse-selection problem. Borrowers who are applying for credit right now are likely to be the ones that are having trouble getting loans elsewhere. Moving existing customers on to higher-priced loans prematurely can strain relations.

#### Nightmare scenario

Low interest rates have steepened the yield curve, the difference between short- and long-term rates, but they also make this a terrible environment for deposit margins, which banks calculate as the dif-

#### Hitting the credit limit

US households' net new borrowing as % of GDP



Sources: Federal Reserve; Bureau of Economic Analysis

ference between what they pay for deposits and what they make by putting them to work in money markets. With interest rates so close to zero, banks are having to cut their lending rates but have no room to drop their deposit rates further. Spreads compress as a result. "The nightmare scenario is a period of extended low interest rates like Japan," says Mr Clark of TD.

There is another threat to profits. Banks make money not just from the spreads they can command on lending but also from fees. The politicisation of banking could easily mean that the fairness of bank fees comes under closer scrutiny. Britain's Office of Fair Trading has already ruled some bank charges unfair. American lawmakers are taking aim at credit-card fees in a proposed law. With voters, ie, consumers, now in charge of the industry, other fees such as overdraft charges may also fall under the spotlight. Offshore banking secrecy is an example of something that did not cause the crisis but has been vigorously targeted in its aftermath.

Wealthier clients are also likely to be less inclined to pay fat fees in such businesses as asset management, as falling markets, frauds such as the Bernard Madoff scandal and broken promises of absolute returns make investors question the value they are getting. As the full effect of the crisis on savings and pensions becomes clearer, consumer activism is likely to rise.

#### A glistering era ends

Add to this picture the drag of continuing losses from toxic assets and souring loans, and it is clear that as an industry, banks are going to find it much tougher to make money than before. Clearly, costs, particularly those related to pay, will fall as well as revenues. But there seems to be broad consensus among industry observers that average returns on equity through the economic cycle will be in the low- to mid-teens henceforth, well down on the 20%-plus achieved before the current crisis.

Another way of looking at the industry is to compare its growth with GDP growth. In emerging markets, the industry should still be able to grow faster than GDP as the use of financial products spreads. In mature markets, with the turbo-boost of leverage gone and bank balance-sheets still to be belimmed, a growth rate in line with GDP is probably as much as can be hoped for. That would still make banking a decent business, comparable to many other industries. And if you look at returns on a risk-adjusted basis, as some converts to the

cause now urge, it may even be a more profitable one than before. But masters of the universe it ain't.

It is possible to glance at the emerging landscape of banking and think that not an awful lot is going to change. Aside from a few tweaks to capital here, some tougher rules on liquidity there, and the disappearance of a handful of badly-run institutions, the same big names dominate the industry. And yes, banks will make less money than before but the industry will still return decent profits and still pay its people well. Their first-quarter earnings showed that they can generate huge amounts of money in even the most difficult times. With so many assets trading at such distressed levels, many expect the wholesale side of the industry to record massive gains when sentiment properly turns around.

Regulators themselves wonder whether the measures now being discussed go far enough. As Mr Borio at the Bank for International Settlements points out, many of the ideas around countercyclicality (setting aside more capital in good times) and macroprudential regulation (safeguarding the stability of the whole banking system as well as of individual banks) were over-ready, having been worked on by a coterie of central bankers, academics and regulators for a number of years. Calls to dismantle the biggest institutions and split up universal banks have not got far.

Yet the scale of the change sweeping over banking should not be minimised. Banks will seek to conserve capital, not find ways to run it down. They will cut their dependence on wholesale funding, and grow more slowly as a result. They

will manage risk, not assume it away. Staff and lines of businesses will have to show they add value to a bank, not just increase its revenues. Regulators will bare their teeth more, and look away less. And taxpayers, whether explicit owners or implicit guarantors, will peer at the industry and its leaders with hostility, not admiration.

As dramatic as these changes will be to those inside the banks, they will be just as striking for banks' customers. During the bubble and during the crisis, credit was tidal. It swept in, buoying everything from subprime mortgages to leveraged buy-outs. And then it swept out again, stranding everyone from investment-grade companies to emerging-market oligarchs. In the future, credit will be riverine. It will stream towards more creditworthy borrowers. It will follow a more defined course, constrained by embankments of capital, funding and risk management. Its flow will be more domestic, less global. Above all, it will be scarcer.

Given what has gone before, that may seem like no bad thing but it will entail costs. No one knows exactly what the right balance of debt and equity is in an economy, but the shrinkage of securitisation in particular makes it more likely that the process of deleveraging will overshoot. Customers, such as new businesses or immigrants, who lack a credit history but could well be terrific economic bets will find it tougher to raise money. Emerging markets that need to wean themselves off cross-border capital will grow more slowly than their potential. For borrowers such as these, the failure of the banks will not be measured in periods of a few dramatic months. Its legacy will last years. ■

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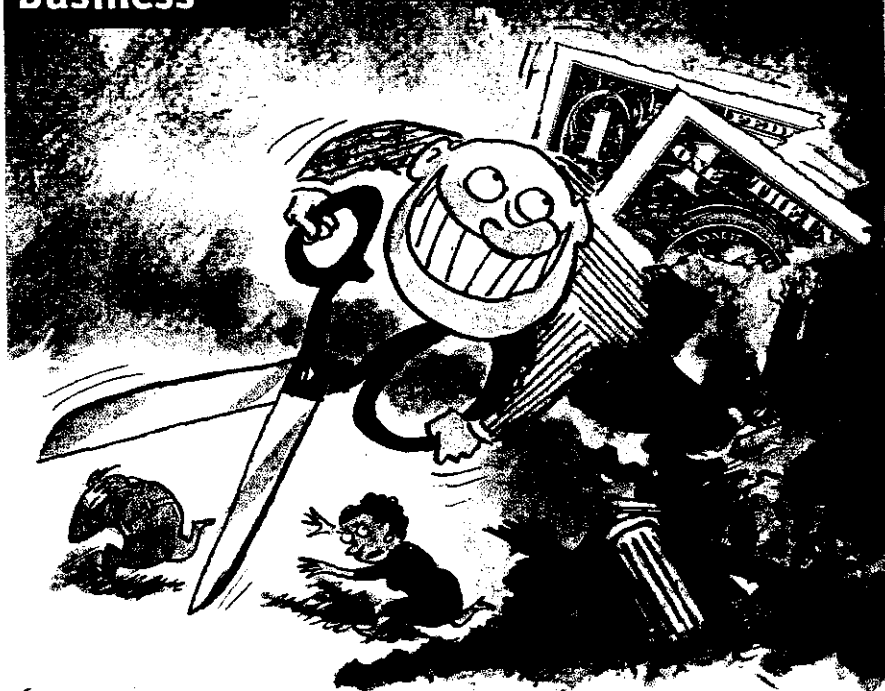
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## Corporate social responsibility

## A stress test for good intentions

LONDON AND SAN FRANCISCO

**The recession is a test of companies' commitments to doing good**

**I**N JUNE Gap, a big retailer based in San Francisco, will hold a strategy meeting for its corporate social responsibility (CSR) team. In previous years that meant flying in people from 20 countries around the world. But this time the company plans to bring them together virtually, via online meetings. The main reason for the switch is not to help save the planet by reducing Gap's carbon footprint, but to help save money. "Everyone's looking to become more efficient," explains Dan Henkle, who leads the company's CSR activities.

As firms grapple with a brutal economic downturn, they are taking a long, hard look at the resources they devote to everything from supporting charities to making their activities carbon-neutral. That is hardly surprising: cutting back on CSR, or "sustainability" as it is sometimes known, would seem to be a quick and relatively painless way to save money. Cassandras who felt many CSR initiatives were little more than publicity stunts in the first place predicted that they would perish as soon as the economy fell off a cliff.

There have indeed been cuts to CSR budgets. A survey conducted late last year on behalf of Business for Social Responsibility, a global network of firms with an interest in CSR, showed that almost a third expected their spending on sustainability

to fall as a result of the crisis. Yet so far the recession has not produced a wholesale retreat from corporate do-gooding. Instead it has led firms to cut things that were at best peripheral to their business interests and, at worst, a waste of time and money.

Most of the cuts have been to corporate-philanthropy budgets, which typically fund charities and NGOs. For instance, Citigroup's charitable foundation says it expects to make \$63m of grants in 2009, down from \$90m last year. The bank says it had already planned to focus its giving in fewer strategic areas before the financial crisis broke and that it is still investing heavily in CSR-related initiatives across its businesses. Given the woes of Citigroup and some other troubled financial institutions, taxpayers might question why banks are still forking out any cash to good causes rather than using it to repay government loans. Yet bankers argue that scrapping such activities altogether would be extremely damaging to their reputations and profits—or, at least, what's left of them. Carmakers are also cutting back. Ford expects its philanthropic arm to shell out 40% less this year, but says it remains committed to the principle of corporate giving.

The downturn has dented other aspects of CSR, too. While businesses were minting money, there was much talk of

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"green" travel and offsetting carbon footprints. Yet a survey of 329 corporate-travel managers and business travellers published in February by the Association of Corporate Travel Executives found that only 17% of them now ranked environmental sustainability as a high priority, compared with 29% a year ago. The silver lining in this carbon-filled cloud is that executives at firms such as Gap are using technology to cut the number of trips they make in order to save money. Accenture, a consultancy, reckons it has saved \$8m in a year by using "telepresence" systems and has avoided journeys that would have generated 2,000 tonnes of carbon dioxide.

But chaos in the global financial system has stymied some big, environmentally friendly projects. American Electric Power (AEP) chose to delay its plans to build a wind farm in Indiana when the heavily indebted utility found its cost of capital had soared because of turmoil in the corporate-bond market. The firm is now exploring other ways of meeting the ambitious targets that it has set for generating energy from renewable sources.

AEP's commitment to greenery is not driven by rose-tinted altruism: it expects demand for clean power to increase as a result of government actions to limit climate change. Other firms are sticking with green-energy projects because they can boost efficiency or cut costs. Intel, the world's largest chipmaker, says it plans to increase investment in energy efficiency this year because the \$23m it has poured into green energy since 2001 cut its fuel bills by \$50m over the same period.

Self-interest also explains why many companies are intent on creating greener supply chains, in spite of the costs. Mars ►

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► and Cadbury, two confectionery-makers, have separately announced plans to increase the amount of cocoa they source from sustainable sources because both are concerned about future shortages if production practices do not change. IKEA is also fretting about one of its most important raw materials. The Swedish furniture giant has agreed a plan to increase the amount of wood in its products that comes from responsibly managed forests between 2010 and 2012.

So the preliminary results of the CSR stress-test are encouraging. Many firms really do seem to have found ways of making the world better while making money at the same time. A few, such as America's GE, have built entire business models around sustainability. This month Jeff Immelt, GE's boss, unveiled a \$6 billion plan to help its health-care division increase its profits while broadening people's access to low-cost health care around the world.

Another reason for optimism is that consumer interest in companies' sustainability credentials remains strong in spite of the recession. Consumers' consciences

have "not been put on hold," notes Simon Propper of Context, a CSR consultancy. Nor have employees'. Many firms have spent a great deal of time getting staff involved in sustainability. Any backsliding would probably damage morale.

It would also damage a firm's chances of recruiting future stars. Gap's Mr Henkle says the college students he meets these days are far more informed about sustainability than their predecessors. Firms that can show they stuck to their sustainable ways during the recession may find it easier to attract the brightest talent when the economy recovers.

There is one other important reason for thinking that companies will maintain their commitments to sustainability through the downturn and beyond: the need to restore confidence in business. The financial crisis was triggered by a bout of corporate social irresponsibility on a massive scale that has tarnished the reputations of even the bluest of blue-chip companies. Now corporate leaders have a chance to show that they are not just motivated by short-termism after all. ■

#### Intel's antitrust ruling

## A billion-euro question

Are the chipmaker's pricing policies anticompetitive?

**I**N THE end all that seemed to matter was the size of the fine. When it was announced on May 13th it turned out to be the largest ever of its type: €1.06 billion (\$1.44 billion). This is what Intel, the world's biggest chipmaker, will have to pay if the European Commission prevails in its view that the firm, which sells about 80% of the microprocessors for PCs, has abused its dominance.

Yet the case against Intel is not chiefly about money that might one day "sponsor the European taxpayer", in the words of Neelie Kroes, Europe's competition commissioner (the fine will sit in a blocked bank account until the case is decided). The main question is: under what conditions can a quasi-monopoly such as Intel give discounts and rebates to computer-makers and retailers?

The commission does not think that such practices are illegal *per se*. But it claims that Intel's discounts and rebates were often conditional on the exclusion of its rival, AMD. The commission says that in one case Intel paid Media-Saturn Holding, Germany's largest electronics retailer, to sell only computers with Intel chips inside, and in another case a computer-maker had to agree to buy at least 95% of the chips in its business PCs from Intel to qualify for rebates.

Computer-makers have to play along,

the commission argues, because they depend on Intel for a majority of their chips—a result of the fact that AMD's production capacity is limited. If a firm decided to buy as many AMD chips as possible, it could end up worse off since it might then have to pay more for the chips purchased from Intel. To overcome this handicap, AMD would have to price its processors below cost, and perhaps even pay its customers. In one case, according to the commission, AMD offered a computer-maker free chips, but it ended up taking only 160,000 of them.

Intel says the claims against it are false. It does not deny making extensive use of discounts and rebates, but insists that it has never required customers to agree not to buy from AMD in order to obtain a discount, and has never raised prices when customers bought from AMD. What is more, says Bruce Sewell, Intel's general counsel, no harm seems to have been done: AMD is alive, chip prices are falling and innovation is rampant.

Intel says it will appeal to the European Court of First Instance. In the meantime, both sides will argue over the evidence in this week's 524-page decision. In the end, whether Intel is found guilty may be less important than whether the case establishes clear rules about what dominant firms are allowed to do.

#### Porsche and Volkswagen

## Payback for Piëch

Only now is the extent of Porsche's defeat becoming apparent

**I**F THERE is one certainty in the European car industry it is that it does not pay to cross Ferdinand Piëch, the 72-year-old chairman of Volkswagen (VW). This week, in bullish mood at the launch of the new VW Polo hatchback in Sardinia, Mr Piëch declared victory over the Porsche family and Porsche's headstrong chief executive, Wendelin Wiedeking.

After reaching an agreement on May 6th to call off Porsche's improbable attempt to take over VW, a company 15 times its size, the Porsche and Piëch families, who control 100% of the voting stock in Porsche Automobil Holding, gave themselves four weeks to hammer out the terms and structure of a merger between the two firms. But Mr Piëch, who personally owns 10% of Porsche, has now made it quite clear that it is he and VW that are in the driving seat and not, as seemed likely only a few months ago, his cousin, Wolfgang Porsche, or Mr Wiedeking. The final shape of the merged group has yet to be fixed, but Mr Piëch dropped some pretty broad hints.

Although there are supposedly two other options still on the table, it looks almost certain that Porsche will be fully integrated into the VW Group, joining its seven other car brands—VW, Audi, Skoda, Seat, Bentley, Lamborghini and Bugatti. And it will be the chief executive of VW, Martin Winterkorn, who will run the show. A gloating Mr Piëch said that he "could not imagine" Mr Wiedeking would be willing to become a mere divisional chief within the merged company, as a man used to "marching through" his career "would have to climb down very many stairs" and practise "humility".

Nor could Mr Piëch imagine VW taking on the €9 billion (\$12.2 billion) debt that Porsche racked up acquiring its 50.8% in VW. And as for giving a senior job to Holger Härter, Porsche's once-feted chief financial officer—well, the joint-architect with Mr Wiedeking of the attempt to win control of VW must now shoulder the blame for the consequences of its failure.

More than two years in the making, the two men's bold plan unravelled in a matter of weeks. At the end of last year Porsche's strategy still seemed on course. In October the company triggered a sensational squeeze on short-sellers when it was slow to admit that it had raised its stake in VW voting shares to 42.6% and had acquired a further 31.5% in the form of secured options. In late November, announce ►



Asian economies

# Crouching tigers, stirring dragons

HONG KONG

The Asian economies are likely to be the first to pull out of the global recession

ASIA'S tiger economies have suffered some of the sharpest declines in output during the global recession, and some fear that, because of their dependence on exports, they will not see a sustained recovery until demand rebounds in America and Europe. However, their doughty resilience should not be underestimated. They came roaring back unexpectedly fast after the Asian crisis of the late 1990s. They could surprise again.

Across the region as a whole, the slump has been as bad as it was in 1998. China and India have continued to grow, but in the rest of emerging Asia GDP plunged by an annualised 15% in the fourth quarter of 2008. Only three economies have published first-quarter figures. China's GDP growth accelerated to an annualised rate of over 6%, up from around 1% in the previous quarter. South Korea's GDP expanded by 0.2%, after plunging 19% in the previous three months. But Singapore's GDP fell by 20%, even more than in the fourth quarter.

More timely export figures suggest that the worst may be over. Although the headline numbers show that South Korea's exports fell by 19% in the year to April, they rose by a seasonally adjusted annualised rate of 53% in the three months to April compared with the previous three months, Goldman Sachs estimates; Taiwan's grew by an annualised 29% over the same period. China's exports over the past few months have managed only to stabilise,

but its industrial production jumped by an annualised 25% in the past three months.

Economists are revising up their forecasts for China's GDP growth this year: 8% may now be possible even if American consumers remain frugal. There is a myth that China's growth depends on American consumers. In fact, if measured on a value-added basis (to exclude the cost of imported components), China's exports to America account for less than 5% of its GDP.

There is more argument, however, over the smaller, more export-driven economies, such as Hong Kong, South Korea, Singapore and Taiwan. Robert Subbaraman, an economist at Nomura, offers several reasons why they are likely to remain sluggish for the time being. The recent rise in exports and production, he argues, largely

reflects the fact that firms are no longer running down stocks. This will provide only a temporary boost unless global demand picks up. Firms' spare capacity also means that investment will continue to fall, while rising unemployment threatens to dent consumer spending. Nor is China's stronger growth likely to save the region. Over 60% of China's imports come from the rest of Asia, but about half of these are components that are assembled in China and then sold to the rich world.

In its latest economic outlook on Asia, the IMF forecast that the region excluding China and India would grow by only 1.6% in 2010, largely because it expects the American economy to be flat. However, Peter Redward of Barclays Capital argues that Asia can recover earlier and more strongly than elsewhere. In 2010, he reckons, the smaller Asian economies could grow by almost 4%, or close to 7% once China and India are added in.

One reason for his optimism is his explanation for why the Asian economies were hit so hard in the first place. Asians are often blamed for saving too much and spending too little, but Mr Redward argues that the main reason for their plight was that manufacturing accounts for a much larger share of GDP than elsewhere. Industries such as cars, electronic goods and capital machinery are highly cyclical. In rich and emerging economies, GDP fell furthest last year in countries with the largest share of manufacturing. This, in turn, could imply a sharp recovery.

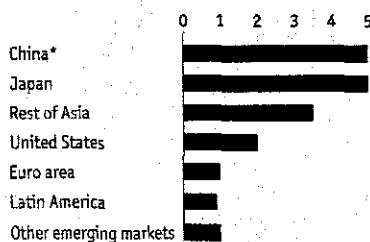
A second reason for expecting a stronger bounce is that fiscal stimulus in Asia is bigger than in other regions (see chart). China, Japan, Singapore, South Korea, Taiwan and Malaysia have all announced fiscal packages of more than 4% of GDP for 2009, twice as large as America's stimulus this year. The pump-priming should also ►►

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## Pumping it up

Fiscal stimulus as % of GDP, 2009



Source: The Economist estimates

\*Including public infrastructure financed by banks

► work better in Asia than in America or Europe, because modest corporate and household debts mean that tax cuts or cash handouts are more likely to be spent than saved. Banks, moreover, are in much better shape and so have more freedom to support an increase in domestic spending.

As the world's largest importers of oil and other commodities, the tiger economies have also benefited hugely from the fall in prices over the past year. This has acted like a tax cut, boosting real incomes and profits. Asia has enjoyed a gain from cheaper oil of almost 3% of GDP this year. Add in lower prices for food and raw mate-

rials and the total gain could match the governments' stimulus (though the danger remains of a renewed spike in oil prices).

Pessimists maintain that Asia has always been pulled out from previous recessions, such as the 1998 financial crisis, by strong exports to the West. However, a recent analysis by Frederic Neumann and Robert Prior-Wandesforde, both of HSBC, finds that, contrary to received wisdom, Asia's recovery from its 1998 slump was led not by exports, but by consumer spending. Exports to the West did not surge until 2000. The region's current-account surplus actually shrank between 1998 and 2001.

Thanks to a large fiscal stimulus and the healthier state of private-sector balance-sheets in most economies, domestic spending (consumption and investment) should revive earlier in emerging Asia than elsewhere, rising by perhaps 7% next year, up from 4.5% this year. America's domestic demand is expected to remain weak in 2010 after falling sharply this year. Indeed, add in Japan and total Asian domestic spending (at market exchange rates) looks set to overtake America's next year.

But what of emerging Asia's longer-term prospects? Much of the increase in Asian domestic demand this year and next ►

## Buttonwood

### A new global system is coming into existence

**A**LL monetary and economic systems are a struggle between borrowers, who favour inflation, and creditors, who are determined to maintain the purchasing power of the currency. In a democracy, this is a very fluid battle. The creditors have the money and therefore the ear of the political elite; the borrowers tend to have the votes.

Creditors have periodically imposed monetary anchors in an attempt to defeat the borrowers' lobby. These anchors are devised in prosperous times but run into difficulty during recessions. The gold standard failed to outlast the Depression. For nations with a shortage of gold, the "right" thing to do was to raise interest rates in an attempt to lure gold back; the austerity this imposed on the rest of the economy was politically unacceptable.

The Bretton Woods era replaced a gold standard with a dollar standard (albeit with the American currency theoretically linked to bullion). The system worked well for more than two decades, helped by the post-war economic boom, particularly in Germany and Japan which began the period with undervalued exchange rates. It broke down because America refused to pay the domestic price for bearing the system's weight.

When Bretton Woods failed, it was not immediately obvious what would replace it. European nations, in particular, maintained a hankering for fixed exchange rates. But floating rates eventually prevailed, particularly for the major currencies of the dollar, yen and D-mark.

The problem for creditors was that the floating-rate system was based on fiat (paper) money. What would keep the inflationary instincts of governments in check? The answer took a couple of decades (and recessions) to hammer out.

Once it was accepted that the markets

could set exchange rates, there was no real need for capital controls. And once capital could flow freely, ill-disciplined governments could be punished by higher bond yields. Politicians accordingly tried to reassure the markets by giving greater power to central banks, some of which set explicit inflation targets.

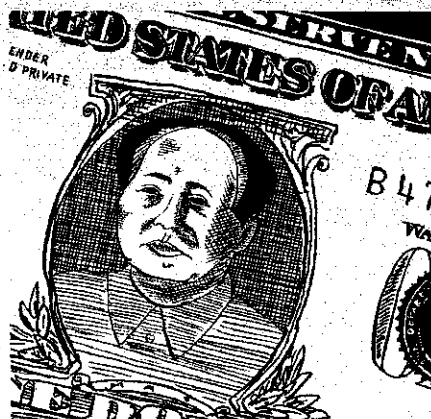
The post-Bretton Woods system worked well, engendering the long period of low inflation and steady growth known as the Great Moderation. But one of the reasons for its apparent success—the growth of India and China—may have sparked its demise. The addition of these two great nations to the international financial system was a supply shock that put downward pressure on inflation rates.

