



Institute of Strategic and International Studies (ISIS) Malaysia

**CURRENT ECONOMIC SITUATION
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CURRENT ECONOMIC SITUATION

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The 74-story
China World
Tower 3, slated
to open
this year

The Building Bubble in China

Much of the country's stimulus money was spent on skyscrapers. Fears of a real estate bust have followed

By Michael Forsythe and Kevin Hamlin
BEIJING

Jack Rodman has cashed in on property busts from Los Angeles to Tokyo, buying and selling soured loans and counseling other investors. Now he's convinced the Beijing real estate market is about to tumble. Rodman figures about half of the city's commercial

space is vacant, and to prove it he keeps a slide show of 55 empty office buildings in the Chinese capital on his computer. There are an additional dozen, he says, that he hasn't had time to photograph. "I took these pictures to try to impress upon people the massive amount of oversupply," says Rodman, president of Global Distressed

Solutions, which advises investors on Chinese property.

Much of the \$1.4 trillion in loans made by Chinese banks last year—with considerable encouragement from officials aiming to boost growth—was spent on skyscrapers and other commercial property. Now empty buildings are sprouting across the mainland. Beijing had an office vacancy rate of 22.4% in the third quarter, the ninth-highest of 103 markets tracked by broker CB Richard Ellis (CBRE). That figure doesn't include projects about to open, such as the 74-story China World Tower 3, Beijing's tallest building. "There's a monumental property bubble and fixed-asset investment bubble under way," says James Chanos, founder of New York hedge fund Kynikos Associates. "And deflating that

gently will be difficult at best."

Worried Beijing policymakers are trying to choke off the supply of funds fueling the property boom. On Jan. 27, the China Banking Regulatory Commission, the chief oversight body, called on banks to curb loan growth. They should "strictly" follow real estate lending policies, the commission said in a notice on its Web site. "The Chinese authorities are clearly trying to bring excessive bank lending under control," says Stephen Roach, the chairman of Morgan Stanley Asia.

HIDDEN EXPOSURE

The central bank on Feb. 12 increased reserve requirements, the money banks must keep on hand to cover potential losses, for the second time this year. That should reduce the amount of money banks have available for new loans, helping to slow growth. Now some economists are speculating that the government could allow China's currency, the yuan, to appreciate against the dollar for the first time since July 2008.

"They're close to moving the exchange rate. I think something's brewing," says Jim O'Neill, London-based chief global economist at Goldman Sachs.

If Beijing can't cool things off and the property boom turns to bust, there could be a surge in nonperforming loans. A 10% fall in property values would triple the number of delinquent mortgages in Shanghai, regulators in the city said on Feb. 4. The damage could be worse than expected because some industrial loans to state-owned companies have been used to invest in real estate, says Charlene Chu, an analyst at Fitch Ratings in Beijing. "There is a lot more hidden property exposure there than we can see," Chu says.

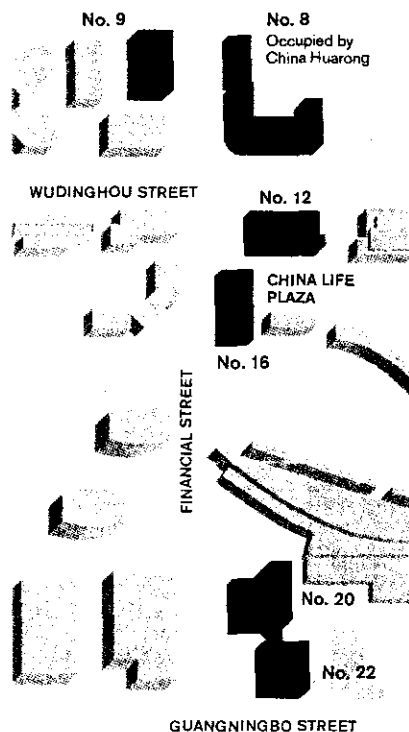
Despite the bubble talk, some analysts say the worries may be overblown. CBRE says vacancy rates are starting to fall and rents are rising

for the best buildings as China's growth buoys demand. "In many cases when you look at these buildings and say, 'That's never going to be fully occupied,' somehow 12 to 18 months later the building is full," says Chris Brooke, CBRE's Asia chief.

Builders, meanwhile, continue to build. Some 13 million square feet of new office space will enter the market in Beijing this year, increasing the total stock by about 13%, according to real estate adviser Jones Lang LaSalle. "We are optimistic about 2010 prospects," says Zhong Rongming, deputy general manager of the China World Trade Center Co., which developed the \$965 million China World Tower 3. "China is taking the lead in the global economic recovery

GHOST TOWN

Empty and nearly empty buildings on Beijing's Financial Street may point to a bust.



Rodman keeps a slide show of 55 unoccupied office buildings in Beijing

with a very positive economic outlook."

Many of the new projects are being built with help from local governments. In eastern Beijing, officials are hoping to double the size of a vast development called the Central Business District, even though its vacancy rate is 35%. Financial Street Holding, whose biggest shareholder is an arm of the municipal government, has plans for 10 million square feet of additional space starting this year.

GATHERING DUST

A mile or so east of Tiananmen Square, the five towers of the Minsheng Financial Center remain nearly empty more than a year after leasing began. Across town, take a walk down Financial Street, and you'll pass No. 9, a 17-story concrete-and-glass tower that's unoccupied. One block south, no lights shine from Nos. 12 and 16, the two towers of the 18-story China Life Plaza. Two blocks farther on are another pair of 18-story buildings, Nos. 20 and 22, belonging to the Bank of Communications. Dirt is gathering at their doors, and a lobby is being used as a parking area for bicycles.

No. 8 Financial St., by contrast, has a new tenant. A company called China Huarong Asset Management has put up its corporate flag and red lanterns in celebration of the Lunar New Year. While any activity on that desolate stretch should cheer those who fear a bubble, Huarong's arrival may do more to fuel their concerns than to allay them. Its mission: selling bad debt from banks. |BW|



Economic Gurus on Future Growth

Four ministers explain China's stimulus measures and future prospects

By HU YUE

The GDP grew 8.7 percent year on year in 2009, beating the government-set target of 8 percent. Though overshadowed by the turbo-charged growth rate the country enjoyed in previous years, the turnaround was swift enough to make China the first major economic power to tide over the downturn.

At a press conference during the Third Session of the 11th National People's Congress, Zhang Ping, Minister of the National Development and Reform Commission (NDRC); Xie Xuren, Minister of Finance; Zhou Xiaochuan, Governor of the People's Bank of China; and Chen Deming, Minister of Commerce, wrapped up discussions on economic situations facing the country and pointed to a bright prospect for future growth.

Shrugging off the downturn

The 4-trillion-yuan (\$586 billion) stimulus package has been an important

part of China's countermeasures to the financial crisis, said Zhang Ping, Minister of NDRC. First, the stimulus package delivered a strong boost to market sentiment and strengthened confidence to shake off the downturn. Second, it has effectively widened domestic demands, allowing the economy to reduce its dependence on exports. Third, massive investments have properly addressed problems of the economy glossed over in past boom times. Fourth, the package is helpful with improving the people's livelihood and conditions for industrial productions. Fifth, China's bailout plan also had a positive impact for the recovery of the world economy, and provided a fresh source of confidence for the crisis-stricken Western world.

More specifically, the Central Government allocated 924.3 billion yuan (\$135.4 billion) in public investments in 2009, 503.8 billion yuan (\$73.8 billion) more than the previous year's budget, according to Zhang.

All money was effectively used to revitalize the economy and no capital went into the real estate market, energy-guzzling sectors, highly polluting industries or exports of resource products, he said.

Around 44 percent of the capital was distributed to affordable housing projects, rural infrastructure, social welfare, education and culture. Around 16 percent of the investments were used to support industrial innovation and technological upgrades, energy conservation and emission reduction, as well as environmental protection, said Zhang.

Infrastructure projects including railways, highways, airports and ports accounted for 23 percent of Central Government investments, and reconstruction in quake-hit areas made up 14 percent, he added.

Fiscal vitality

In response to the international financial crisis, the Chinese Government put in place a proactive fiscal policy and moderately



JIANG XIAOYING

China will adjust its monetary policy according to changes with the country's economic indicators and feedback from policy implementation.

—Zhou Xiaochuan, Governor of the People's Bank of China



JIANG XIAOYING

It is necessary to maintain continuity and stability of the policies, i.e. We'll continue to implement a proactive fiscal policy this year.

—Xie Xuren, Minister of Finance

easy monetary policy, and further improved its stimulus packages, said Xie Xuren, Minister of Finance. Over the past year, fiscal departments at all levels carefully implemented the proactive fiscal policy by enhancing public investments and spurring domestic consumption.

The government pressed ahead with structural tax reductions as a commitment to helping with investments of enterprises and residential consumptions. Meanwhile, vigorous efforts were made to improve people's livelihood, including education, health insurance, affordable houses and environmental protection, Xie said.

These efforts have obviously accelerated rebalancing of the economy and helped ensure a stable and healthy growth prospect, added Xie.

Looking ahead, China will have a much better economic environment this year than in 2009, but the foundation of recovery remains unsteady. So it is necessary to maintain continuity and stability of the policies, said Xie.

This year's 1.05-trillion-yuan (\$154 billion) deficit will be comparable to 2.8 percent of estimated GDP in 2010, a tolerable and basically safe level of debt. But it is still needed to strengthen management over local governments' debts and fend off possible fiscal risks. Efforts are needed to streamline the financing vehicles of local governments to promote sustainable development of local economies, said Xie.

Supportive measures are also in place for hi-tech industries, environmentally friendly businesses and the service sector, added Xie.

Guarding against crisis

China will adjust its monetary policy according to changes with the country's economic indicators and feedback from policy implementation, said Zhou Xiaochuan, Governor of the People's Bank of China, the central bank.

The government will continue with a moderately easy monetary policy but at the same time closely follow the inflation issue and unfolding economic scenarios, Zhou said, noting that inflation control will be more complicated this year.

China will eventually have to withdraw its economic stimulus package sooner or later, but the timing must be treated with great caution, Zhou added.

The country will enhance the focus and flexibility of its policies and strike a balance between inflation expectation management and maintaining sound growth, he said.

Zhou also showed concerns about China's holdings of U.S. dollar assets. China is currently the biggest foreign holder of U.S. Treasury debts, but recent depreciation of the U.S. dollar has aroused concerns about safety of the dollar investments. The greenback is still a key currency in global trade, and China will closely monitor its trend in value against other currencies, Zhou said.

Export conundrum

As a result of the serious global recession, China's exports fell a hefty 16 percent last year, forcing painful factory closures and sending numerous migrant workers home. The export woes, however, have

showed signs of healing this year, but China still faces an uphill battle to pick up the slack on the trade front. The world economy still remains fragile and volatile, casting an ominous shadow over the trade sector, said Chen Deming, Minister of Commerce.

The United States, for example, is still reeling from staggering unemployment while southeastern European countries are confronted with sovereign debt risks. That is why China should have a basic understanding of the global economy and press ahead with stiff efforts to revitalize exports, he said.

Meanwhile, China has taken measures to support imports and keep a relatively balanced trade account. The trade surplus in 2009 shrank by 34 percent to around \$196 billion. As imports continued to pick up this year, the surplus in the first two months of 2010 dropped 50.2 percent from the same period last year, according to Chen.

More specifically, China derives 73 percent of its surplus from the United States and 55 percent from the EU. At the same time, China is recording trade deficits with more than 50 countries worldwide, he said.

China's huge surplus with the United States is resulted from serious restrictions on exports to China. This is unfair for U.S. residents and entrepreneurs, and also harmful to employment and the recovery of the crisis-stricken U.S. economy, notably against the background that President Obama pledged to double U.S. exports in five years, said Chen. ■



The stimulus package delivered a strong boost to market sentiment and strengthened confidence to shake off the downturn.

—Zhang Ping, Minister of the National Development and Reform Commission



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—Chen Deming, Minister of Commerce

From Coast to Coast

Asia-Pacific economic integration seems destined to take on new dimensions. On March 15, officials from eight nations began talks in Melbourne, Australia, on the expansion of a trans-Pacific free trade agreement. The United States, Australia, Peru and Viet Nam are seeking to join the Trans-Pacific Partnership (TPP), which already includes Chile, Singapore, New Zealand and Brunei. In an article published in the Beijing-based *World Affairs* magazine, **Yang Zerui**, a researcher with the China National Committee for Pacific Economic Cooperation, pointed out that the TPP might offer a new approach to creating a free trade area in the Asia-Pacific region. Excerpts from this article follow:

Unlike the loose Asia-Pacific Economic Cooperation (APEC) forum, the TPP is a binding agreement aimed at achieving free trade with an incremental approach. In other words, instead of trying to pursue an across-the-board free trade agreement from the very beginning, TPP members have focused on the liberalization of certain economic sectors step by step. They are also ready to admit new members from the Asia-Pacific region.

The origins of the TPP date back to 1998 when some APEC members started exploring the possibility of establishing free trade among themselves following the failure of APEC's Early Voluntary Sectoral Liberalization initiative. Chile, Singapore and New Zealand inaugurated free trade negotiations four years later at the APEC forum in Mexico. The three countries signed the TPP in July 2005, and Brunei joined the pact a month later.

The four countries have placed high hopes on their free trading bloc. Singaporean Prime Minister Lee Hsien Loong said at an APEC meeting in November 2009 that he hoped this "little seed" would grow over time into a "significant tree and pillar" for free trade in the Asia-Pacific region.

The United States first announced its intentions to join the group in September 2008. In November 2009, President Barack Obama reaffirmed the United States would engage the TPP with the goal of "shaping a regional agreement that will have broad-based membership and the high standards worthy of a 21st century trade agreement."

The participation of the United States and other countries will surely bring about major changes to the TPP process. According to 2008 statistics, the four original members of the TPP have a total population of 24.4 million, accounting for less than 1 percent of the population of all APEC members. Their

combined gross domestic products (GDP) amounts to \$467.8 billion, representing less than 1.5 percent of the GDP of all APEC member economies.

If the United States, Australia, Peru and Viet Nam become members of the TPP, the group's total population and GDP would reach 463.4 million and \$15.88 trillion, taking up 17 percent and 49 percent, respectively, of the APEC total.

Besides dramatic increases in its total population and economic power, America's status portends to be another bonus for the TPP.

Moreover, the eagerness shown by less developed APEC members such as Peru and Viet Nam poses a serious challenge to the stereotypical view that poor countries tend to

resist free trade.

Some experts have predicted that Canada, Mexico, Japan, South Korea, Malaysia and Indonesia may also join the TPP in the foreseeable future.

A trans-Pacific economy

The reason many Asia-Pacific countries are taking a deep interest in the TPP is that current economic cooperation mechanisms in the region cannot meet their needs.

Given the stalemate of the Doha Round negotiations of the World Trade Organization, Asia-Pacific economies have forged a large number of regional trade agreements and bilateral free trade agreements. Their efforts, however, have only rendered regional economic relations even more complicated.

The United States is the biggest export market for most Asia-Pacific economies, as well as a major source of technology and investment for the region. Consequently, U.S. trade and fiscal deficits have transcended America's borders to become common

The reason many Asia-Pacific countries are taking a deep interest in the TPP is that current economic cooperation mechanisms in the region cannot meet their needs





AN EASY EXCHANGE: Vietnamese women load goods at a border trade area in Pingxiang, southwest China's Guangxi Zhuang Autonomous Region on February 5. China and the Association of Southeast Asian Nations formally launched their free trade area at the beginning of this year

concerns of the Asia-Pacific region. In this sense, the economy in this region has demonstrated a "trans-Pacific nature."

Rather, although East Asian countries have made rapid headway in economic integration in recent years, an East Asian economic cooperation process excluding the United States is wishful thinking at best.

From the U.S. perspective, APEC serves as the premium mechanism for regional cooperation. Despite its sluggish progress, Washington still expects APEC to play a leading role in promoting regional trade and investment liberalization.

During the 2010 and 2011 APEC forums to be held in Japan and the United States

respectively, the two allies are expected to make concerted efforts to boost APEC's competence in this regard. If their efforts turn out to be futile, however, the United States might well abandon APEC and turn to the TPP instead.

As an open economy that relies on foreign markets and resources, China also needs to consider taking Asia-Pacific partnership as a major channel for its regional economic cooperation.

Today, there is a heightened economic interdependence across the Pacific Ocean, as evidenced, most notably, by the "structural dependence" between China and the United States. China's development and the development of the Asia-Pacific region at large are

impossible without the collaboration of the United States. The United States' role in regional trade, economic restructuring as well as money and financial markets is also undeniable.

At the same time, it should also be noted that Asian economic cooperation mechanisms face bottlenecks because of economic, political and strategic differences among member countries. Mechanisms such as cooperation between China, Japan and South Korea and "ASEAN plus three" (a cooperative initiative between the Association of Southeast Asian Nations and China, Japan and South Korea), for instance, have yet to make substantive breakthroughs. ■

DIPLOMATIC DYNAMICS

China and Britain

China and Britain held their first upgraded strategic dialogue in Beijing on March 16 during British Foreign Secretary David Miliband's visit to China.

Chinese State Councilor Dai Bingguo and Miliband co-chaired the dialogue, which had previously been held at the vice foreign ministerial level.

Dai said he hoped the two countries could make use of this mechanism to discuss "strategic issues in bilateral and international relations."

During a separate meeting, Chinese Premier Wen Jiabao told Miliband that China highly values its relationship with Britain. China welcomes investors from Britain and is willing to offer favorable conditions for them, he said.

China and Britain should work more closely together on the green economy, environmental protection and climate change, while jointly opposing trade protectionism, Wen added.

China and U.S.

China has urged the United States to cease interfering in other countries' sovereign affairs by issuing regular reports on human rights records, said Chinese Foreign Ministry spokesman Qin Gang.

"China is willing to have dialogues and exchanges with all other countries on human rights on the basis of equality and mutual respect to promote understanding and reduce disputes," Qin said in a March 12 statement. "However, it firmly opposes any country interfering in its internal affairs in the name of human rights."

The day before, the U.S. State Department released its 2009 Country Reports on Human Rights Practices. As in previous years, this year's report condemned human rights conditions in China.

The Chinese Government attaches great importance to safeguarding human rights, Qin said, adding that China's Constitution and laws also respect and preserve human rights.



A BIG ASIA-PACIFIC FAMILY: Leaders of Asia-Pacific Economic Cooperation member economies gather at their 17th summit in Singapore on November 14, 2009

Ashcroft and the Tories

Friends like these

The real issue raised by Lord Ashcroft's tax status is David Cameron's judgment



THE ennobling of Michael Ashcroft, a controversial businessman and Conservative Party donor, in 2000 was a messy matter; for he partly lived, and had extensive business interests, in Belize. As a condition of his peerage, he agreed

to take up "permanent residence" in Britain. Ever since, senior Tories have been forced into humiliating contortions when asked whether Lord Ashcroft, who is now deputy chairman of the party, was resident in Britain for tax purposes: ask him, they blustered, knowing that he was unlikely to answer.

Now he has. But his response has provoked new questions about his own affairs, and a big one about David Cameron, the current Tory leader—who, despite a recent dip in the polls, is still the man most likely to be prime minister after the general election that is expected to be held on May 6th.

On March 1st Lord Ashcroft (pictured left, with Mr Cameron) revealed that when he signed a binding commitment to take up "permanent residence", what it actually meant was "long-term" residence (see page 61), a status that let him claim exemption from British tax on his overseas earnings as a so-called "non-dom". This is hard to square with the statement in 1999 by William Hague, then Conservative leader and now shadow foreign secretary, that Lord Ashcroft's residence pledge would cost him and benefit the Treasury by "tens of millions" of pounds. British law does not make tax status a qualification for sitting in the Lords. And Labour also numbers a non-dom lord among its big donors. But none of that exempts Lord Ashcroft from the obligations that he undertook.

There are other worries about Lord Ashcroft. "If home is where the heart is," his autobiography confides, "then Belize is my home." The affection does not seem to be entirely reciprocated.

Last year the prime minister of Belize referred to a "particular individual" who "is very close to approaching acquiring the status of an enemy of the people". The Belizean government has fought bitter disputes with a bank controlled by Lord Ashcroft and a telecoms company that it says he also controls (his spokesman has said he doesn't). How much that little country has benefited from his involvement is unclear.

Cut him loose, Dave

Lord Ashcroft's importance to the Tories, on the other hand, is plain (another difference with Labour's "non-doms", who, as well as being less secretive, are much lesser political figures). He manages his party's target-seats campaign for the forthcoming election. He has accompanied Mr Hague on official business. He has also been an exceptionally generous donor, giving or lending many millions of pounds in cash and kind. Especially in the late 1990s, when the party was, in Lord Ashcroft's account, "a financial basket case", his support was vital.

But if Mr Hague's embrace of Lord Ashcroft then was dubious but understandable, Mr Cameron's intensification of the clinch since becoming leader in 2005 is much less so. Lord Ashcroft now accounts for a much smaller proportion of Tory funds (a corporate vehicle through which he donates is anyway being investigated by the regulators). As this paper pointed out last year, the party could have survived without him and the bad publicity he attracted. Instead, Mr Cameron has doggedly clung to the man he made deputy chairman.

The big question this affair raises concerns Mr Cameron's judgment. He is seeking to portray himself both as an advocate of transparency and a resolute chief executive. Probably the Ashcroft furore will not in itself halt Mr Cameron's march on Downing Street. But it raises doubts about his willingness to take tough, principled decisions if he gets there. To dispel them, Mr Cameron should cut Lord Ashcroft loose. ■

Dealing with budget deficits

Who pays the bill?

Throughout the rich world battle lines are being drawn in the coming fight over deficit reduction



is similar: the arguments start when the tab has to be paid.

The battles will be all the more fierce this time around because the deficits are so large and likely in the short term to stay that way. With developed economies still weak, many governments are (often rightly) keen to run large deficits for a while

WHEN friends go out to dinner, the convivial atmosphere can be shattered once the waiter brings the bill. A pleasant evening can descend into a dispute about who had a starter and who ordered the lobster. Running a public-sector deficit

longer. But the bond markets are getting impatient, especially with weaker European countries. Greece was forced to announce a third austerity package this week, after its initial efforts failed to reassure either the markets or its neighbours (see page 55). Although Britain has a lower debt-to-GDP ratio than Greece and its debt has an average maturity of 14 years, sterling also wobbled this week, with investors spooked by the prospect of a hung parliament. True, the three biggest rich-world economies, the United States, Germany and Japan, are under less pressure. But Japan has high debt levels and America has the government-bankrupting cost of ageing baby-boomers.

If the world were run by economists, deficit reduction would be a very complicated balancing act. For politicians ►►

► one question may well dominate all others: who is going to pay? The candidates differ from country to country, but the list usually includes taxpayers, public-sector workers, entitlement recipients (such as state pensioners or public-health users), foreign investors and future generations. Already battle lines are being drawn: witness the strikes by Greece's public-sector unions and the tea parties thrown by America's tax protesters.

Two immediate answers appear, which should be easier for politicians to embrace than all those spending cuts and tax rises. The first is to be honest about the size of the problem. Public-sector accounting is Enronesque. Creditors will punish governments with dodgy numbers, as the Greeks have discovered. And voters can hardly make judgments about what to scale back if they do not know what promises have been made. Talk in continental Europe of an "Anglo-Saxon" conspiracy of greedy speculators is also dishonest. The speculators did not invent the deficits. As one bank analyst has tartly remarked: "You can't blame the mirror for your ugly face."

The second is to focus on economic growth. Higher growth reassures markets, increases tax revenues and reduces spending on unemployment benefits and other welfare payments. So politicians should eschew policies that reduce the long-term growth rate, such as protectionism or higher taxes, and focus instead on measures that boost the growth potential, such as more flexible labour markets and other productivity-enhancing reforms. No matter what taxes it raises, Japan will not solve its fiscal woes without faster growth. Many European governments are walking into the same trap.

Even assuming that most governments tell the truth a bit more and their economies grow a bit faster, there will still be hard choices. The main fault-line is often intergenerational. Some promises, particularly on public-sector pensions and health care, may impose too great a burden on the next generation. Middle-aged Americans have written cheques on the

accounts of their children. Scaling back those promises, for example by raising the pension age, is a prerequisite for getting public finances in order just about everywhere, even if it will not do much to reduce the deficit in the short term.

The more immediate fight, which is already starting to break out in many European countries, is between taxpayers and public-sector workers, and between raising taxes and cutting public spending (see page 76). Politically, the contest is evenly matched, pitting powerful unions against the biggest taxpayers—corporations and high-earners—who often have the ear of politicians. In terms of economics, though, the bulk of the adjustment should come in the form of spending cuts.

There is no alternative

The state had to step in during the credit crunch, given the scale of the banking crisis, but this expansion of its scope should be temporary. This is not just ideological bias on our part; economic studies suggest that fiscal adjustments that rely on spending cuts do better than those based on tax rises. Yes, some tax rises may be necessary, if only out of the political necessity of persuading the electorate that the burden is being shared. But tax rises, like Japan's in 1997, can kill a recovery.

In the past some governments have dealt with debts by walking away from them. Iceland is voting on a milder form of that solution this weekend (see page 56). The graver threat this time is that countries are tempted to diminish their debts through higher inflation. But that would be a dangerous option to adopt and may not even be possible, given that markets can see such policies coming and demand higher bond yields.

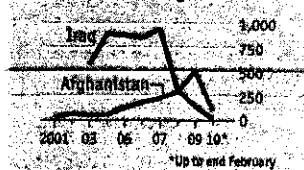
Whichever path governments choose will be hard. As a period of loose credit gives way to an era of austerity, the social cohesion of many nations will be put to the test. Not all countries will pass. Over the next few years the careers of many politicians will be made and broken in the bond market. ■

Iraq's election

Don't wash your hands of it

Iraq may ask for more American help. Barack Obama should not hold back

Coalition military fatalities



SEVEN years after the Americans invaded Iraq and toppled Saddam Hussein, two momentous events are approaching: a general election on March 7th and the promised departure of all American combat troops by the end of August. Yet governments across the world, most notably Barack Obama's, seem to have turned their attention elsewhere. Iraq is already yesterday's story. This is a grave error. The country has been devastated, in good part thanks to the miscalculations of America and its Western allies. It is progressing shakily and still needs outside help. And it is vital to the stability of the region. The mission has by no means been accomplished.

Iraq is far less dangerous than it was three years ago, when the Americans damped down a civil war with their last-gasp military surge. Since American troops withdrew to encampments outside the towns, their death rate has happily dived (see chart). But Iraq is still bloody. Several hundred Iraqis are

still dying violently for political reasons every month—more, by the way, than in Afghanistan. Iraq's nationalist insurgency has faded, but al-Qaeda is still wreaking carnage every month or so. Flashpoints, particularly along a "trigger line" between Iraq's Arabs and Kurds, threaten the peace. Baghdad is not open for normal business, except for firms that can afford their own bomb-proof security systems.

Not yet a functioning country

The run-up to the coming election has been mixed. Despite its flaws, the election should fairly reflect the people's wishes. This is still a rarity in the Arab world—and a cause for celebration. A few months ago, hopes were rising that cross-sectarian parties, appealing to both Sunnis and to the majority Shias, were gaining strength. But in January several hundred candidates were excluded because of their alleged former membership of Saddam's Baath party—a shabby piece of chicanery that was bound to upset Iraq's Sunni Arab minority. Although the leading Sunni candidates and their parties have resisted the temptation to call for a boycott, the ban pushed too many ►►

Two of Miss Park's supporters in the assembly, Hong Sa-duk and Lee Sung-hun, have accused Mr Lee's office of dirty tricks, saying they have been the targets of a smear campaign. The presidential office denies the allegations, but the echoes of tactics used by former military dictators such as Miss Park's father to suppress dissent have been bad for Mr Lee's image.

The feud with Miss Park threatens other parts of Mr Lee's ambitious agenda, too, such as a big sale of state enterprises and a massive project to improve navigability in the country's four biggest rivers. Without the votes of Miss Park's faction, these are unlikely to pass the National Assembly.

Mr Lee had hoped to be a unifying figure. But his tin ear for politics has damaged his standing within both his own party and the National Assembly. And time is running out. He has entered his third year in office, usually the last chance for South Korean presidents to realise their legislative ambitions. After that parliament tends to stall new laws, and voters turn their attention to the next presidency. ■

Thaksin Shinawatra

Divided loyalties

BANGKOK

Some scent compromise; more fear a looming showdown

IN THAILAND politics has long been about compromise rather than conviction. Political parties run on expediency, not ideology, which makes it possible to cobble together all manner of oddball coalitions. But in recent years pragmatism has given way to more rigid loyalties. Rival camps rally their base with fiery talk of an all-out struggle for the nation's soul, all the while tugging relentlessly at its seams.

Might compromise yet make a comeback? Some scented a whiff of detente on February 26th, when the Supreme Court ruled on the family fortune of the former prime minister, Thaksin Shinawatra. But that still seems wishful thinking. The nine judges found Mr Thaksin guilty of abusing his powers while in office to favour Shin Corp, his family-owned telecoms group, which was sold in January 2006 to Temasek, a Singaporean sovereign-wealth fund. The court decided to seize \$1.4 billion of the \$2.3 billion in proceeds from that sale, which had been frozen after the army deposed Mr Thaksin in September 2006.

In theory that leaves a tidy sum for Mr Thaksin to live it up in self-exile in Dubai. The remaining \$900m represents the value of the family's stake in Shin Corp before Mr Thaksin became prime minister in 2001. But that money is unlikely to be re-

Vietnam's economy

The Tet effect

HANOI

Worries about renewed overheating

DURING Tet, the lunar new year holiday, money is everywhere in Vietnam. It is dished out to children, gambled in roadside card-games, and splurged on gifts, feasts, and trips to home villages. This leads to an annual bump in inflation. And this year's spike in the consumer-price index, which rose by 2% in February, seemed bearable at a time of rapid growth. GDP grew by 5.3% last year. It came, however, among some more worrying signs.

On February 10th, just before Tet, the central bank devalued the currency, the dong, by 3.4%, following a devaluation of 5.4% in November. The aim was to entice holders of dollars to buy dong. A dollar shortage has been starving Vietnam's exporters of the currency they need to purchase imported parts and materials.

The government blamed the shortage on dollar hoarding, but the prime cause was its own stimulus spending. That juicy growth-rate came at a price. It is believed to have spent over \$1 billion in 2009 (over 1% of GDP) to prop up the economy, mainly by subsidising banks' loans to businesses. As a result, the credit supply expanded by 37%, driving up the black-market price of dollars.

Meanwhile, the exchange rate was artificially high, leading to a sharp rise in the trade deficit. Foreign-exchange reserves have shrunk. The government has reluctantly raised state-controlled commodity prices: petrol, electricity and coal are all to be more expensive. All of this has observers wondering whether inflation might be about to take off again, as it did in early 2008.

Some analysts saw it coming. In April last year Jonathan Pincus, an economist who has long followed Vietnam, wrote a paper arguing that Vietnam's options for responding to the global financial crisis were limited. With a small, open economy, it cannot maintain an overvalued exchange rate and pour in stimulus

spending without seeing much of the money leak away into trade deficits. At the time Mr Pincus argued it should depreciate its currency to boost exports, and focus investment on labour-intensive small businesses rather than inefficient state-owned enterprises (SOEs). The government did the opposite. The loan-subsidy programme largely benefited well-connected SOEs, and the currency has been kept artificially strong.

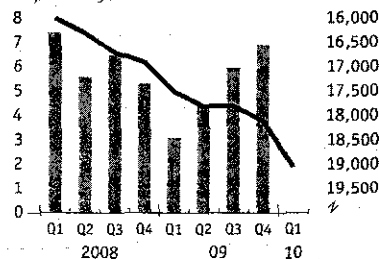
Independent Vietnamese economists have criticised the timing of the government's devaluations and price rises. If investors expect devaluations every three months, they argue, they will buy dollars and wait for the next one. Foreign businesses, meanwhile, are worried about how the government might respond if inflation does take off. The finance ministry has been circulating a draft decree that would allow the government to impose price controls on a wide range of essential goods. The European Chamber of Commerce has warned that such measures may well lead to nothing but "shortages" and "hoarding". So March's inflation data will be closely watched, for evidence of whether February's were simply a seasonally exuberant blip, or something more dangerous.

Going for a dong

Vietnam's:

GDP, % increase on previous year

Dong per \$ inverted scale

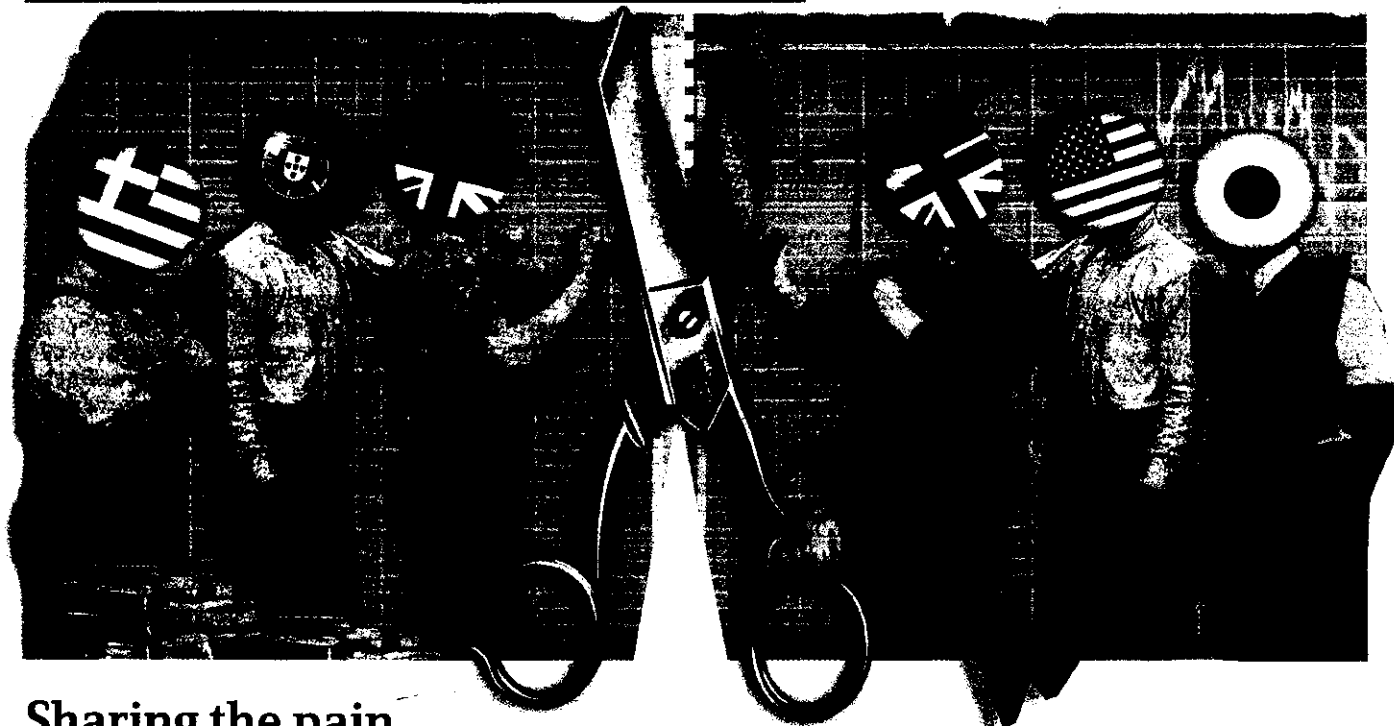


Sources: General Statistics Office; Thomson Reuters

turned soon, if at all. A large tax bill has to be paid. The court's verdict exposes Mr Thaksin and his family to a range of civil and criminal charges. Prosecutors may go after members of his cabinet and officials accused of helping Shin Corp. The government can also try to claw back lost revenue from Shin Corp, and particularly its lucrative mobile-phone unit, AIS.

Mr Thaksin lost no time in attacking the verdict and urging his red-shirt supporters to seek justice. Political life is "really

tough", he moaned. A mass rally in Bangkok is planned on March 14th, with the aim of unseating the prime minister, Abhisit Vejjajiva, and forcing fresh elections. Red-shirt leaders claim that 1m people will converge on the capital, by road and river, to join a "people's war against the elite" over several days. The actual crowds are likely to be more modest, admit rally organisers, but the incendiary rhetoric is menacing, as are the drumbeats from the army as it prepares for a possible repeat of last April. ▶▶



Sharing the pain

Increasing budget deficits and rising government debts are likely to entail fierce political battles—not least between taxpayers and public-sector workers

WHEN times are hard, many people are tempted to let their credit cards take the strain for a while. And when economies fall into recession, many governments are happy to let their budget deficits widen, to tide the economy over.

Sensible as this may be, deficits in several countries have increased so much and so fast during the economic crisis of the past 18 months or so that it is generally agreed that remedial action will be needed in the medium term. Deficits of 10% or more of GDP cannot be sustained for long, especially when nervous markets drive up the cost of servicing the growing debt.

Market pressure explains why deficits have come to the fore in southern Europe. Greece and Portugal, in particular, have seen a sharp rise in their cost of finance and some investors have questioned their ability to roll over their debt. But deficits will also be at the centre of the forthcoming British election campaign, and in America the “tea party” movement has launched a populist campaign against rising government spending.

There is no absolute rule on when deficits or public debts are too high relative to an economy’s size. Prior to the crisis the general consensus was that rich countries could safely have public debts worth 60% of GDP. Yet although Japan’s debt has exceeded its GDP for many years, the government has yet to suffer a financing crisis,

perhaps because it has a large number of willing domestic buyers of its bonds. But when the markets do lose confidence in a government’s fiscal rectitude, a crisis can arise quite quickly, forcing countries into painful political decisions.

Plainly, economic growth makes policymakers’ lives much easier. Growth reduces deficits automatically by increasing tax revenues and cutting spending on unemployment benefits and so forth. As the economy grows, deficits fall, debts become more sustainable, lightening the adjustment burden and reassuring investors.

Nations have recovered from huge debt burdens in the past, often in the aftermath of wars, when men and resources were released from conflict and put to more productive work. When politicians turn to today’s deficit problems, it is vital that they choose policies that enhance long-term growth prospects. They will not lack opportunities: in several countries, for example, increases in statutory pension ages and other reforms that make labour markets more flexible are anyway overdue.

It would, however, be unwise to assume that a burst of rapid and prolonged growth is imminent in many rich economies. Ageing or even shrinking populations make sluggish growth more likely. Growth also tends to be weak in the aftermath of financial crises. In a recent book on sovereign debt, “This Time is Different”,

Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard conclude that “the evidence offers little support for the view that countries simply grow out of their debts.”

So, short of debt default or implicit default via inflation, that leaves two other ways of closing the deficit. Spending must be cut or taxpayers must pay more. Many political battles of the next few years will be fought on these simple lines, with taxpayers on one side and the beneficiaries of public spending on the other. One imminent battle will be between taxpayers and public-sector workers. In some countries, one party can be seen as representing taxpayers (the Conservatives in Britain and the Republicans in America) and the other the workers (Labour and the Democrats, respectively).