As Stephen King, an economist at HSBC, has pointed out, the result might have been a benign deflation that boosted Western living standards. But central banks struggled to avoid a deflationary outcome; the result was a loose monetary policy that encouraged asset bubbles. Those bubbles lasted longer than expected because the flood of savings from developing markets held down the risk-free rate.

Now it seems to be recognised that inflation targeting is not enough. Given the explicit government guarantee behind the banking system, central banks need to monitor both financial stability and asset prices. At the same time, some central banks have adopted (via quantitative easing) a policy of creating money to boost markets that also has the convenient side-effect of funding budget deficits. That is just what opponents of fiat money feared would happen in the long run.

The same old dilemma will eventually occur. Having spent a fortune bailing out their banks, Western governments will have to pay a price in terms of higher taxes to meet the interest on that debt. In the case of countries (like Britain and America) that have trade as well as budget deficits, those higher taxes will be needed to meet the claims of foreign creditors. Given the political implications of such austerity, the temptation will be to default by stealth, by letting their currencies depreciate. Investors are increasingly alive to this danger: ten-year Treasury bond yields are around a percentage point higher than they were at the start of the year.

Creditor nations tend to set the rules and the new global monetary system will be unable to operate without the approval of China, a creditor country that has capital controls and a managed currency. It has been assumed that China will have to move towards the Western model. But why not the other way round? Western countries adopted free capital markets, as the British adopted free trade in the 19th century, because it suited them. Will China now be able to call the shots? Uncomfortable as it might be for the West, the next monetary order is more likely to be made in Beijing than in New Hampshire.





will come from government investment. Unlike rich countries, emerging Asia has room to keep investing in infrastructure for several years but governments need to encourage more consumption to fill the gap after the infrastructure projects are completed. Asian households' low rate of consumption and borrowing means that they have huge scope to spend more. Better social safety-nets might encourage Asians to save less. Governments also need to lift households' share of national income by reducing their bias towards capital-intensive manufacturing and encouraging more labour-intensive growth.

Ultimately, relatively robust expansion in domestic spending should help most Asian economies to keep growing faster than the rest of the world. But the tigers are unlikely to return to their heady growth rates of recent years. Nor would that be desirable given the impact on inflation and the environment.

Suppose that net exports contribute nothing to growth, and that domestic demand grows at roughly the same pace as it has in the past five years. Then emerging Asia could see annual growth of almost 7% over the next five years (around 8% in China, a more modest 5% in the smaller economies). That might sound disappointing for economies that enjoyed average growth of 9% in the three years to 2007. But it would still be around three times as fast as in the rich economies. ■

## Stress tests

# Hospital pass

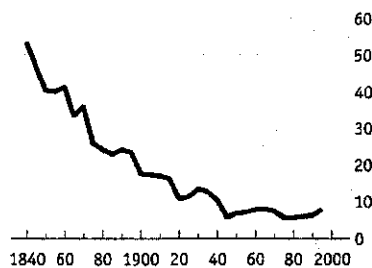
## America's stress tests were too easy

ARE America's banks: a) healthy, b) insolvent, or c) being kept alive by the government but delighted to pretend otherwise? After announcing the results of the stress tests of the 19 biggest lenders on May 7th, officials and bankers invited the world to tick answer a)—though c) looks far more plausible. Ben Bernanke, chairman of the Federal Reserve, said the public and investors should take "considerable comfort". Executives testified to how conservative (read absurdly pessimistic) the tests were and share prices reacted euphorically. For a moment it felt like everyone might start high-fiving and originating subprime mortgages again.

Since the results, six banks have together sold \$19 billion of common stock, going some way to plugging the \$75 billion overall capital gap that the tests identified. Further capital-raising is imminent. Bank of America has the biggest shortfall. It plans

## History is not on the syllabus

US commercial banks' equity as % of assets



Sources: Berger, Herring and Szegö, "The role of capital in financial institutions" (1995); Bank of England

to sell shares worth \$17 billion and on May 12th sold a \$7.3 billion stake in China Construction Bank to mainly Chinese and Singaporean investors. Add in a couple more bumper quarters of earnings, the banks say, and the \$75 billion gap will close. Only GMAC seems at risk of being nationalised. The former financing arm of General Motors is now partly owned by private-equity firms and is terribly thinly capitalised.

That any bank can sell equity is one big benefit of the stress test. By producing a credible estimate of losses over the next two years—\$600 billion—officials have restored some confidence in the banks' word. Many observers believe the economic assumptions being used are a bit too optimistic (although the IMF has come up with a similar number for losses). But investors can now buy a bank's shares and be confident that its books are not being cooked flagrantly and that it is not about to be nationalised. The rally in recent months has helped, as has the commendably clear presentation of the test results.

It is the buffer needed to absorb the projected losses where the tests are lax. The precise definition of core capital used—"tier-one common"—allows banks to take advantage of the recent relaxation of accounting rules. And the tests state that the 19 banks' core capital be at least 4% of risk-weighted assets (this equates to 2.7% of their assets). This is below where the system was at the end of 2008 (5% of risk-weighted assets), below today's European levels (7%), below the IMF's suggested range (6-9%) and below the strongest standards it is feeble (see chart).

Although banks do typically run down capital in a recession, it is clear that they still do not command enough market confidence to borrow at commercially attractive rates. Immediately after the stress-test results, Bank of America and Morgan Stanley issued bonds without state guarantees. If this was meant to be a show of bravado it fell flat; both paid an interest rate of four to five percentage points more than the government. On May 13th JPMorgan Chase, which passed the stress test and is judged

## Bank regulation

# Dilute or die

## Using market signals to gauge a bank's health

AS THE tab for bank bail-outs rises, the notion that a firm can be "too big to fail" has become almost too much to stomach. What is needed is a regulatory regime that disciplines banks without forcing them to the wall in such a way that their demise wrecks the payments system. One way is to make banks hold so much equity, and so little debt, that even huge losses would not lead to insolvency. Debt has its advantages, however. For instance, it can be cheaper than equity finance, thanks to tax breaks.

In new research, Oliver Hart, of Harvard University, and Luigi Zingales, of the University of Chicago, argue that the mix of debt and equity should fluctuate according to the risk of bank failure. Banks should hold less capital in good times and reduce leverage when losses loom. This could be achieved in the absence of an all-wise regulator by using the cost of credit-default swaps (CDS), which insure against default, as a guide to the right capital structure.

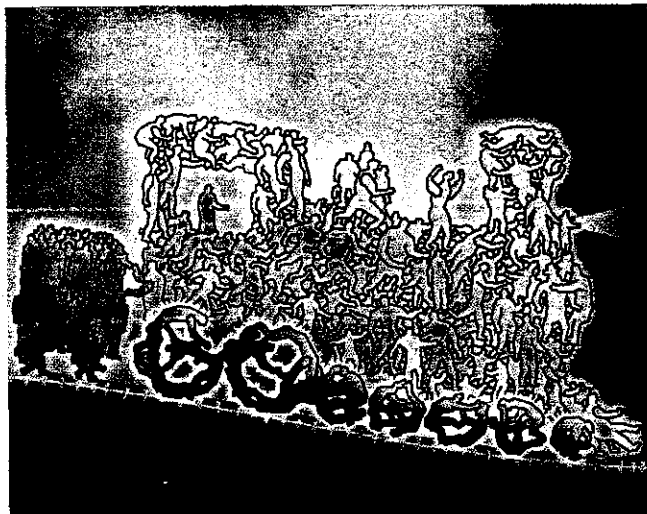
In their scheme, when a bank's CDS price stays above a certain threshold, the regulator forces managers to inject enough equity capital to cushion bondholders against losses. If the bank does not act swiftly to push the CDS price back down, the regulator seizes the assets, wipes out shareholders and sacks the management. The bank is recapitalised as a going concern and later sold. Creditors get some of the proceeds, but would not be made whole.

The appeal of this kind of capital regime is that regulators would be less prone to capture. The market does the monitoring job: CDS prices act as a check on excessively risky business strategies. But banks are opaque outfits and markets prone to panics, so CDS prices could easily be wrong. To counter the risk of a false alarm, the regulator would reserve the right to declare a bank solvent after an audit. That would give lobbyists an opening to sway the outcome, but the process would at least be transparent.

The idea's main strength is that it creates a trigger for action. Banks are forced to raise equity, and regulators to intervene quickly, before trouble spreads. A rule based on CDS prices would have forced earlier interventions in this crisis—though perhaps not early enough. For such a scheme to work, everyone needs to believe that banks would be allowed to fail. The trouble is, who would credit that now?

## Economics focus | Damage assessment

How much will the financial crisis hurt America's economic potential?



**A**MID the hubbub over a few less-bad-than-expected statistics, America's economic debate has turned to the nature of the recovery. Optimists expect a vigorous rebound as confidence returns, pent-up demand is unleashed and massive government stimulus takes effect. Most observers, including this newspaper, are bracing for a long slog, as debt-laden consumers rebuild their savings, output growth remains weak and unemployment continues to rise. There is, however, something that eventually will have a much bigger impact on Americans' prosperity than the slope of the recovery. That is the effect of the crisis on America's potential rate of growth itself.

An economy's long-term speed limit (its "trend" or "potential" rate of growth) is the pace at which GDP can expand without affecting unemployment and, hence, inflation. It is determined by growth in the supply of labour (the number of workers and how long they toil) along with the speed with which productivity improves. The pace of potential growth helps determine the sustainability of everything from public debt to the prices of shares.

Unfortunately, the outlook for America's potential growth rate was darkening long before the financial crisis hit. The IT-induced productivity revolution, which sent potential output soaring at the end of the 1990s, has waned. More important, America's labour supply is growing more slowly as the population ages, the share of women working has levelled off and that of students who work has fallen. Since 1991 the labour supply has risen at an average annual pace of 1.1%. Over the next decade the Congressional Budget Office expects a 0.6% annual increase.

According to Robert Gordon, a productivity guru at Northwestern University, America's trend rate of growth in 2008 was only 2.5%, the lowest rate in its history, and well below the 3-3.5% that many took for granted a few years ago. Without factoring in the financial crisis, Mr Gordon expects potential growth to fall to 2.35% over the coming years.

That alone is grim news. But has the Great Recession made things worse? In theory, it could do. Slumping investment may slow the pace of innovation. Soaring government debt could raise interest rates. Higher taxes, designed to reduce the debt, might dull incentives to work and invest. More regulation, in finance and beyond, could deter innovation. Workers' skills may

atrophy as a result of joblessness. On the plus side, well-targeted government spending on, say, infrastructure or education could boost potential output, while the huge wealth that Americans have lost may induce more of them to work for longer.

History sends mixed signals about how much these effects matter. Surprisingly, the 1930s bode well. Despite the deep slump in growth and investment, America's potential growth rate is reckoned to have risen smartly during the decade, as innovations from nylon to synthetic rubber proliferated, while business processes were fundamentally overhauled. Alexander Field, an economist at Santa Clara University, has called the 1930s the "most technologically progressive" decade of the 20th century.

In the modern era Sweden offers grounds for optimism. Its productivity growth accelerated after the early 1990s financial crash, in part because the government dealt swiftly with the banking mess. Japan, in contrast, saw productivity growth shrivel in the early 1990s. Several studies pin blame for that on Japan's unwillingness to tackle its banking mess. But the process was not irreversible; Adam Posen of the Peterson Institute has argued that by the late 1990s Japan's potential output had risen modestly, thanks to financial reform and broader deregulation. Nor is there much sign that Japan's gaping budget deficits have crowded out private investment. Yields on long-term Japanese bonds slumped from 7% in 1990 to 1% in 2003, and are still only 1.45%, even as gross public debt is heading for 200% of GDP.

Is this cause for optimism about America? Possibly not. Compared with the 1930s, America's workers are more specialised, which makes it harder to shift occupation; they are also more cushioned with social protection, which reduces the urgency to adapt. Workers are less flexible because the housing bust will prevent many from selling their houses to move to where the jobs are. JPMorgan estimates that America's natural rate of joblessness may have risen from 4.75% to closer to 6%.

Today's investment slump may have particularly pernicious effects on productivity because, unlike Japan's, it does not follow a capital-spending binge. During the recent bubble years, America's housing investment boomed, but corporate investment was laid low by the dotcom bust.

### Debt burden

Most important, even if Americans become thriftier, soaring public debt may crowd out private investment more than in Japan, which, unlike America, is a creditor country. Already American bond yields are starting to rise. Academics differ about just how much bigger budget deficits and higher public debt affect interest rates, but most agree that they do. A 2004 study suggests that interest rates rise by 0.03% for every 1% increase in the debt/GDP ratio. That ratio is set to rise by 30 percentage points between 2008 and 2011, which implies a 1% higher risk-free interest rate, and commensurately lower private-sector investment. Even if higher private saving blunts the effect, some crowding out is eventually all too likely.

All of these effects can be mitigated by good policies, or exacerbated by bad ones. Sensible approaches to reducing America's long-term deficit, by tackling entitlement spending or reforming the tax code, would minimise the rise in long-term yields and might even boost potential growth. Misguided efforts to prop up declining industries or dictate lending decisions would add to the damage. America is heading for an era of slower growth. Just how much slower is still up for grabs. ■



Emerging economies

## Decoupling 2.0

The biggest emerging economies will recover faster than America



**R**EMEMBER the debate about decoupling? A year ago, many commentators—including this newspaper—argued that emerging economies had become more resilient to an American recession, thanks to their strong domestic markets and prudent macroeconomic policies. Naysayers claimed America's weakness would fella the emerging world. Over the past six months the global slump seemed to prove the sceptics right. Emerging economies reeled and decoupling was ridiculed.

Yet perhaps the idea was dismissed too soon. Even if America's output remains weak, there are signs that some of the larger emerging economies could see a decent rebound. China is exhibit A of this new decoupling: its economy began to accelerate again in the first four months of this year. Fixed investment is growing at its fastest pace since 2006 and consumption is holding up well. Despite debate over the accuracy of China's GDP figures (see page 72), most economists agree that output will grow faster than seemed plausible only a few months ago. Growth this year could be close to 8%. Such optimism has fuelled commodity prices which have, in turn, brightened the outlook for Brazil and other commodity exporters.

That said, even the best performing countries will grow more slowly than they did between 2004 and 2007. Nor will the resilience be universal: eastern Europe's indebted economies will suffer as global banks cut back, and emerging economies intertwined with America, such as Mexico, will continue to be hit hard. So will smaller, more trade-dependent countries. Decoupling 2.0 is a narrower phenomenon, confined to a few of the biggest, and least indebted, emerging economies.

It is based on two under-appreciated facts: the biggest emerging economies are less dependent on American spend-

ing than commonly believed; and they have proven more able and willing to respond to economic weakness than many feared. Economies such as China or Brazil were walloped late last year not only, or even mainly, because American demand plunged. (Over half of China's exports go to other emerging economies, and China recently overtook the United States as Brazil's biggest export market.) They were hit hard by the near-collapse of global credit markets and the dramatic destocking by shell-shocked firms. In addition, many emerging countries had been aggressively tightening monetary policy to fight inflation just before these shocks hit. The result was that domestic demand slumped even as exports fell.

### Not such a bad idea after all

But the global shocks are now abating. Firms cannot slash stocks for ever. And as investors' panic recedes, so credit markets are beginning to function. This will not be enough to spur a vibrant recovery in America, where households must painfully rebuild their balance-sheets. But it removes a drag on big emerging economies—all the more so because their governments have dramatically loosened the fiscal and monetary reins. China's stimulus is the most spectacular, but Brazil has also been able to cut interest rates and boost spending.

Government activism helps explain why the creditworthy big emerging economies can recover more quickly. But it cannot create long-term resilience. China's rebound will only be sustained if the economy shifts further from state-sponsored investment to private consumption. That will require tough structural changes, from forcing state-owned firms to pay fatter dividends to a stronger social safety net. Other countries, notably India, must calibrate their government finances even more carefully (see previous leader). The idea of decoupling lives on, but that does not mean sustained prosperity in the big emerging economies is a foregone conclusion. ■

Climate change and Congress

## Weak medicine

Compromise has enfeebled America's cap-and-trade bill. A carbon tax would be better



**F**OR those who believe that climate change is a serious problem, the decisions that America makes now are of momentous importance. In Copenhagen in December, the world will decide whether to reinvigorate or abandon its effort to avert serious climate change, and what America does between now and then will in large part determine the outcome. So the fact that Barack Obama clearly intends to turn America from being a laggard into a leader in this task is therefore encouraging.

Good intentions, however, are not enough. Moves in Wash-

ington over the past week have indicated the shape of America's policy. And although impressively far-sighted by the standards of the Bush era, it looks disappointing when measured alongside what is probably needed to insure against the real-though-hard-to-quantify threat of serious climate change.

### A price that pinches

"Oil lost and coal won," was an insider's verdict on the two big developments in Washington this week (see page 33). The oil industry got hit by the administration's decision to tighten vehicle fuel-efficiency standards. Though hardly punishing by international measures—China has already adopted similar targets—the new rules will at least bring America within hail-»

## Banyan | May the good China preserve us

China is enjoying its new prestige as a global economic helmsman, but it still has problems at home



THE sense that someone else's loss is your gain, leading even to rejoicing at their disaster—*xing zai le huo*—is as hard-wired into the Chinese psyche as anywhere. Honed by American policymakers' past fondness for hectoring China about the need for better risk-management and exchange-rate flexibility, this emotion has come to the fore since the United States was overtaken by financial calamity. China's leaders are at pains to show their increasing sophistication, so public dancing around the corpse of the American financier is frowned upon. But many Chinese think their country is having a rather good crisis.

The realisation first reached a wider Chinese audience in early April, at the time of the G20 summit in London. There, President Hu Jintao was seated in the front row of the official photograph, next to Britain's prime minister, Gordon Brown. Among the country's elites, triumphalism found its clearest expression later in April at an ebullient Bo'ao forum, China's annual answer to Davos. There, one high official dismissed the G20, dominated by Western powers, as all hat and no cattle. Talk of a "new world order" was in the air, with China at its heart.

So much for Deng Xiaoping's dictum that China should keep a low profile and "never take the lead". The international financial crisis has become a kind of induction ceremony for China as a world power, which will go through another ritual when Timothy Geithner, America's treasury secretary, pays tribute in Beijing next month. Zbigniew Brzezinski, ex-President Jimmy Carter's national security adviser, has proposed a new "G2", where America and China get together to tackle the financial crisis, climate change and more. China has plenty of reasons not to want such a condominium, but is chuffed that Americans are talking about it. Nor does it mind if others believe it is happening anyway. Late last year China pulled out of its annual summit with the European Union because France's president, Nicolas Sarkozy, was to meet the Dalai Lama. It agreed to renew high-level relations with the EU only after France grovelled. So this week China's prime minister, Wen Jiabao, travelled to Prague for a reconvened EU summit, with an agenda gutted of anything that might embarrass China. Just before it, David Miliband, Britain's foreign secretary, spoke to the *Guardian*, a British daily, with something of the fervour of a miracle-watcher. China was an "indispensable

power". At the G20 in April, "what was striking was that when China spoke, everybody listened." And he quoted a joke: "After 1989 capitalism saved China. After 2009 China saved capitalism."

China has been doing its bit to act the part. It has blessed the IMF with a promise of \$40 billion of its money. It has been signing up "swap" agreements with central banks from Indonesia's to Argentina's giving them access to billions of dollars-worth of Chinese yuan in a crisis. It has encouraged experiments with an inchoate offshore market in yuan in Hong Kong. And its central-bank governor has talked loftily of the need to replace the dollar as the world's reserve currency with something like the IMF's Special Drawing Rights (SDRs).

So far, however, all this smacks of political posturing. Since most Chinese exporters invoice in dollars it is hard to see who would want all those yuan anyway. China seems in no hurry to move towards full convertibility of the yuan and greater exchange-rate flexibility. And the talk of ditching the dollar comes oddly from a country that has done little to diversify its own massive holdings of foreign exchange. Raising the issue when it did seemed more designed to make a splash and change the subject at the G20 away from anything that might embarrass China.

In public, most Chinese leaders scoff at the idea that their own policies might have contributed to the crisis. They blame over-indebted American consumers going on an unsustainable binge, leading to a gaping American trade deficit. Yet the counterpart is an unsustainable Chinese export drive, to America above all, that was built on a cheap currency. The dollars earned from the drive went flooding back to America, pushing down interest rates there, raising house prices and encouraging Americans to borrow even more to buy Chinese stuff. As Nicholas Lardy, an American economist specialising in China, has put it, the two countries were as co-dependent as a dope-dealer and an addict.

### Restoking the old fires

Now, with the American consumer laid up indefinitely, the world has turned to China to take up the slack. A country with so many factories geared to exports has its own reasons for wanting to boost domestic demand. So the government acted swiftly late last year to unveil a \$586 billion spending package. A notable economist says it sets the fiscal-stimulus "gold standard".

It does, however, bring some problems. For one thing, some of the money is being spent subsidising Chinese exports. This worsens the overproduction at the heart of the crisis. And much of the rest is going on state-driven projects, reinforcing the state's rent-seeking or megalomaniac proclivities. By contrast, household demand is not getting any real long-term boost, despite a few notable initiatives, including better health care. Indeed, demand is depressed precisely because household savings are being funnelled by the state banks, paying measly rates of return on deposits, to big companies. Loans to small businesses have actually fallen.

If domestic demand is to grow, then finance has to be liberalised to allow savers to earn an honest return and deserving companies to get finance. But this would be to challenge the state's chief powers, which is why it will happen only slowly, if at all. In the short run, the government may either tolerate the speculative fires the stimulus is igniting, or douse them by tightening credit. Either way, China's leaders will be too busy saving China to bother about running the world. ■



## Bust and boom

**The precipitous fall in oil prices over the past year may just be paving the way for another spike**

**R**ISING oil prices, believes Ali al-Naimi, Saudi Arabia's oil minister, may soon "take the wheels off an already derailed world economy". His Iranian counterpart agrees: "When the global economic crisis comes to an end, and the demand for oil picks up, the oil market could experience another price shock," he says. The boss of Chevron, America's second-biggest oil firm, also worries that "another period of tight supply" is at hand. Britain's energy minister is fearful too. Indeed, at a recent summit of oil grandees convened by the Organisation of the Petroleum Exporting Countries (OPEC) it was hard to find anyone who did not expect a price rise to rival the giddy leap to \$147 a barrel last year.

On the face of things, this concern is absurd. The plunge of \$15 in the price of oil from its peak last July to its nadir in December was the most precipitous the world has ever seen. Demand for oil is still falling, as the world economy atrophies. The International Energy Agency (IEA), an intergovernmental body which advises rich countries, thinks that global oil consumption will fall by 2.6m barrels a day (b/d) this year, or about 3%. That follows a fall of 200,000 b/d last year. World demand has

not shrunk for two years running since the early 1980s.

In recent weeks America's oil inventories have been higher than ever at this time of year, and higher than at any point save September 1990, in the run-up to the first Gulf war. There is little room left to store any more crude, says Jeff Currie of Goldman Sachs. Rumours abound of traders hiring tankers to store their excess oil. Rich countries' stocks cover 62 days' consumption, the most since 1993 (see chart 1 on the next page). The average over the past five years has been 52 days' worth.

### Slack in the system

Meanwhile, oil firms are not pumping nearly as much as they could. OPEC has announced three separate rounds of production cuts since September in a bid to steady prices. In all, it has vowed to trim its output by 4.2m b/d. Analysts reckon its normally ill-disciplined members are indeed pumping some 3.3m b/d less. That leaves them with as much as 6m b/d of spare capacity to bring back into use should demand pick up. Saudi Arabia alone says it could pump 4.5m b/d more than it is now.

Despite this growing glut, however, the price of oil has been rising steadily in recent weeks (see chart 2). On May 20th it closed above \$60 a barrel for the first time in more than six months. That marks an increase of more than 75% since February 12th, when it sank below \$34—the fourth-biggest three-month rise on record, according to Mr Currie. The price of futures contracts suggests that energy traders see the price rising higher still in the coming months and years.

The explanation is simple. Oilmen are worried because they believe that many of the factors behind the record-breaking ascent last year remain in place. Much of the world's "easy" oil has already been extracted, or is in the hands of nationalist governments that will not allow foreigners to exploit it. That leaves firms to hunt for new reserves in ever more inhospitable and inaccessible places, such as the deep waters off Africa or the frozen oceans of the Arctic. Such fields take a long time and a lot of expensive technology to develop. Worse, new discoveries tend to be smaller than in the past and to run dry faster.

So oil firms must work doubly hard to replace declining fields and to increase output. As Francisco Blanch of Merrill Lynch puts it, they must find another Saudi Arabia's worth of oil every two years just to maintain their production at today's levels. Yet the oil industry is short of equipment and manpower, thanks to decades of underinvestment in the 1980s and 1990s, when prices were low. That left it struggling to expand despite the strong price sig- ➤

nal of recent years, and thus poorly positioned to cater to vast new markets in the developing world, including China and India, where oil consumption has been growing fast. At the height of the boom, with the price repeatedly setting records, production outside OPEC even fell.

As soon as the world economy starts growing again, the theory runs, demand for oil will once again outstrip the industry's ability to supply it. The seemingly ample cushion of inventories and spare capacity will quickly be exhausted, sending prices soaring. In other words, the global recession has only interrupted the "supercycle" of which many analysts used to speak, during which the normal boom-and-bust cycle of oil and other commodities would give way to a protracted period of high prices, as ever-growing demand from emerging markets swallowed everything the extractive industries could produce. "The commodity supercycle is not over, just resting," says Mr Blanch.

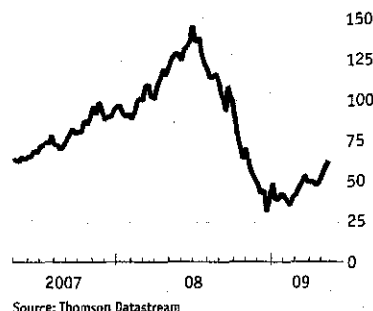
#### Clear diagnosis, missing remedy

Oil bosses, OPEC ministers and anxious bankers all agree on what is needed to prevent this scenario becoming reality: lavish investment in the development of new fields and in exploration. Yet the reverse is happening. The oil industry is cutting its spending, bringing fewer new fields into production and exploring less. The IEA reckons that overall investment will drop by 15-20% this year.

The number of drilling rigs in use around the world fell by 32% in the year to April to 2,055, according to Baker Hughes, an oilfield-services firm. In America, where there is a glut of natural gas as well as oil, the number of rigs in use has fallen by over half since its peak last year. OPEC countries, says Abdalla Salem el-Badri, the organisation's secretary-general, are cancelling or delaying 35 big projects. Cambridge Energy Research Associates, a firm of consultants, reckons that 5.5m b/d of additions to capacity will fall by the wayside around the world in the next few years. That amounts to a third of the projected net increase in output by 2014.

#### Not dead, but resting

Oil price, West Texas Intermediate, \$ per barrel



In theory, this should not be happening. Big Western oil firms ("majors" in the industry jargon) claim that they continue to invest steadily throughout the cycle, irrespective of gyrations in price. Big fields, they argue, can take a decade or more to develop, and may then produce oil or gas for several decades more. The price of oil at the time the investment is approved is irrelevant; the important thing is to make sure projects will be profitable across a range of possible future prices. If anything, given that most oilmen expect prices to rise in the medium term, you would expect them to be increasing their investment, to capitalise on the good times to come.

For the most part, the majors are sticking to their strategy. They have all, by and large, continued to invest on a scale similar to that of previous years, despite the huge dent made in their revenues by lower oil prices. Exxon Mobil, the biggest, increased its capital spending by 5% in the first quarter. Royal Dutch Shell and Chevron plan to invest as much this year as they did last: \$31 billion and \$23 billion respectively. BP plans a slight cut, from \$21 billion to less than \$20 billion. But BP, like Shell, is taking on more debt in order to preserve both its dividend and its investment plans.

Nonetheless, the extreme volatility of prices over the past year must have made big oil firms more cautious about future investments. Shell, for example, has delayed its expansion plans in Canada's tar sands, a particularly viscous form of oil that requires lots of processing and is therefore less profitable than the conventional sort. Both it and BP are cutting staff. And shareholders will presumably countenance only a certain amount of borrowing before they get cold feet.

Smaller oil companies, meanwhile, do not have nearly the same financial muscle, and so cannot maintain spending at last year's rate. All America's big "independent" firms, meaning those without refining arms, have cut their investments sharply. One, Devon Energy, plans to reduce its capital budget to \$4 billion or so this year from \$9 billion in 2008. The smaller independents, says Ayman Asfari, the boss of

Petrofac, a British-based oilfield-services firm, "have been decimated". On London's Alternative Investment Market, a magnet for speculative ventures in natural resources, oil firms managed to raise just £23.6m (\$37m) in the final quarter of last year, compared with £229m in the previous quarter.

A handful of independents, such as Premier Oil, a British company that recently completed a successful rights issue, have sound enough finances to increase their spending. But Premier's boss, Simon Lockett, says it will focus more on completing existing projects and less on exploration. That certainly seems to be the pattern in the North Sea, at least. In the first quarter oil firms drilled the same number of wells to delineate past discoveries as they had a year before, according to Deloitte, an accounting firm. But the number of exploration wells plunged by 78%.

Then there are the state-owned firms in oil-soaked countries. These companies control the overwhelming majority of the world's oil. The better managed and funded of them plan to continue investing despite the downturn. Saudi Aramco, the world's biggest oil producer, recently completed a five-year scheme to expand its production capacity from 10m b/d to 12.5m b/d, at a cost of \$70 billion. Over the next five years it is setting aside more than \$60 billion for further investments. But it is naturally reluctant to continue to develop new fields when it already has 4.5m b/d of capacity sitting idle.

Petrobras, in which the Brazilian government owns a controlling stake, plans to increase its investment by 55% to \$174 billion over the next five years. Its recent offshore discoveries are thought to be among the biggest oilfields ever found. But they lie far underground, below deep waters and a thick, drill-foiling layer of salt. No one yet knows how expensive it will be to develop them or how long it will take, but the huge scale of the investment programme suggests their oil will not come cheap.

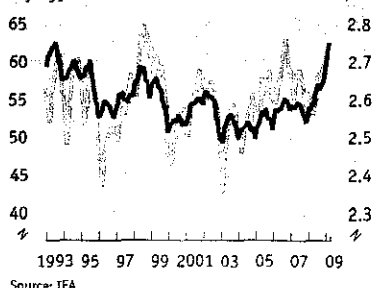
Moreover, most state-owned firms do not have nearly as much money to spend. In Russia, the world's second-biggest oil producer, output is falling largely because private capital has been scared off by a series of expropriations, while the state starves the firms it controls of sufficient cash for investment. By the same token, Venezuela's national oil company is so short of money that it has not been paying the oilfield-services firms it uses as subcontractors. When some of them refused to continue working until they had been paid, the government seized their assets.

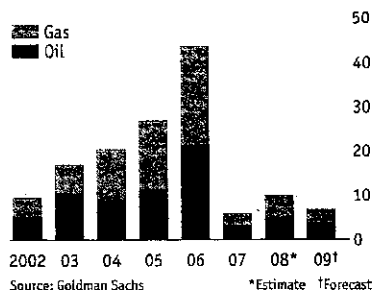
And most oil-rich states, naturally enough, are happy to see the price rise. Many have become used to bumper revenues in recent years and have struggled to balance their budgets since the price slumped last year. Saudi Arabia's king has

#### Overflowing

OECD total oil stocks

Days of forward demand cover



**Drying up**Oil and gas projects approved  
Million barrels of oil equivalent, reserves

► indicated that he thinks \$75 a barrel would be fair. Iran and Venezuela are much more hawkish. They are unlikely to invest heavily in order to reduce prices.

Similarly, countries that had raised taxes on oil when prices were high, such as Britain and Russia, are now particularly reluctant to reduce their take yet further by lowering them again. Yet their high marginal tax rates are helping to deter investment in new production capacity.

**Slow service**

Among the first to suffer the consequences of all this are oilfield-services firms. Their predicament gives a sense of the slowdown in the industry. Schlumberger, the biggest, cut its planned investment by 13% this year to \$2.6 billion after its profits fell by 30% in the first quarter. It has shed 5,000 jobs this year and plans to eliminate more. Baker Hughes, a rival, has got rid of 3,000. Clients, says Petrofac's Mr Asfari, are trying to secure big reductions in prices.

Falling investment does not simply crimp exploration and delay large projects. It can also lead to lower spending on maintenance and thus prompt faster declines in output. The IEA estimates that the output from mature fields outside OPEC would naturally drop by about 11% a year. But through tricks such as injecting water or gas to maintain pressure, oil firms manage to reduce the rate of decline to 7.7%. Lower investment this year, the IEA calculates, is likely to push the rate up to 9.4%. That will reduce world oil output by 10,000 b/d this year, by a further 250,000 b/d next year and, through compounding, by increasing amounts thereafter. Merrill Lynch, meanwhile, thinks the IEA underestimates the likely rate of decline.

Falling costs within the industry will offset the impact of falling investment budgets to some extent. BP argues its slight cut in investment does not really represent a reduction, thanks to deflation. Some prices are plunging: renting a drilling rig in South-East Asia cost \$225,000 a day last year but only \$160,000 a day in April, according to Mr Lockett of Premier Oil.

Yet many constraints on expansion re-

main. For one thing, the world still does not have as many experienced petroleum engineers and geologists as it needs, says Iain Manson of Korn/Ferry, a recruiting firm. He expects it to take a decade or more to overcome the shortage. Meanwhile, he says, wages in the oil industry are not falling by nearly as much as other costs.

Worse, there is little sign that governments are willing to grant oil companies easier access to the most promising territory for exploration. Iraq's plans to sign big new contracts with foreign firms are years behind schedule, as is its new oil law. American sanctions continue to impede investment in Iran. The Mexican government did recently broaden the scope for Pemex, the state-owned oil monopoly, to hire foreign contractors. But it abandoned more sweeping plans to allow private investment in exploration and production in the face of strong political opposition. The Nigerian government has been unable to quell the insurgency in the Niger delta, making it difficult for oil firms to operate there. Even in America, despite years of debate, most coastal waters and much of Alaska remain off-limits to drilling.

In short, argues Mr Currie of Goldman Sachs, "above ground" problems such as limited access and rising costs have not gone away, and will continue to limit the growth of the world's oil supply. He points out that even when prices were high, these constraints limited the volume of new projects approved by oil firms (see chart 3). Falling investment will simply compound the shortfall. So when demand begins to revive, a sharp rise in prices is inevitable.

That does not mean that a price spike is just around the corner, however. The speed with which it arrives will depend on the strength of the global recovery. If oil firms run out of storage capacity before demand begins to pick up, says Mr Currie,

prices could yet swoon again.

For the moment, global consumption of oil continues to fall, despite the slight brightening of the economic outlook. The latest figures suggest that China's thirst is increasing again. Imports are nearing pre-crisis levels and sales of new cars hit a new record in April. But that will not be enough to reduce global inventories, given that the drop in demand from the rich world is greater than China's total imports.

Ed Morse, of LCM Commodities, a broking firm, points out that after previous price shocks, growth in demand has not usually reverted to previous rates, thanks to efficiency measures taken when prices were high. Moreover, technological advances are allowing oil firms to tap new sorts of resources, including gas trapped in seams of coal and shale, and "sub-salt" oil fields, which are likely to be found off the coast of Angola as well as Brazil.

Furthermore, governments could do various things to dampen the impending rise in prices, argues McKinsey, a consultancy which is also predicting an oil-supply crunch in the next few years. One simple measure would be to allow trucks to pull longer trailers, thereby increasing fuel efficiency. Rich countries could also increase fuel supplies by removing tariffs on imported ethanol, the company argues. Persuading developing countries to drop fuel subsidies would make a big difference. In the longer run, ever more stringent restrictions on carbon emissions and ever higher efficiency standards for vehicles around the world will presumably help crimp demand for oil.

At the OPEC powwow Mr al-Naimi, the Saudi oil minister, argued that a low oil price always sowed the seeds of a future price rise, since it led to underinvestment. The only question this time is how quickly the strain will emerge. ■



Where are we heading this time?

process still required it to raise more capital. BNP's tortuous capture of Fortis gives it the euro area's biggest deposit-taking franchise. But the dealmaking baubles go to Barclays for its cut-price acquisition of Lehman's North American business; to JPMorgan Chase for its swoops on Bear Stearns and Washington Mutual; and to Santander for emerging from the ABN AMRO transaction, which killed off RBS and Fortis, with a big presence in Brazil at a fair price.

However the pack is shuffled, a few names keep resurfacing—in America, Goldman Sachs and JPMorgan Chase; and in Europe, Credit Suisse, Deutsche, BNP,

Barclays and Santander. They can be whitened further. In Europe, concerns over what lies on the balance-sheets of Deutsche and Barclays are ebbing but are not gone. The British bank's willingness to consider a sale of BGI, its asset-management arm, suggests worries over capital. Both banks still have lots of legacy assets, many of them tucked in the banking book.

Santander should rightfully take its bow alongside its regulators, who closed off the capital benefits of building up big off-balance-sheet positions and required Spanish banks to put aside provisions during the upswing. BNP has played its hand

very well, but its business mix (a stable home market and a focus on equity derivatives) helped massively by keeping it away from the worst blow-ups.

In America, Goldman still has legions of admirers. It has posted losses of less than \$3 billion to date, a performance not nearly as bad as those of its direct peers. Its focus on risk management is a template for others to follow. But its renewed swagger should not conceal the fact that it needed to convert into a bank-holding company in order to survive the market storm—nor the questions that hang over its future earnings in a re-regulated industry. ▶▶

## Buttonwood

The feedback loops that sustained the bull market can work in reverse to devastating effect

**B**ULL markets are about more than just rising prices. They create their own momentum, not to mention their own intellectual rationale (remember the "new era" talk of the late 1990s). When bull markets stop, those effects tend very quickly to go into reverse. The greater the excesses of the boom, the longer and deeper the reaction is likely to be.

The best known of these feedback loops is the use of borrowed money to buy assets. Rising prices make banks more willing to lend, creating more demand for the assets in question, pushing up prices even further and thereby appearing to ratify the original lending decisions of the banks. When markets fall this leverage works the other way, as could be seen when investors offloaded assets at fire-sale prices last year.

There are many other positive-feedback processes. Take share buy-backs, for instance. Companies used their cash (or borrowed money) to reduce their share capital. Markets might have treated this as evidence of a lack of imagination, or a paucity of profitable projects. Instead, they saw it as evidence that the managers were focusing on "shareholder value" and boosting earnings per share, however ephemeral that might have been.

By shrinking the supply of shares in the market, the buy-back splurge played its own part in prolonging the bull market. In America, Smithers & Co, a consultancy, says that net corporate buying of shares peaked at an annualised rate of around \$1 trillion in late 2007. Companies were buying far more of their own shares than anyone else did. But the buying spree was unsustainable. Smithers calculates that American-owned companies were paying out some 70% of their profits at the peak, if you include dividends and buy-backs. They have since slashed divi-



dends and will have to start issuing shares as well. Instead of borrowing money to pay back shareholders, companies now need to raise equity to pay back creditors.

The shift in the supply-demand balance is not confined to America. European companies have already raised a total of €56 billion (\$76 billion) in rights issues this year, according to dealReporter, an information service. Robert Buckland, a strategist at Citigroup, says that British equity supply was shrinking at 4% per annum in early 2008, and is now growing by a similar amount. That is all down to financial companies, which have had to raise capital to repair their balance-sheets; net issuance from the rest of the market is basically flat.

The recent stockmarket rally has undoubtedly helped companies successfully issue shares. But it will also tempt more businesses to sell equities, putting a potential cap on the rally. As Mr Buckland puts it: "Equity issuance soaks up money that might otherwise have been used to drive the market higher."

Another positive-feedback loop in bull markets used to be the final-salary pension fund. As share prices rose, pension

schemes would move into surplus, allowing sponsoring companies to enjoy contribution holidays. That boosted both their cashflow and their profits, giving a further uplift to share prices. American companies could include an "expected return" from pension assets in their income statements, a return that drifted higher over the life of the bull market.

But a dismal decade for equities and low bond yields have now sent many companies into deficit. In Britain, under the fairly conservative assumptions used by the Pension Protection Fund, private-sector schemes had a deficit of £88 billion (\$277 billion) in April. Having an exposure to a final-salary pension scheme is now a drag on a company's share price, not a boon. BT, for example, is almost having to double its annual pensions contribution to £525m, a move that helped prompt a 59% decline in the British telecoms giant's annual dividend.

Tax and regulation also work in a buoyant market's favour. Booms tend to bolster tax revenues and make the government appreciate the virtues of the finance industry; cities compete to attract banks and asset managers by offering tax advantages and minimal regulation. When the bust comes, taxes rise and regulations are tightened. Activity slows and investment is discouraged.

All these effects can take many years to gain momentum, and help explain why bull markets can last much longer than observers expect. By the same token, however, when these processes go into reverse, they can also be self-perpetuating. And that is why there will have to be a lot more evidence than a couple of months of rising share prices before one can say that a new bull market is under way.



▶ That leaves Credit Suisse and JPMorgan Chase to take the grand prizes. Credit Suisse has had its share of mishaps during the crisis but it was quick to scale down its balance-sheet, has plotted a credible strategy for its investment bank and pulled well ahead of UBS, its main rival in wealth management. As for JPMorgan Chase, it has kept a tight rein on risk, managed capital well and acquired sensibly. None of this is much comfort for weary Swiss and American taxpayers, of course. Well-run or not, both banks present the problem of being far too important to fail. And that's to say nothing of the curse of awards. ■

#### Japan's woeful GDP figures

## That kitchen-sinking feeling

TOKYO

At least things can't get much worse

WHEN companies want to emphasise a turnaround in their prospects they paint the past in a dark light so that the future can only appear brighter. Japan's first-quarter GDP figures also look as though all the bad stuff has been thrown in—except, perhaps, the kitchen sink.

The data, showing a 4% contraction of GDP on a quarterly basis, and a 15.2% annualised slump, reflect a continuation of Japan's worst economic performance since the second world war. Not only were the first-quarter figures bad. The previous quarter's horrendous fall was itself revised downward by more than two percentage points, to an annualised 14.4%.

The collapse of exports was the economy's Achilles heel in the fourth quarter, and exports continued to slide, down 26% in the first quarter compared with the previous three months. But it was the domestic repercussions of this decline that took the biggest toll on GDP in the first quarter. As companies jammed the brakes on expansion plans, capital expenditure fell 10.4%. Amid widespread lay-offs and consumer unease, household spending slid 11%. Destocking acted as a further drag, though inventories have further to fall, which does not bode well for the future.

Markets responded with a shrug, however, partly because there are glimmers of a turnaround. Figures on May 19th revealed that industrial production in March rose by 1.6% from a month earlier. Consumer spirits have also improved. The consumer-confidence index jumped to 32.4 in April, having increased every month since December's trough of 26.2. Many economists believe the April-June quarter may produce a small recovery which could gain momentum in the second half of the year.

However, the factors supporting it are temporary in nature, and it is far too soon to say that Japan is fully on the mend.

The first pillar of support is government fiscal stimulus, which could amount to about 5% of GDP this year. This may look particularly impressive in the second quarter after a negligible contribution to growth from government spending in the first three months of the year. But it will be short-lived. The second pillar is more technical: as depleted inventories are eventually restocked, production will rise, even if there are few end-buyers for the goods. Exports to China, where the economy may expand by 8% this year (see Economics focus), will provide a fillip.

The trouble is, if the world economy does not rebound strongly it is hard to see where the final demand will come from to stimulate production, exports and investment on a more sustainable basis. Moreover, wholesale prices fell 3.8% in April from a year earlier, their fastest decline in almost 22 years. The risk of deflation is exacerbated by rising unemployment and falling incomes because of less overtime and a huge cut in summer bonuses.

What will drive Japan's long-term economic growth—not least as the population shrinks and ages—is even more uncertain. But in the immediate future, there are enough green shoots to sustain some hopes of a rebound. It is just that, as with rice, they start off underwater. ■

#### Credit cards in America

## Knocked off balance

NEW YORK

A once-glittering business loses its shine

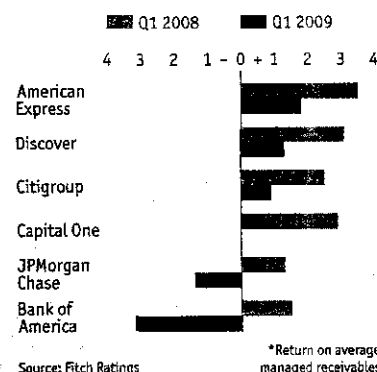
CREDIT-CARD borrowers who roll over a portion of their balance each month are known as revolvers. These days lenders are in a spin as they struggle to cope with write-offs, a regulatory crackdown and changes in consumer behaviour.

On May 18th American Express, a credit- and charge-card giant, announced a second round of job cuts (bringing the total to 11,000), slashed its marketing and business-development budgets and offered a "very cautious" outlook. A few days earlier Advanta, a provider of cards to small businesses, froze all existing accounts after charge-offs (uncollectable debt) reached a dizzying 20%. The shutdown sent a shiver through the market for bonds backed by credit-card debt, which is only now starting to recover from the ravaging securitised assets took last year.

The rise in unemployment—which card defaults track and may now be exceeding,

#### Maxed out

Credit-card return on assets\*, %



given the recession's severity—has splattered a once-profitable business with red ink (see chart). David Robertson of the Nilsson Report, a newsletter, expects card write-offs in America to hit \$94 billion this year, up from \$61 billion in 2008.

As hopes that credit cards would avoid the pain felt in mortgages have dwindled, so has any chance of the industry avoiding a political backlash. This week both houses of Congress voted through a bill that would sharply curtail card issuers' ability to charge punitive fees and raise interest rates. Barack Obama, who has railed against card issuers' "anytime, any-reason rate hikes", was expected to sign it into law after *The Economist* went to press.

Edward Yingling, head of the American Bankers Association, huffed that the bill "fundamentally changes the entire business model of credit cards by restricting the ability to price credit for risk." Some banks will react by reintroducing annual fees that they cut as they jostled for business during the boom, predicts Dennis Moroney of Tower Group, a consultancy.

The industry's claim that the bill will choke off access to credit is a bit rich given its own rush to reduce its unsecured lending. The three largest card issuers—Citigroup, JPMorgan Chase and Bank of America—withdrew credit lines worth \$320 billion in the first quarter alone. By the end of 2010, the industry will have cut a staggering \$2.7 trillion, forecasts Meredith Whitney, an analyst, triggering an "unprecedented liquidity crunch" that could tip creditworthy consumers into distress.

Card firms face further headwinds. One is the rise of the debit card, which takes payment directly from the customer's current account and is less lucrative for banks than credit, because transaction fees are lower and there is no opportunity to earn interest. This year, for the first time, debit- and prepaid-card spending in America on Visa is expected to overtake purchases on its credit cards (like MasterCard, Visa is a network that processes cards on behalf of banks). Much is spending that ▶▶

## Economics focus | The art of Chinese massage

### Is China overstating its true rate of growth?

PART of the recent optimism in world markets rests on the belief that China's fiscal-stimulus package is boosting its economy and that GDP growth could come close to the government's target of 8% this year. Some economists, however, suspect that the figures overstate the economy's true growth rate and that Beijing would report 8% regardless of the truth. Is China cheating?