Another of these fights will be between generations. In America the biggest medium-term budget busters are pensions and health care for the old. A big deficit may ease the economic pain in the short term but risks saddling the next generation with a growth-sapping burden of higher taxes and interest payments. The battles are also intertwined: taxpayers finance the pensions of public employees which are, by and large, more generous and predictable than in the private sector.

The outcome of these battles will vary from country to country. Both sides have potent weapons. Many of the biggest taxpayers are political donors and have access to people in power. If they are ignored, they may pack up and move to a more friendly jurisdiction. In Europe especially, public employees, together with recipients of public services, probably have numbers ►►

on their side. They are certainly better organised, via their trade unions, and they are political donors too. As French workers have often shown, public-sector unions can intimidate governments with strikes and demonstrations. Their Greek brethren have been trying to emulate them.

The case for cuts

Experience suggests that governments should focus on spending cuts rather than tax increases. An NBER study of 1996 concluded that "fiscal adjustments which rely primarily on spending cuts and the government wage bill have a better chance of being successful and are expansionary. On the contrary, fiscal adjustments which rely primarily on tax increases and cuts in public investment tend not to last and are contractionary." A paper by António Afonso of the European Central Bank and Davide Furceri of the OECD found that increases in government spending as a proportion of GDP tended to be correlated with slower economic growth. And a paper published by Policy Exchange, a right-of-centre British think-tank, concluded that successful debt consolidations had put 80% of the emphasis on spending cuts (see table).

Some of the more successful deficit-cutting programmes were accompanied by falls in inflation and interest rates. These made it easier for economies to rebound and helped shore up governments' electoral support. But today inflation is already low, as are most countries' bond yields. So cutting spending may not bring much reward from the markets in the shape of lower interest rates. Yet the thought that spending might not be cut may bring punishment in the form of higher ones.

Cutting public spending is, however, a hard slog. Spending on welfare rises automatically in a recession; pension payments continue to grow as the population ages. Western countries used the end of the cold war to slash defence budgets in the 1990s, but given continued military action in Afghanistan and the threat of terro-

rism, further big reductions are hard to envisage. Nor are there the easy, one-off gains to be made through privatisation of big industries pioneered in Britain in the 1980s under Margaret Thatcher.

Barack Obama's promise to freeze discretionary spending (excluding defence and homeland security) saves \$250 billion over ten years—not much when annual deficits are \$1 trillion or more. So government will have to tackle much more politically sensitive areas. Changes to Social Security (pensions), which are not part of discretionary spending, are likely to form part of any fiscal reform in America. Should the Conservatives win the British election, they may change eligibility for welfare payments.

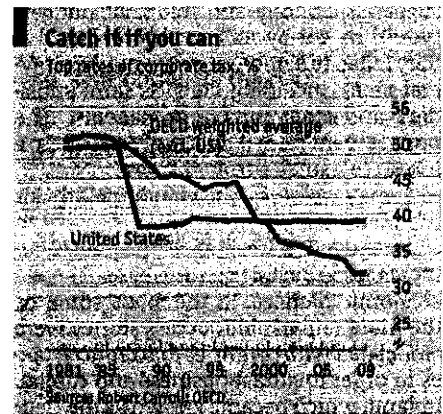
Many governments have boxed themselves in by rewarding their own supporters with jobs or subsidies. In Greece, the right-wing New Democracy party came to power in 2004 pledging a liberalisation of the economy. When it left office in 2009, it had more civil servants than when it started. Such "clientelism" tends to lead to an ever bigger presence for the state in the economy, with more and more citizens depending on the government for employment and income. These people then vote in favour of the status quo. It may take a crisis to force governments to act in ways that hurt their core supporters.

When a crisis does occur, the markets tend to insist on public-expenditure cuts as a kind of test of the government's machismo. In a recent paper Ms Reinhart and Mr Rogoff say: "Even countries that are committed to fully repaying their debts are forced to dramatically tighten fiscal policy in order to appear credible to investors and thereby reduce risk premia."

Governments may thus find their political decisions driven by the need to keep markets onside. That is why the choice is so stark for the southern European countries, which are tied into the single-currency zone. No longer do these countries have the option of devaluing their currencies, which they have resorted to many times in the past. Nor can they combine tighter fiscal policy with loose monetary policy, because they do not control the latter.

Voters or creditors?

If the cuts demanded are particularly painful, governments may simply be unwilling to bear the political cost of pushing them through. A classic example occurred in 1931 when Britain was trying to remain on the gold standard. The then Labour government was told that cuts in the budget deficit, in particular unemployment benefits, were required to appease the markets; otherwise the Bank of England's gold reserves would run out in two weeks. The cabinet split. Ramsay MacDonald, the prime minister, took charge of a (largely Conservative) coalition and has been reviled in left-wing



circles ever since. And after all that effort, the austerity plan failed to do the trick; Britain left the gold standard within months.

The 1931 episode was viewed in Labour Party history as a "bankers' ramp" in which financiers tried to bounce a government into hurting the poor. Modern governments can also be tempted to blame "speculators", a category covering everyone from bankers to hedge-fund managers, for their own failings. The idea that creditors might be concerned about the governments' ability to pay their debts—and thus insist on a higher interest rate—seems to be hard for politicians to accept. At the Davos economic forum in January George Papandreou, Greece's prime minister, said: "This is an attack on the euro zone by certain other interests, political or financial, and often countries are being used as the weak link, if you like, of the euro zone."

Even so, the Greek government has accepted that its deficit needs to be trimmed. In the politics of deficit reduction Mr Papandreou has some crucial advantages: opinion polls suggest that Greeks accept the need for austerity; he won a substantial election victory last year; the opposition is being supportive; and his Pasok party has strong links with the trade unions. It may be easier for a left-wing party to push through budget cuts.

Supportive social cohesion may explain Sweden's successful fiscal tightening after the banking crisis of the early 1990s. The Social Democratic government turned a budget deficit of 9.3% of GDP in 1994 into a surplus of 1.2% by 1998. Spending fell by more than five percentage points as a proportion of GDP and tax revenues rose by almost as much. Growth averaged 3.2% in 1994-98 and unemployment was lower at the end than at the start—surely a political as well as an economic boon.

Politics within the government can help or hinder deficit reduction. Canada had three failed attempts at fiscal reform before a successful austerity programme was unveiled in the Liberal Party's budget in 1995. Earlier efforts had been blocked by government departments. On the fourth attempt departments were encouraged to ▶▶

Closing the gap
How economic volatility is reduced by public spending

Country	Period	OECD average	Public spending balance
Britain	1980-85	46	35
Britain	1985-90	45	35
Britain	1990-95	45	35
Canada	1980-85	46	35
France	1980-85	46	35
Germany	1980-85	46	35
Germany	1985-90	45	35
Germany	1990-95	45	35
Ireland	1980-85	46	35
Netherlands	1980-85	46	35
Netherlands	1985-90	45	35
Netherlands	1990-95	45	35
Sweden	1980-85	46	35
Sweden	1985-90	45	35
Sweden	1990-95	45	35

Source: Policy Exchange

► suggest sacrifices—and told that budgets would be cut by 10% across the board if they failed to agree. Cuts were made in several areas, including defence, farm subsidies and unemployment benefits. The budget went from a deficit of 6.7% of GDP in 1994 to a small surplus in 1997.

It may be that tax hikes, particularly for the better off, are politically necessary to ensure popular acceptance that pain is being shared. But big tax increases can do economic damage. In the 1990s some of the more remarkable success stories were associated with countries that reduced taxes in order to attract business and capital. Ireland, which became known as the Celtic tiger because of its growth rate, has a corporate-tax rate of just 12.5% and chose not to raise it when it tightened its belt last year.

The corporate-tax trend over the last 30 years has been remorselessly downward. A survey by Robert Carroll of American University in Washington, DC, found that the top rate in OECD countries (excluding America) had fallen from 51% in the early 1980s to 32% by 2009 (see chart on the previous page). If businesses are attracted by low taxes, they may leave if rates rise.

High-tax European governments have complained in the past about competition from countries like Ireland; the current crisis may lead to more calls for co-ordination of tax policies. Indeed, many countries will be raising taxes simultaneously, which may reduce the temptation for businesses to shift. Much depends on where countries start; it should be easier for those with lower tax burdens to increase their take.

High earners can also be mobile. So many French professionals moved to London in the past decade that Nicolas Sarkozy, France's president, pleaded with them (and offered tax deals) to come back. Britain is gradually losing its appeal to high-earning foreigners. Calculations by PricewaterhouseCoopers, an accounting firm, show that British authorities will take a bigger tax bite out of the pay packet of a married executive earning £250,000 (\$373,000) than any other G20 nation except Italy.

The need for countries to maximise their take from their citizens has caused a renewed interest in preventing tax evasion. Countries in the G20 have been pushing hard for low-tax countries such as Switzerland to provide information on foreign depositors. Nevertheless, there are plenty of legitimate ways for businesses and individuals to move to countries with more favourable tax regimes.

So the temptation will be to impose taxes that will be difficult to escape, in particular sales or value-added taxes. The political drawback of such levies is that they fall more heavily on the poor than the rich. This will be unpopular, especially

because many people regard this crisis as the fault of high-earning bankers. Furthermore, if higher taxes eat into demand, economies may slip back into recession. A Japanese consumption-tax increase in 1997 is still blamed for derailing its recovery.

European governments have accordingly produced a mix of measures in their austerity packages. Greece, Ireland, Portugal and Spain have all promised to attack the public-sector wage bill by cutting or freezing wages or by reducing the number of staff. Greece announced a new round of cuts on March 3rd. But the packages have also contained tax rises (motorway tolls in Portugal, fuel taxes in Greece) and assaults on tax evasion.

In Greece, tax evasion seems to be rife among the professional classes, with very few citizens declaring high incomes; one response from the government has been to try to encourage the use of receipts. High earners claiming the personal tax allowance of €12,000 (\$16,270) will need to provide receipts of at least that value.

Despite this attempt to spread the pain, the Greek government has been confronted with a wave of strikes by public-sector workers. Governments can use outside financial pressure as an excuse to push through reforms that might otherwise be politically unacceptable. But it is a fine balance. Voters may be more resistant if harsh measures are seen as being dictated by foreigners, whether from the EU or the IMF.

The people aren't revolting

Lord Salisbury, a British prime minister, and other 19th-century conservatives feared that democracy would lead to the overthrow of private property rights. Debtors tend to outnumber creditors, and

thus can outvote them.

Such pessimism has yet to be proved right. Sometimes, irresistible force meets immovable object. In California, for instance, voters have the right to vote on specific fiscal policies in referendums. The result has been a cap on taxes with no apparent limit on spending. Iceland is about to provide a specific test of this theory in a referendum, in which voters are being asked to accept or reject the terms for compensating foreign depositors in failed Icelandic banks.

However, the efforts of Canada and Sweden suggest progress can be made, if the crisis is acute enough. And dictatorships are unlikely to be better than democracies. Military regimes in Latin America (except Chile) had poor economic records; they saw the state as a source of cushy jobs for officers and subsidies for arms factories. In addition, their very lack of legitimacy may tempt autocracies to bribe influential sections of the electorate.

Nevertheless, democracies face awkward decisions in the years ahead. One of the biggest problems is pensions, which will dwarf the cost of the recent bank bailout. When state pensions were introduced in 1889 by Otto von Bismarck, the German chancellor, life expectancy was 45; the idea was to provide an income for those who simply could not work any longer. Women who make it to 65 these days can expect 20 years of retirement.

Even that tricky calculation relies on people working to 65 in the first place. Many employers, particularly in the public sector, developed the habit of letting workers retire in their late 50s or early 60s. Germans, who will soon face a state retirement age of 67, will resent being asked to bail out Greeks, who are only just being asked to work to 63.

In Britain, most public-sector workers are still members of final-salary, or defined-benefit, schemes, whereas new employees in private companies are usually placed in defined-contribution schemes with uncertain benefits. The difference in cost may be as much as 30% of payroll.

Raising the retirement age, probably to 70, and cutting the public-sector pension bill will deliver only modest savings in the short run, but will immensely improve the long-term picture. It will, however, be staggeringly unpopular. The proportion of the population in or nearing retirement is increasing; and older people are much more likely to vote than younger citizens. Without reform, however, those apathetic young voters face a crippling tax burden.

There are many battles over deficits to come: taxpayers against public-sector workers; old against young. Well-chosen policies that foster growth may make them less fierce. They may be bloody even so. ■



course, what seems a credible plan to a government may appear less plausible to an agency. Agencies also have to make qualitative judgments about a range of other factors such as, for example, the willingness of euro-zone governments to bail out the likes of Greece (which unveiled another austerity plan on March 3rd, in part to head off a further downgrade).

Trickiest of all perhaps is the question of contingent liabilities such as bank-insurance schemes, public-sector pension schemes and the like. Even when the agencies are aware of such commitments, the scale of the problem may not be clear. "The state of public-finance accounting is extremely rudimentary relative to private-sector accounting," says Mr Cailleteau. As more of those contingent liabilities become due, the agencies will be forced to make further decisions that could raise the cost of government debt and make budget-balancing even harder. The agencies will be in the limelight for a while yet. ■

Multilateral development banks

Cap in hand

A difficult time for a fund-raising spree

A SENIOR World Bank official describes its efforts to secure an additional \$3 billion-5 billion in paid-in capital as a "once-in-a-generation increase to deal with the effects of a once-in-a-generation crisis". The bank agreed to lend \$32.9 billion to poor countries in the year to June 2009, two-and-a-half times the previous year's outlay of \$13 billion. If it carried on at this rate, Robert Zoellick, the bank's president, warned in October, its lending would face constraints by the middle of this year.

But its search for funds is being complicated by two factors. Some of its rich-country backers have overstretched budgets of their own, to put it mildly. And other large multilateral development banks (MDBs) are also seeking cash.

Some are further along than others. The board of the Asian Development Bank (ADB) approved tripling its capital base to \$165 billion last April, though only 4% of the increase would be paid-in capital. The shareholders of the European Bank for Reconstruction and Development (EBRD) agreed on February 24th to augment its €20 billion (\$27 billion) capital base by 50%, including €9 billion in callable capital (which countries commit but do not immediately pay). The African members of the African Development Bank want to triple its capital to \$99 billion (94% of which would be callable). The Inter-American

Financial inclusion

A FAB idea

NEW YORK

Should every child receive a bank account at birth?

YOU come into the world with nothing, the saying goes. A new campaign proposes to change that by giving every newborn child in the world an online bank account with \$100 in it. The aim of the Financial Access @ Birth (FAB) campaign is to do something about the fact that half the world's population has no access to mainstream financial services. This is a huge handicap, exposing people who are typically already on the poverty line to risks that wealthier folk can manage through savings or insurance, and leaving them in pay unregistered money-lenders through the nose.

The campaign is the brainchild of Bhagwan Chowdhry, a finance professor at the University of California, Los Angeles, and is starting to attract some prominent supporters, including Peter Singer, a well-known philosopher, and Vijay Mahajan, an Indian social entrepreneur.

FAB dovetails with another big idea: an effort being led by Nandan Nilekani, an outsourcing tycoon turned government minister, to provide every Indian with a legal proof of identity in the form of an electronic smart card. The prospect of a bank account with \$100 in it—this initial amount would be untouchable until the child's 16th birthday—would encourage parents to register their newborn babies. The account could then be used by governments or charities to

make direct payments, to fund things like the child's education or health care.

Opening accounts for babies has been tried before, but only in rich countries such as Britain, Canada and South Korea, where its potential impact is far smaller. Mr Chowdhry expects the parents of the richest 35m children born each year voluntarily to forgo the free money, which would leave accounts for the other 100m newborns born each year to be funded. The campaign proposes that national governments each donate one-fiftieth of one percent of GDP to cover the estimated \$10 billion annual cost.

That is still a tough sell in today's economic climate; one issue to be thrashed out is whether the accounts have to be funded at birth, or whether the money needs to arrive only when the child turns 16. But governments are not the only potential donors. The idea stands perfect for banks, which would gain a potentially lucrative army of future customers and could polish up their battered images at the same time.



Development Bank (IDB) and the World Bank are finalising their capital-increase plans ahead of their annual meetings in March and April respectively.

The begging competition is affecting how much money the MDBs feel they can ask for, and how they plan to raise it. The World Bank, for instance, is only seeking enough money to allow its lending to return to pre-crisis levels. It wants to raise over half of its new capital from developing countries, partly in return for giving them greater say in its running. The dominance of callable capital in the other MDBs' proposals also reflects the unfriendly climate for fund-raising.

All the banks are keen to highlight improved efficiency. The IDB says that administrative costs per \$1m in loans approved have declined by 57% between 2006 and 2009, to \$26,833. But that still exceeds the

\$19,000 the World Bank spent per \$1 million lent in 2009. The latter also raised charges on its loans last year, partly to assuage rich countries who want it to generate more income internally.

Fine-tuning their demands and pushing further on institutional reform will probably ensure that no MDB is denied cash, even if the politics are likely to be messy all around. But Nancy Birdsall, a former senior official at both the IDB and the World Bank, thinks a more fundamental reorientation is needed. Although these institutions have begun to place greater emphasis on measurable results, she argues, their focus is on pushing money out. The percentage of the IDB's projects whose impact was rigorously evaluated doubled between 2005 and 2009, but only to 14%. Changing that would be an excellent use of a once-in-a-generation crisis. ■

Economics focus | On deaf ears

Does India's government pay any heed to its economic advisers?

ECONOMISTS like nothing better than giving advice to governments. But why do they, of all people, imagine that anyone listens? In their models economists assume that governments, like other actors in the economy, have objectives of their own, which they seek to advance as best they can. They are not disinterested servants of the public good. So governments will ignore a recommendation from their advisers unless it suits them, in which case they would have done it anyway.

In his book "Prelude to Political Economy", published in 2000, Kaushik Basu of Cornell University wrestled with this paradox. "If, seeing high unemployment in an economy, a person... advises entrepreneurs to employ more labourers, or consumers to demand more goods, this typically causes economists to share a laugh." And yet economists routinely advise governments to act in the economy's interests rather than their own.

Mr Basu is now living the conundrum he theorised about. In December he became the chief economic adviser to India's finance ministry, occupying an office amid the sandstone domes and colonnades of Sir Herbert Baker's Secretariat buildings in Delhi. On February 25th he released the ministry's annual economic survey, a day before the minister, Pranab Mukherjee, presented the budget. What advice did Mr Basu give? And did his boss upstairs pay him any heed?

Quintessential

The survey welcomes India's remarkable escape from both the financial crisis and a disappointing monsoon. The economy is expected to grow by 7.2% in the fiscal year ending on March 31st and it should return to growth of about 9% in the medium term, the survey argues. This government, however, will not settle for any old growth. It has committed itself to "inclusive growth". The phrase is often invoked, but rarely defined precisely. In the survey Mr Basu offers a "statistical summing up" of what inclusive growth might actually entail.

He proposes that the nation should measure its progress by the growth in per-capita income of the bottom quintile, or 20%, of the population. This simple yardstick gives due weight to both the poor and to growth. Mr Basu cites some figures crunched by S. Subramanian of the Madras Institute of Development Studies (see left-hand chart). They show India's poor making what Mr Subramanian describes as "a modestly plodding climb out of considerable income deprivation".