Economists have long doubted the credibility of Chinese data and it is widely accepted that GDP growth was overstated during the previous two downturns. In 1998-99, during the Asian financial crisis, China's GDP grew by an average of 7.7%, according to official figures. However, using alternative measures of activity, such as energy production, air travel and imports, Thomas Rawski of the University of Pittsburgh calculated that the growth rate was at best 2%. Other economists reckon that Mr Rawski was too pessimistic. Arthur Kroeber of Dragonomics, a research firm in Beijing, estimates GDP growth was around 5% in 1998-99, for example. The left-hand chart, plotting the official growth-rate against estimates by Dragonomics, clearly suggests that some massaging of the government statistics may have gone on. The biggest adjustment seems to have been made in 1989, the year of political protests in Tiananmen Square. Officially, GDP grew by over 4%; Dragonomics reckons it actually declined by 1.5%.

China's growth in the first quarter of this year has led some to conclude that the government is up to the same old tricks. According to official figures, GDP was 6.1% higher than a year earlier. Yet electricity production in the first quarter was 4% lower than it had been a year earlier; in comparison, production grew by 16% in the year to the first quarter of 2008. In the past, GDP and electricity output have moved broadly together, although it is not a one-to-one relationship (see right-hand chart). But the gap between the two lines is now wider than it has ever been. Given that power statistics are less likely to have been tampered with than politically sensitive GDP figures, is this evidence that the latter have been fiddled?

Probably not. Paul Cavey, an economist at Macquarie Securities, argues that the discrepancy is explained by the fact that energy-guzzling heavy industries, such as steel and aluminium, bore the brunt of the slowdown last year. Mr Cavey calculates that the metals industry accounted for 40% of the growth in electricity consumption in 2001-07, but only 16% of the increase in industrial production. Steel output fell by more than 10% in the year to the fourth quarter, so it is hardly surprising that energy use dropped.

Distrust of the GDP numbers has prompted Capital Economics, a research firm based in London, to create its own proxy of economic activity, which includes electricity output, domestic freight volumes, cargo traffic at ports, passenger transport and floor area under construction. It suggests that GDP growth slowed to only 4% in the year to the first quarter. However, it tracks mostly industrial activity, and thus excludes two-fifths of the economy, most notably services, which are growing faster.

Then there are government tax revenues. These have fallen by 10% over the past year, compared with a surge of 35% in early 2008, suggesting that incomes and output have tumbled. But Stephen Green, an economist at Standard Chartered, says that revenues were inflated in early 2008 by a sharp rise in taxes from the boom in land sales, which has since subsided. Another possible distortion is that local officials may be hiding tax revenue to make their finances appear worse, in order to get more money from Beijing to finance infrastructure projects.

Overall, Dragonomics's Mr Kroeber thinks that GDP growth in the year to the first quarter of 2009 was not significantly overstated. One reason why others are more suspicious is the fact that the National Bureau of Statistics (NBS) does not publish quarterly GDP figures as developed economies do; its year-on-year changes give it more scope to smooth growth rates (for example, output probably did stall over the past two quarters). To be fair, many developing countries do this as well. One reason is that seasonal adjustment is tricky in such countries where the shift from agriculture to industry changes the pattern of seasonality over time, says Mr Kroeber.

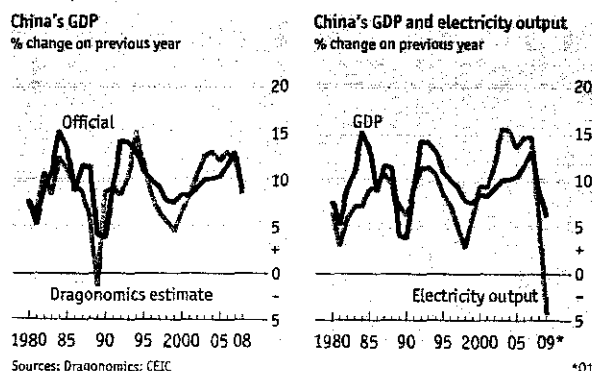
And for all today's misgivings, Beijing's growth estimates consistently proved to be too low until recently. One of the quirks of Chinese data has long been that the provinces reported higher numbers than the central government did—a phenomenon that was put down to the fact that local officials inflated growth rates in order to get promoted. Yet the NBS GDP figures have almost always been revised upwards. For example, growth in 2007 was first reported as 11.4%, but in January it was marked up to 13%.

### Cutting the fudge

The NBS has improved its data-gathering methods in recent years, by extending its coverage of services, for example. This month Beijing also introduced new penalties for officials who falsify statistics. But the real test is whether the government itself is prepared to publish politically embarrassing bad news. There are encouraging signs that it is becoming more open. On May 14th an essay on the NBS website by Xu Xianchun, the bureau's deputy director, was surprisingly frank about some of the flaws in Chinese statistics. Mr Xu admitted, for example, that the retail-sales numbers include some purchases by companies and the government, which should not be counted as consumption. He estimated that consumer spending in the first quarter grew by 9%, compared with the 15% increase reported for retail sales.

Andy Rothman, an economist at CLSA, a regional broker, believes that Chinese statistics are much more trustworthy than they used to be. This is partly because there are alternative numbers to go on; CLSA, for example, produces its own purchasing-managers' index. There are also more private-sector economists keeping tabs on China than there were a decade ago. The more eyes there are on China, and the more crucial its economic performance becomes for the rest of the world, the harder it is for officials to tamper with the speedometer. ■

### A shocking discrepancy





## Fighting the Pakistani Taliban

## A necessary catastrophe

To fight militancy, Pakistan needs to conquer its radicalised north-west, then govern it



A CATASTROPHE is unfolding in Swat, a picturesque region of Pakistan's North-West Frontier Province (NWFP) once loved by honeymooners. Nearly 2.4m people are reported to have fled an army offensive against Taliban militants,

launched early this month at America's behest. Thousands of civilians are trapped, with dwindling supplies of clean water and food. Hundreds are alleged to have been killed or maimed. On the evidence of two previous offensives in Swat, this may achieve nothing good. It risks leaving Swatis even angrier with their government and more vengeful than before, hardening the Taliban's hold over the region. In a country as unstable as Pakistan, it is tempting to fear, America's new foreign-policy chiefs should be more careful what they ask for.

For all that, the government was right to take military action to drive the Taliban from Swat. The most economically developed area of Pakistan in militant hands, it has long been prime evidence for those who accuse the government of scarcely trying to quell the militancy sweeping the north-west of the country. Unlike the semi-autonomous tribal areas adjoining NWFP, many of whose Pushtun inhabitants fight for the Taliban on both sides of the border with Afghanistan, Swat has a semblance of a functioning state. Its better-educated people have no love for the Islamist hooligans in their midst. Yet the army's stuttering campaigns, and a recent effort to appease the militants by offering to institute Islamic law in Swat and other parts of NWFP, have strengthened their control over it.

One reason for optimism is that, on early signs, this offensive is more serious than its forebears in Swat and elsewhere (see page 28). During the army's last fight in Swat, which ended in February, a small force tried to drive the Taliban from Min-

gora, the district's biggest city, with shellfire. This resulted in many civilian deaths and local fury. With a bigger force, including 6,000 soldiers reportedly shifted from the Indian border, the army now seems to be fighting more carefully.

Another hopeful sign is that many Pakistanis claim to support this offensive. Hitherto, most have considered the army's war against the militants as a regrettable service to America. But recent Taliban excesses, including their well-publicised flogging of a teenage girl, have convinced many that the Islamists need pegging back. The Urdu media, which are roundly anti-American, back this offensive, and the main political parties have declared their support. To keep that consensus and confound the Islamic parties which remain outside it, the army must redouble its efforts to minimise civilian casualties and the government must do more to care for the displaced.

## After the battle, prove you're a state

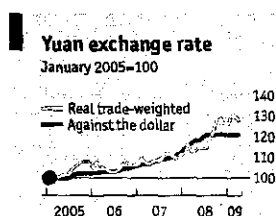
But if the offensive is to mark a real turning-point in Pakistan's flailing war against the Taliban, the government needs above all to train and equip NWFP's police and local administration to control the ground its soldiers have cleared, and to oversee the economic development that must follow. The government's failure to plan for this in the past, far less achieve it, has been the main reason for the Taliban's recent successes.

Given the weakness of Pakistan's civil institutions, this is a daunting task. In the tribal areas, where the army is expected to resume campaigning after it finishes in Swat, and where the state is currently a figment, addressing it will require serious thought. Unless it attends to these basics, Pakistan will neither turn back the Taliban tide nor retain popular support for its effort. Even now, few Pakistanis may consider the Taliban to be the existential threat to their country America says it is. But all Pakistanis can appreciate the merits of having better government. Pakistan has to show it can provide one. ■

## China, America and the yuan

## Time for a Beijing bargain

Sino-American economic policy needs a new start. Tim Geithner's visit to China provides an opportunity



kets and a more flexible yuan. But as Tim Geithner, the current treasury secretary, prepares to make his maiden trip to Beijing on May 31st, Wall Street is synonymous with greed and failure, America's economy is on its knees and it is the Chinese who have been doing the lecturing. With America's budget deficit

HOW times change. When George Bush's treasury secretaries first visited China, Wall Street was booming, America's economy was growing and the president's emissaries routinely lectured their Chinese hosts on the need for freer financial mar-

soaring and the Fed's printing presses running at full speed, China is complaining loudly of the risks that inflation and depreciation pose to its huge stash of dollars, and arguing for an alternative to the greenback as the world's reserve currency.

The tables may have turned, but the dynamics on both sides of the Sino-American economic relationship are remarkably similar. The lecturing tone is driven largely by politics at home. Just as American treasury secretaries needed to shout loudly about China's currency in order to appease a potentially protectionist Congress, so Beijing officials must hector Americans about their profligacy to assuage rising domestic fury about the losses China faces on its reserve holdings. On both sides, the most egregious posturing is economically illit-

erate. America's bilateral trade deficit with China does not prove that Beijing manipulates its currency, as many congressmen have argued. And despite the huffing in Beijing, the losses that China faces on its reserve portfolio have more to do with its own policy choices than America's spendthrift ways.

### Courageous choreography required

Both China and America should use Mr Geithner's three-day visit to set a new tone in which co-operation replaces rhetoric. The two countries need to act on a broad economic agenda from global warming (real progress is impossible without co-operation between the world's two biggest carbon emitters) to funding the expansion of the International Monetary Fund (China has yet to come up with any cash and Congress has not authorised the \$100 billion promised by the Obama administration). The priority, however, should be a healthier macro-economic relationship between the world's biggest sovereign borrower and America's largest creditor. What is needed for a sustainable global recovery is well known. China must foster

private-sector domestic demand with a stronger currency, among other things. And America must lay out a credible route to the eventual unwinding of its massive stimulus.

In today's febrile markets any misstep could cause the dollar to tumble and Treasury yields to soar further. So the moves must be carefully choreographed. China should be more forthright on the yuan. After a welcome appreciation alongside a stronger dollar in 2008, China's currency has fallen on a trade-weighted basis in recent weeks as the dollar has tumbled. Mr Geithner's hosts should make it clear that even if the dollar continues its slide against other currencies, the yuan will not follow suit. Instead it will gradually appreciate. To forestall any additional surge in Treasury yields, Mr Geithner should elaborate on how the Obama administration intends to cut spending and raise tax revenue in the medium term.

It will take political courage for the Chinese to eschew a weak currency and for an American treasury secretary to unveil fiscal details in Beijing. But the parlous state of the world economy demands nothing less. ■

## Computing

# Unlocking the cloud

Open-source software has won the argument. Now a new threat to openness looms



"FIRST they ignore you, then they laugh at you, then they fight you, then you win." Mahatma Gandhi probably never said these words, despite claims to the contrary, but they perfectly describe the progress of open-source software over

the past 15 years or so. Such software, the underlying recipe for which is created by volunteers and distributed free online, was initially dismissed as the plaything of nerdy hobbyists. Big software firms derided the idea that anyone would put their trust in free software written by mysterious online collectives. Was it really secure? Whom would you call if it went wrong?

At the time, selling software to large companies was sometimes likened to drug dealing, because once a firm installed a piece of software, it had to pay a stream of licence fees for upgrades, security patches and technical support. Switching to a rival product was difficult and expensive. But with open-source software there was much less of a lock-in. There are no licence fees, and the file formats and data structures are open. Open-source software gained ground during the dotcom boom and even more so afterwards, as a way to cut costs.

Microsoft, the world's biggest software company, went from laughing at the idea to fighting it, giving warning that there might be legal risks associated with using open-source software and even calling it a "cancer" that threatened to harm the industry. Yet the popularity of open-source programs such as the Linux operating system continued to grow. The fact that Google, the industry's new giant, sits on a foundation of open-source code buried the idea that it was not powerful or reliable enough for heavy-duty use. One by one the industry's giants embraced open source. Even Microsoft admits that drawing on the expertise of internet users to scrutinise and improve software has its merits, at least in some cases.

The argument has been won. It is now generally accepted that the future will involve a blend of both proprietary and open-source software. Traditional software companies have opened up some of their products, and many open-source companies have adopted a hybrid model in which they give away a basic version of their product and make money by selling proprietary add-ons (see page 65). The rise of software based on open, internet-based standards means worries about lock-in have become much less of a problem.

### Clouding the picture

But now there is the danger of a new form of lock-in. "Cloud computing"—the delivery of computer services from vast warehouses of shared machines—enables companies and individuals to cut costs by handing over the running of their e-mail, customer databases or accounting software to someone else, and then accessing it over the internet. There are many advantages to this approach for both customers (lower cost, less complexity) and service providers (economies of scale). But customers risk losing control once again, in particular over their data, as they migrate into the cloud. Moving from one service provider to another could be even more difficult than switching between software packages in the old days. For a foretaste of this problem, try moving your MySpace profile to Facebook without manually retyping everything.

The obvious answer is to establish agreed standards for moving data between clouds. An industry effort to this effect kicked off in March. But cloud computing is still in its infancy, and setting standards too early could hamper innovation. So buyers of cloud-computing services must take account of the dangers of lock-in, and favour service providers who allow them to move data in and out of their systems without too much hassle. This will push providers to compete on openness from the outset—and ensure that the lessons from the success of open-source software are not lost in the clouds. ■

sional approval. Public pension funds have also joined together to lobby against a reduction in the SEC's power.

Moreover, the economically rational may not be politically feasible. Though it would make sense to merge the SEC with the Commodity Futures Trading Commission, which regulates derivatives, Congress's powerful agriculture committee would probably block the move.

Debate about other thorny issues, such as what restrictions to place on, or whether to dismantle, banks that are too big to fail has barely begun. Congressional leaders cannot even agree on whether to pass new rules in pieces or roll them up into one mega-bill.

All of which explains why pundits now expect to see few, if any, further financial reforms passed in 2009. Delay could play into the financial industry's hands, to the extent that it reduces the likelihood of heat-of-the-moment laws like Sarbanes-Oxley, rushed through after the Enron scandal. But if measures that would increase stability fall victim to politics, everyone will be worse off. ■

Lloyd's of London

## Eggs and baskets

**After AIG, firms buying insurance are keener to spread their risk. But how?**

WHEN American International Group (AIG), the world's biggest, meanest and supposedly safest insurer, collapsed into the government's arms in September 2008, there must have been a few cheers from its rivals. Many hoped to win its customers, particularly large firms paranoid about having high exposure to one (dodgy) counterparty. It also seemed possible that the model for insuring companies' big risks—buildings or a mine, for example—might change. Instead of placing them with a few insurers, it might be better to syndicate out those risks to many, not least through Lloyd's, the insurance market founded in a London coffee house in 1688.

Eight months on, the revolution has yet to arrive. There has been no stampede of corporate customers from AIG, says Andrew Rear of Oliver Wyman, a consultancy. Loyalists reckon this reflects the fact that its insurance operations were safely ring-fenced from its kamikaze derivatives adventures. Sceptics point out that since the bail-out it has the backing of a government that (for now) retains a AAA credit rating. Yet despite AIG's refusal to die, the instinct of customers to diversify is still alive. Sally Bramhall of Willis, an insurance broker, says that big insurers are no longer assumed to

be safest or best, and that clients are prepared to put their eggs in more baskets.

How they do this is, however, less clear. One possibility is that traditional subscription markets do better, most noticeably Lloyd's. There, the end customer enlists a broker to place his risk among multiple syndicates (which are, in turn, often dominated by outside insurance firms). The customer gets a single contract, but the potential losses are spread. And because the market is partly mutually owned, the customers have the security of both syndicate members' capital and, as a last resort, a shared cash pool funded by all members.

Mark Gregory, chief executive of Bowring Marsh, a unit of insurance broker Marsh, says clients particularly admire the skill of Lloyd's underwriters at dealing with unusual and complex risks (try Ugly Betty's smile). Most observers note its improved risk management too, which should prevent individual syndicates from losing their discipline, or falling victim to the "herd mentality" that one industry veteran says is Lloyd's historical weakness.

Furthermore, even by the relatively hygienic standards of most insurers, the asset side of Lloyd's balance-sheet is squeaky clean, while the toxic claims that brought it to its knees in the 1990s are now parcelled off to Warren Buffett's Berkshire Hathaway. And, for the customer, the benefits of having a single contract with one set of wording and terms should not be underestimated. After the September 11th terrorist attacks, some insurance companies, which had written slightly different contracts, disputed whether one or two events had occurred, says Chris Hitchings, an analyst at Keefe, Bruyette & Woods.

Yet for all that, a big shift towards subscription markets does not seem imminent. In part that reflects the relative lack of scale of Lloyd's. Europe's leading insurance companies rival it in terms of non-life premiums written and balance-sheet

oomph. Such firms' big books of business should allow their customers to benefit from diversification. And just in case they "do an AIG", there are other ways to spread risk. Brokers already take big bits of business and split them between individual companies, Lloyd's and other markets such as Bermuda (where rather than using a subscription model, the lead insurer often subcontracts risk to peers). In future many clients may just instruct their brokers to divide up the business even more—and sort out the resulting complexity. ■

China's dubious earnings numbers

## Red flags

HONG KONG

**Investors appear to have little faith in company accounts**

CHINA'S stockmarket has been one of the best performing in the world this year, and the country's firms have so far steered through the global financial crisis better than many of their global peers. Partly they may have been buoyed by robust business conditions in China. But two recent studies, which raise serious questions about the credibility of China's corporate earnings, suggest that companies may also have had an artificial boost.

The less damning of the two is issued under the auspices of the Hong Kong Monetary Authority and written by Giovanni Ferri, of Italy's University of Bari, and Li-Gang Liu of BBVA, a bank. It argues that the profits of China's large state-owned companies are entirely a product of subsidised financing by state banks, which lets them borrow much more cheaply than private or foreign firms (see chart on next page).

To reach that conclusion the authors sifted through government data from 1999-2005. Mr Liu believes that such subsidies may have even increased since last summer, because the big state-owned enterprises have been the main beneficiaries of China's economic stimulus. In the short term the subsidies will have boosted profits, not least compared with the firms' credit-starved private peers. But in the longer term Mr Liu believes that the political component of the loans will mean capital is being allocated inefficiently, raising the prospect of future losses.

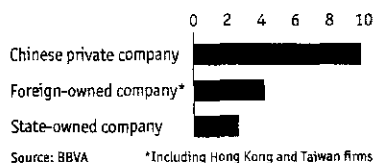
At least the academics are convinced that the profits are genuine, even if they are subsidised. But an exhaustive working paper by TJ Wong and Danqing Young, of the Chinese University of Hong Kong, and Xianjie He, of Shanghai University of Finance and Economics, reaches a more alarming conclusion. It suggests investors have little faith in the numbers. ▶▶



Spelling is not the only improvement

**All right for some**

Average interest rate paid on bank loans by different types of firms in China, 2001-05, %



► To measure this they looked at Chinese firms before and after the country broke with its accounting traditions in 2007, adopting something akin to international accounting standards, which base valuations on market prices. They then dissected earnings in three ways. First, they compared how shifts in earnings correlated with shifts in share prices under the old accounting system and the new. An improvement in accounting practices should have

meant a closer correlation between earnings and the performance of the share price. Not only did this not happen—there were some signs that things got worse.

Nor were there correlations between the share price and the shift in reported value of investment instruments, goodwill and the impairment of assets—all typically critical to an investor's analysis. Lastly, the academics examined a nuance in the new standards that allowed Chinese firms to book profits by restructuring debt that was owed to affiliated companies. Before the change in accounting standards, this kind of debt restructuring was rare. Afterwards, it was common: more than 200 companies, or over 15% of those in the study, did it in 2007. This resulted in clear gains to earnings but no impact on share prices. So is there anything in the company reports that investors do consider to be meaningful? That, says Mr Wong, is the subject of the next study. ■

**Headaches for a hedge-fund manager****Good gRIEF**

NEW YORK

**A brilliant investor has trouble replicating his success**

**"LUCK"**, James Simons, the founder of Renaissance Technologies, a hedge fund, once said, "plays a meaningful role in everyone's lives." Mr Simons, a 71-year-old former university professor and a celebrated mathematician, has been blessed with the stuff. His flagship fund, Medallion, has had average annual gains of more than 35% for 20 years. Last year he was named the best-paid hedge-fund manager in America by *Alpha*, a hedge-fund magazine, reportedly earning \$2.5 billion. Medallion gained 80% last year, and this year is up a further 12%.

But Medallion is 98% employee owned and has not accepted new money for 15 years. So to cater to outside investors, Renaissance has since 2005 marketed another "mega fund" known as the Renaissance Institutional Equities Fund (RIEF). The problem is that this has not proved anything like as successful as Medallion. Before its launch a small army of Renaissance PhDs—there are more than 70 on the payroll—back-tested RIEF's performance with a simulated portfolio of \$100 billion. From 1992 to 2005, its theoretical return was more than double that of the S&P 500, with less than two-thirds of the volatility. Investors queued up like Trekkies waiting for tickets to the new film.

In the first two years RIEF raised more than \$1 billion a month. With new money coming in faster than it could be invested, monthly contributions were capped at \$1.5 billion. By August 2007 the

fund was managing almost \$28 billion. But in 2008 RIEF lost 16% and investors withdrew \$12 billion from Renaissance, which was the largest prime-brokerage client of both Bear Stearns and Lehman Brothers, two investment banks that failed. The downward spiral has continued this year, with RIEF losing 17% so far. It now has less than \$10 billion of assets under management.

Mr Simons explains the lopsided returns by saying that the two funds approach investing in different ways. Medallion attempts to identify "predictive signals" in the market. Its high-powered computers are programmed to profit from split-second price distortions. RIEF moves much more slowly. Most positions are held for a year. Like Medallion, it uses computers to buy and sell stocks. The fund is designed to provide investors with smooth returns, the success of which is measured against the S&P 500.

It has, in fact, beaten the S&P 500 by almost 4% a year since inception, but it has also trailed behind an index of its peers. In general, computer-driven funds are becoming less popular with investors. But Mr Simons is RIEF's biggest investor, which gives him every reason to want to improve its performance. This could be the biggest lesson of the whole episode. Though investors may think they are seduced by the wizardry of Renaissance's computer-driven models, what they are really betting on is the magic touch of the man himself.

**The Gulf's nascent bond market****Crisis and opportunity**

MANAMA

**A market for Islamic and conventional bonds is stirring**

**A**FTER the 1997 Asian crisis Malaysia, bruised by what its government saw as the buccaneering spirit of Western capitalism, threw itself into Islamic finance with renewed vigour. Bahrain hopes to follow a similar path. The credit crunch did not come a moment too soon, as far as Manama was concerned. It has breathed new life into a regional market for bonds—both Islamic and conventional ones—and Bahrain has ambitions to be a hub for issuance and secondary trading. "We really needed a crisis like this," says Salman bin Isa Al-Khalifa, the executive director of Bahrain's banking operations.

Until now the Gulf's bond markets have been anaemic. Debt securities make up 33% of world capital markets but only 3% in the Middle East. The growing popularity of Islamic finance over the past decade has provided a small boost. Issuance of *sukuks*, which comply with *sharia* law prohibitions on interest, grew to \$43 billion in 2007, though that is a sliver of the \$50 trillion-plus global bond market. But last year global *sukuk* sales more than halved (see chart on next page). Companies hunkered down after the credit crisis, taking out bank loans when they could. And oil-rich governments had no need to borrow.

But debt finance can provide large amounts of liquidity quickly in moments of crisis, says Rohit Chawdhry of Bahrain Islamic Bank. Governments learnt this lesson too late when they suddenly found themselves with rising deficits or, in the case of the United Arab Emirates, with ►

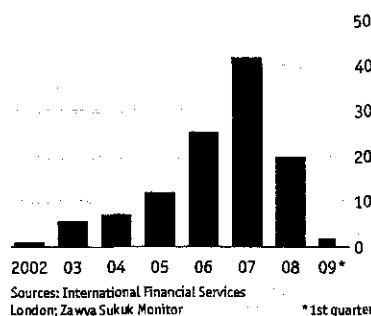
**The name is Bond. Or Sukuk**

what is believed to be a fall of 75% in foreign-currency reserves. They have been forced to sell large amounts of paper.

Abu Dhabi, Dubai and Qatar, some of the world's richest sovereigns, have issued billions of dollars-worth of conventional bonds in recent months. Bahrain is expected to offer a \$500m *sukuk* shortly, its first in 2009, and hopes to hold regular bond auctions afterwards. Other Gulf countries including Kuwait and ultraconservative Saudi Arabia may follow. At the same time quasi-government institutions are seeking credit ratings so they too can issue debt.

These are not isolated acts. Regional governments are co-ordinating efforts to develop secondary bond trading; in the past creditors tended to hold the few bonds that were issued to maturity. The new government issuance will help develop a yield curve, which will make for more efficient pricing and give corporate issuers a benchmark to price against (Bahrain hopes that firms will follow the government lead). Aldar, one of the largest emirati property developers, has reportedly re-

**Sukuk hiccup**  
Sukuk issuance, \$bn



tained advisers to consider issuing bonds.

Nor should the region be particularly discouraged by the high-profile default of a *sukuk* this month when Investment Dar, the Kuwaiti part-owner of Aston Martin, James Bond's favourite car, missed a \$100m payment. A bona fide default just makes the *sukuk* market look even more like its Western equivalent. ■

## Why banks sponsor sport

### Play on

#### Banks are still packing stadiums despite the crisis

FOR fans of Newcastle United, a terrible season ended as they had long feared on May 24th, with relegation from the Premier League, the top level of English football. Newcastle's players have proved about as buoyant as their shirt sponsor, Northern Rock. The nationalised mortgage bank is based in the city.

In the world of sport, it is hard to get away from banks. The Premier League is sponsored by Barclays. HSBC is backing the British & Irish Lions' rugby tour to South Africa, which starts this weekend. The success of Lewis Hamilton, Formula One's champion driver, has helped make Santander better known in Britain. On May 27th it said it would rebrand its well-known British operations, Abbey, Alliance & Leicester and Bradford & Bingley, under the Spanish name. It reckons the task has been made easier by its high visibility as McLaren's sponsor.

American banks are just as eager as European ones. In 2008, says William Chipps of IEG Sponsorship Report, a newsletter, banks laid out \$900m on North American rights, 9% of the total. Andrew Zimbalist, an economist at Smith College, says banks' interest has grown enormously with the "gentrification" of sport. Stadiums are newer, seats are comfier (and prici-

er) and the crowd is better heeled.

Not surprisingly, global recession and the banking crisis have taken their toll. Mr Chipps expects sponsorship of sport (by all companies, not just banks) to grow by just 1.8% in North America this year, down from 14.8% in 2008 and 11.2% in 2007. Banks and their customers are watching every penny. With many financial institutions propped up by taxpayers' money, so are politicians and the press.

Some deals have ended: RBS (mostly owned by the British government) is quitting Formula One at the end of next season. Some have not gone ahead. Bank of America (BoFA) has put off a juicy long-term deal with the New York Yankees and extended its existing contract for a year. Others have been quietly shelved or derided as monuments to corporate excess.

More surprising, given all the fuss, is that plenty of banks are still sponsoring sport. This month Investec, a bank already keen on rugby and cricket, agreed to support the (English) Derby until 2013. The classic horse race had long been seeking a backer. It looks likely that Santander will switch to Formula One's most famous name, Ferrari, in 2010. In Britain the £80m (\$124m) of support agreed on in 2007 by Lloyds TSB (now Lloyds Banking Group)

for the 2012 Olympic games has raised barely a squeak, despite the copious state support Lloyds has received.

Why do shareholders—and taxpayers—play along? For a start, sponsorship gets you noticed, especially in a new market. Among big banks, BoFA has made it a speciality, becoming the "official bank" of several sports and forming partnerships with several teams. A deal with a team, for example, brings in retail custom, through affiliated debit and credit cards and the automated teller machines dotted around a stadium. It opens the door to managing the wealth of a team's owners and players, or to arranging the finance for a new stadium. On top of that come tickets, space to entertain and impress clients, and the marketing value of having the bank's name emblazoned around a stadium.

The bank claims to make \$3 of profit for every \$1 it spends on sports marketing, a rate of return that may look too good to be true (if it can make 300%, it should do nothing else). The long-term deal with the Yankees, says Ray Bednar, BoFA's head of sponsorships, "worked fantastically from a return-on-investment perspective, but the environment was wrong. We walked away from a lot of revenue and profit."

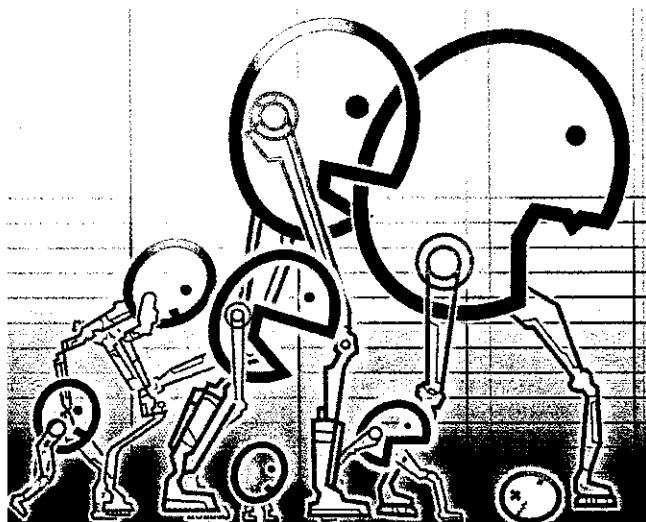
Sponsorship is also important inside as well as outside the sponsoring company. Stephen Greyser, a professor of marketing at Harvard Business School, notes that UBS, a Swiss bank, used its sponsorship of Alinghi, the sailing team that won the America's Cup in 2007, to enthrone its employees. Sally Hancock, director of group sponsorship at Lloyds, says that backing the Olympics "changes the way we think and act as a business". The bank can bring in British Olympians to meet and help motivate staff. "What people don't see is how we're using the Olympic access for our training and development," she says. That is timely. If ever Lloyds needed Olympians, it is now. ■



Rock and a hard place

## Economics focus | What's mine is yours

When should firms be required to share their intellectual property with rivals?



**E**CONOMIC policy is rarely uniform on either side of the Atlantic, but the differences in some cases are exaggerated or soon narrowed. That is true of antitrust policy, where there has been a great deal of convergence. The European Commission's trustbusters tend to take a more cautious view of big global mergers, but the way such tie-ups are assessed is very similar to American practice. In the policing of cartels, the commission has adopted many of the methods and models of its American cousins.

On one antitrust issue, though, the transatlantic gulf has been unusually wide: how to deal with firms with a market share so large as to dwarf their rivals. In high-tech industries, such as computing and telecoms, the power of network effects encourages firms to settle on an industry standard to ensure that gadgets and software are compatible. That gives the owners of the winning standards, such as Microsoft, a great deal of market muscle.

That kind of dominance creates a tension between property rights and antitrust principles. American competition authorities have been loth to compel dominant firms to grant rivals access to their private property, whether physical (as in the case of telecoms networks) or virtual (as with computer code). In their view intellectual-property rights have to be upheld to induce firms to innovate. Patents and copyrights are the rightful prize for new inventions. Trustbusters should be wary of compelling firms to hand over their business secrets in the name of competition.

By contrast, Europe's trustbusters have acted to free up access to telecoms networks in France and Germany. Backed by the courts, they have required Microsoft to make private information about its Windows operating system available to rivals, who can then compete more readily in software development.

Which view is right? In a new paper\* John Vickers of Oxford University surveys the economics literature and concludes that a hands-off approach is far from ideal. Mr Vickers, once head of the Office of Fair Trading, Britain's main antitrust outfit, says that like many economists he finds himself "rowing in the mid-Atlantic" when it comes to the treatment of dominant firms. American policy is too cautious about treading on big firms' toes but Europe's trustbusters may intervene too boldly.

Drawing on recent academic work, Mr Vickers makes the case for intervention on three counts. First, he outlines models that

suggest a rival is less likely to develop new products if it cannot share in the profits from the dominant firm's invention. If the leading firm is free to licence its technology on stringent terms, it curbs the profits of rivals who have to stump up. True, it spurs rival firms to innovate since the prospective pay-off is greater. But on balance, the incentive to innovate is greater where access is granted more freely, because upfront profits are more valuable.

A second argument for reining in dominant firms is that the contest to innovate tends to be keenest where there is a neck-and-neck battle to be the dominant firm. If market leaders are forced to license their know-how on easy terms, that reduces the pay-off from research and development (R&D). But it also allows much smaller firms to catch up quickly. Although profits from any new inventions will be lower, they will be chased more aggressively when competitors are on a similar footing.

Trustbusters may have most reason to trespass on property rights if the dominant firm uses them to stifle "follow-on" innovation. An ideal set-up would reward seminal inventions without strangling their related offspring at birth. That means giving the breakthrough inventor a share of profits from related products while leaving enough left over to make rivals' R&D viable. If the dominant outfit is afraid a new add-on will make its own technology redundant, it will not deal with competitors on any terms. So trustbusters may have to step in. Indeed, the case against Microsoft in America was that it tried to force Netscape out of the market for web browsers, fearing its rival's software could be used as a platform to compete against Windows.

### From east to west

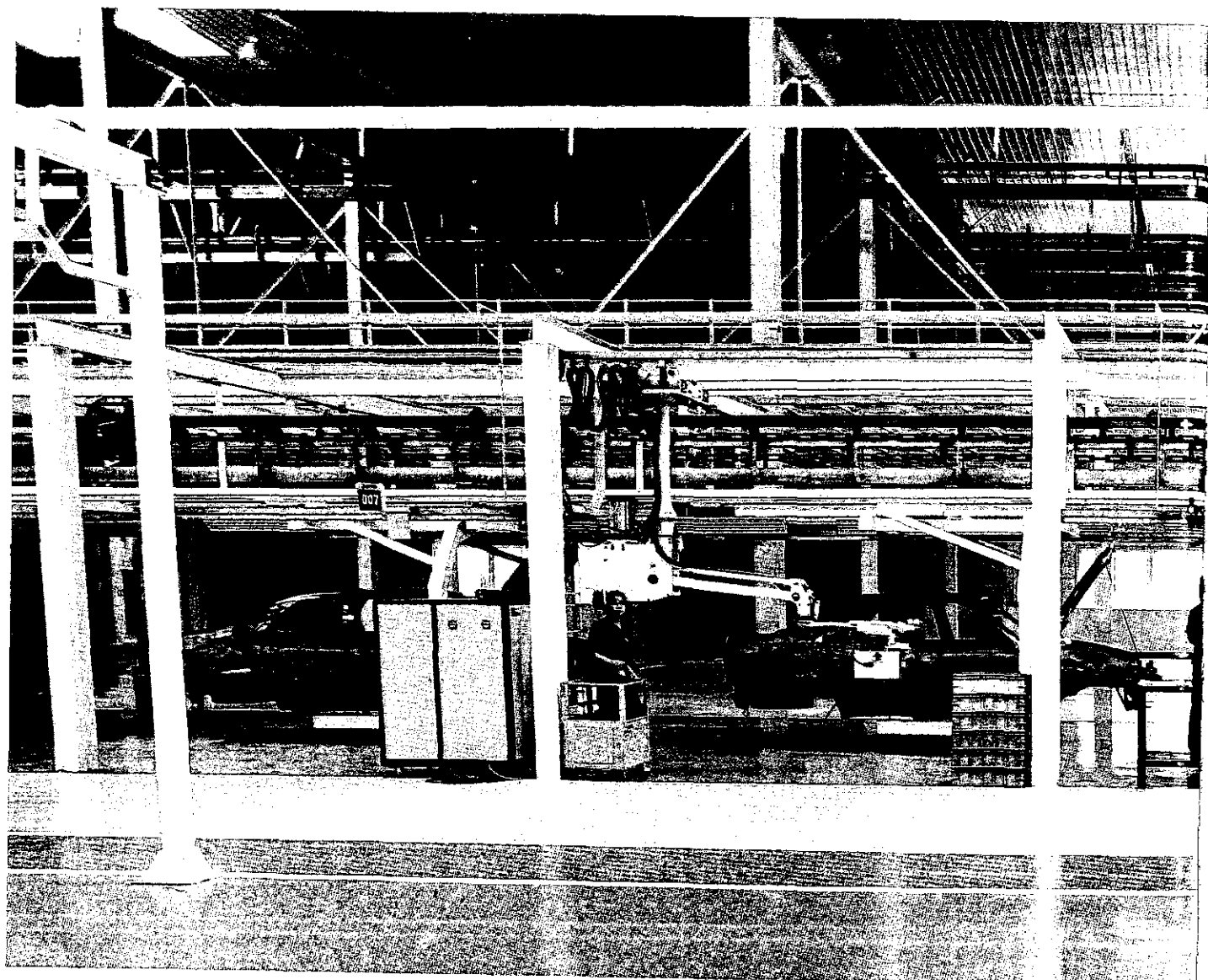
The literature surveyed by Mr Vickers suggests that if trustbusters act to keep dominant firms in line, that will not necessarily curb innovation. It may even promote it. Economic thinking in this sphere is not so securely fixed as to provide firm guidance on when to intervene. It does, however, call into question the scepticism that guided America's competition policy in recent years—the idea that trustbusters cannot be certain that their interventions will help, so should back off. That doctrine has been abandoned. Christine Varney, President Obama's chief trustbuster, gave a speech on May 11th in which she repudiated the "overly lenient" course favoured by the previous administration.

Ms Varney's remarks suggest that the transatlantic flow of ideas on antitrust policy may now be moving from east to west. Yet Mr Vickers frets that European courts may not exert enough discipline on the commission's future actions in this area. The court ruling that upheld the commission's action against Microsoft, in September 2007, suggests that the hurdle for such an intervention is less exceptional than had previously been thought. The "elastic" reading of case law left it unclear in what circumstances a dominant firm must share its intellectual property.

For Mr Vickers the one clear lesson is that intellectual-property rights should not be set too broadly. A precedent for the European case against Microsoft was a 1990s judgment against television companies, which forced them to hand over broadcast schedules to publishers of TV guides. The broadcasters fought the case tooth and nail to preserve their publication monopolies. Yet many may now wonder how such information could ever have been thought of as intellectual property. ■

\*"Competition Policy and Property Rights" (May 2009).  
[www.economics.ox.ac.uk/research/wp/pdf/paper436.pdf](http://www.economics.ox.ac.uk/research/wp/pdf/paper436.pdf)





CARS

# A Lean, Green Detroit

China is now the world's largest market for cars; Chinese leaders aim to own the biggest piece of it.

By MELINDA LIU

**A**ERICAN TASTES DOMINATED THE WORLD'S AUTOMOTIVE MARKET for a century, but all that's changing now. Today it's the increasingly well-to-do Chinese car-buyer that industry wants to woo and win, thanks to this incredible fact—China has, over the last three months running, surpassed the U.S. in terms of volume sales of automobiles. Ever wonder why Ford's new Fiesta has an instrument panel that looks like a cell phone? Because that's what's familiar to its target audience of

20- and 30-something Chinese. It's also why Chinese versions of the Fiesta come in sedan size, with four doors, rather than as hatchbacks, which are anathema in the Middle Kingdom.

The future of auto design was on display last week at the Shanghai Auto Show, where, in 30 football fields worth of space, international and domestic carmakers vied for the attention of Chinese consumers. The timing of the biennial event, China's oldest international auto show, was fortuitous. No one expected the Middle Kingdom to nab first place in the global auto market from America for at least another decade, but the financial crisis has had a



sharp dampening effect on U.S. sales. The Chinese, meanwhile, spurred on by their government's enormous stimulus package, have kept spending. Beijing's 2009 auto sales target is 10 million units, an increase of 10 percent from 2008, and a figure that would cement its position, with an estimated 1 million more unit sales than the U.S. "No one expected China to emerge as the leading volume market this fast," says William Russo, a Beijing-based business consultant who specializes in the automotive sector. "This will give China a huge say in setting the standards and architecture for the entire industry."

If Beijing gets its way, the future will be small, green and—of course—made in China. The shock of the global financial crisis, and the resulting need to stimulate the auto sector has persuaded Beijing to dig deep into government coffers with more than \$733 million to promote the rural sales of small cars and trucks (which

domestic makers specialize in) and \$220 million to fund and upgrade new green automotive technologies that many consider to be the wave of the future for the industry. Ultimately, Chinese planners want to create a new Detroit—a leaner, meaner, cleaner global automotive hub.

It won't be an easy road. The five top-selling brands in the country are still familiar foreign names—Volkswagen, Hyundai, Toyota, Honda and Nissan, in that order—though the top four are all joint ventures between these foreign giants and old Chinese-state run companies, like Shanghai Automotive Industry Corp. or SAIC, a behemoth that has joint ventures with both Volkswagen and GM. But muscling their way onto the scene are some brash, local rising stars—including private carmakers Chery Automobile Co., Geely Automobile Holdings and BYD Auto Co.—that have been ramping up production and sales. While most are still beginners when

#### **NEW GEELY: No longer a sofa on four wheels**

it comes to things like brand development, marketing and quality control, together they already represent one third of domestic sales—and Beijing's policymakers think it's time for local players to lift their profile. The first big push toward that goal will come via stimulus-package money. In late January, domestic carmakers were thrilled to discover they would reap the lion's share of benefits from official stimulus efforts simply because they specialize in small, inexpensive cars popular in second-tier cities and towns. Government initiatives included the halving of retail taxes (from 10 to 5 percent) on vehicles with less than 1.6-liter engine displacements, and \$700 million in government subsidies to entice farmers into trading their tractors and rural clunkers in for new small cars and trucks.

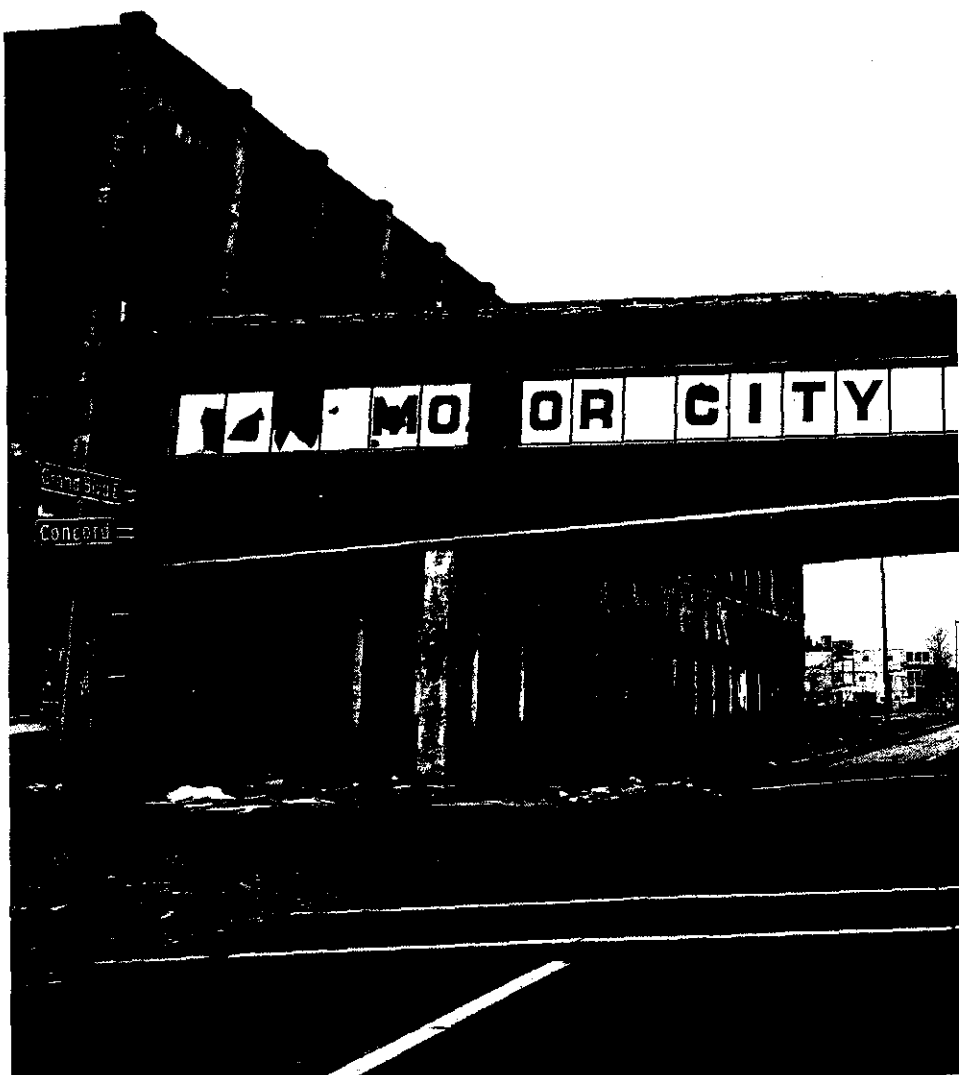
Local players immediately began reap-



## BUSINESS

ing the benefits. China's fifth-biggest manufacturer, Chery, saw sales in January and February shoot up 25 percent; it's aiming for 18 percent growth in 2009. By shifting its policy support to smaller cars Beijing has upped the pressure on China's biggest manufacturers, both foreign and domestic, to scale down in vehicle size. Just by coincidence, Ford started selling its new Fiesta—with an engine displacement of 1.5 liters—in China a little more than a month after the new tax cut. Customers bought more than 4,000 in six weeks of presales transactions. Yet smaller cars are only the first part of the government's master plan. China's stimulus package also includes \$220 million for upgrading automotive technologies, especially in alternative-energy vehicles. To help offset the high cost of buying clean-energy vehicles, subsidies of nearly \$8,800 are being offered to local government agencies and taxi fleets in 13 cities for each hybrid vehicle purchased. The rebate will also reportedly be offered to private car-buyers to soften sticker shock. Such incentives helped make Shanghai's auto extravaganza last week the greenest A-list car show in history. Although none of them represent cutting-edge technologies, China's homegrown electric and hybrid vehicles were visible at every turn. Chery, China's top-selling local brand, exhibited four alternative-energy cars. The private Lifan Group, based in Chongqing, unveiled its hybrid 320 EV. And BYD Auto, a Shenzhen-based firm best known for putting batteries in one fourth of the world's cell phones, had on display its much-touted F3DM, a plug-in electric car with a backup gasoline engine, that started selling last December for around \$22,000.