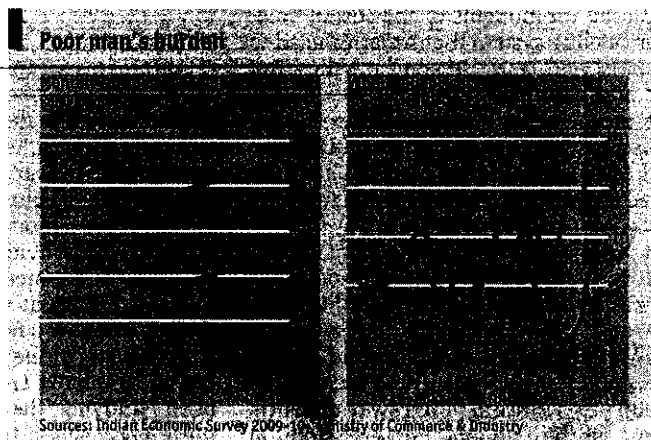
For growth to be inclusive, Mr Basu suggests, it is not enough that the income of the bottom 20% rise at the same percentage rate as the average. Instead, they should get an equal absolute share of the income the economy adds. If the economy grows by \$100 billion in a year, the poorest fifth should get \$20 billion. That is a high bar indeed. Certainly, it would be impolitic for the government to hold itself to such a demanding standard. But as Mr Basu noted in his book, the adviser's objectives are not always quite the same as the government's.

To help the poor plod a bit faster out of deprivation, the government will spend almost 1.9 trillion rupees (\$41 billion) this year on social services and rural development—including education, health and a workfare scheme for the rural poor—by the end of this fiscal year. That some of this money has reached the poor, Mr Basu argues, is demonstrated by the rising price of the foods they buy. Indeed, inflation (or "skewflation", as Mr Basu calls the lopsided rise in prices) is now the government's biggest political headache (see right-hand chart).

One puzzle is why the government has not quashed food prices by releasing more grain from its overflowing stockpiles. There is, after all, little point holding a buffer stock if you never run it down. "If there are certain minimal amounts of grain that we are committed to holding at all times," Mr Basu points out, "then it is the same as not holding them." When the government has released grain, it has also made the mistake of doling it out in hefty batches to a handful of suppliers, who can then corner the market between them. In January the government sold smaller batches of grain to a larger number of traders, with far greater effect on prices. In this case, economic logic revealed a more effective means to the government's chosen end.

Another way the government purports to help the poor is to subsidise grain and fuel, selling them at controlled prices through "ration shops" to the poor. Some propositions, Mr Basu writes, seem obvious with a little thought, but far from obvious with a lot of thought. Price controls are one of them. It seems clear at first blush that one can cushion the poor from the vagaries of the market by regulating the prices of basic necessities, like food, fuel and fertiliser. But a good economic adviser knows better. Mr Basu points out that ration-shopkeepers divert much of the subsidised grain on to the open market, adulterating the remaining grain with gravel. Reetika Khera of the Centre for Development Economics in Delhi has found that in some states, when market prices rise the poor paradoxically get less subsidised grain, because so much is diverted. It would be better, Mr Basu argues, to give the money to the poor directly, through food, fertiliser or fuel coupons, which they could spend anywhere they please.

Has his boss heeded any of this advice? The government recently decided to raise the price of urea, a fertiliser. Mr Mukherjee also increased import duties and production taxes on fuel. This will help him reduce the central government's fiscal deficit to 5.5% in the next fiscal year, down from 6.7% this year. It also prompted the opposition and some of the ruling coalition's own allies to walk out in the middle of his speech. Thanks to these measures, fuel prices will be higher—but no freer. Shortly before the budget an expert committee headed by another economist urged Mr Mukherjee to liberalise the prices of petrol and diesel. In his budget Mr Mukherjee left that decision to his cabinet colleague at the petroleum ministry. The government's economic advisers, both in the finance ministry and outside it, may not be pleased by this dodge. But at least one of them should not be surprised by it. ■





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Productivity growth

Slash and earn

Productivity has surged in America and slumped in Europe. Neither trend can last

LIKE physical fitness or a healthy diet, productivity is a worthy goal that can require an unappetising change in habits. Producing more by working less is the key to rising living standards, but in the short term there is a tension between efficiency and jobs. America and Europe have managed this trade-off rather differently. America has gone on a diet: it has squeezed extra output from a smaller workforce and suffered a big rise in unemployment as a consequence. Europe, meanwhile, is hoping to burn off the calories in the future. It has opted to contain job losses at the cost of lower productivity. That probably means America's recovery will be swifter. Further out, productivity trends in both continents are likely to be uniformly sluggish.

Analysis by the Conference Board, a research firm, shows just how different the recession was on either side of the Atlantic. America's economy shrank by around 2.5% last year but hours worked fell at twice that rate, so productivity (GDP per hour) rose by 2.5%. The average drop in GDP in the 25 countries that made up the European Union before its expansion in 2004 was larger, at 4.2%. But hours worked fell less sharply than in America and, as a result, EU productivity fell by 1.1% (see table). Workers that held on to jobs in America and Europe had their hours cut by similar amounts. The reason total hours worked fell by more in America was that there were more job losses there: employ-

ment fell by 3.6% last year, compared with a 1.9% fall in the EU.

What accounts for this stark contrast? One theory is that the GDP figures in America are overstated. Fresh revisions will take in information from small firms, which may have been forced to cut back by more than big firms because of scarce credit. So GDP could be revised down, narrowing the gap with Europe. Another view is that American firms were panicked into shedding jobs too quickly (though brutal cuts in capital spending suggest that Europeans were scarcely calmer).

In fact, much of the productivity-growth gap is explained by different labour regulations. America's more flexible jobs market makes it far easier and cheaper to lay off workers. In many parts of Europe, by contrast, firing workers is costly and unemployment benefits are generous. Firms think twice about firing, and governments are keener to provide in-work subsidies if

it means avoiding payouts to the newly jobless. Unemployment has risen most where workers are easiest to offload, as in Ireland or Spain.

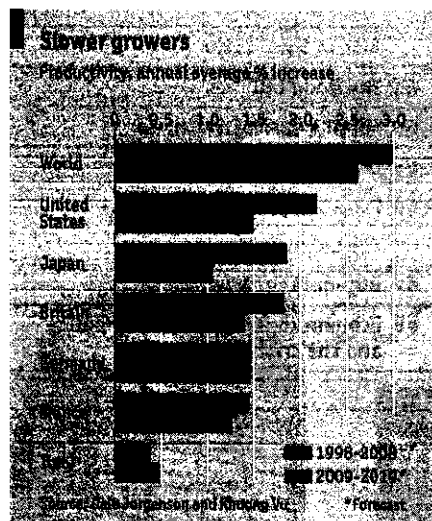
American workers who can so easily be laid off may not be hired back as quickly. Some fear a repeat of the "jobless recovery" after the 2001 recession when increasing demand was met by rising productivity. That surge in productivity was in part a result of an earlier splurge in capital spending on information technology. Though IT spending had collapsed in 2000, firms were still finding new ways to apply the computing power they had invested in so heavily. It will be harder to repeat that trick this time. Since much of the capital accumulated during the last boom was in housing, there is not the same scope for a similar burst of "delayed" productivity. Even so, it may be surprisingly strong for a while, says Bart van Ark of the Conference Board. The recession has made executives realise that they can keep their operations going with fewer staff, he says.

Even if productivity growth does tail off, it may still be strong enough to match sluggish demand. And if spending is more robust, businesses will first choose to offer existing part-time workers longer hours. The Federal Reserve said on March 16th that although the economy was stronger, firms were still reluctant to hire.

In Europe the shock of recession is likely to persist for even longer. Falling productivity pushes up unit-wage costs, hurting profits and cashflow. Firms cannot bear that for ever. Long hiring freezes seem likely and some businesses will be forced into lay-offs. Aggregate demand is likely to stay feeble. Weak profits will hurt investment, and consumers will not spend freely if they believe jobs will be shed.

The drive for more output from fewer workers seems a threat when jobs are





scarce. But over time productivity is essential to improving living standards. Indeed, as the share of working-age adults in the population shrinks, there will be a greater reliance on productivity to drive GDP growth. That makes it all the more worrying that analysts have become gloomier about medium-term prospects: America's productivity will grow by just 1.5% a year in the next decade, according to new forecasts by Dale Jorgenson of Harvard University and Khuong Vu of the National University of Singapore (see chart).

Much of the expected slowdown reflects changes in technology, says Mr Jorgenson. The burst of strong growth in American productivity after 1995 was spurred by advances in the semiconductor industry, which led to sharp falls in the price of computing power. The technology is still improving but at a slower pace, and productivity trends will soon reflect that. The global outlook is brighter, because the benefits of IT are far from exhausted in big emerging economies, such as China and India. But that is no longer the case in America, says Robert Gordon of Northwestern University. "We've already picked the low-hanging fruit," he says.

Europe largely missed out on the IT-led productivity boom: might it yet reap the benefits? Much of the growth gap with America is accounted for by "market services"—ie, retailing, transport, finance and business services. These industries would be more efficient if there were a genuine single EU market in services. As it is, firms operating in niche national markets often do not have the scale to make big IT investments pay off. And firms cannot profit from new technology unless they can flexibly match it with skilled workers, argues John van Reenen at the Centre for Economic Performance in London. The remedies for Europe's productivity malaise are familiar ones: an end to over-regulated product and jobs markets. For Europe, though, these are hard habits to break. ■

Financial reform in America

The hand of Dodd

WASHINGTON, DC

The Senate bill is finally published

CHRIS DODD, the soon-to-retire chairman of the Senate Banking Committee, has staked his legacy on overhauling America's financial regulations. If he fails, it won't be for lack of trying.

On March 15th Mr Dodd unveiled a sweeping proposal to rearrange the duties of America's financial regulators while creating new powers and authorities to sniff out and squelch the risks that brought on the financial crisis. This is not the first reform blueprint: the House of Representatives has passed its own bill, the Treasury issued proposals last year, and Mr Dodd himself had already unveiled one, aborted draft of the Senate bill. This version, however, is the first to reflect substantial input from Republicans, whose support is necessary to reach the 60-vote margin needed in the Senate for the bill to become law.

The causes of the financial crisis are countless, and the 1,336-page bill takes aim at most of them, from credit-rating agencies to derivatives. But the two most sensitive proposals are its plans to deal with big, risky firms, and the creation of a new body to protect consumers.

To curb risks to the financial system, Mr Dodd would create a Financial Stability Oversight Council composed of regulatory chiefs who can designate any big financial firm as systemically important. That would put it under the eye of the Federal Reserve. Republicans have justifiably worried that designating any firm as systemically important would encourage markets to assume it is too big to fail, making it cheaper for the firm to borrow.

Mr Dodd's bill seeks to make size unappealing by requiring firms with more than \$50 billion in assets to fund a resolution kitty to deal with failing firms, also worth \$50 billion. And it opens the door to the adoption of Barack Obama's "Volcker rule", which would restrict banks and other Fed-regulated financial companies from proprietary trading and sponsorship of hedge funds and private equity.

More importantly, Mr Dodd has also made the resolution process deeply unpleasant. If a failing firm were deemed a threat to the system, the Fed, the Federal Deposit Insurance Corporation and the Treasury, with the agreement of three bankruptcy judges, could impose an "orderly liquidation" on the firm, forcing shareholders and unsecured creditors to take losses. Such a resolution mechanism has long existed for banks but not for other

big financial companies or for bank-holding companies.

It may prove unworkable, of course. The threat of being wiped out in bankruptcy could cause creditors to flee both the troubled firm and any firms like it, precisely the sort of panic the resolution regime is meant to avoid. "In a severe financial crisis it will be too terrifying for politicians and bureaucrats to use" the new process, predicts Douglas Elliott of the Brookings Institution. Instead, he says, they will resort to ad hoc measures as they did in 2008.

Less important but much more controversial is the issue of consumer protection. Democrats want to take that job away from bank regulators and give it to an independent agency. Republicans fear such an agency would kill off legitimate products and circumscribe banks' financial health. Mr Dodd's clunking compromise is to place a Consumer Financial Protection Bureau inside the Fed (where it gets a chunk of the Fed's budget), make its director a presidential appointee and allow the oversight council to overrule its decisions.

There are other compromises, too. Mr Dodd had originally planned to merge America's four overlapping bank regulators into one. He has given up that laudable fight. Just the hapless Office of Thrift Supervision will disappear. The Fed will lose authority over smaller banks—a move it opposes—while retaining it over large bank-holding companies. The bill also includes politically motivated loopholes: ▶



Dodd bandages things up

ed to the firm by Bear Stearns, a failed investment bank.

Others, however, are pulling the plug. In December the w hotel in Union Square in Manhattan, which had been bought for \$282m by an arm of Dubai World, was sold at auction to one of its debtholders for \$2m. In Britain Lloyds Banking Group this month swapped almost \$1 billion in debt into shares in the Alternative Hotel Group. "Whether banks take [legal] control of the assets or not, there has been a shift of control from the owner to the lender," says Kirk Kinsell of InterContinental Hotels.

"We will be in for a long period when they will be the reluctant owners."

There are two main reasons why hotel loans are so troubled. The first is that in many cases they were taken out by investors who need steady cash flows to repay debt, or were financed using instruments such as CMBS that also require steady income streams. Yet unlike office blocks or shopping malls, which sign leases with tenants for ten years or more, hotels have to let their rooms by the night. The revenue earned for each room (an industry measure of room rates and occupancy) fell by

almost 17% in America last year.

The second reason is that lenders signed especially generous contracts with hotel owners and operators, which in many cases allow them to throw in the keys without the banks having recourse to their other assets. In a particularly galling case, Sunstone Hotel Investors, a real-estate investment trust in California, said it had decided to stop "subsidising" debt payments on \$300m of debt and would give 13 hotels to its bank. Just days later it told its investors that it was looking at opportunities to buy hotels at a discount. ■

Buttonwood

Private-equity managers face a difficult outlook

THE locusts went hungry in 2009. The private-equity industry, the *bête noire* of many a European politician, managed just \$81 billion of buy-outs, compared with more than \$500 billion in 2007. Indeed, almost anything that could go wrong for the industry last year did so, as a recent report from Bain, a consultancy, makes clear.

Private equity has prospered for most of the past 25 years thanks to a favourable combination of circumstances: easy access to cheap credit, rising asset prices, a relatively stable economy and a friendly regulatory environment. But credit was neither available nor cheap last year. The industry raised just \$20 billion of new loans in 2009, perhaps because managers were unwilling to pay double the spread (or excess interest rate) they had paid in the middle of the decade.

Equity prices did rebound last year but that was a double-edged sword. The result was that even those private-equity firms with access to capital found that deals were not as cheap as they might have hoped. Nor were markets quite strong enough for managers to offload the companies they had acquired earlier in the decade. Private-equity firms realised only \$68 billion last year, down from \$324 billion in 2007.

The lack of "exits" from investments had a further knock-on effect. When private-equity managers sell companies in their portfolios, they distribute the proceeds to their clients, known as limited partners (LPs). These distributions allow the LPs to invest in new private-equity funds. In addition, many LPs are pension funds or endowments which have target allocations to private equity in their portfolios. Because the declared returns of private-equity managers outperformed public markets in the crisis (something that may have more to do with the way



portfolios are valued rather than any inherent superiority), many LPs found their weighting to private equity reached its maximum allocation. With distributions also low, LPs were unable to sign up for new funds. The industry raised just \$248 billion in 2009, down from more than \$600 billion in each of 2007 and 2008.

The good news, as Bain points out, is that some managers still have plenty of "dry powder" left, having raised funds in the boom years. Around \$1 trillion of uninvested capital could be put to work. The bad news, from the managers' point of view, is that with debt harder to get hold of, more of this capital will have to be invested in the form of equity. That means gross returns will be lower than in the golden days of the industry when internal rates of return reached 30-50%.

Another big problem is the refinancing hump that faces the industry between 2012 and 2014, when Bain estimates that some \$460 billion of loans will need to be rolled over. The investor base that originally bought this debt—the managers of collater-

alised-loan obligations (CLOs), specialist funds that purchased leveraged buy-out loans—will not be able to help, as the market for new CLOs has collapsed in the wake of the credit crunch.

Many of these loans relate to deals done in the boom conditions of 2005-07, when prices were high and companies ended up being financed by too much debt. There may still be bad news to come from those deals. Banks have been reluctant so far to force problems into the open by adhering to the strict terms of debt covenants—they have little desire to create more write-downs on their stretched balance-sheets.

The final factor to throw into the mix is the effect of tighter regulation. European politicians postponed debate on the Alternative Investment Fund Managers directive this week (see *Charlemagne*) but the industry is still worried about the legislation that will finally emerge from the Brussels sausage machine.

To offset all this, the industry needs a charm offensive. It needs to show, both to investors and to politicians, that its returns are based on something more than exploiting cheap finance and the tax-deductibility of interest payments. And it needs to show that it can manage companies for growth, not just cost-cutting.

Of course, many private-equity fund managers would argue that academic studies already demonstrate they have such virtues. The difficulty, at least on the European side of the Atlantic, is that there are very few Googles—high-growth, well known businesses that can trace their initial success to private-equity or venture-capital backing. And in a slow-growth economic environment, it will be very difficult for the industry to start generating such examples in the next few years.

The Lehman report

Beancounters in a bind

NEW YORK

Banks' professional advisers come under scrutiny

IF SUNSHINE really is the best disinfectant, the 2,200-page report into Lehman Brothers' downfall by its court-appointed bankruptcy examiner may do more to clean up finance than any number of new regulations. It paints a remarkably detailed, and damning, picture of Dick Fuld, Lehman's ex-boss, and the executives around him. Their spectacularly ill-advised strategy was to take on oodles more risk in property just as everyone else was running the other way. Risk management was risible, with risk limits raised whenever they were breached and dodgy investments excluded from stress tests.

Lehman's former leaders are not the only ones squirming in the glare. Some of its counterparty banks get a slap on the wrist for changing the terms of their collateral demands, for instance. But the strongest criticism of those who interacted with the flailing firm is reserved for Lehman's auditor, Ernst & Young (E&Y), for failing to "question and challenge improper or inadequate disclosures". The main "accounting gimmick" hidden from investors, but apparently known to the auditor, was called Repo 105. This technique helped the firm flatter its numbers by temporarily moving assets off its balance-sheet at the end of each quarter. Lawyers are also in the spotlight: unable to find an American law firm to approve the transaction as a "true sale" of assets, Lehman got the nod from Linklaters in London. Both E&Y and Linklaters deny any wrongdoing.

Although Repo 105 appears to have been in line with American accounting standards, its effect was to deceive. The technique allowed Lehman to reduce its reported leverage substantially and thus avoid ruinous ratings downgrades as it fought for survival. Investors would like to think that auditors consider not just the letter of the rules but their spirit, too. The examiner concluded that there was enough evidence to support a case for malpractice against E&Y.

The report identifies two other aspects to E&Y's involvement. Lehman used subjective, inconsistent methods to value its illiquid assets. The examiner raises numerous questions about the auditor's scrutiny of those "marks", though he finds no evidence of deliberate misvaluation. Secondly, he accuses E&Y of failing properly to investigate claims about Repo 105 by a whistleblower, or to report these to the company's audit committee (a claim

which E&Y disputes).

All of which threatens to dent E&Y's credibility and, perhaps, lighten its pockets. Class-action suits may follow. Lehman's trustee could sue to recover losses suffered by creditors, who are seeking more than \$800 billion in (at the last count) 64,000 separate claims. Nobody expects E&Y to suffer the same fate as Andersen, whose work for Enron led to its break-up in 2002, reducing the Big Five global accounting firms to four. But the industry, which had to swallow a raft of reforms, including Sarbanes-Oxley, after that scandal, could face calls for further tightening if similar tactics are exposed elsewhere.

Lehman is unlikely to be an isolated case, argues Prem Sikka, an accounting professor at the University of Essex, because "the guards are in bed with the prisoners." Like rating agencies, auditors suffer from a potential conflict of interest because they are paid by those they judge (and can still tout for other work from them, despite post-Enron restrictions). E&Y's annual bill for Lehman was \$31m. With such big fees on the line, there may be a temptation to wave through practices that meet the rules but present a misleading picture of a client's financial health. ■

Private equity in Japan

The waiting game

TOKYO

There are lots of private-equity funds in Japan, but very few deals

"PPRIVATE equity is the garbage can of corporate Japan," laments the boss of one fund with more than \$1 billion invested in the country. The firm wants to do more deals, but there is nothing worth buying. By the time ailing firms are willing to accept outside capital and advice, it is too late: they are on their deathbeds. "They need morticians, not doctors," sighs the boss of another private-equity fund.

Across Tokyo it is the same refrain: private equity in Japan barely exists. "I'm in the non-profit sector," grumbles one manager. The value of all transactions in 2009 totalled a mere \$3.8 billion, according to Dealogic (see chart). For the world's second-largest economy, it is a pittance. Permira, a major international fund, has done one deal since it came to Japan in 2005. Kohlberg Kravis Roberts (KKR), which opened a Tokyo office the same year, has the same tally. Carlyle has done numerous good deals, but on March 12th it saw a \$330m investment in Willcom, a bankrupt wireless operator, wiped out in a refinancing.

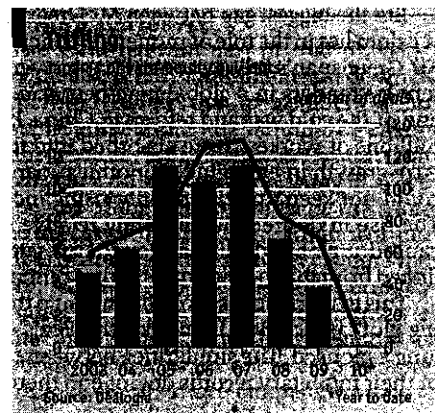
Private equity has its critics, but if it is needed anywhere, it is Japan. The country

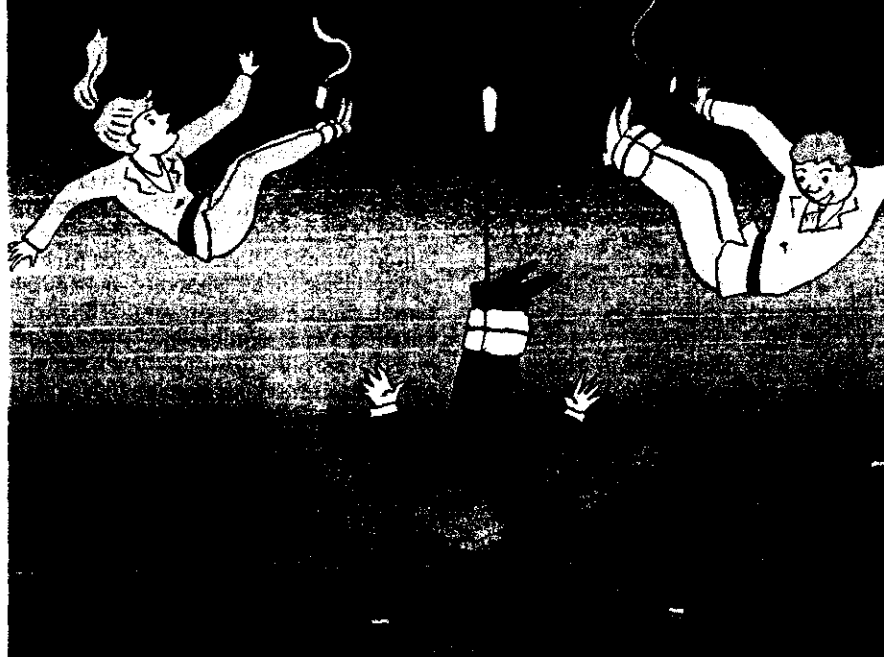
teems with medium-sized firms with world-class technology that need to consolidate and globalise in order to grow. Japanese firms' return on equity is around half that of American and European firms. A generation of bosses who founded their firms after the war are ready to retire but lack successors. Fund managers estimate there are 500-1,000 such companies, which is why they stick around.

Cultural factors are one reason for the lack of transactions. The idea of turning to a third party is considered an admission of failure. Japanese businessmen generally regard outside investors as greedy speculators rather than partners. Some Japanese firms insist on maintaining jobs as a condition for a sale, undermining the rationale of a deal to restructure the business.

Also thwarting private equity are massive conglomerates and big banks. Japan's networks of corporate families mean that big firms regularly throw lifelines to ailing smaller ones. In February, Honda and two Mitsubishi companies poured much-needed capital into Pioneer, an audiovisual firm that has struggled for years. Japan's long-standing near-zero policy rate means that firms can borrow cheaply from banks, putting off the need for reform. This month Sumitomo Mitsui Banking Corporation unveiled plans to establish a corporate turnaround fund of ¥30 billion (\$332m) to support its banking clients.

An even deeper reason for the dearth of deals is the state. "The Japanese government kills the private-equity market," says Akira Yamauchi of Strategic Alternative Investment Research. A recent policy to let companies delay loan repayments for up to three years relieves the pressure on them to perform. The Enterprise Turnaround Initiative Corp (ETIC), a newly established state-run entity flush with ¥1.6 trillion in cash and loan guarantees, gives dying companies another shot at redemption: it agreed this week to provide a ¥12 billion credit line to Willcom. ETIC officials say it is no rival to private equity, since it funds firms that private equity on its own would avoid. In other words, an even bigger rubbish bin? ■





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Securitisation Earthbound

NEW YORK

Large parts of the securitisation markets remain stagnant. Not all efforts to reform them are helpful

FOR most capital markets, the financial crisis resembled a stomach-churning bungee jump: a precipitous fall followed by a sharp rebound, albeit not to the heights enjoyed before the turmoil. The big exception was securitisation, large parts of which are still dangling near the ground. Even as it struggles to recover, the market that brought the world the joys of collateralised-debt obligations faces two stern tests: the phasing-out of central-bank support and a raft of tougher rules.

Securitisation's boom and bust was spectacular. The packaging of mortgages, car loans, credit-card receivables and other debt to sell to capital-markets investors began to take off in the 1980s. By 2006 it was being used to channel around two-thirds of all residential mortgages and half of all consumer credit in America. By distributing loans, banks could cut their capital needs, allowing them to lend more. Hedge funds, insurers and the like gained access to a broader range of credit risks.

As the boom reached fever pitch, however, the quality of the loans being pooled into securities dived, especially in mortgages. When losses started to mount, asset-backed issuance dried up (see chart on next page), forcing governments to take up the slack. In some parts of the market, they are now stepping aside again. The Federal Reserve is winding down its liquidity sup-

port for credit-card and car-loan transactions. Some \$5 billion of prime, private-label car deals were priced in February. Structured vehicles for risky corporate loans are making a comeback, too.

By contrast, housing markets remain almost wholly reliant on government-backed agencies to package and guarantee mortgage-backed securities (MBSs). No residential MBSs have been sold in America without such backing for more than two years. Europe has seen a few private deals, but these were structured to be highly attractive to investors and acceptable as collateral at the European Central Bank's discount window. No wonder Ralph Daloisio, chairman of the American Securitisation Forum, talked of an "existential" crisis in his speech to the industry group's annual conference last month. He even wondered what Jean-Paul Sartre would make of it.

The prosaic reason for the dearth of private issuance is the wide gap between what investors demand and what borrowers will pay. "Jumbo prime" mortgages, decent-quality loans above the price threshold that Fannie Mae and Freddie Mac can buy at, are likely to be the first part of the new-origination market to come back. But it is currently non-economic to securitise these loans, says Laurie Goodman of Amherst Securities. To place a new issue, given the yields demanded by investors, the in-

terest rate payable by borrowers must be 6.85%, a full percentage point higher than current levels. This differential is "the fundamental issue" for MBS markets, argues Tim Ryan of SIFMA, a securities-industry association. Rating agencies' belated tightening of their methodologies has made this gap even harder to close.

The market for mortgage securities issued by Fannie and Freddie is also about to be tested. The Fed's purchases of almost \$1.25 trillion-worth of such MBSs since last year have helped keep rates near record lows. But this programme is due to expire at the end of March. Most think the effect of the Fed's withdrawal will be muted, because the move has been telegraphed and because there is money on the sidelines waiting to take the Fed's place. But rates are still expected to rise at a time when housing demand remains muted: sales of new homes hit a record low in February.

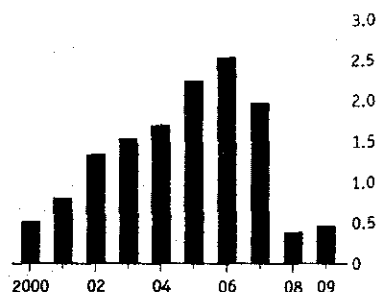
Investors also want the future shape of the industry to be clearer. On both sides of the Atlantic, lawmakers are struggling to strike the right balance between encouraging a revival of securitisation and protecting the financial system from the instability it can produce. Take the bill currently being debated in America's Senate. Few would argue with its tightening of disclosure requirements, including more information on loan repurchases so that inves- ▶▶

Applications are invited for *The Economist's* 2010 Marjorie Deane internship. Financed by the Marjorie Deane Financial Journalism Foundation, this award is designed to provide work experience for a promising journalist or would-be journalist, who will spend three months at *The Economist* writing about finance and economics. Applicants are asked to write a letter introducing themselves, along with an original article of no more than 500 words that they think would be suitable for publication in this section. The deadline is April 23rd 2010. To apply, visit www.marjorielaide.com

Crash

Global securitisation deals, \$trn

■ Public sector ■ Private sector



Source: Dealogic

►tors can better identify shoddy lenders. Similar calls are coming from central bankers, who want more data on the securities that they accept as collateral.

The benefits of the bill's requirement that securitisers retain 5% of a deal's credit risk are less clear. Toughening up the warranties that securitisers sign, agreeing to buy back duff loans, would have the same effect without tying up precious capital. And forced asset-retention could constitute "control" under new accounting rules. If so—no one seems sure either way—issuers would have to hold capital against the entire deal, not just the retained slice.

Another turn-off is the uncertainty surrounding "safe harbour" rules, which were created to reassure investors in securitised assets that they would continue to receive payments if a sponsoring bank failed. Revisions proposed by the Federal Deposit Insurance Corporation (FDIC)—on hold for now—would punch holes in this ring fence, say industry groups.

A more immediate worry is the cacophony of competing interests exposed by the downturn. Banks that service mortgages, for instance, are reluctant to forgive principal, even if that would benefit borrowers and investors, because it would trigger write-downs of second-lien loans on the banks' own books. One investor likens mortgage securitisation to "class warfare" (although Bank of America's decision to forgive some principal on a limited number of loans may herald a wider ceasefire).

For many, the most off-putting factor is the question-mark hanging over Fannie and Freddie, which have been in government conservatorship since September 2008. Until their role is clarified, the future shape of the market, and the opportunities for private competitors, are unknowable. In testimony this week Timothy Geithner, America's treasury secretary, said that he was committed to encouraging private capital back into the market and to shaking up the two agencies. But no details were offered. Amid such uncertainty "only a madman would ramp up securitisation efforts now," says one banker. ■

Greece's bail-out maths**Safety not**

Greece is likely to need far more financial aid than seems to be on offer

IN FEBRUARY European Union leaders vowed to take "determined and co-ordinated action" to protect Greece against a sovereign-debt default and to stop its troubles infecting the rest of the euro area. Weeks later the same politicians are still discussing how precisely to meet that pledge (see page 49).

The need for clarity is now more urgent. Greece has to refinance some €20 billion (\$27 billion) of debts that mature in April and May. The yields on ten-year Greek government bonds rose to 6.3% this week, a spread of some three percentage points over German Bunds. The euro fell to its lowest level against the dollar for ten months after Portugal, another troubled euro-zone country, suffered a downgrade.

A standby fund for Greece of €25 billion is rumoured, and euro-zone ministers now seem less frosty at the thought of help from the IMF. That may be enough to calm markets and enable Greece to roll over its debts. But it will be only a temporary fix. It will take years to repair Greece's public finances, which means a much larger rescue fund will be needed if it is to avoid default.

The Greek government has somehow to keep its economy on an even keel while pushing through a huge fiscal tightening. Countries that seek IMF help generally have to endure brutal cuts in public spending, which deepen recessions. To counter that effect, the IMF typically counsels a weaker currency. Sadly, this is not an option for Greece. Stuck in the euro, its exchange rate with its main trading partners is fixed. Greece cannot devalue, so it needs more time to adjust than the three years it has agreed with its EU partners—and a bigger safety net while it does.

Just how big? Analysis by *The Economist* suggests a figure of €75 billion rather than €25 billion. Greece is likely to need five years to get its deficit down below 3% of GDP (see table). On our projections interest payments will rise from 5% of GDP to 8.4% in that time, to reflect the higher cost of issuing new debts and of refinancing old ones. Other budgetary cuts will be needed to offset this. By our reckoning the Greek government will have to increase the "primary" budget balance (ie, excluding interest payments) by 13.5 percentage points of GDP to cap its debt burden. That is bound to have an effect on growth. Our projections assume that nominal GDP will be 5% lower by 2014.

This is necessarily a stylised analysis,

which requires some brave assumptions (some of which may even be too kind). The estimate of how big a bail-out Greece may need hinges on a particularly heroic one: that private investors have had their fill of Greek bonds but would still roll over existing debts if a bail-out fund covered the country's new borrowing. Our projections imply that Greece will run-up an extra €75 billion of debt by 2014, by which time its debt will stabilise at 153% of GDP. This figure is a rough guide to how much financial aid Greece may require.

That may be too much even for the newly flush IMF. For its share of Latvia's rescue, says Laurence Boone of Barclays Capital, the fund stretched to 12 times the country's "quota", the amount a member country contributes to the fund's coffers. A €75 billion package would require the IMF to provide around 40 times Greece's quota if the costs were split with the EU.

Optimists say that demand for Greek bonds will revive as its budget deficit falls and confidence returns. There is no theory that says investors will tolerate debts of 113% of GDP (Greece's ratio in 2009) but balk at anything higher. Japan's gross public debt is almost 200% of its GDP with as yet few signs of revulsion. But Japan is the only sovereign issuer of yen bonds, while ►►

A ruinous picture

Greece's:

	2009	2014*	Change
Nominal GDP (€ billion)	237.5	225.6	-5.0 ¹
Debt (% of GDP)	113.4	152.5	39.1 ¹
Deficit (% of GDP)	-12.7	-2.6	10.1 ²
Interest payments (% of GDP)	5.0	8.4	3.4 ²
Debt (€ billion)	269.3	344.2	74.9

Sources: European Commission; *The Economist**Economist projections
1Percent 2Percentage points

► Greece is the least creditworthy of the many countries offering euro bonds. Japan is a creditor nation that can rely on domestic savers. Greece is a deficit country that depends on "footloose" investors, says Thomas Mayer of Deutsche Bank.

Greek bonds are attractive because of their generous yields. If the interest-rate spread stays close to 3%, a buyer of a ten-year German bond who holds it until it matures would make only three-quarters of the return he could make on a similar Greek bond. For bold investors, such a gap is ample insurance against the risk that Greece may not be able to pay back all it has promised. Others think the reward may not be worth the gamble. A debt restructuring, where bondholders are forced to swallow losses, is a "substantial risk" if recession in Greece drags on, says Marco Annunziata of UniCredit. Its would-be rescuers may conclude that throwing money at a weak, if profligate, country is still the cheapest way to stop trouble spreading. But the likely bill for Greece's bail-out looks larger than many are assuming. ■

Rising prices in Asia

A weight on their shoulders

Inflation in Asia is not as bad as it looks

SUPPORTERS of Mayawati, a member of India's downtrodden castes who is now chief minister of Uttar Pradesh, India's most populous state, show their appreciation by offering her garlands to wear around her neck. The one presented to her at an event earlier this month was enormous. It was estimated to weigh 65kg, according to the *Times of India*. The garland was made not of marigolds, but of crisp 1,000 rupee (\$22) notes.

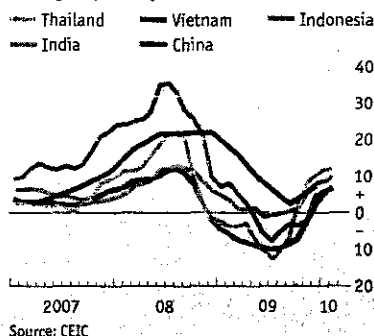
That is as good a sign as any that money is too easy in India. Consumer prices for agricultural workers (among whom Mayawati has her supporters) rose by 16.5% in the year to February. Wholesale prices, which the central bank watches more closely, rose by 9.9% over the same period. That prompted the Reserve Bank of India (RBI) to raise interest rates on March 19th by 0.25 percentage points, without waiting for its scheduled meeting.

The central bank's decision follows rate hikes by the central banks of Australia, Malaysia and Vietnam. The RBI perhaps should have beaten them to the turn. But like other Asian central banks, it was nervous of raising rates while America's rates were on the floor. It also blamed rising prices on the worst monsoon since 1972, which hurt the harvest of foods that weigh

It's back

Producer/wholesale prices

% change on previous year



so heavily in India's inflation indices, especially its four measures of consumer prices. In those circumstances, the central bank's duty is not to stop a one-time jump in prices. It is only to prevent this jump spilling over into broader inflation, creating expectations of future price rises that can become self-fulfilling.

Such a spillover is now visible. In a statement accompanying the rate rises, the RBI noted that wholesale prices of non-food manufactured goods, which had fallen by 0.4% in the year to November, were now rising by 4.3%. A survey by Hewitt Associates suggests that employers will raise salaries by 10.6% this year, compared with a 6.6% rise in 2009. And in an article in *Economic and Political Weekly*, an Indian journal, Rajiv Kumar of the Indian Council for Research on International Economic Relations and his colleagues note that rice retailers charged a markup of 12% over the wholesale price in December 2009, compared with 8% a year earlier. They believe this is suggestive of the "hoarding" that politicians like Mayawati love to blame for higher prices.

Having never fallen as steeply as elsewhere in Asia, India's wholesale prices are now rising faster than anywhere except Thailand (see chart). "India is at one extreme," says Robert Prior-Wandesforde of HSBC. Elsewhere, he says, the upward swing in the global price of commodities such as oil, food and metals, is beginning to show up in broader prices but the inflationary pressure is not remotely like 2008.

In that year commodity prices were rising much faster and Asia's economies were wound much tighter. After several quarters of robust growth, industrial production has caught back up with its long-term trend in all Asian countries except Japan, Singapore and Malaysia, according to HSBC. In 2008 it was far above this trend. Under those conditions, firms passed higher costs onto consumers quite promptly.

Mr Prior-Wandesforde believes headline inflation in Asia will peak soon. Having doubled last year, oil prices would have to double again to maintain the same

rate of increase, he points out. But that does not mean Asian central banks can rest easy. Given the lags that afflict monetary policy, they must set rates today for the Asian economy of 18 months from now. Their policies still reflect nervousness about a relapse in America and Europe. They are consequently too loose for a region that is recovering so briskly.

Even in India the spring harvest should help quell wholesale-price inflation. But these prices are a poor guide for India's monetary policy. They tell the central bank a lot about forces it cannot control, such as the monsoon and the global commodity markets. But they tell it little about the things it can hope to influence, such as domestic demand. The RBI, according to Mr Prior-Wandesforde, is "flying blind most of the time".