The company leveraged its famous



## Chinese companies have a key advantage—the fact that most are favored by the Chinese government.

battery expertise to create what it says is a safer and more environmentally friendly lithium-ion phosphate battery for the new plug-in. BYD has now leaped ahead of more established international models such as Toyota's Prius and GM's Volt to bring an affordable plug-in car to the market—BYD's model is nearly half the expected cost of the Chevy Volt.

But despite the hype, officials and consumers alike acknowledge that small-

er, greener homegrown vehicles are still in their infancy. It's perhaps telling that at the Shanghai show, BYD Auto officials decided to exhibit their plug-in with genuine license plates, rather than mock-ups as is typical. "The technology is so new that some Chinese worry such cars would never even get licensed," says marketing representative Jasmine Huang. "This will reassure them." Despite the reassurances, only a few dozen F3DM's

have been sold, and even then, not to individuals but to government units and banks. Private purchases are expected to begin only in June. Meanwhile BYD's target date to start selling in the U.S. market has slipped from 2010 to 2011, due to the ongoing economic crisis, says export manager Henry Li.

This underscores the many challenges facing China's domestic players. At present their ability to penetrate export markets is insignificant, partly because Chinese safety standards lag behind those in Europe and the U.S. Even at home, for example, Chery's popular QQ compact suffers from a perception of being too flimsy to be safe—especially after a photo circulated on the Internet, showing a QQ



wedged between two buses, squashed like a soft-drink can.

Marketing and consumer research also remain alien concepts to domestic players. At the Shanghai Auto Show, Geely unveiled nearly two dozen new models—including a blatant clone of a Rolls-Royce Phantom, down to the winged hood ornament. Company chief Li Shufu then invited visitors to fill out suggestion forms to record their reactions to the bewildering proliferation of new products. “We’re trying to get opinions from all walks of life,” says Li, whose firm had to delay its entry into the U.S. market due to quality-control issues.

By contrast, Ford, for example, intensively researched China’s under-30 consumers who are the new Fiesta’s target

audience. Its findings encouraged Ford to team up with Microsoft to develop SYNC technology so that drivers can connect their cars to their MP3 players. “We spent a lot of time talking with 25-year-old Chinese women about their tastes,” says John Parker, Ford’s executive VP for Asia-Pacific and Africa. “They wanted styling, fuel economy—and Internet connectivity.”

Chinese auto companies still have a key competitive advantage—the fact that most are run by (and favored by) China’s command-and-control government. The state can tweak policy and macroeconomic levers that virtually change the game overnight—witness Beijing’s swift and successful response to the financial crisis. Compared to democratic countries where

**SO LONG BIG THREE:** *China’s target is to create 10 world-class carmakers*

policymaking can be protracted and messy (just look at America’s efforts to revamp the automotive industry), Beijing has a major leg up. They can simply decide what the future will look like, and state-owned enterprises must toe the line.

Already, Chinese leaders have signaled their determination to consolidate the country’s chaotic and overcrowded auto sector, and drag it up the value chain. Of 150 entities licensed to produce vehicles, just 20 of them account for 95 percent of the market. Beijing has decided that of these 20, a globally competitive “Top Ten” will emerge (a decree which will inevitably be helped along by the fact that Beijing has less pesky unions and local and regional politicians to deal with). “We even know who eight of those 10 are,” says Russo, who cites industry sources saying such numbers are guidelines only.

To speed up the process, Beijing has taken the unusual step of warning Chinese auto firms to focus on getting their own affairs in order before rushing off to buy foreign automotive assets at fire-sale prices. With prestigious names such as Volvo and Hummer on the block, “the world is for sale and looking for Chinese partners,” says Eduardo Morcillo, an M&A specialist with InterChina Consulting in Shanghai. But government officials have spread the word that, as tempting as distressed foreign assets might be, they’re hard to digest. “Chinese buyers [would] need to learn to deal with different management techniques, labor unions and whole new ways of thinking,” warned senior planning official Chen Bin in a widely quoted interview with local media. “That can be difficult.” Indeed—when China’s biggest carmaker SAIC bought a 49 percent share of South Korea’s Ssangyong Motor back in 2004, the venture ended in tears when Korean unions resisted Chinese cost-cutting.

These days, of course, cost-cutting is the mandate in Detroit, Seoul and Shanghai, which is the closest thing to a nerve center that China’s far-flung automotive industry has, thanks to SAIC’s overshadowing presence. And no one does fiscal prudence better than the Chinese, who have managed to keep growing amid the recession thanks to their \$2 trillion in reserves and the ability of their autocratic system to turn on a dime to deal with whatever new economic challenge is presented. Re-creating a cleaner, leaner, meaner Detroit in the Middle Kingdom is a lofty goal indeed, but if anyone can do it, it’s the Chinese. ■



## ENVIRONMENT

# A Green Trade War?

The U.S.'s coming around on climate change was supposed to be good news. Instead, it's trouble.

By STEFAN THEIL

**B**E CAREFUL WHAT YOU WISH for. For years, much of the world has been bashing America for refusing to cooperate in the fight against climate change. Now that President Barack Obama has pledged American leadership in cutting greenhouse-gas emissions—and as a far-reaching package of green legislation begins to wind its way through the U.S. Congress—relief is giving way to worry. In recent weeks European, Indian and Chinese officials have warned that the result of America's long-awaited change of mind might not be cooperation but conflict, and possibly the world's first green trade war.

That's because as Washington debates how to regulate emissions, a powerful coalition of energy-intensive industries, labor unions and Rust Belt state legislators is clamoring for protection from imports. They argue that the new cap-and-trade system envisioned by Obama and congressional leaders, which will require major polluters to acquire permits for the right to emit CO<sub>2</sub>, will put them at a competitive disadvantage against competitors based in countries that don't have similar carbon-pricing schemes. In March Obama's energy secretary, Steven Chu, said the U.S. is prepared to use a border tax on imports as a weapon to force countries

like China to limit their own emissions, triggering a warning by Su Wei, China's chief climate negotiator, that this would lead to retaliatory measures. India has since warned the West not to engage in "green protectionism."

So far, the threats have been limited to words, but that may soon change. Introduced in Congress on April 1, America's proposed scheme is loosely based on Europe's, which gives homegrown energy-intensive industries like steel, aluminum and cement generous free allowances of pollution permits, in effect grandfathering them into the new system. The president would have the authority to impose "border adjustments" only if U.S. companies were determined to be at a competitive disadvantage after a five-year trial period. But with the American debate over climate change increasingly driven by worries over jobs and competitiveness, some form of protection seems increasingly likely. In Europe, politicians have called for EU trade sanctions against both China and the U.S. if they don't agree to cut emissions.

**The biggest victim of a confrontation: the environment that U.S. regulators purport to save.**

**CLOUDY:** A miner and child in polluted China

Because they already regulate emissions, the Europeans would likely be exempt from any U.S. carbon tariffs, which appear squarely aimed at China.

The biggest victim of a confrontation, however, would be the environment that U.S. legislators are purporting to save. China is just beginning to get serious about its own environmental record, and as a member of the G20 seems finally to be taking its first baby steps toward a more involved and constructive international role. The global climate regime that the world's biggest polluters will try to hammer out at the U.N. climate conference in Copenhagen in December will not work without major developing-world emitters like China onboard. A nasty trade fight with the United States would make cooperation by Beijing even less likely, says Benjamin Görlach, emissions expert at the Ecologic Institute in Berlin.

Not only does the debate over imports threaten to obscure the original environmental-policy goals, it also obscures the facts. The greatest share of carbon-intensive imports reaches the U.S. not from China but from heavily regulated Europe. What's more, a number of studies have found the effects on industrial competitiveness to be minimal. Among other things, they found that the cost of complying with environmental regulation plays little to no role when companies decide where to locate—access to local markets is by far the most important factor, followed by labor costs. In some cases, such as Germany's €160 billion chemical industry, efficiency improvements prodded by environmental regulation have even helped make the industry more competitive, not less. Even the Chinese case is anything but clear. China itself may be polluted, but its exports tend to come from modern, efficient plants, and the country already has higher efficiency standards for vehicles and appliances than the U.S., leading a Chinese official to remark at a Brookings Institution conference in Washington last year that it may be China that should slap carbon tariffs on U.S. products, not the other way around. The trouble now is that the debate is driven less and less by environmental concerns and is turning into one defined by longstanding domestic U.S. worries that cheap Chinese goods will continue to flood the U.S., take jobs and hurt companies. So far in this downturn, the protectionists have been held in check by fears of repeating the mistakes of the 1930s, when a global tariff war plunged the world into depression. Under the cover of green, they could yet have their day. ■

GLOBAL INVESTOR  
Rana Foroohar

# The Bogus Bank Recovery

**I**F YOU TAKE THE HEADLINES AT FACE VALUE, IT HAS BEEN A GOOD MONTH for banks. Wells Fargo announced \$3 billion in first-quarter profits, Goldman Sachs racked up \$1.8 billion, JPMorgan Chase had \$2.1 billion, Bank of America \$4.25 billion and even beleaguered Citigroup tallied \$1.6 billion in profits. Treasury Secretary Tim Geithner validated the good news by declaring that the “vast majority” of the nation’s banks are now well capitalized and solvent. Markets rallied. The worst of the

financial crisis, it seemed, had passed.

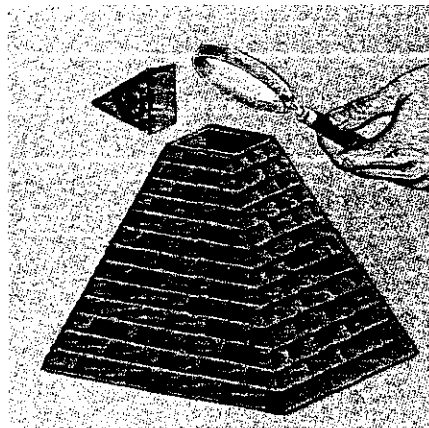
Smart investors know better. At the core, this financial crisis has been driven by uncertainty—about who’s holding what, how much it’s worth and when it might blow up. A careful look at last week’s profit news reveals that there’s still plenty of uncertainty lurking on the balance sheets of America’s top banks.

First, the most glaring examples: even as Bank of America was chalking up its profits, it was also warning that it faced growing credit losses, due to a decline in credit quality across all of its businesses (the bank’s provisions for credit losses rose to \$13.4 billion in the first quarter from \$8.5 billion in the last quarter of 2008). “Make no doubt about it,” said BOA chairman Kenneth Lewis, “credit is bad, and we believe it will get worse before it eventually stabilizes and improves.”

At least he admits it. Goldman’s chair Lloyd Blankfein certainly didn’t go to any pains to explain that a chunk of his bank’s good news came not from savvy trading, but from an accounting shift. Goldman switched from being a securities firm to a bank holding company last autumn, which changed its fiscal year, allowing it to leave much of December—a month with plenty of write-downs—largely off the books. And that’s only the bad news that we can see.

As a high-level source in credit research (who didn’t want to be quoted by name speaking about Goldman) pointed out to me, the bank carries around \$585 billion worth of what are known as “level 2” assets—securities that may not have a clear market price but can be accounted for in the company’s books by comparing them to a similar asset.

That leaves a lot of wiggle room when it comes to recording the value of such assets, which can include loans, securities, etc. If even a small fraction of them are actually worth less than Goldman assumes, it could account for a few billion worth of the company’s first-quarter rev-



**At its core, the financial crisis is about uncertainty; who’s holding what, how much it’s worth, when it will blow up.**

enue. A spokesman for Goldman would not confirm or deny the \$585 billion figure, or whether any level-2 assets had been marked up, but did say, “Goldman Sachs did not announce any material write-ups for the first quarter.”

There are plenty of smart people who believe that the improved profits of not just Goldman, but also most of the big banks in question are in large part the result of relaxed accounting rules. Banks have been lobbying hard for the Federal Accounting Standards Board to lift the “mark-to-market” rule that requires them to account for the value of their assets based on current market prices. Banks didn’t seem to mind this rule when prices were up—and made their results look better—but now they say the rule is unfair, because troubled assets are so hard to sell these days. Early in April, the board relented, easing the rule and allowing banks to write some of those assets back up.

Bottom line: there’s less clarity than

ever about what the remaining junk on bank balance sheets is worth. And it won’t become clear whether those strong first-quarter earnings represent a turning point in the crisis or just more fudging of the numbers, “until it doesn’t matter anymore,” says Sean Egan, head of Egan-Jones, one of the country’s largest independent credit-rating agencies. Government money will ultimately help banks out of the crisis, whatever the cost to taxpayers; forensics on the accounting will have to be done by the historians.

Meanwhile, Ken Lewis isn’t the only one expecting more write-downs. The IMF now expects that total losses in the global financial sector will reach \$4.1 trillion (with \$2.7 trillion of that coming from the U.S.). Banks are expected to carry two thirds of those losses, with insurance companies, pension funds, hedge funds and others taking the rest.

Another recent report by McKinsey takes a similarly bleak view, noting that U.S. banks still hold more than \$2 trillion in toxic assets. Perhaps the most disturbing thing noted by the McKinsey authors is that most of the write-downs that have been taken by banks to date have been on securities and loans that are clearly marked to market. McKinsey notes, however, that about 60 percent of the credit on the balance sheets of U.S. banks are for items that aren’t marked to market, but to those ever-nebulous financial models that got us into all the trouble to begin with. That murky area is where most of the future losses are likely to occur.

This is not to say that there haven’t been some real green shoots in the real economy. But make no mistake—the banking sector isn’t yet out of crisis. Financial executives should be wary of paying back their bailout money until they are much more certain that they aren’t going to need it.

**N** Read our global economics blog, *Wealth of Nations*, at [xtra.newsweek.com](http://xtra.newsweek.com)

# The Bias Against Oil and Gas

**C**ONSIDERING THE BRUTAL RECESSION AND THE WIDESPREAD WARNINGS of a feeble recovery, you'd expect the Obama administration to be obsessed with job creation. And so it is, say the president and his supporters. The trouble is that there's at least one glaring exception to their claims: the oil and natural-gas industries. The Obama administration is biased against them—a bias that makes no sense on either economic or energy grounds. Almost everyone



loves to hate Big Oil (the Exxons and Chevrons), and even small oil, but promoting domestic drilling is simply common sense.

Contrary to popular wisdom, the United States still has huge oil and natural-gas resources. The outer continental shelf (OCS), including parts that have been off limits to drilling since the early 1980s, may contain much natural gas and 86 billion barrels of oil, about four times today's "proven" U.S. reserves. The U.S. Geological Survey recently estimated that the Bakken Formation in North Dakota and Montana may hold 3.65 billion barrels, about 22 times a 1995 estimate. And then there's upwards of 2 trillion barrels of oil shale, concentrated in Colorado. If 800 billion barrels were recoverable, that's triple Saudi Arabia's proven reserves.

None of these sources, of course, will quickly provide much oil or natural gas. Projects take 5, 10, 15 years. The OCS estimates are just that. The oil and gas must still be located—a costly, chancy and time-consuming process. Extracting oil from shale (in effect, a rock) requires heating the shale and poses major environmental problems. Its economic viability remains uncertain. But added oil from any of these sources could ultimately diminish dependence on imports, now almost 60 percent of U.S. consumption, while the exploration and development process would immediately boost high-wage jobs (geologists, petroleum engineers, roustabouts, steelworkers).

Though straightforward, this logic mostly eludes the Obama administration, which is fixated on "green jobs," and wind and solar energy. Championing clean fuels has become a political set piece. On Earth Day (April 22), the president visited an Iowa factory that builds towers for wind turbines. "It's time for us to [begin] a new era of energy exploration in America," he said. "We can remain the world's leading importer of oil, or we can become the world's leading exporter of clean energy."

The president is lauded as a great educator; in this case, he provided much miseducation. He implied that there's a choice between promoting renewables and relying on oil. Actually, the two are mostly disconnected. Wind and solar mainly produce electricity. About 70 percent of our oil goes for transportation (cars, trucks, planes); almost none—about 1.5 percent—generates electricity. So expanding wind and solar won't displace much oil, though there might be some small effect on natural gas for heating. Someday, electric cars may change this. But at best, that's decades away.

For now, the only ways to reduce oil imports are to use less or produce more. Obama has paid some attention to the first with higher fuel-efficiency standards for vehicles. But his administration is undermining the second. At the Department of the Interior, which oversees public lands and the OCS, Secretary Ken Salazar has taken steps that dampen exploration and development: he canceled 77 leases in Utah because they were too close to national parkland, extended a comment period for OCS exploration to

evaluate possible environmental effects and signaled a more cautious policy toward shale for similar reasons.

Any one of these alone might seem a reasonable review of inherited policies, and it's true—as Interior officials say—that Salazar has maintained a regular schedule of oil and gas leases. Still, the anti-oil bias seems unmistakable. Salazar didn't just double the normal comment period on OCS from two months to four; he quadrupled it to eight months. Conceivably, he may reinstate administratively most of the restrictions on OCS drilling that Congress lifted last year. Meanwhile, he's encouraging wind and solar by announcing new procedures for locating them on public lands, including the OCS. "We are," he says, "setting the department on a new path"—emphasizing renewables.

It may disappoint. In 2007 wind and solar generated less than 1 percent of U.S. electricity. Their share of total U.S. energy use was still lower. Even a five- or tenfold expansion of these industries will leave their contribution small. By contrast, oil and natural gas now provide two thirds of Americans' energy. Rise or fall, they will dominate our consumption for decades. Any oil produced here will mostly reduce imports; added natural gas will

**Expanding any fossil-fuel production offends many Americans. But policies placating this prejudice aren't in our national interest.**

tend to displace coal in electricity generation. Neither weakens any anti-global-warming program that Congress might adopt.

It's insane not to encourage U.S. production. The same is true on economic grounds because the promise of green jobs is wildly exaggerated. Look at the numbers. In 2008 the oil and gas industries employed 1.8 million people. Jobs in the solar and wind industries are reckoned (by their trade asso-

ciations) to be 35,000 and 85,000, respectively. Now do the arithmetic: a 5 percent rise in oil jobs (90,000) almost equals a doubling for wind and solar (120,000). Modest movements, up or down, in oil and natural gas will swamp plausible changes in green jobs. They won't save the economy.

Improved exploration and production techniques—drilling in deeper waters, horizontal drilling, hydraulic "fracturing" (pumping liquids into fields to open up seams)—have increased America's recoverable amounts of oil and natural gas. The resistance to availing ourselves of these resources is mostly political and psychological. Among many environmentalists, the idea of expanding fossil-fuel production is a cardinal sin. It offends their religion. The Obama administration too often caters to this reflexive hostility. The resulting policies aim more to satisfy popular prejudice—through reassuring photo ops and sound bites—than meet the country's needs.

POINT OF VIEW  
Barton Biggs

# Why the Markets Are Up

**E**QUITY MARKETS AROUND THE WORLD ARE SURGING IN THE FACE OF THE SICKEST global economy in more than half a century, a crippled banking system that needs billions of dollars of equity capital, a flu scare and house prices that are still falling at a dizzying rate. On April 30, the front page of *The New York Times* read **ECONOMY SLIDES AT FASTEST RATE SINCE LATE 1950S**. That same day, the German finance minister said his country would suffer “the worst recession since the Second World War” and that other European economies were in dire straits.

The declines have been even more severe in Asian economies such as Japan, Korea and Singapore, and most experts are skeptical about the better numbers from China. The “great minds” of the investment world and the most highly regarded economists are preaching gloom and doom and a generation of wealth destruction. The question now: why are stock markets going up when so many economic numbers are going down? First, recognize that the statistics you are now reading are already out of date. The U.S. government reported on April 29 that real GDP fell 6.1 percent in the first quarter after a 6.3 percent drop in the fourth quarter, the steepest six-month decline in 50 years. Yet U.S. stocks rallied to a new recovery high the same day. Why? Because beginning in mid-March, there were signs of what Ben Bernanke called “green shoots” in the real economy, namely that the rate of decline, or the so-called second derivative, was decelerating. Some investors began to believe the world economy was bottoming out.

Now those green shoots are budding into foliage. In the last couple of weeks, there have been signs that the U.S., Germany and Asian economies are on the verge of not just bottoming, but rebounding. It’s beginning to appear that real GDP growth could be positive in the second half of the year—maybe even sooner. Leading indicators, including new orders and the purchasing managers survey, are rising. New home sales, the best leading indicator of the price of existing homes, seem to be stabilizing. Historically, the steeper the GDP decline, the stronger the rebound. Ed Hyman, the most highly regarded Wall Street economist, is talking about 4 percent real growth in the third quarter.

The second key reason markets are up is that most of the gloomy news that is on television and the front pages is already discounted in stock prices. Equity markets are looking ahead, not behind. Remember, this brutal bear market began in the summer of 2007, when the world still appeared to be booming.

As for the “great minds,” once they become celebrities they are wedded to their views. These newly minted heroes dash off books, and get paid big speaking fees. They become committed to their forecast. This is not just true of bears; it happens in bull markets, too. The point is that it is very hard now for the bears to reverse their position. Only the really good ones will.

The third reason equity markets are rising is the unparalleled amount of cash on the sidelines, which will eventually have to be invested. Money-market-fund cash is at a record 40 percent of the

total U.S. market capitalization. Professional sentiment, which we monitor systematically, has risen some in recent weeks, but it is still extremely pessimistic. Major pension funds and endowments—which for decades have automatically sold stocks when they went above a preordained portfolio level, and then bought back into them when they went below the minimum—have suspended automatic buying out of fear. The 25 percent rise in prices we have already experienced puts immense pressure on them to at least get back to their minimums. The pain of missing a bull market is very severe. My guess is they will soon be buyers. We are talking about billions of dollars here.

The fourth reason for the rally is that credit and money markets have improved dramatically. Spreads on everything from high-grade corporate credit to junk bonds have narrowed. The three-month interbank lending rate, which affects so many other rates, has fallen from its recent high of 4.82 percent (right after Lehman failed) to 1.02 percent. And, of great importance, a large number of high- and low-grade credit deals are getting done.

Many analysts call this just a bear-market rally, which has about run its course and should be sold. Instead, I believe this is a cyclical bull market within a broad trading range, which means prices could go up another 10 percent to 20 percent. One signal to do some selling will come when you’re hearing about how much better the world is looking on CNBC television and from your friends. Another warning will be when the market no longer goes up on good news.

We’ve still got huge legacy problems. The aftermath of saving the system through massive monetary and fiscal stimulus is bound to be unpleasant. The piper will eventually have to be paid. Using the S&P 500 as a benchmark, my prediction is that we’ll see a broad trading range somewhere between the March lows of 700 and the 2000 and 2007 highs in the area of 1450 to 1500 over the next few years. Be prepared: within this cage there will inevitably be periodic cyclical bull and bear markets to torture us.



**SHOW ME THE MONEY:** News is bad, but markets are up

**To understand the rally, recognize that the GDP statistics you are reading are already out of date.**

BIGGS is managing partner at Traxis Partners hedge fund in New York.

# The Engine That Could

As the economy shows signs of life, Europe's slow and steady model is proving there's more to life than hypergrowth.

BY CHRISTOPHER DICKEY

AT THE END OF THE RACE BETWEEN THE tortoise and the hare, at least as the 17th-century French fabulist Jean de La Fontaine told the tale, the terrapin cries out, "I won! And what would have happened if you'd been carrying your house on your back!"