In its statement, for example, the central bank cited increasing capacity utilisation as an inflationary threat. By one measure, prepared by the National Council of Applied Economic Research in Delhi, capacity utilisation has returned to its pre-crisis peaks. But India lacks a robust measure of core inflation, or comprehensive measures of employment and wage pressures. Inflation watchers must instead take their cues from surveys, casual observation and telling anecdotes—as well as the weight of money garlanding politicians' necks. ■

Life insurance in Asia

Age concern

TOKYO

Local investors show confidence in shrinking markets

INVESTORS may salivate over insurance prospects in the emerging markets of Indonesia, India and China, but the more mature Asian markets seem to have life in them yet. On March 17th Korea Life became the first of the country's big life insurers to go public. Others are following. Dai-ichi—a household name in Japan—this week priced an \$11.2 billion initial public offering, the biggest since Visa's \$19.7 billion listing in 2008. Samsung Life, another South Korean industry heavyweight, hopes to come to market in May. Foreign firms are also taking up positions in the region's greyer markets: Alico, an AIG subsidiary which makes 70% of its revenue in Japan, has just been snaffled by MetLife.

At a time when new investment opportunities are few and far between, the arrival of an entire industry on Japanese and South Korean stockmarkets has attracted lots of attention, particularly from locals. Korea Life's shares debuted below initial estimates due to weak foreign demand, ►

Economics focus | Tricky Dick and the dollar

Does Richard Nixon have anything to teach Barack Obama about economic diplomacy?



THE "Nixon shock" is not the name given to President Richard Nixon's resignation in 1974 amid the Watergate scandal, his bombing of Cambodia during the Vietnam war or his audacious visit to communist China. It refers instead to a bundle of economic policies unveiled to an unsuspecting world on August 15th 1971. The president imposed a freeze on wages and prices for 90 days to break inflation, ended the convertibility of dollars into gold, and slapped a "surcharge" or tariff of 10% on imports.

Nixon is not usually a source of inspiration for left-leaning pundits such as Paul Krugman of the *New York Times*. But like 130 congressmen, who this month signed a letter to Timothy Geithner, America's treasury secretary, he is calling on the White House to emulate Nixon and impose a "surcharge" on imports from China. The tariff is supposed to force China to strengthen its currency, the yuan, against the dollar, just as Nixon's surcharge prompted America's trading partners to renegotiate their exchange rates four months later.

Mr Krugman argues that China's weak yuan is costing America roughly 1.4m jobs. Its cheap currency gives its exporters an edge in the American marketplace. China then squanders its dollar earnings away in American securities rather than spending them on American goods. In normal circumstances these asset purchases would lower interest rates, boosting American borrowing and spending. But America, like other rich countries, is now caught in a "liquidity trap". Interest rates are as low as they can go. By saving dollars rather than spending them, China is draining demand from the world economy.

China's foreign-exchange reserves now total \$2.4 trillion, of which about 70% are thought to be in dollars. In 1971 the central banks of America's trading partners had amassed a rather smaller hoard, of about \$40 billion. But that was enough to buy the gold in Fort Knox three times over, if America upheld its commitment to sell the metal at \$35 an ounce. Britain's request to exchange dollars for gold on August 13th 1971 was the last straw. "Although the US government attached no great importance to the gold as such, a run on this gold would have been a sorry spectacle," wrote George Shultz and Kenneth Dam, two prominent economic officials in the Nixon administration, in their book "Economic Policy Beyond the Headlines". On August 15th Nixon, in

effect, announced that America was now unwilling to do what it would soon be incapable of doing—converting dollars into gold at the agreed exchange rate.

Messrs Shultz and Dam argue that the import surcharge was intended as "an attention-getter and a bargaining chip". It allowed John Connally, Nixon's treasury secretary and a Texan, to stride down the corridors of international finance "with both guns blazing". In the face of this bravado America's trading partners duly backed down. By December they agreed to let the dollar fall (by a trade-weighted average of 6.5%) and the surcharge was removed. Nixon was able to present the humbling of the dollar as a political victory. But were Barack Obama to emulate him, would he really enjoy the same result?

The obvious difference is that in 1971 America was locked into a system of fixed parities. By pegging to the dollar, a currency was automatically fixed to everything else. Since July 2008 China has pegged the yuan to the greenback. But over that period its currency has swung up and down against those of its trading partners and competitors. On a trade-weighted basis the yuan is back to where it was when the financial crisis started. Indeed, compared with China's emerging-market competitors in its big export markets, the yuan is about 12% more expensive today than it was before the collapse of Lehman Brothers, according to a measure (the "third-country" effective exchange rate) calculated by the Hong Kong Monetary Authority. By this indicator China's currency is about 25% above its level in 2005.

The second difference is related to the first. Because everybody was pegged to the dollar in 1971, everybody had to pay the surcharge. Nixon dismayed everyone but discriminated against no one. China's critics today, on the other hand, urge Mr Obama to slap a tariff on Chinese goods alone. This will reduce the demand for Chinese imports, which constitute about 15% of America's total. But there is no guarantee that customers will switch from Chinese goods to American ones instead. They are more likely to buy from China's rivals in Asia. The surcharge may change the composition of America's trade deficit, without necessarily changing its size.

Nixon goes to China

The Nixon shock holds lessons for China as well as Mr Obama. Like China today, Germany in the 1960s disavowed any responsibility for the world's imbalances, insisting that the solution lay with tighter policies in deficit countries rather than looser policies in surplus countries. (Germany is still singing a version of that song.) But by holding fast to the dollar, Germany ended up importing America's laxity. It could not insulate itself from the loose monetary policy engineered to help Nixon win the 1972 election. German prices rose by over 5% in 1971. China, too, risks a loss of macroeconomic control if it continues to peg to the dollar. Its money supply grew by about 35% in the year to February. That kind of surge may be a precursor to inflation.

The advocates of a surcharge argue that China will not act unless it is forced to do so. They point to defensive remarks by Wen Jiabao, China's prime minister, arguing that the yuan was not undervalued and would remain "basically stable". But the demise of the Bretton Woods system suggests that official statements can be a poor guide to future policy. The decision not to revalue is "final, unequivocal and for eternity". That's not a Chinese official in 2010, but a German official in the Nixon era—just five months before the Deutschmark was revalued by 9.3%. ■

ECONOMY

Not as Good as They Look

Inflation will hurt emerging markets.

BY RUCHIR SHARMA



FOR MOST ECONOMIC analysts, the past is the present. It is a popular sport to find historical parallels with the current period, and the strong consensus now is that 2010

has 2004 written all over it.

After all, 2004 also was the second year of a global economic recovery. The Chinese economy was also overheating, and authorities there were tightening monetary policy. Following a volatile first half, the year ended up being relatively benign for financial markets as fears of inflation subsided in China and the global economic recovery rolled on uninterrupted. Analysts expect 2010 to unfold in a similar manner.

But history repeats itself only for those who don't know the details. The global economy was on much stronger footing in 2004 to withstand any Chinese tightening. Economic growth across the world averaged 5 percent that year, with the developed world fully participating in the recovery process. This time around, the global recovery is far more uneven and the annual pace of expansion is slower, at just under 3.5 percent. What's more, while a boom in exports to the West helped China maintain a 9 percent growth rate back in 2004 even as its domestic economy slowed, it can hardly expect a similar contribution from the developed world this year. Indeed, developing economies led by China are

now themselves the main engines of the world's economy. In order to keep the global economic momentum going, they need to steam ahead at a pace similar to the 7 percent that they averaged during the 2003-07 boom period.

The fundamental obstacle to achieving that is inflation. It has resurfaced much too quickly in many emerging markets, especially given the ample spare capacity in the world. Commodity prices have flared up to levels far above what can be justified by any increase in underlying demand. Food and energy prices, which typically account for a third of the consumer's basket in developing countries, are already back at 2007 levels. Not only do higher commodity prices boost headline inflation, they usually also pass through to other items over time in

developing economies.

By mid-2010, both headline and core inflation in most emerging markets should touch levels similar to those of 2006—the fourth year of the emerging-market boom and the third of a strong global economic recovery.

Why have commodity prices climbed so

far and so fast in only the second year of a subpar global recovery? The lazy explanation strewn about by several market analysts has to do with runaway Chinese demand. Facts do not bear this out, however. While Chinese demand has undoubtedly been strong, inventories for almost all commodities, from aluminum to oil, are at multidecade highs, as global demand remains weak.

A better explanation for the irrational exuberance in the commodity pits is that interest rates remain so low across the world. Financial investors spurred on by cheap money and eager to acquire hard assets after the crisis poured more than \$50 billion into commodity funds in 2009—more than three times the average sum in the 2003-07 boom years. This link is evidenced by the fact that in recent weeks commodity prices knee-jerked lower at the first signs of tightening by emerging-market central banks such as China's. In 2004 too, Chinese tightening took the wind out of any buildup in commodity-price inflation, although at the cost of a domestic economic slowdown for a few quarters.

All this suggests the global recovery is precarious. It is weaker than in 2004, yet inflation is already reaching the upper limit of the tolerance band in many emerging markets, and the speculative juices are continuing to flow freely in the commodity markets. This means that central banks will have to tighten monetary policy aggressively in the months ahead to keep inflation in check. That could, in turn, derail the fragile global healing process.

Unless the link between a tentative recovery and unjustifiably high commodity prices is somehow broken, 2004 and 2010 will have little in common. The current year may instead turn to be more like one in the late 1930s or in the mid-1970s—a sharp rebound, after which both the global economy and the world's stock markets struggled, making little progress through all the slush left over in the system after the big storm.

SHARMA is head of emerging markets for Morgan Stanley Investment Management.

REUTERS

ECONOMICS

GROWTH

HOW AFRICA IS BECOMING THE NEW ASIA

BY JERRY GUO

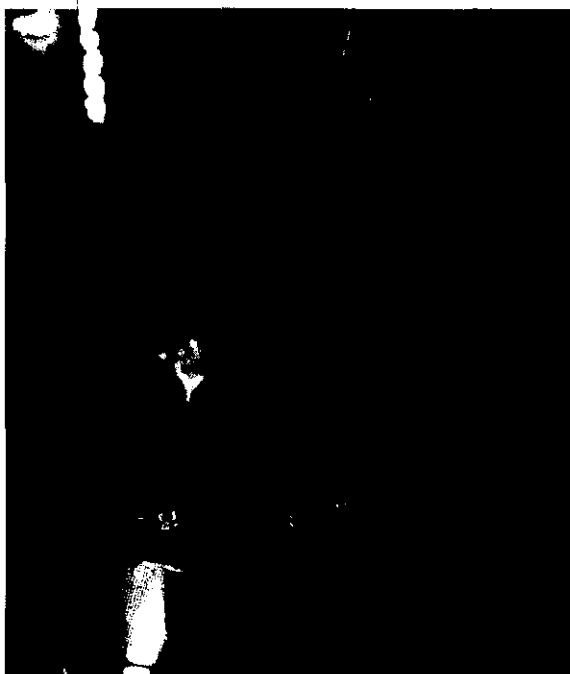
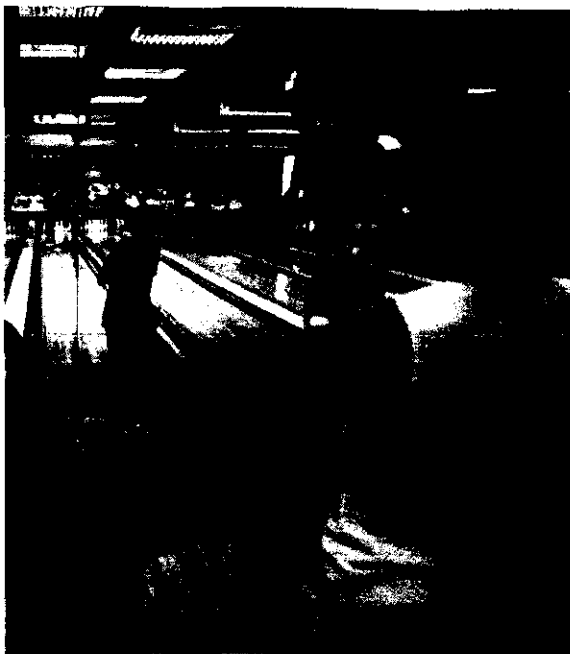
CHINA AND INDIA GET ALL THE HEADLINES for their economic prowess, but there's another global growth story that is easily overlooked: Africa. In 2007 and 2008, southern Africa, the Great Lakes region of Kenya, Tanzania, and Uganda, and even the drought-stricken Horn of Africa had GDP growth rates on par with Asia's two powerhouses. Last year, in the depths of global recession, the continent clocked almost 2 percent growth, roughly equal to the rates in the Middle East, and outperforming everywhere else but India and China. This year and in 2011, Africa will grow by 4.8 percent—the highest rate of growth outside Asia, and higher than even the oft-buzzed-about economies of Brazil, Russia, Mexico, and Eastern Europe, according to newly revised IMF estimates. In fact, on a per capita basis, Africans are already richer than Indians, and a dozen African states have higher gross national income per capita than China.

More surprising is that much of this growth is driven not by the sale of raw materials, like oil or diamonds, but by a burgeoning domestic market, the largest outside India and China. In the last four years, the surge in private consumption of goods and services has accounted

for two thirds of Africa's GDP growth. The rapidly emerging African middle class could number as many as 300 million, out of a total population of 1 billion, according to development expert Vijay Majahan, author of the 2009 book *Africa Rising*. While few of them have the kind of disposable income found in Asia and the West, these accountants, teachers, maids, taxi drivers, even roadside street vendors, are driving up demand for goods and services like cell phones, bank accounts, upmarket foodstuffs, and real estate. In fact, in Africa's 10 largest economies, the service sector makes up 40 percent of GDP, not too far from India's 53 percent. "The new Africa story is consumption," says Graham Thomas, head of principal investment at Standard Bank Group, which operates in 17 African countries.

Much of the boom in this new consumer class can be attributed to outside forces: evolving trade patterns, particularly from increased demand coming out of China, and technological innovation abroad that spurs local productivity and growth like the multibillion-dollar fiber-optic lines that are being laid out between Africa and the developed world. Other changes are domestic





A NEW MIDDLE CLASS
IN NIGERIA: BOWLING;
A NIGHTCLUB; FACTORY
WORKERS.

and deliberate. Despite Africa's well-founded reputation for corruption and poor governance, a substantial chunk of the continent has quietly experienced this economic renaissance by dint of its virtually unprecedented political stability. Spurred by eager investors, governments have steadily deregulated industries and developed infrastructure. As a result, countries such as Kenya and Botswana now boast privately owned world-class hospitals, charter schools, and toll roads that are actually safe to drive on. A study by a World Bank program, the Africa Infrastructure Country Diagnostic, found that improvements in Africa's telecom infrastructure have contributed as much as 1 percent to per capita GDP growth, a bigger role than changes in monetary or fiscal policies. Shares of stocks in recently privatized local airlines, freight companies, and telecoms have skyrocketed.

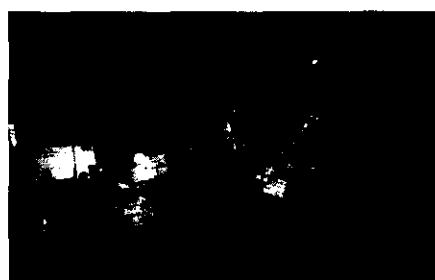
Entrepreneurship has increased at the same time, powered in part by the influx of returning skilled workers. Just as waves of expats returned to China and India in the 1990s to start businesses that in turn attracted more outside talent and capital, there are now signs that an entrepreneurial African

diaspora will help transform the continent. While brain drain is still a chronic problem in countries such as Burundi and Malawi—some of the poorest in the world on a per capita basis—Africa's most robust economies, such as those in Ghana, Botswana, and South Africa, are beginning to see an unprecedented brain gain. According to some reports, roughly 10,000 skilled professionals have returned to Nigeria in the last year, and the number of educated Angolans seeking jobs back home has spiked 10-fold, to 1,000, in the last five years. Bart Nnaji gave up a tenured professorship at the University of Pittsburgh to move back to Nigeria in 2005 and run Geometric Power, the first private power company in sub-Saharan Africa. Its \$400 million, 188-megawatt power plant will come online this fall as the sole provider of electricity for Aba, a city of 2 million in southeast Nigeria. Afam Onyema, a 30-year-old graduate of Harvard and Stanford Law, turned down six-figure offers in corporate law to build and run a \$50 million state-of-the-art private hospital with a charitable component for the poor in southeast Nigeria.

Many experts believe Africa, with its

expansive base of newly minted consumers, may very well be on the verge of becoming the next India, thanks to frenetic urbanization and the sort of big push in services and infrastructure that transformed the Asian subcontinent 15 years ago. Just as India once harnessed its booming population of cheap labor, Africa stands to gain by the rapid growth of its big cities. Already the continent boasts the world's highest rate of urbanization, which jump-starts growth through industrialization and economies of scale. Today only a third of Africa's population lives in cities, but that segment accounts for 80 percent of total GDP, according to the U.N. Centre for Human Settlements. In the next 30 years, half the continent's population will be living in cities.

Nowhere is this relationship between the consumer class and urbanization more apparent than in Lagos, Nigeria, a megalopolis of 18 million that has the anything-goes pace of a Chongqing or Mumbai. On Victoria Island, the city's commercial center, real estate is as expensive as in Manhattan. Everywhere you look, there is construction: luxury condos, office buildings, roads, even a brand-new city nearby being dredged from the sea that will hold half a million people. "Everything is in short supply, so everything's a high-growth area," explains Adedotun Sulaiman, a venture capitalist and chairman of Accenture in Nigeria. "In terms of opportunities, it's just mind-blowing." Aliko Dangote, Africa's richest black entrepreneur, has also cashed in on this consumer culture, with a net worth of \$2.5 bil-



CITY LIFE
THE AFRICAN
MEGALOPOLIS,
LAGOS, NIGERIA.

lion, according to *Forbes*. His empire, which began in 1978 as a trading business that imported, among other things, baby food, cement, and frozen fish, is focused on Nigeria's burgeoning domestic growth, producing cement for shopping and office complexes; renting luxury condos; making noodles, flour, and sugar; and now expanding into services such as 3G mobile networks and transportation. "There's nowhere you can make money like in Nigeria," says the 53-year-old Dangote. "It's the world's best-kept secret."

Not anymore. A recent study by Oxford economist Paul Collier of all 954 publicly traded African companies operating between 2000 and 2007 found that their annual return on capital was on average 65 percent higher than those of similar firms in China, India, Vietnam, or Indonesia because labor costs are skyrocketing in Asia. Their median profit margin, 11 percent, was also higher than in Asia or South America.

African mobile operators, for instance, showed the highest profit margins in the industry worldwide. As a result, foreign multinationals like Unilever, Nestlé, and Swissport International report some of their highest growth in Africa. So even as foreign direct investment fell by 20 percent worldwide in 2008, capital inflows to Africa actually jumped 16 percent, to \$61.9 billion, its highest level ever, according to a report by the Organization for Economic Cooperation and Development. Even Chinese companies are thinking of outsourcing basic manufacturing to Africa. The World Bank is now helping China set up an industrial zone in Ethiopia, the first of perhaps several offshore centers akin to the sprawling free-trade zones that opened up China's economy in the 1980s.

Still, Africa remains at the very frontier of emerging markets. Despite its gains, the difficulty and cost of running a business there are the highest in the world, according to data from the International Monetary Fund. Couple that with pervasive corruption—Transparency International calls the problem "rampant" in 36 of 53 African states—and it's no wonder Africa is often regarded as a toxic place to operate. But World Bank president Robert Zoellick says that in the aftermath of the economic crisis, long-term investors have recognized that "developed markets have big risks too." Like China and India, Africa is exploiting that fact, and perhaps more than any other region it is illustrative of a new world order in which the poorest nations will still find ways to steam ahead.

PREVIOUS SPREAD: JACOB SILBERBERG—PANOS (5); THIS PAGE: BENEDICTE KURZEN—NEW YORK TIMES-REDUX, JACOB SILBERBERG—PANOS; BENEDICTE KURZEN—NEW YORK TIMES-REDUX

WORLD VIEW

DEFUSING THE DEBT BOMB

BY FAREED ZAKARIA

EVERYONE SEEMS TO BE PESSIMISTIC ABOUT AMERICA THESE days. In poll after poll, Americans worry about their future. Pundits, myself included, write despairingly about the monumental challenges we face. Academics plan seminars on America's decline.

So, perhaps more to cheer myself up than anything else, I decided to ask what it would take to fix the U.S. There is one problem that overshadows all else. Washington is taking on debt burdens that are huge and, as the baby boomers retire, look truly frightening. The Peterson Institute estimates that the U.S. government's programs for Social Security and health care are already \$43 trillion in the hole. To cover this, the government would have to eliminate virtually all other spending and/or jack

These three fixes alone would place the United States on a firm fiscal footing.

up tax rates into the 70 percent range. Foreigners would almost certainly demand higher interest rates if they lent money to the United States. And if we raised interest rates, the economy would stagnate—making the debt burden even more onerous.

So, this problem looks unavoidable, but also insoluble. Remember, though, that America has a \$14 trillion economy that was, until recently, growing quite fast. We can find ways to address even this challenge. Here are three simple proposals that would defuse the debt bomb, with money to spare:

First, adopt a value-added tax. More than 100 countries have some kind of a national sales tax. If America were to enact one tomorrow, at something like the average for industrial countries (18 percent), and drop income-tax rates to compensate somewhat, we could bring in hundreds of billions of dollars every year. To get a sense of the revenue potential, imagine if the United States were to adopt a VAT at the high end of the range—25 percent, similar to that of many Scandinavian countries whose economies have still grown as fast as America's over the last three decades. Such a tax, Leonard Burman calculates in the *University of Virginia Tax Review*, would bring in enough money to bal-

ance the federal budget, pay for health-care expansion, eliminate the income tax for all those earning less than \$100,000 (90 percent of households), and cut the top tax rate to 25 percent. The tax would also restrain Americans from over-consuming and reward them for saving, the single most important long-term shift we need to encourage.

Second, end the massive, distorting subsidies for homeownership, health care, and agriculture. These three subsidies together cost the federal government about \$250 billion a year. All of them encourage behavior that is bad for the economy. The interest deduction on mortgage has encouraged the massive accumulation of debt that is at the heart of the current crisis. (No, it does not encourage homeownership. Neither Canada nor Britain has the subsidy, and both have slightly higher rates of homeownership than we do.) Tax exemptions for employer-based health plans encourage overconsumption of health services—a point on which economists from both left and right agree. Agricultural subsidies, mostly handouts to large agribusinesses, are so egregious and market-distorting, one doesn't really know where to begin.

Finally, make sensible adjustments to entitlements. The most important fix is to tie benefits to rises in income, not wages, a seemingly technical matter, but one that could save the government hundreds of billions of dollars. Then raise the retirement age by a couple of years, and link it to life expectancy, which increases by three months every year. This is not impossible. Germany just raised its retirement age to 67. In fact, many European countries have fixed their pension systems so that they will be solvent for decades, even longer.

Each of these policies could be phased in so that the timing is right. They could be pared back, especially if other savings and reforms are enacted. (Currently, tax breaks and deductions cost the government \$1.1 trillion a year.) But just these three fixes would place the United States on a firm fiscal footing, leaving it with ample resources to invest in research, education, infrastructure, alternative energy, and whatever else we want.

I know, I know—it's the politics that makes this look hard. I understand how impossible it is for Congress to impose even a little pain, despite general agreement that we are in a severe crisis. But as we sink, let's not pretend that our problems are insurmountable. The solutions are out there in plain sight.

SCOPE **InternationalList****STILL
BETTING ON
ASIA'S GROWTH**

BY KATIE BAKER

BRICS

AS THE GLOBAL FINANCIAL downturn drags on, some investors have started to question the pre-recession storyline of robust BRIC growth. Analysts like Morgan Stanley's Ruchir Sharma are predicting that inflation will throw cold water on emerging-market recoveries; others, such as emerging-market fund manager Mark Mobius, claim that cracks within the BRICs will soon develop. Mobius recently declared, for instance, that Brazil's economy will be "more sustainable" than China's because of resource self-sufficiency.

But a new study from Capital Economics suggests that, despite these hurdles, it's still going to be an Asian century. While the U.S. and Europe are expected to slog through a meager 3 percent and 1.5 percent GDP growth this year, respectively, emerging Asia's GDP is set to surge 8 percent on average in 2010 and 6 percent in 2011. Not surprisingly, the rebound will be led by China—slated to grow 10 percent in 2010—followed closely by India (8.5 percent), Taiwan (7 percent), and Vietnam (7.5 percent).

The study's authors point to rising domestic demand as the engine fueling Asia's recovery. Throughout the slump, household spending has held up well in China, thanks

to tax breaks and Cash for Clunkers-type schemes, and rapidly expanding private consumption in Southeast Asian nations such as Thailand and Malaysia has helped boomerang them out of the crisis. In Asia's other big economies, India and Indonesia, consumer confidence has returned to pre-recession levels, and retail sales growth remains strong thanks to rising incomes, low personal debt, and high household savings.

Of course, there are caveats. The big risks for Asia are an expected downturn in trade over the course of the year as foreign demand flags (which could hurt export-dependent China and South Korea) and overheated asset bubbles caused by easy credit sloshing through the markets. There's also some question as to whether

countries where consumer debt remains high—South Korea, Australia—will be able to sustain domestic consumption. And if food or oil prices skyrocket to 2008 levels because of rising inflation (as some analysts now forecast), it would seriously wound household spending abilities across the region. Finally, if governments pull back stimulus measures too quickly, consumers may not be poised to pick up the slack yet—particularly in China.

Still, many of Asia's governments are already moving to contain inflation and rein in lending. And, as the study notes, government debt levels are more manageable than in the West, and banking systems are in better shape. Which all means that it's Asia's century to lose.

lic officials—including 10 mayors—in the drug-infested state of Michoacán on suspicion of cartel links. Interior Secretary Fernando Gómez Mont hailed the operation as necessary "to defend our institutions."

But now the high-profile haul looks less like progress and more like politicking. Only three of the mayors remain in jail; the rest have been released for lack of evidence—some after spending 250 days in prison—and have returned to their jobs. Critics point out that the arrests took place one month before the country's midterm elections, and that nine of the 10 mayors belonged to opposition parties. "The timing definitely responded to a political calendar," says John Ackerman, a

political scientist in Mexico City. The episode reveals that Calderón's government will go to great lengths to convince voters of its success in the fight against drug traffickers, but that it may be doing it at the expense of democracy and the rule of law.

**CASTING
TOO WIDE A NET
FOR CARTELS**

BY MICHAEL MILLER

MEXICO

IN THE FIGHT AGAINST Mexico's drug cartels, President Felipe Calderón's hardball tactics have won him many supporters. Yet his push to weaken organized crime may be compromising Mexican democracy. Last May, federal troops arrested nearly 30 pub-



BEIJING STEPS UP DOMESTIC SECURITY

BY ISAAC STONE FISH

CHINA CHINA'S GROWING defense budget has many neighbors worried that this economic hyperpower has global military ambitions, too. But when Beijing recently announced that its military budget will rise by a relatively modest 7.5 percent in 2010 (last year it registered a 14.9 percent hike), pundits debated what the slowing rate of increase means for China's role in the world. And for the moment, at least, Beijing seems more concerned with turning its guns inward. China's domestic-security budget this year will hit \$75.3 billion, slightly less than the military budget but growing at a faster rate of 8.9 percent annually. The

paper estimates that China employs 21 million people in public security, dwarfing the approximately 3 million members who make the People's Liberation Army the world's largest military force. This focus on internal peace and quiet is happening not just in places like Xinjiang, which doubled its security budget this year after the region was rocked by deadly ethnic riots in 2009. Even relatively calm provinces like Yunnan are doubling their per capita security spending. The numbers are a potent reminder that it is not the stability of the exchange rate that will determine China's future, but the stability within its own borders.

PRETENDING WE'RE NOT IN A TRADE WAR

BY BARRETT SHERIDAN

ECONOMY EVEN IN THE DARKEST days of the recession, as job reports registered stomach-flipping descents, politicians around the globe swore not to give in to protectionism. Now, as the economy starts to stabilize, the World Trade Organization has offered them a muted congratulations. Its analysis of anti-free trade actions in 2009 reveals some minor slippage, but in general "paints a reassuring picture."

But like all self-portraits, this one tends to flatter the painter. The WTO relies on countries to report their own transgressions, "and when you grade yourself, you tend to be an easy grader," says Gary Clyde Hufbauer, an economist with the Peterson Institute for International Economics. That's es-

pecially true when the guidelines allow for lots of wiggle room. When the U.S. slaps a tariff on Chinese tires, it's a clear act of protectionism and is duly reported to the WTO. But elbowing foreign firms out of government purchases—as the U.S. did to Airbus over a \$40 billion contract for aerial-refueling tankers—doesn't require a confession.

A more accurate assessment of the state of trade comes from independent watchdog Global Trade Alert, which estimates that governments enacted at least 100 new protectionist measures per quarter last year. "Any suggestion that 2009 was a benign, low protectionism era should be dismissed," the latest report reads. The "reassuring picture," it turns out, has plenty of blemishes.

BY THE WAY BUYING UP THE WEST

As the recession eased in the second half of 2009, rich nations continued to acquire assets in emerging markets, while developing economies began buying up Western assets. China's purchases, according to a report from the U.S. Trade Representative, were the most significant.

16

30

47

52

In China's annual report on the state of the world economy since 2009

The No-Growth Fantasy

Europe's attack on capitalism.

BY STEFAN THEIL



TAKE THE WORST economic crisis in 60 years. Combine it with the erosion of the West's predominance. Add apocalyptic warnings of climate change. What you'll get are some

radical new ideas.

One of those now swirling through the European zeitgeist turns out to be a very old one, albeit in new garb. It's the revival of the assertion that economic development is and should be finite—limited today by scarce resources, overpopulation, and rising sea levels.

In Britain, a government commission has drawn up plans for a "steady state economy" that forgoes future economic growth in the name of sustainability by cutting work hours and banning TV commercials (to reduce consumerism). In Germany, new bestseller called *Exit: Prosperity Without Growth* is just the latest in a growing body of literature pleading for Germans to learn to live with less. In France, President Nicolas Sarkozy—who once

came to power exhorting the French to work harder and earn more—has thrown his weight behind an expert report that declares the pursuit of GDP growth a "fetish" and strives to replace the GDP statistic with a broader measure of national contentment.

Few would argue the world can just go back to the old go-go economy, where a large part of what was taken as growth was financed by unsustainable bubbles

in credit and asset prices. The 2008 spike in the cost of food and oil reminded us that the present rate of resource depletion can't go on forever. And the debate over whether GDP statistics are really the proper measure of human progress is perfectly valid—and not new. Economists are the first to admit that GDP is at best a proxy for prosperity, not an end in itself.

Yet today's no-growthers seem to make the same mistakes as their many predecessors, from Thomas Malthus—who predicted in 1798 that rising populations would inevitably starve—to the Club of Rome, a group of scientists who warned in 1972 that the world would start running out of key resources in the 1980s. Such movements extrapolate growth rates for resource use and pollution but don't take enough account of technical innovation, environmental regulation,

greater efficiency, and behavioral change. Take *Exit* author Meinhard Miegel's claim that the world is running out of food. It largely ignores, among other things, the barely tapped potential of genetic engineering and other plant-breeding technologies.

Such faults are often overlooked because the

no-growthers resonate in Europe today for intellectual and political reasons, not economic or technological ones. Critiques of growth have always been, at their core, about uneasiness with capitalism itself. That this critique becomes mainstream when capitalism seems to be failing us is no surprise. After all, the Club of Rome made its first splash in the 1970s, during a long slowdown when people were also becoming newly

aware of environmental degradation.

It's also no surprise that the movement is now centered in Europe and led by a French president. In no other country on earth is public disapproval of the market economy, as measured by opinion polls, deeper. French children, in a widely used and by no means exceptional schoolbook, learn that "economic growth imposes a hectic form of life that produces overwork, stress, nervous depression, cardiovascular disease, and cancer." To the 2.6 billion people worldwide trying to stay alive on less than \$2 a day, the idea that economic growth causes stress may sound crazy. But in Europe, even conservatives have widely bought into the Marxist idea of "economism"—the notion that capitalism has reduced our lives to a series of market transactions.

There's something to these critiques. But the no-growthers are unrealistic about how painful a no-growth reality would be. As the Harvard scholar Benjamin Friedman argues eloquently in *The Moral Consequences of Economic Growth*, a society that gives up on growth invites nasty fights over the distribution of limited resources and paves the way for intolerance and populism. That economic growth isn't everything—it doesn't measure the value of our relationships, our communities, our culture—is obvious. But so is the correlation between prosperity and quality of life, including health, longevity, and the freedom to pursue happiness. Even if the critics are right and growth is going to be harder to attain post-crisis, that's no reason to give up on it. Just the opposite: all the more reason to spend our energy coming up with the right policies—from education and innovation to entrepreneurship and competition—that will help foster it.

A society that gives up on growth invites nasty fights over limited resources and paves the way for intolerance.

ECONOMY

Trouble in the Desert

Why the Gulf has yet to emerge.

BY RUCHIR SHARMA



IT IS ALL ABOUT Shanghai, Mumbai, and Dubai: that was the chorus at the peak of the emerging-market boom in 2007. But although China and India are back in vogue, investors

have bid goodbye to Dubai.

Its decline is symptomatic of the fading fortunes of the Middle East. The stock markets of the Gulf countries—including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have been severely lagging their emerging-market peers. After falling by as much as 55 percent in 2008, they rose by a rather modest 18 percent last year, compared with an average gain of 80 percent for all emerging markets. The credit bubble that led to Dubai's debt crisis in late 2009 did not appear in the other Gulf countries, but the emirate's debt debacle highlighted problems that are common across the region: poor transparency, weak regulations, and opaque ownership structures.

The axiom of the dark old days of emerging-market investing in the 1990s was "What you see is not what you get," and in many ways that's still true of the Middle East today. The balance sheets of many Gulf companies are out of date with financial numbers disclosed well after the standard reporting period and few checks on insider trading.

There's also a major disconnect between economic and stock-market

performance. Over the past five years, the GDP of the Gulf region expanded at an annual pace of nearly 5 percent, a rate in line with the average for all developing economies. Yet the Gulf stock markets fell 20 percent, while mainstream emerging markets gained 80 percent. The problem is that so many Gulf companies are privately held either by wealthy merchant families or by the state. Gulf exchanges list so few quality companies that they end up lacking the breadth to capture the region's economic growth.

These narrow markets reflect a larger problem: the Gulf lacks the homegrown human capital and technology needed to create a genuinely diversified manufacturing base. Dubai's apparent success building a glitzy service sector (including banks and tourism) inspired other countries such as Qatar to go down the same path. But the potential of finance and tourism in the desert has its limits, as Dubai's fall shows.

The only way to diversify the Gulf's oil economy in the long run is to create a skilled workforce through better education. Policymakers in Saudi Arabia, the region's largest economy, know this, and have begun allocating large sums of money toward improving primary-, secondary-, and university-level education.

However, measures to improve the quality of the labor force take a long time to yield results, and so in the meantime Saudi leaders are spending heavily (and smartly) on modernizing their transportation networks and building new

power plants. With combined financial reserves of more than \$1.5 trillion accumulated from huge oil and gas exports, the Middle East, including Saudi Arabia, has the wealth to keep such major projects going. That should keep growth chugging along at a 4 to 5 percent rate over the next couple of years.

To translate that growth into stock-market returns, authorities need to push major reforms, starting with the financial system. The region's sovereign wealth funds control hundreds of billions of dollars, but tend to invest only a small part of their reserves at home. Better regulation and oversight of the financial markets would encourage more of that money to stay in the region. What's more, creating a regime that's friendly to global investors would help make the local economies more efficient, because higher standards for disclosure and transparency will reduce the cost of financing for domestic companies. Since the standoff over Dubai World's decision in November 2009 to delay its debt payments, Gulf corporations have been unable to tap international capital markets—thereby raising their cost of borrowing.

To be sure, the Gulf markets have come a long way in the last decade. The market capitalization of the regional markets has risen 700 percent, and trading volumes have increased more than 10-fold. But last year Dubai was only the most publicized of the Gulf debt blowups, which also hit corporations in Saudi Arabia and Kuwait. So it may be some time before anyone mentions Dubai, or any Gulf capital, in the same phrase as Shanghai.

SHARMA is head of emerging markets at Morgan Stanley Investment Management.

Financial numbers in many Gulf firms are disclosed late, and there are few checks on insider trading.

Essay



Michael

Schuman

The Real Deal. Asia has achieved much prosperity, but the U.S. should not draw the wrong lessons from its economic rise

FOR SOME FOUR DECADES, AMERICANS HAVE LOOKED AT Asia's phenomenal economic growth and asked, What are they doing right, and what are we doing wrong? Today the question rings louder than ever. As Asia surges out of the Great Recession, experts are searching for the secrets of the region's resilience, those nuggets of Eastern wisdom that can rejuvenate a tired American economy.

Asia can provide lessons for the West, but Americans often take the wrong lessons from Asia's growth stories. That's because many people mistakenly believe that Asia offers a superior political-economic model for meeting the modern world's economic challenges. That perception is based on the incorrect notion that Asia's success is the product of intrusive governments.

In the 1980s, when Japan was Asia's rising giant, some argued that its state-led economic system, in which bureaucrats picked winners by targeting industries for special support, was superior to the West's more laissez-faire practices. Today, pundits see China's "state capitalism" as the contender for global dominance. The heavier hand of the Chinese government, this thinking goes, acts as a source of strength in hard times while firmly guiding the nation into the industries of the future. China's vibrancy has even led Americans to question the viability of democratic capitalism. Scholar Orville Schell wrote in a column around the time the People's Republic commemorated its 60th anniversary last October, "It is intellectually and politically unsettling to realize that, if the West cannot quickly straighten out its systems of government, only politically unreformed states like China will be able to make the decisions that a nation needs to survive in today's high-speed, high-tech, increasingly globalized world."

Sure, the authoritarian rulers in Beijing can sometimes implement policies more efficiently than the democrats of the West. That's why Beijing's recession-busting stimulus plan proved more effective than Washington's. With no political debate, China's bureaucrats splashed money everywhere to toss up new infrastructure. The slumping economy needs more credit? That's easy—if you own the banks. Just open a spigot and see the money flow. China's government can also push ahead on long-term projects with greater speed. While health care reform in the U.S. languishes, China is building an extensive

health care system to cover nearly all its 1.3 billion people.

But China's stimulus program could have undermined the health of the banking system. The Chinese economy is riddled with excess capacity, inefficient state enterprises and asset bubbles. More importantly, the idea that the state made China rich is simply not true. China only started growing when the overbearing government got out of the way and allowed private enterprise to thrive. The same is true in India. Across Asia, the primary engine of growth has always been the market, not the state. All rapid-growth Asian economies, including

China's, succeeded by latching onto the forces of globalization, through free trade and free flows of capital. South Korea, Taiwan and Singapore had active bureaucrats, but the true source of their growth was exports manufactured by private companies and sold to the consumers of the world.

The problem with today's analysis of Asia is that it is far too focused on China. Just about everywhere else, policy-makers are rejecting the China

model. In fact, they are heading in the opposite direction. The Presidents of South Korea and Taiwan believe deregulation is crucial for the future of their economies. In Japan, Prime Minister Yukio Hatoyama has made weakening the power of the bureaucracy—not expanding it—one of his primary policy goals. Asia has become a leader in promoting free trade, as a proliferation of free-trade agreements continues to push back the power of the state.