As the world's economies slog toward the still-not-quite-visible end of the crisis, Europeans are hoping they'll be able to make a similar boast to the Americans. And thus far, going slow and steady, it looks as if they just might win this marathon, or at least set a useful example. Sure, the U.S. economy is known for being faster off the mark, unfettered by the accumulated weight of what some would call the

welfare state or, God forbid, "socialism." But it's also been the first to crash. And in hard times, Americans are left looking, sometimes rather desperately, for shelter. In continental Europe, especially as the French and Germans see it, the shell is really the secret of long-term success, offering protection from the ferocious storms in the global economy and allowing society to keep functioning smoothly.

Of course, we should drag out this metaphor only so far, but even the hitherto insouciant jack rabbits of laissez-faire capitalism are starting to look at the continental models more closely. The British, who jettisoned much of their burdensome carapace in the





Thatcher years, are so chagrined by their current woes that the free-market bards of *The Economist* recently wrote a paean to ... France! So, too, *The Wall Street Journal*. Lo and behold, they've discovered that French and German workers, even the unemployed ones, are still able to lead decent lives, free of want, free of fear, and with enough left over to buy lunch and go to the movies.

Yet, to understand how this race is playing out, it's not enough just to describe the pricey protections—the universal health care, the generous unemployment benefits—that are the roof and supports of the European economies. The essential difference with the United States lies in attitudes toward government spending and borrowing, a difference that is especially important today, as trillions have become the new billions. “Americans look at debt more as wasteful expenditure, whereas the Europeans look at debt more as an investment,” says Felix Rohatyn, the distinguished banker who helped save New York City from bankruptcy in the 1970s and served as the U.S. ambassador to France in the 1990s. “The Americans by and large look at the government as the enemy.”

The result in the United States was apparent even before the current crisis. Across the country, government-funded infrastructure has been crumbling. “The nation is falling apart—literally,” Rohatyn writes in his recent book, *Bold Endeavors: How Our Government Built America, and Why It Must Rebuild Now*. The spirit of government enterprise that purchased the Louisiana Territory, built the Erie and Panama canals, brought electricity to rural communities and gave GIs college educations after World War II—all those public endeavors that contributed so much to the success of private enterprise seem to have been forgotten.

President Barack Obama is trying to turn those attitudes, and that situation, around. But you know how it is in Washington and on Wall Street. Words like “socialism” are tossed out as epithets, and it's hard to change gears. For at least 30 years Americans have been taught that Europeans are sentimentalists out of touch with the real

world, squandering funds on bleeding-heart *solidarité* with the indigent—and indolent—while piling taxes on the business people who just want to make an honest buck, or euro, as the case may be.

Like all caricatures, there's some truth in that picture. But basically it misses the point. And that, to return to Rohatyn's word, is “investment.” As Europeans tend to see things, governments spend money to acquire assets, both tangible and intangible. This isn't socialism, it's more like Accounting 101 or a corporate report: a reasonable balance sheet. At the national level, the assets might include highways and bridges, air-force bases and nuclear reactors. Add to that the government shares in massive corporations like *Électricité de France* that actually can be sold, in part or in whole. Harder to price but just as important are intangible assets like a well-educated population, police and courts that have the trust of the public and assure orderly life and commerce; and, yes, health care, and, yes, generous (by American standards) unemployment insurance and welfare payments. These are not measurable on stock-market tickers or at auction, but they are real. You might write them up as good will.

At a time of economic crisis, all these elements work together—or they should—and, for the most part in modern Western Europe, they have. So, to use an oft-cited example, people being laid off in Europe do not need to be terrified of getting sick. The social order does not break down. Schools remain open. Commerce continues. There are protests, to be sure, but they pale by comparison with past revolutions in a continent that has deep memories of apocalyptic upheaval. Even the recent spate of “boss-nappings” in France, where workers took over corporate offices and held executives more or less captive, were essentially about getting better payouts from foreign-owned factories they knew would close anyway. In short, they were about exploiting the system, not exploding it.

French President Nicolas Sarkozy, whose relentless energy has been compared to the drum-beating bunny in battery advertisements, came to office in 2007



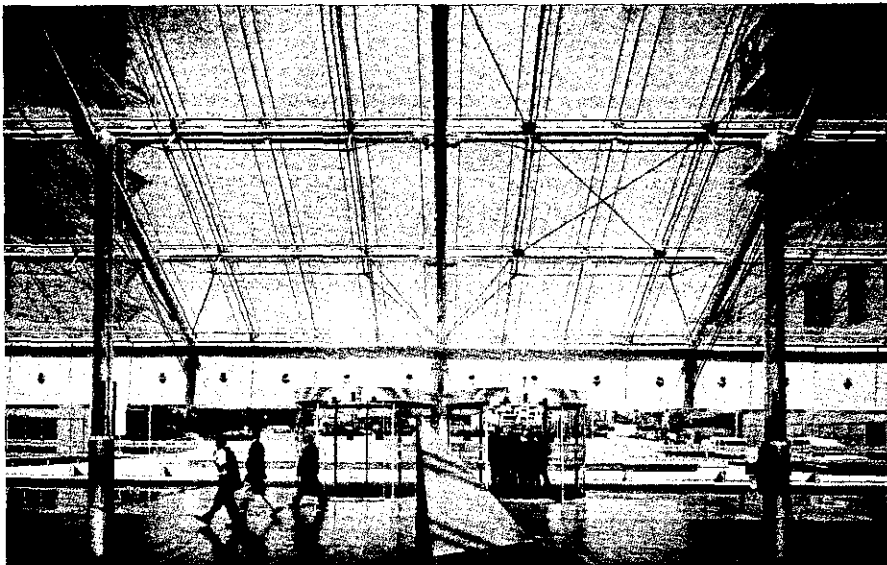
preaching the Anglo-Saxon-style gospel of less government and lower taxes. But the experience and responsibility of office have led him to appreciate the wisdom of the old European tortoise. Not only does he talk about looking at national debt compared with national assets, he's even started to rethink that core indicator of prosperity, the growth of gross domestic product.

In 2008, Sarkozy called on American Nobel laureate Joseph E. Stiglitz to head a commission looking at what might be called the real wealth of nations. “Sarkozy felt there was a tension between what citizens were asking him to do about the environment, noise pollution and all these other quality-of-life issues, but also the pressure around maximizing GDP,” says Stiglitz. “They seemed to be inconsistent with one another, but he felt they shouldn't be. So, we thought we'd try to get a better way of measuring growth, one that would take into account all these factors.”

Measuring the intangible assets for what amounts to a revolutionary accounting project is “extremely difficult,” Stiglitz says, “but it's conceptually correct. We don't yet have a new kind of metric that can replace GDP, but what we want to do

GILLES COULON—TENDANCE FLOUE





PARIS WORKERS  
(OPPOSITE);  
THE POMPIDOU  
HOSPITAL

is start a conversation around this issue. Governments have a misguided way of accounting that looks only at debts, rather than also incorporating assets."

None of this is to suggest that it's better to borrow than not, or that all government investments are made wisely. Many developing countries have shown what happens when massive borrowing is squandered on ill-conceived projects. The burden of servicing the debt starts to impinge, and in some cases overwhelm, every effort to deliver the services and security—the intangible assets—that governments are supposed to provide.

Before the crisis, when French state debts were topping 66 percent of GDP and the United States was in the same range, leaders including Sarkozy were concerned that the burden would weigh on France's ability to compete. But several French economists, among them Anton Brender in books like *France Confronted With Globalization*, argued that the perspective changed radically if you compared debts to assets. As late as 2007, France's government debts were billions of euros less than its tangible assets alone.

As one French economist put it, speaking privately, even in Europe many commentators talk about the amount of debt

each child is going to be born with. But they rarely talk about the amount of assets he or she inherits as part of a modern Western society. Europeans sometimes forget just how well off they are: "The income of a jobless French person," Brender wrote, "is very much higher than most of the workers in the world!"

Which brings us to the critical question of consumption. Such is the relatively relaxed public mood in Europe that there are sometimes stunning displays of nonchalance. As the global economy looked like it was in total free fall a couple of months ago, *Le Parisien*, a popular daily paper with a mainly working-class readership, ran this headline across its front page: IT'S TIME TO THINK ABOUT SUMMER VACATION. But Americans, looking at such examples, tend to miss the most important economic point. In European systems where you can still be a consumer even when you lose your job, the economy keeps cranking, cushioning the fall for everyone.

With U.S. unemployment at 8.9 percent, which exceeds France with 8.3, many Americans feel their backs are to the wall. Unemployment insurance varies from state to state, but generally kicks in later and termi-

nates sooner than in Europe. A study at the University of Connecticut tried to calculate a "generosity index" comparing the U.S. with other industrialized countries. The Americans are way down the list, not only in terms of the unemployment compensation they earn, but, most strikingly, the potentially catastrophic impact of medical expenses. Add to that the problem of pensions that are tied to equity and bond markets: when the markets are tanking, the unemployed in the United States see their long-term as well as short-term future in jeopardy. The effect is to make Americans want to save in a crisis, not spend. And so the crisis risks getting worse.

One of the ironies of the current situation is that the Americans, who have been critical of the Europeans as spendthrifts for years, now knock them for not spending enough. Because the Europeans already have a protective system in place, extensive bank regulation and much less dependency on easy credit to keep consumers spending, they have had less interest than the Americans, and less need, to pour massive amounts of money into the financial system. And one place where the Europeans do not spend nearly so much money is on their militaries. The United States spends more on defense than all other nations in the world combined: more than half a trillion dollars a year. And that doesn't include the roughly \$2.5 billion a week spent on the wars in Iraq and Afghanistan. While all that may prime the pump in some states and at some companies, it hardly has the same impact as healthy consumers who can keep spending even when they lose their jobs.

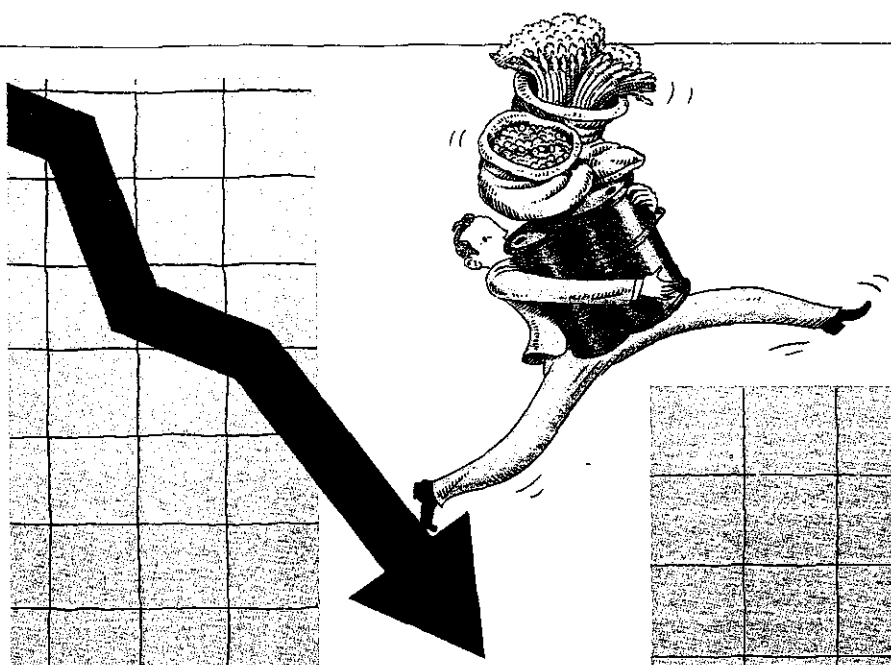
So, what's the moral of the tale? In the real world it shouldn't be about winners and losers, in fact. It should be about the hare who learned a thing or two from the tortoise, then kept on going strong.

With RANA FOROOGHAR in New York City and STEFAN THEIL in Berlin

#### NEXT ►

ON THE HUNT  
FOR JOSEPH KONY  
The last warlord  
in Africa

BY SCOTT JOHNSON



## GLOBAL INVESTING

## Commodities Conundrum. Prices for raw materials are rising despite the recession—and big jumps may be in store

BY MICHAEL SCHUMAN

EIGHTEEN MONTHS AGO, WHEN THE WORLD was awash in asset bubbles, there was perhaps no market more overheated than commodities. Prices of everything from iron ore to palm oil to corn reached dizzying heights. Crude oil nearly quintupled in five years; rice tripled in only five months. World Bank President Robert Zoellick called rising food and oil prices a "man-made catastrophe" that had the potential to quickly erase years of progress in overcoming poverty. Pundits dusted off Malthusian theories that the planet was physically unable to support the burgeoning appetites of an increasingly wealthy global population.

What a difference a financial crisis makes. After the worldwide economic boom went bust, demand abruptly evaporated for many commodities. The Dow Jones-AIG commodity price index has shed more than half its value since mid-2008. The most visible turnaround has been in oil. A year ago, Western governments were pleading with Persian Gulf oil states to ramp up production as oil sped toward \$150 a barrel; today, OPEC is twisting off the spigot in an attempt to support crude prices around \$50. Some experts believe prices may stay depressed for years to come, due to greater energy efficiency, technological improvements in oil production and greater availability of alternative fuels like biofuels.

But over the past several months, the

prices of oil, copper, palm oil and others have rallied. This shouldn't be happening given the parlous state of the world economy. The International Monetary Fund in April cut its global growth forecast for 2009, predicting GDP would contract by 1.3%, the most severe recession since the 1930s. Yet oil is some 60% more expensive now than in December. Palm oil, which is used in a wide variety of manufactured foods, has surged more than 50% this year. "The only area of the world economy I know of where the fundamentals are improving is commodities," says investment guru Jim Rogers. "The fundamentals for General Motors are not improving. The fundamentals for Citibank are not improving. The fundamentals for cotton are improving."

The reason: demand is recovering, slightly, for some raw materials. In the case of oil, supplies have been reduced by OPEC cutbacks. And commodities traders are bidding up market prices in general on expectations that supply shortages will return with just a modest improvement in demand. That's because miners, farmers and oil drillers, hit by the credit crunch, can't finance investments that would increase

**China and India will continue to be ever more voracious consumers of oil, iron ore and food**

their production capacity. Many won't invest today even if they have access to financing because depressed prices make projects uneconomic. The amount of investment in the oil sector, for example, will likely be 30% lower in 2009 and at least 40% less in 2010 than was expected before the financial crisis, according to Merrill Lynch.

Since new oilfields and copper mines take years to get into full production, lower investment today causes tighter supply down the road. At the same time, there is every reason to believe that emerging markets such as China and India will continue to be ever more voracious consumers of iron ore, oil and food as their economies get bigger and their citizens richer. Palm-oil prices, for example, have been rising of late partly because demand from India, with its population of 1 billion, is holding up. In March, China imported a record amount of iron ore and coal, while imports of crude oil hit a 12-month high. The binge is being fueled in part by optimism that Beijing's \$586 billion stimulus program will drive a turnaround in the sagging economy. "After a brief pause, China's appetite for natural resources has returned to buoyant levels," Jing Ulrich, chairman of China equities at JP Morgan in Hong Kong, wrote in a report last month.

Of course, different types of commodities will react differently as the global economy improves, based on their own specific supply-and-demand conditions. This makes timing a turnaround complicated. Rogers says he expects commodities prices to be among the first to rise, out of all asset classes, when economic growth begins to return. Other experts argue against a rapid rebound, because inventories are high for commodities such as oil, and because demand for natural resources has been so thoroughly squelched in some industries that it may not fully recover any time soon. Francisco Blanch, head of commodities research for Merrill Lynch in London, says he doesn't expect overall demand will return to 2007 levels until 2011 at the earliest. "Over a number of years we will get back to supply constraints," says Blanch, but "it won't happen over the next six to 12 months."

Still, bullish investors see little downside in commodities, although returns may not come overnight. Some consider commodities a hedge against another looming threat: inflation. If loose monetary policies implemented by central banks to stimulate growth eventually spark inflation, commodity prices might escalate rapidly. "If the world economy is going to improve, commodities are going to be the best place to be," asserts Rogers. "If the world economy doesn't improve, commodities are going to be the best place to be." Anyone for a truckload of soybeans?

BUSINESS ROUNDTABLE NO. 1

# The Future of Capitalism

**TIME 100** | With our economic world changing so rapidly, many writers and thinkers are looking at the roots of capitalism and how it must evolve. In the first of our series of TIME 100 roundtables, we gathered a stellar cast of honorees to ponder the road ahead

**ARIANNA HUFFINGTON**, *Web entrepreneur*

**ON CAPITALISM** It was clear among many of the founders of capitalism that there had to be a moral foundation. What happened is that capitalism was reduced to Ayn Rand-ian selfishness. We need to recapture the principle that you do well, but in the process of doing well, you give back.

**ON THE BAILOUT** What is fascinating is the agreement among serious economists that we're doing the wrong thing by trying to protect the Wall Street oligarchy. What's amazing is that we're not having enough of a populist outrage about that.

**ON THE MARKET** My concern is that we're looking at the stock market as an indicator of self-correction, and I think that's a fallacy. There is still an illusion among many in this country that we can just get back to where we were, and I believe a) we cannot and b) we should not.

**ON POVERTY** The World Food Program estimates that if you spend just over \$2 billion, you can feed every schoolchild going hungry around the world. We actually need to look at the opportunity cost of what we are not doing when we are saving Citigroup.

**TAVIS SMILEY**, *radio host and broadcaster*

**ON CAPITALISM** I don't think that left to its own devices, capitalism moves along smoothly and everyone gets treated fairly in the process. Capitalism is like a child: if you want the child to grow up to be free and productive, somebody's got to look over the shoulder of that child.

**ON THE BAILOUT** Let's be clear: everybody in this room now is a stockholder in companies that we did not intend to be stockholders in. I'm a stockholder now by chance and not by choice.

**ON POVERTY** I think the American people are O.K. with rich people doing O.K. There is no war against the rich in this country. The question is, When do you start balancing the conversation and start talking about how to lift everybody else up out of poverty? That's not what's happening.

**ON UNEMPLOYMENT** A rising tide lifts all boats, but if you're in a yacht and I'm in a dinghy, we still got a problem here. And that's not counting the folks who are in the water but don't have a yacht or a dinghy.

David Sheff

Somaly Mam

Stephan Schuster

Wendy Kopp

John Legend



**STEPHAN SCHUSTER**, *molecular biologist and biochemist*

**ON CAPITALISM** The system as a whole is still working. But for capitalism to have a future, it needs to survive. What are the regulatory mechanisms that will ensure that in 100 years—in 500 years—there still is a system?

**ON THE ECONOMY** Decisions are being made on quarterly reports, annual reports. National decision makers are re-elected on four-year cycles, six-year cycles. You cannot plan a robust, resilient future if all the decisions that you make have to be paid back in the time frame that you as a person would benefit from.

**ON UNEMPLOYMENT** In other areas of the world, the crisis is about finding qualified people. It's not about finding jobs.

**ON POVERTY** We've been talking about converting bonds into equity. Maybe we need to let people convert the equity that they got into vouchers that can be used for education.

**DAVID SHEFF**, *author of the addiction memoir Beautiful Boy*

**ON HEALTH CARE** A very short time ago, it would have been unthinkable that we would be able to break apart our health-care system in ways that it needs to be broken apart. Here's an opportunity to rethink the whole thing.

**ON ADDICTION** Recently President Obama said something that anybody who works in this field knows intimately: that we need a new paradigm. We have to treat

addiction, drugs and mental illness for what they are: a health-care crisis. For every dollar spent to treat mental-health-related problems, we save \$36 on other costs.

**ON DRUGS** In the field that I've been working in, there's a conversation about something that was unthinkable years ago: decriminalizing marijuana. Instead of sending people to jail, that money can be directed to treatment.



**TIME 100 panel**  
Participants met recently with managing editor Richard Stengel, far right

**WENDY KOPP**, *CEO, Teach for America*

**ON SERVICE** If someone had said 20 years ago that 15% of Princeton's senior class would apply to teach in our highest-poverty communities, people wouldn't have believed it. There's something truly profound about that.

**ON EDUCATION** We could solve education inequity. We can certainly reach the point in our country where every kid gets an excellent education. There's nothing keeping us from that other than enough tremendous leaders, tremendous talent, channeling their energy in that direction.

**ON INEQUALITY** We are seeing evidence that when we build our schools in a certain way, when we teach kids in a certain way, we can take kids that face challenges of poverty and racism and put them on a level playing field.

**ON THE GLOBAL LEARNING GAP** On these international comparisons, our kids are comparable to the average kids in Spain and Portugal. They're quantifying the impact of that to it costing us between \$1.3 trillion and \$2.3 trillion a year.

**SOMALY MAM**, *activist*

**'Sexual exploitation is happening around the world. It's not just in Cambodia, not just in poor countries ... If women don't have an education, they can be exploited everywhere.'**

**JOHN LEGEND**, *musician*

**ON CAPITALISM** I believe there is a role for the government to play in evening the playing field and investing in development. We need to invest in the future and invest in the global good. Capitalism is not just a free-for-all, every man for himself.

**ON EDUCATION** It is not acceptable for our education system to be as poor as it is. We know we can raise people's IQ significantly, just based on a better [learning] environment, better parenting techniques and better schools.

**ON THE FUTURE OF WORK** Young people going into the workplace have to be more dynamic. We won't stay in a job for 30 or 40 years like our parents did. My dad worked in a truck factory from the day he got out of the National Guard to when he retired. The same factory. Those jobs aren't going to be there.

**ON POVERTY** It's going to be better for the globe, it's going to be better for capitalism itself if we don't have nearly a billion people living on less than a dollar a day.

# Global Business

□ MIDDLE EAST SPECIAL

INSIDE

The gloomiest predictions—that the sand dunes will reclaim the skyscrapers—are overdone.

ANDREW LEE BUTTERS ON DUBAI'S DOWNTURN



## GLOBAL ECONOMY

**Buying Muslim.** Islam has always dictated how certain foods should be prepared. Now firms are applying halal concepts to everything from perfume to hotels. A look at a trillion-dollar industry

BY CARLA POWER

KHALFAN MOHAMMED HAS LONG BEEN buffeted by culture shock while staying in five-star hotels. As a devout Muslim he has learned to ask staff to remove the minibar's alcohol. He loathes lobbies with loud discos and drunken guests. When traveling with his parents, it is the bikinis that rankle most. "It was quite shocking for my mother to sit in a restaurant with undressed people," the Abu Dhabi-based businessman says. "My mom and dad are not used to seeing people in public wearing their underwear." To avoid such embarrassment, the Mohammeds took to renting furnished apartments.

No longer. On a trip to Dubai last year, Mohammed stayed in the Villa Rotana, one of a growing number of hotels catering to Muslim travelers. In the lobby—all white leather, brick and glass, with a small waterfall—quiet reigns. Men in *dishdashas* and veiled women glide by Westerners who are sometimes discreetly reminded to respect local customs. Minibars are stocked not with alcohol, but with Red Bull, Pepsi and the malt drink Barbican.

Time was, buying Muslim meant avoiding pork and alcohol and getting your meat from a halal butcher, who slaughtered in accordance with Islamic principles. But the halal food market has exploded in the past decade and is now worth an estimated \$632 billion annually, according to the *Halal Journal*, a Kuala Lumpur-based magazine. That's about 16% of the entire global food industry. Throw in the fast-growing Islam-friendly finance sector and the myriad other products and services—cosmetics, real estate, hotels, fashion, insurance—that comply with Islamic law and the teachings of the Koran, and the sector

is worth well over \$1 trillion a year.