The evidence from Asia shows that its economies became more market-driven as they became more advanced. That's been true in China as well. Despite all the talk of state capitalism, Beijing's leaders continue to liberalize the economy. In January, a free-trade agreement between China and ASEAN came into full effect, creating a free-trade zone with more potential customers than NAFTA. China's State Council also approved the very capitalist practices of short-selling of stocks and futures trading.

Asia's economic strength stems not from some ancient Chinese secret or special economic model, but from simple, old-fashioned free enterprise—the kind Americans love to love. The democratic capitalism being questioned in the U.S. is finding new roots in a rising Asia. If Americans want to learn the correct lessons from Asia, they can ironically find them right at home.



Old wisdom A slogan at the 1939 New York World's Fair

Global Business

□ FINANCE □ MANUFACTURING □ TECHNOLOGY □ TRADE □ MANAGEMENT □ MARKETS

INSIDE
'We are more nimble and disciplined, and customers are coming back.'

HOWARD SCHULTZ, CEO OF STARBUCKS,
ON BATTLING THE DOWNTURN

PUBLIC DEBT

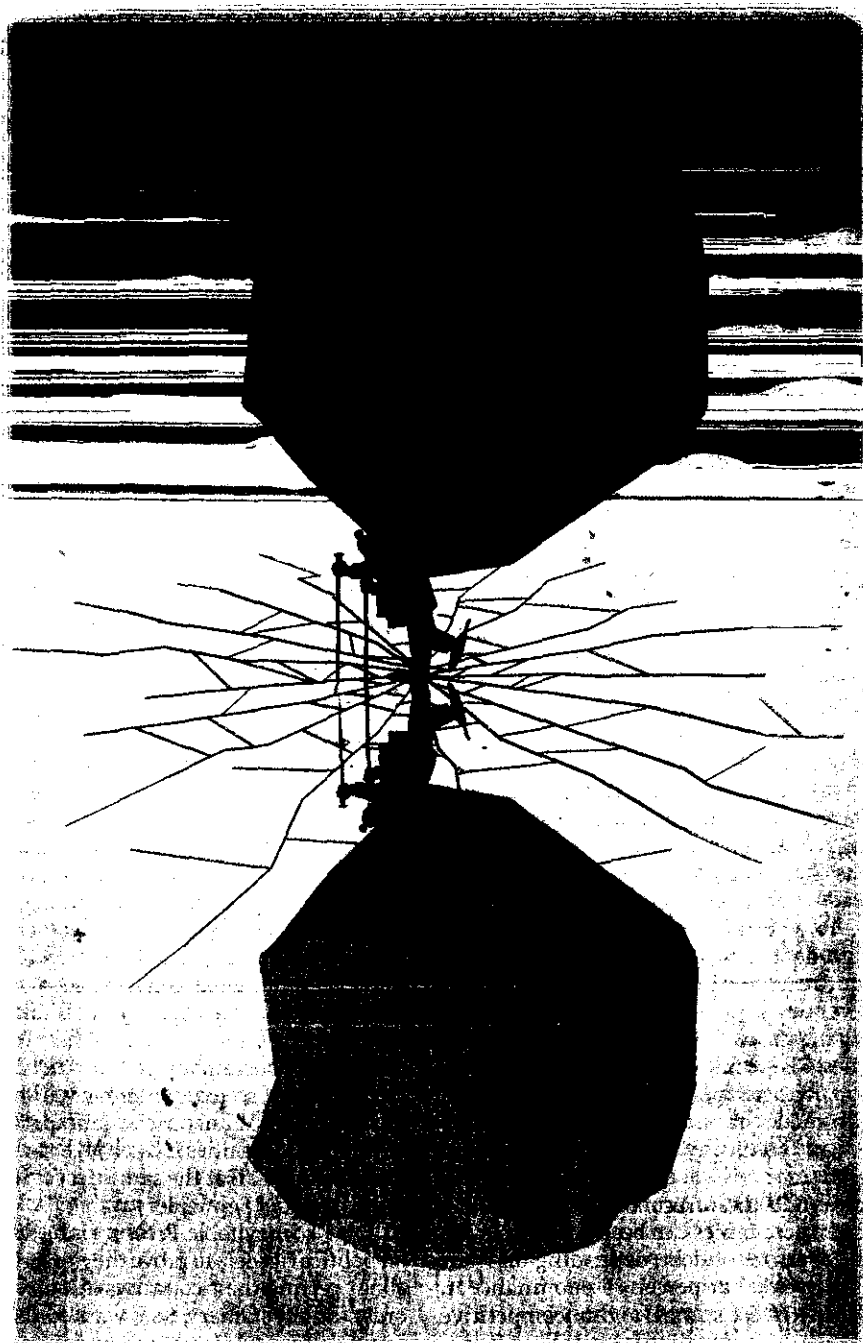
Weighed Down.

From Greece to Japan, rich countries have racked up massive state debts. Paying them off will take time—and pain

BY MICHAEL SCHUMAN

COUNTRIES AREN'T SUPPOSED TO GO BANKRUPT. Governments, after all, are funded by the tax revenues of entire economies, and, since they manage nations, they're not likely to evaporate, Enron-style, in a sudden financial flame out, or close up shop and flee their creditors. That's why lending money to states is considered the surest bet around. Reputation aside, however, politicians abuse their ability to borrow just like any spendthrift with too many credit cards, and often pile up more bills than they can handle. Argentina, Russia, Mexico and others have stiffed their bankers over the past 30 years. In fact, the sovereign-debt crisis goes back as far as the concept of the sovereign state. The first recorded government default took place in the 4th century B.C., when Greek municipalities failed to pay back loans granted by a temple.

Perhaps, then, it's only fitting that Greek government debt is the biggest threat to global financial stability today. Warning that Greece was in "critical condition,"



Prime Minister George Papandreou recently said that his country "faces the risk of sinking under its debt." Jitters over a potential Greek default have punished the value of Europe's common currency, the euro, and driven down stock markets around the world. Policymakers worry that Greece's woes will spread to other weaker members of the euro zone, such as Portugal, Ireland, Italy and Spain—a collection of countries traders have nicknamed the PIIGS. Government leaders nowhere near Europe are concerned as well. "Such events far away can hurt Singapore," warned Lee Hsien Loong, the city-state's Prime Minister, in his Chinese New Year address. "Singaporeans should be psychologically prepared... and not let down our guard too soon."

Lee's right to be worried. The debacle in Greece could be a harbinger of a new stage of the financial crisis, one in which irresponsible politicians, not bankers, are the main source of economic turmoil. Across the developed world, sovereign states have amassed potentially unsustainable mountains of debt. The Organization for Economic Cooperation and Development (OECD) forecasts that by 2011 the ratio of government debt to gross domestic product—the main measure of a state's financial health—will reach 100% in the U.S., up from 62% in 2007. That's almost as large as Greece's burden today. Ireland's debt burden is expected to triple over that same period to 93%, while the U.K.'s could double to 94%. Japan is the worst of the bunch, with its ratio likely to top 200%. Just as risky private-sector indebtedness caused the Great Recession, government debt, if not addressed, threatens to stall economic growth and spark renewed waves of confidence crises in global financial markets. "Attention has shifted to the second part of the story, to the impact [of the financial crisis] on government balance sheets," says David Beers, global head of sovereign ratings at Standard & Poor's in London. That has "intensified the pressure that was already there to start a process of repair."

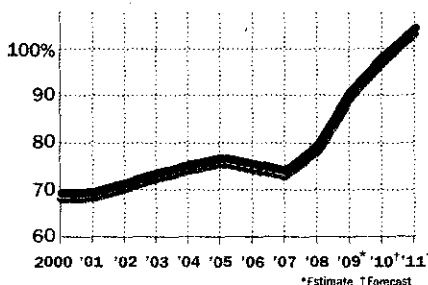
To a certain extent, mounting sovereign debt is a natural outcome of the recent recession. As in any downturn, tax revenues shrank but government spending increased to stimulate sagging economies. The result: budget deficits and more borrowing. Expensive banking-sector bailouts made the burden even heavier. That's not automatically dangerous. There is no particular level of debt that acts as a trip wire and tosses an economy into crisis. Different economies can bear different levels of government debt, depending on their ability—real or perceived—to finance it. While Greece's small and uncompetitive economy is struggling to stay afloat, Japan,

with ample domestic sources of funds, hasn't had trouble financing its deficits, and investors still consider U.S. Treasury bills a safe haven. In a January report, Barclays Capital argued that the cost of the crisis on the U.S., the U.K. and Japan would be spread over many years and is therefore less scary than it may appear. "We do not believe that the global crisis is a watershed for the long-term fiscal sustainability" of those countries, the report said.

That doesn't mean there's no downside. Supersized sovereign debt is likely to depress economic growth. Hefty debt payments lead to heavier taxes, which bite into consumer spending and corporate investment. Economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University found in a recent study that once a country's government-debt-to-GDP ratio passes 90%, growth declines

A Heavy Burden. Public debt is rising— and scaring investors

Gross government debt as a percentage of GDP (OECD nations)



Source: OECD

by at least one percentage point a year. For industrialized economies that rarely expand more than 2% or 3% a year, that's a huge chunk. "We're coming at a point in which growth prospects are really taking a hit," Reinhart says. Growth could also be restrained by the budget cuts necessary to narrow deficits and reduce borrowing. The effect could be felt for a protracted period. Jean-Luc Schneider, a deputy director of the economics department at the OECD in Paris, says some countries will take as many as 10 years to reduce their fiscal deficits to more sustainable levels. And since the deficits of so many nations will have to shrink simultaneously, the impact on developed economies is likely to be amplified. "Doing it all at the same time will be more painful," Schneider says.

But also inevitable. Pressure is building on political leaders to prove they're serious about getting their countries' finances in order. In late January, S&P warned that it could downgrade Japan's sovereign rating

if the new administration of Prime Minister Yukio Hatoyama doesn't rein in the deficit. In his January State of the Union address, President Barack Obama pledged to freeze discretionary fiscal spending for three years starting in 2011. "Like any cash-strapped family, we will work within a budget to invest in what we need and sacrifice what we don't," Obama said.

Nowhere is the urgency to deal with debt greater than in Europe, where it has become the most serious test of the 11-year-old euro-based monetary system. While euro-zone nations use the same currency, there is no mechanism in place to financially aid wayward members. That's how a crisis in Greece, which represents a mere 2.8% of the zone's GDP, can have such an outsized impact. The ultimate fear is that Greece will default, dragging down the euro with it. "A lot of the euro's problems today are rooted in those members having failed to integrate enough," says Bob Hancké, a professor of European political economy at the London School of Economics. "I'm one of those people who can imagine there being no euro—or at least not one similar to what we know today—within three years." That may be an extreme view, but the severity of the problems is forcing a significant change in the way the euro zone works. In a dramatic step in mid-February, Europe's leaders pledged a coordinated rescue for Greece, if necessary, to preserve stability in Europe overall (though how that would be done was left uncertain).

That help has a price. European ministers are insisting that Greece implement a severe austerity plan to quickly reduce its fiscal deficit. Papandreou has already promised pay cuts for public employees and tax hikes, but his European counterparts are demanding an even stricter program. That presents a huge test to his regime. Government workers have already staged strikes to protest Papandreou's plans. So far, he's held firm. A recent poll showed that two-thirds of Greeks believe the Prime Minister's measures are necessary; only 41% think they go far enough. "The government has seen the problem and is trying to do something," says Helen Tourkogeorgou, a 32-year-old stay-at-home mother in Athens. "The crisis has opened its eyes."

The same realization will have to come to governments across the developed world. But S&P's Beers warns that process has only just begun. "There is hope that somehow the square can be circled," he says. But "it is going to be increasingly hard to say there aren't difficult choices to be made." Hopefully our political leaders won't just skip town. —WITH REPORTING BY BRUCE CRUMLEY/PARIS AND NICOLE ITANO/ATHENS ■

Perception Gap

The ultimate difference between China and the U.S. is in their visions of their destinies

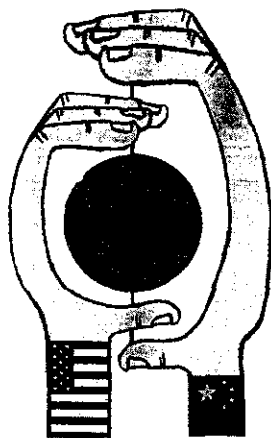
BEHIND THE RECENT SKIRMISHES BETWEEN China and America—the latest surrounding the Dalai Lama's visit to the U.S.—lies a wide divide between the two nations over how they see themselves, each other and their place in the world.

The U.S. prefers China to be like Japan: economically powerful and politically cooperative but strategically dormant and militarily inhibited. Knowing that this was never realistic, the second best outcome for Washington—captured succinctly in a 2005 speech by the then U.S. Deputy Secretary of State and current World Bank president Robert Zoellick—would be for China to demonstrate it is a “responsible stakeholder.” America would ensure that China benefits from the global system of international rules and laws developed since World War II and institutions like the World Trade Organization. In return, having acquired a stake in this system, China would realize that it is in its own enduring interest to support the pre-existing global order.

This approach is not only designed to preserve the peace. It is also intended to be transformative. As with other East Asian success stories, the U.S. expects that further economic liberalization will bring prosperity, and that this will gradually bring political reform to China and domestic respect for human rights.

But American faith in the transformative power of China's economic rise might be misplaced. Capitalism with Chinese characteristics places far more power and wealth in the hands of the state sector than what has ever occurred in countries such as Japan and South Korea. Beijing is nurturing state-owned champions to dominate domestic

markets and crowd out the private sector in order for the Chinese Communist Party (CCP) to keep its economic relevance, privileged status in Chinese society and hands on the country's wealth. This means the CCP does not believe sweeping economic, much less political, liberalization is required for China's continued rise, let alone that it constitutes the endgame.



Then there is the issue of size and China's past greatness. Washington assumes that China's destiny is plastic. Yet, to the CCP, it is predetermined. China is home to four-fifths of the population of East Asia and has 2½ times more people than the whole of Southeast Asia. It has been the dominant civilization in Asia for 3,000 years and has had the largest economy in the world for 18 of the past 20 centuries. For a country that views its natural place at the center of Asia, expectations that it behave as a responsible stakeholder merely perpetuate a regional hierarchy that places China beneath the (relatively) recent American interloper.

Washington seeks the perpetuation of Pax Americana, a liberal peace underwritten by American power in Asia, despite the re-emergence of the world's most populous country. The U.S. wants the endgame in China to resemble the rest of East Asia—genuinely believing

that this will ultimately achieve lasting stability and mutual prosperity—and complains that China remains an insular, self-interested and subversive beneficiary of the system.

The CCP sees it differently. In leading one-fifth of the world's population toward greater prosperity, China is creating its own paradigm that borrows freely, but stands apart, from the East Asian model of development, let alone Western approaches. Therefore, foreign criticisms about poor progress in economic and political reforms do not apply. Moreover, Pax Americana in Asia has been an aberration in existence for only six decades. In contrast, in Beijing's view, the return of the Chinese civilization-state simply restores Asia's natural order.

Few would want to deny what China's leaders since Mao Zedong have termed China's return to “dignity,” a reference to the country's re-emergence as a great power in Asia. But even though other Asian states welcome economic opportunities offered by China's rise, the vast majority prefer the preservation of Pax Americana. The American-backed order has hitherto offered protection for smaller players by binding more powerful states (including the U.S. itself) to agreed rules of behavior and processes of dispute resolution.

Asian states worry that an alternative order based on the superiority of the Chinese civilization will eventually become hierarchical. A still insecure and internally weak China has largely pursued win-win economic relationships to appease a nervous region. But if its domestic example is anything to go by—where the authority of the CCP to wield power and control resources is absolute and dissent is harshly treated—a dominant Middle Kingdom might show little future restraint in the relentless quest to enhance China's national power. ■

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China borrows freely, but stands apart, from the East Asian model of development, let alone Western approaches

Europe's Errors

The view from Asia is of an inward-focused continent in danger of being left behind

EUROPE JUST DOESN'T GET IT. IT DOES not get how irrelevant it is becoming to the rest of the world. And it does not get how relevant the rest of the world is becoming to its future. The world is changing rapidly. Europe continues to drift.

I am not exaggerating when I say Europe's obsession with restructuring its internal arrangements is akin to rearranging the deck chairs of a sinking Titanic. The focus on internal challenges when the real threats are external is the first of three strategic errors Europe is making. One does not have to be a geopolitical genius to figure out where Europe's main long-term challenges are coming from. The E.U. may be a comfortable oasis of peace now, free of the threat of wars between member states. But an aging Europe cannot ignore the rising population and Islamic anger in North Africa and the Middle East, the divisions in the Balkans and the Caucasus, and an angry Russia. Europe has not worked out any coherent or consistent long-term geopolitical strategy to handle these challenges.

To understand why, just study the diaries of the European leaders. They spend most of their time addressing Europe's domestic challenges. Years were wasted trying to get the Lisbon Treaty right. The goal was to produce strong European leadership to handle a more complex world. The result: Europe chose two nonentities as the first President and Foreign Minister. This alone speaks volumes.

The greatest strategic challenge to Europe is the Islamic one. It exists within the body politic of many European societies. And the fastest-rising Islamic demographic is on Europe's doorstep. Europe should, therefore, see it in its long-term interest to defuse Islamic anger. Instead, it

has shown moral cowardice on the Israel-Palestine issue, refusing even to admit that an unbalanced American policy will hurt European interests more than American interests. No major European leader has the moral courage to speak truth to power on this issue.

Europe's second error is to ignore its No. 1 strategic opportunity: Asia. A strong Asia-Europe partnership will yield positive dividends to both. A rising Asia



Early days Birth of economic community, Rome, 1957

welcomes European technology and culture and provides huge new markets for sophisticated European products. If Europe could think and act strategically, it would be busy knocking on Asian doors. Instead, it was the Asians who thought ahead. In the mid-1990s, Singapore proposed an Asia-Europe meeting (ASEM). Initially the E.U. reacted enthusiastically but then came the great Asian financial crisis of 1997. This provided Europe an opportunity to prove it was not a fair-weather friend. Instead, Europe turned its back on Asia. Even though the ASEM process continues on autopilot, the Europeans fail to see that they have not won over Asian hearts and minds.

Curiously, few Asians bear any resentment towards Europe, despite centuries of colonial rule and domination. Asians are focused on the future, not the past. However, they do expect Europeans to treat them with respect, not cultural condescension. This is another thing Europeans do not get. The protests in European

capitals before the Beijing Olympics, the efforts to dictate human-rights clauses in the India-E.U. cooperation agreement and the obsession with Burma show both a lack of sensitivity and of strategic thinking. If Europe does not act fast, it will miss the boat on Asia.

The third strategic error is to remain obsessed with the transatlantic relationship. It is difficult to capture in a few words the strange mix of European atti-

tudes towards America: admiration and resentment of American hyperpower, respect and condescension towards U.S. culture, dependence on and discomfort with American leadership. At the core of this is a deep European belief that culture is destiny and that the common Judeo-Christian heritage and common Enlightenment values will ensure an eternal commonality of interests. America will always put Europe first because Europe, not Asia, exists in American hearts.

Over the long run, geography—when combined with economic shifts of power—determines destiny. America's interests in Asia are rising while its interests in Europe are declining. A growing Hispanic population will make Latin America more important. This is why the time has come for Europeans to think the unthinkable: the "natural" transatlantic partnership may someday come to an end.

The whole world wants to see a strong Europe. It can provide an alternative pole of growth, a model for abolishing wars between neighbors, cultural education and a moral voice for supporting initiatives like the Kyoto Protocol and the International Criminal Court. There are no shortages of opportunities for Europe to provide leadership. But, as Copenhagen demonstrated, it may no longer even be in the room when crucial decisions are being made. ■

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One does not have to be a geopolitical genius to figure out where Europe's ... challenges are coming from