One reason for the rise of the halal economy is that the world's 1.6 billion Muslims are younger and, in some places at least, richer than ever. Seeking to tap that huge market, non-Muslim multinationals like Tesco, McDonald's and Nestlé have expanded their Muslim-friendly offerings and now control an estimated 90% of the global halal market.

At the same time, governments in Asia and the Middle East are pouring millions into efforts to become regional "halal hubs," providing tailor-made manufacturing centers and "halal logistics"—systems to maintain product purity during shipping and storage. The increased competition is changing manufacturing and supply chains in some unusual places. Most of Saudi Arabia's chicken is raised in Brazil, which means Brazilian suppliers have built elaborate halal slaughtering facilities. Abattoirs in New Zealand, the world's biggest exporter of halal lamb, have hosted delegations from Iran and Malaysia. And the Netherlands, keen to maximize Rotterdam's role as Europe's biggest port, has built halal warehouses so that imported halal goods aren't stored next to pork or alcohol.

Such arrangements cost, of course, but since the industry's anchor is food, business is booming, even in the economic crisis. "What downturn?" asks Nordin Abdullah, executive director of the *Halal Journal*. "You don't need your Gucci handbag, but you do need your hamburger."

Not just hamburgers. Drug companies such as the U.K.'s Principle Healthcare and Canada's Duchesnay now sell halal vitamins free of the gelatins and other animal derivatives that some Islamic scholars say make mainstream products *haram*, or unlawful. The Malaysia-based company



Granulab produces synthetic bone graft material to avoid using animal bone, while Malaysian and Cuban scientists are collaborating on a halal meningitis vaccine.

In the Gulf, the Burooj real estate company is carving out a niche, not just because it deals exclusively with Islamic banks, but because it designs spas and swimming pools that segregate the sexes. For Muslim women concerned about skin-care products containing alcohol or lipsticks that use animal fats, a few cosmetics firms are creating halal makeup lines.

## A Halal Shopping Cart. From fast food to fashion, the sector is thriving



### FOOD

Non-Muslim multinationals such as KFC and Nestlé dominate the halal food market. But Muslim-owned manufacturers such as Dubai-based Al Islami—which sells everything from chicken burgers to packaged ingredients—are growing fast.



### LIFESTYLE

Muslims—many of them young and increasingly middle-class—are buying more magazines, such as U.K.-based Emel, and halal cosmetics made, like these Saaf products, without alcohol or animal fats, which Islam considers haram, or forbidden.





The burgeoning Islamic finance industry is using the global economic crisis to win new non-Muslim customers. Investors are attracted by Islamic banking's more conservative approach: Islamic law forbids banks from charging interest (though customers pay fees) and many scholars discourage investment in excessively leveraged companies. Though it currently accounts for just 1% of the global market, the Islamic finance industry's value is growing at around 15% a year, and could reach \$4 trillion in five years, up from \$500 bil-

**Fresh look** Malaysia-based El Hajj markets skincare products such as moisturizer and facial cleanser to pilgrims headed to Mecca

lion today, according to a 2008 report from Moody's Investors Service.

Those who define the halal market in the traditional sense—as a matter of meat, and no more—see the industry stopping at Islamic food standards. But the movement's more bullish advocates envisage Muslim cars and halal furniture built in accordance with Muslim finance, labor and ethical principles. Citing the kosher and organic industries as successful examples of doing well by doing good, some entrepreneurs even see halal products moving into the mainstream and appealing to consumers looking for high-quality, ethical products. A few firms that comply with the Shari'a code—the religious laws that observant Muslims follow—point out that already many of their customers are non-Muslim. At the Jawhara Hotels, an alcohol-free Arabian Gulf chain run by the Islam-compliant Al Lotah conglomerate, 60% of the clientele are non-Muslims, drawn by the hotels' serenity and family-friendly atmosphere. Dutch-based company Marhaba, which sells cookies and

**'People will not buy halal simply because it's halal. Ideology doesn't make a better-tasting burger, or a better computer.'**

—ZAHED AMANULLAH, EUROPEAN MANAGING DIRECTOR, ZABIHAH.COM

chocolate, says a quarter of its customers are non-Muslims, mostly people concerned not about religious edicts but about food safety. "People are always looking for the next purity thing," says Mah Hussain-Gambles, founder of Saaf Pure Skincare, which markets halal makeup.

### Going Mainstream

TODAY, THOUGH, THE BIG BUSINESS IS IN working out how to serve the increasingly sophisticated Muslim consumer. "The question now for companies is: What products and services are you going to provide to help Muslims lead the lifestyle they want to lead?" asks the *Halal Journal's* Abdullah. It's a code worth cracking. A 2007 report from the global ad agency JWT describes the Muslim market thus: "It's young, it's big, and it's getting bigger." Parts of it are well-educated and wealthy. The buying power of American Muslims alone is estimated at a hefty \$170 billion annually. But with few exceptions, American marketers ignore them, says Ann Mack, JWT's director of trendspotting. "Muslims don't feel that brands are speaking to them," she says. "When we did the study, it was very difficult to find mainstream companies that were making significant programs geared toward the Muslim population."

That's less of a problem elsewhere. Indeed, the most innovative new halal products and services often come out of Europe and Southeast Asia, places where your average food supplier or bank may know little, if anything, about halal. In Europe—the biggest growth region according to the *Halal Journal*—young devout Muslims are hungry for Islamic versions of mainstream pleasures such as fast food. "The second- and third-generation Muslims are fed up with having rice and lentils every day," observes Darhim Hashim, CEO of the Malaysia-based International Halal Integrity Alliance. "They're saying, 'We want pizzas, we want Big Macs.'" Domino's now sources halal pepperoni from a Malaysian company for the pizzas it sells from Kuala Lumpur to Birmingham; KFC is testing halal-only stores in Muslim areas of the U.K., and the Subway sandwich chain has halal franchises across Britain and Ireland.



### SERVICES

Hotels run along Islamic lines, such as Dubai's Villa Rotana, offer quieter and more family-friendly places to stay. Banks that operate according to Shari'a law are doing well during the global downturn because they tend to be more conservative.

STILL: PALANI MONAN—REPORTAGE BY GETTY IMAGES FOR TIME; HOTEL: MATLOO GATTONI—ARABIAN EVE FOR TIME





Hot product A Dubai fast-food chain markets its wares at Kuala Lumpur's World Halal Forum

Swiss food giant Nestlé is a pioneer in the field. It set up its halal committee way back in the 1980s, and has long had facilities to keep its halal and non-halal products separated. Turnover in halal products was \$3.6 billion last year, and 75 of the company's 456 factories are geared for halal production.

For non-food companies like South Korea's LG and Finnish cell-phone giant Nokia, targeting Muslims is also big business. LG offers an application to help users find the direction of Mecca, while Nokia has free downloadable recitations from the Koran and maps showing the locations of major mosques in the Middle East. Such offerings increase brand loyalty, according to market research by the Finland-based Muslim lifestyle portal Muxlim.com. "There's a lot of room out there for mainstream brands to appeal to Muslims without making changes to their products," says Muxlim.com's CEO Mohamed El-Fataty. "It's just about their marketing messages, about showing that this brand is interested in them as consumers."

It's also about understanding the nuances. The hypermarket run by French supermarket giant Carrefour at the Mid Valley Megamall in Kuala Lumpur is overwhelmingly halal, with an elaborate system to keep halal foods separate from the *haram* ones. Goods that divide scholars on whether they're halal or *haram* because they could have trace elements of wine—Balsamic vinegar, say, or Kikkoman Marinade—get slapped with little green stickers to alert customers. More blatantly *haram* items are confined to La Cave, a glassed-in room at the back of the store for goods containing alcohol, pork or

tobacco. Wearing special blue gloves, La Cave's staff handle *haram* goods and seal them in airtight pink plastic wrapping after purchase, so as not to contaminate the main store. "I'm so scared," said Norini Razak, a 23-year-old regular Carrefour shopper in a grey-and-white hijab. "It's difficult for one to know what is halal and what is not, so I'd prefer to go to a shop with labels [to help me]."

### It's Not Just Business

THE RISING CONCERNS OF CONSUMERS like Razak herald not just a global economic trend, but a cultural one. During the 1980s and '90s, many Muslims in Egypt, Jordan and other Middle Eastern countries expressed their religious principles by voting Islamic. Today, a growing number are doing so by buying Islamic, connecting to their Muslim roots by what they eat, wear and play on their iPods. Rising Muslim consumerism undermines the specious argument often heard after 9/11: that Muslims hate the Western way of life, with its emphasis on choice and consumerism. The growing Muslim market is a sign of a newly confident Islamic

identity—one based not on politics but on personal lifestyles. "Muslims will spend their money more readily on halal food and products than on political causes," says Zahed Amanullah, European managing director of the California-based Zabihah.com, an online guide to the global halal marketplace.

Like many Muslim Americans, Amanullah grew up eating Jewish kosher food in order to conform to Muslim strictures on animal slaughter. But increasingly, there's no need for Muslims to go kosher. Zabihah offers tens of thousands of reviews of halal restaurants, from fried chicken joints in Dallas to pan-Asian restaurants in Singapore. Says Amanullah: "We can't keep up."

The dazzling range of new products and services also reflects the seismic social changes under way in the Muslim world. One of the reasons why halal frozen food, lunch-box treats and quick-fix dinners are growing in popularity is that many more Muslim women, from Egypt to Malaysia, have full-time jobs.

Western Muslims, whose minority status sharpens their sense of identity, are also helping refine the notion of a Muslim lifestyle. In Britain, advertisers are increasingly embracing the power of the "green" pound (that's Islamic green, not environmental green), says Sarah Joseph, editor of *Emel*, a glossy lifestyle monthly for British Muslims. When *Emel* launched in 2003, the notion of a Muslim lifestyle barely existed. "People were confused that we could present everything from food, fashion, travel and gardening, all from a Muslim perspective," says Joseph. But Muslims are the fastest-growing segment of the middle class in Britain; they have big families—an average of 3.4 children against the national average of 1.9—so they buy big cars; they spend money on home decoration and twice-yearly vacations—"not just going back to Pakistan or Bangladesh, like their [immigrant] parents did," says Joseph. Bucking the current publishing trend, *Emel* is hiring extra staff and planning new magazines to cater to Muslim readers. Advertisers include British Airways and banking giant HSBC.

To keep growing, halal firms know they can't simply rely on religion. "Ideology does not fit within a consumer mindset," observes Amanullah of Zabihah.com. "At the end of the day, people will not buy halal simply because it's halal. They're going to buy quality food. Ideology doesn't make a better-tasting burger, a better car, or a better computer." But it sure makes a powerful marketing pitch. —WITH REPORTING BY SHADIAH ABDULLAH/DUBAI

### BY THE NUMBERS ...

**16%**

Halal's share of global food industry

**\$632 billion**

Annual halal food market

**1.6 billion**

Worldwide Muslim population

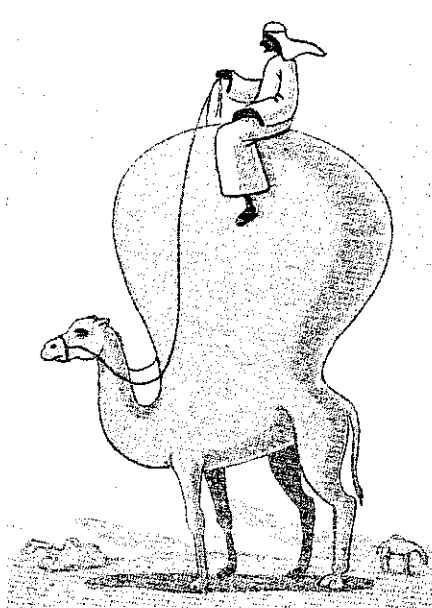
# Lessons Learned

Saudi Arabia has been through boom and bust before. That's given it an edge over many of its neighbors

THE ECONOMIC BOOM IN THE GULF countries over the past few years—fueled by the continuous rise of oil prices between 2003 and 2008—helped put the region on the global economic map. In some ways, the boom became captive to a “mine is bigger than yours” syndrome. Competing states embarked on advertising campaigns and hired in public-relations firms to tout their wares. Developers and rulers alike pushed artificial islands (Dubai, Abu Dhabi, Qatar, Bahrain, Kuwait), and in many places real estate became the main economic activity. Officials promoted their cities as financial hubs as a way to diversify away from oil. Hundreds of millions of dollars were poured into national air carriers and airports, which were seen both as a source of national pride and as another way to expand the energy-dependent economies.

While oil revenues were flowing, sovereign wealth funds acquired foreign assets with the flair of peacocks. The humility that typified the past was supplanted by conspicuous consumption. Yes, all that infrastructure and new property that was built still exists—but its quality and engineering is, in many cases, dubious.

In contrast, Saudi Arabia's institutional memory of the boom and bust cycle served it well during what was the kingdom's third great oil boom of the past four decades. After the high prices of the 1970s, Saudi Arabia's economy went through a long-drawn-out slowdown as oil revenues plummeted for most of the 1980s. After a spike when Iraq invaded Kuwait, prices weakened again in the 1990s, even as Saudi struggled to pay off its (large) chunk of the bill for the first Gulf War. At the height of the Asian fi-



nancial crisis in 1998, oil prices had fallen to just \$12 a barrel. This meant that Saudi Arabia—which sells its precious black gold at a discount, on average—was getting just \$7 a barrel. Deficit financing was the only solution, and the government started borrowing at home and abroad. By 1999, Saudi Arabia's government debt was bigger than its economy. And then came 9/11, which drove the final nails into the coffin of the country's image. A series of terrorist attacks inside the country added to the sense of chaos. Some predicted the end of the House of Saud.

But when oil prices started to rise in 2003, Saudi Arabia was ready. For one thing, the Saudi Arabian Monetary Agency, the country's central bank, had greatly expanded the number of well-trained national staffers. Second, it had at its helm officials who remembered the bad days of low oil revenues. That meant that when the oil gushers were turned up again, money was saved and not aggressively spent as elsewhere in the region. The nation's wealth was also placed in very liquid investments, predominantly U.S. government paper as-

sets, rather than real estate. While other regional investment funds were buying into international banks, Saudi Arabia was purchasing U.S. government bonds, or paying down its debt. The country can tap into those liquid assets while its neighbors are struggling to sell their investments in banks, equities and companies—Saudi's debt now stands at just 13% of the total size of its economy.

Third, King Abdullah, though often criticized as being too “frugal,” has stuck to sensible spending. It is this that has saved Saudi Arabia. Even the ambitious economic cities that were announced at the end of 2005 were private-sector initiatives, not state-financed ones.

Fourth, the banking sector, thanks to its experience during the 1990s, has taken a conservative approach to lending, and remains highly unleveraged. Importantly, real estate in Saudi Arabia did not experience the same bubble that occurred in the country's neighbors; as a result consumers and lenders have been protected.

Fifth, during the boom years, Saudi Arabia invested more than \$70 billion in expanding its oil production capacity to 12.5 million barrels per day, not only to secure its future but also to address global supply imbalances.

To be sure, the two stock market slumps in 2006 and 2008 created negative wealth effects. High-net-worth businessmen have been hit by the current global financial crisis. But there is no doubt that the macroeconomic picture is solid and healthy. Over the next five years Saudi Arabia has outlined a \$400 billion spending program. In a decade or thereabouts, Saudi Arabia will become a \$1 trillion economy and will be better placed than the rest in the region to capitalize on its knowledge and strengths. During the boom years, some critics said Saudi Arabia should become more like Dubai. Now the rest of the region might want to become a bit more like Saudi Arabia. ■

*John Sfakianakis is chief economist of the Saudi British Bank (SABB)*

**While oil revenues were flowing, sovereign wealth funds acquired foreign assets with the flair of peacocks**

ILLUSTRATION FOR TIME BY ALISON SEIFER

## ECONOMY

## Sand Castles. Dubai's property boom has imploded, leaving behind broken dreams and angry investors



**Beached** The bust has hurt developers behind projects like Palm Jumeirah, and left tens of thousands of properties empty across the city

BY ANDREW LEE BUTTERS/DUBAI

AS THE MANAGER OF A DUBAI REAL ESTATE brokerage, Imran Mohamed, a Scot of Pakistani descent, had a front-row seat at one of the most incredible property bubbles ever. Early last year, a few months before the height of the emirate's boom, he fought his way through the lines at the opening sale of a new waterfront condominium development. Such launches always attracted crowds of investors eager to get the first shot at a new offering, but the buzz that day was especially intense, remembers Mohamed. (He asks that his real name not be used because his company is in financial difficulty and he may leave the country.) Helicopters circled the event "as if David Beckham had arrived at the airport," he says. Inside, Mohamed put a down payment on an apartment, walked out the door, and sold the unit to a Russian man on the street for double

his purchase price. The man paid cash. In just 20 minutes Mohamed had made \$408,000. The lesson: "In Dubai, you can throw your ethics and economics textbooks right out the window, because the rules just don't apply."

For a long time, the normal laws of economics did not seem to apply in Dubai, the most populous of the seven states that comprise the United Arab Emirates. Abu Dhabi, the seat of political power in the UAE, controls most of the country's oil

**'It was like a game of musical chairs. When prices went down, liquidity dried up, and you got stuck.'**

—ROBERT MCKINNON, HEAD OF REAL ESTATE RESEARCH AT AL MAL CAPITAL

resources. With less oil to tap, Dubai has used low taxes, easy money and cheap Asian labor to transform itself into one of the region's most dynamic economies. The city state developed a kind of signature swagger, expressed most gaudily in the gargantuan real estate projects—an indoor ski slope, man-made islands shaped like palm fronds, the world's tallest building—that have turned a sandy sliver on the Gulf into one of the world's fastest-growing cities.

Inevitably, though, the laws of economics have reasserted themselves. Since oil prices plummeted, and world stock markets crashed last fall, some \$75 billion worth of real estate projects have been suspended and canceled in Dubai, according to a report by the local branch of HSBC bank. Business journal the *Middle East Economic Digest* puts the figure at more than \$300 billion. Postponed developments include the World, a luxury man-made

island community designed to resemble a world map, and Dubailand, a theme park planned to be twice the size of Florida's Disney World. Housing prices have fallen 20%-40% from their peak in late 2008, and about 30% of the city's existing real estate space is lying empty.

The gloomiest predictions—that the sand dunes will reclaim the skyscrapers—are overdone. Abu Dhabi has kept Dubai afloat by snapping up \$10 billion of a \$20 billion Dubai bond issue. Among other things, the bailout money has helped shore up the state-owned development companies behind most of those massive building projects. Still, the shakeout is probably not over yet, according to Saud Masoud, an analyst at the Dubai office of investment bank UBS. Masoud predicts house prices could eventually fall as much as 70% from last year's highs. "You can't just put in more capital," he says, arguing that Dubai needs to be more transparent about the seriousness of the real estate crisis, and diversify its economy. "At some point demand has to meet supply. Dubai needs to think long and hard about re-branding itself into something more than just a luxury real estate investment paradise. Right now investors are scared."

Dubai's rise had been decades in the making, but the property market really exploded following a 2003 law change that made it easier for foreigners to own land. With credit cheap and readily available, no income tax, and many more sunshine hours than Britain or Russia, Dubai attracted a new wave of Europeans, who arrived with big hopes and little understanding of Muslim values. In one infamous culture clash, two Britons were imprisoned for having sex on a public beach and insulting police officers after a drunken Friday brunch.

The one language that everyone agreed upon was real estate, and the property frenzy was soon dragging in locals and newcomers alike. Nightclub promoters became fund managers overnight, simply by collecting money from their pub mates back home. "It's not rocket science," says Martin Rumney, a 44-year-old former golf instructor from Britain turned Dubai real estate agent. "This is pretty easy money. You just have to be a people person."

There was just one problem. Though prices rose by as much as 400% during the boom years, few people wanted the finished properties they had purchased—usually off plan, and often well before the first spadeful of earth had been turned. The market was driven by speculators, interested only in trading—or "flipping"—incomplete units, which often sold for more than completed buildings, and might get

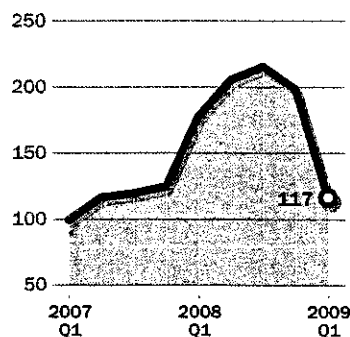
flipped 10 times before construction finished. "You can't believe how crazy this was," says Robert McKinnon, head of real estate research at Al Mal Capital, a local investment firm. "Everyone knew it was like a game of musical chairs. When prices were going up and there was liquidity, you could get three offers by the end of the day. But when prices went down, liquidity dried up, and you got stuck."

When the bottom finally fell out, many investors found themselves holding properties they didn't want or couldn't afford. Others found themselves with nothing at all. Only 70% of the off-plan projects will end up being built, according to McKinnon. More than half of all developers have simply shut up shop or been delisted by real estate regulators; more reputable developers are consolidating projects and offering investors in canceled developments ownership in different locations.

Nigel Knight, a 45-year-old carpenter

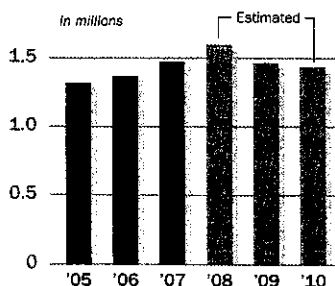
## After the Party. House prices are diving and foreign workers leaving

**A BUBBLE BURSTS**  
Dubai property price index (foreign-owned apartments and houses)



Source: Colliers International

**HEADING HOME**  
Population of Dubai



Source: UBS Investment Research

from Britain, started a lobbying group of disgruntled Dubai investors after he found that the developer of a villa he'd bought near the future site of Dubailand wasn't depositing his money in an escrow account reserved for construction funds. He suspects his and other investors' money was used by the developer to purchase more land and then sell off more units without ever starting construction at a single site. "It seems to be some kind of Ponzi scheme," he says. What's worse, he then discovered that the company may have sold his property twice. "I thought Dubai looked like the safest place to invest in the Middle East," he says. "They appeared to have laws that would protect investors." But Dubai's real estate regulatory body was set up just two years ago. And Dubai's legal system gives no right to bring class-action suits, leaving Knight and his group drawing names out of a hat to see which of them gets to go first.

## Used Car, Low Miles

RATHER THAN FIGHT THE SYSTEM, MANY foreigners are fleeing the country. Used-car dealerships have been bombarded by departing foreigners trying to sell their vehicles, but dealers have stopped buying because there's no longer a resale market. "I've got no space; no one has any money; and no one's buying," says one. A government-run auction is doing a brisk business selling vehicles that have either been repossessed or been abandoned by their debt-ridden owners at the airport. Local website classified sections are filled with desperate ads offering entire household furnishings—often practically new—for a song. "Relocation forces complete sale of all furniture and household items," reads one. "Massive savings as a job lot."

Mohamed, the Scottish real estate broker, is thinking of leaving too. His company is declaring bankruptcy, he says, and security guards recently prevented him from removing furniture from his office because of a rent dispute with the landlord. A local bank keeps calling to ask for the whereabouts of a former employee, a male nurse from Edinburgh who came to Dubai, hit the nightclub scene, bought a Porsche convertible, and then fled home after a week on the job, leaving about \$115,000 in debt. "What were [they] thinking, loaning £80,000 to a 24-year-old with no stable job who'd been in the country just eight weeks?" asks Mohamed. "When things are good, no one wants to open their eyes." He recently bumped into his former employee in Edinburgh. "He said 'I don't know you and you don't know me,'" says Mohamed. "What happens in Dubai stays in Dubai."