



Institute of Strategic and International Studies (ISIS) Malaysia

**CURRENT ECONOMIC SITUATION
(SELECTED ARTICLES FROM MAGAZINES)**

MARCH 2009

**INFORMATION SERVICES DIVISION
ISIS MALAYSIA**

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CURRENT ECONOMIC SITUATION

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tors during a February earnings call that targets long out of reach are now affordable: "There are companies that we've wanted for years. Those assets are out there."

Government spending is likely to spur dealmaking in the energy and defense sectors. Big Oil is taking a hard look at companies that specialize in wind, solar, ethanol, and other types of alternative energy. Such businesses could benefit from the Obama Administration's push to decrease the country's dependence on foreign oil. In February, San Antonio-based refiner Valero Energy agreed to acquire some of the assets of ethanol producer VeraSun Energy, which is bankrupt.

There could be an air of desperation to some marriages. Struggling companies may look to mergers to stave off their demise. Those deals, though, don't always work out. Sirius Satellite Radio and XM Satellite Radio joined forces nearly a year ago, figuring they could solve their woes with a merger. But in February the newly formed Sirius XM needed a \$530 million cash infusion from Liberty Media in a last-ditch attempt to avoid bankruptcy. Says Jones Day's Profusek: "We will likely see deals where two companies, facing declining revenue, will join with the hope that two plus two equals something more than four." | BW |

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An Appetite for Acquisitions

Despite the rocky times, executives in Europe and Asia remain upbeat about dealmaking. Boston Consulting Group surveyed 164 European companies between September and November and found that nearly a third planned to make an acquisition in 2009. In Asia, more than half of the 924 executives polled by The Economist Intelligence Unit said at least one deal is likely this year.



To read these reports, go to <http://bx.businessweek.com/mergers-and-acquisitions/reference/>



JAPAN IS RUNNING OUT OF OPTIONS

With a stalled stimulus plan, soaring yen, and plunging exports, can the anemic nation revive its economy?

By Ian Rowley



On Feb. 16, Japan's Cabinet Office announced that the country's gross domestic product contracted at an annualized rate of 12.7% between October and December. The fall was more than expected and marked the biggest quarterly slump since 1974. "There's no doubt that the economy is in its worst state in the postwar period," Economic & Fiscal Policy Minister Kaoru Yosano said in Tokyo (Yosano is also picking

up the portfolio of Shoichi Nakagawa, who abruptly resigned as Finance Minister after appearing to be drunk at a G-7 meeting).

The shrinkage is evidence that Japan has slipped into an even deeper sinkhole than the U.S. During Japan's lost decade of deflation in the 1990s, it could still count on the American appetite for Japanese goods to sustain the factories of Osaka and Tokyo. Now the slump in demand for Japanese autos and electronics has spread from

YURIKO NAKAGAWA/REUTERS

%

Household spending fell in December for the 10th month in a row

by the subprime scourge. In 2008 the yen gained 20% against the dollar and even more against the

euro and other currencies. Exporters, even after extensive cuts, need a yen rate of about 100 to the dollar to make money. Today the yen is at 94.

Can Japan right this mess? It should be able to—it has \$1 trillion in foreign reserves, almost \$16 trillion in household assets, and perhaps the most skilled workforce on the planet. But its options are surprisingly limited.

UNEMPLOYMENT CLIMBS

The first is to try stimulus, something Tokyo did repeatedly in the 1990s. Yet today the ruling Liberal Democratic Party, which once held undisputed power, faces a serious political opposition that has blocked passage of a \$111 billion stimulus bill partly in hopes of forcing an election. Even if the bill passes, critics point out the amount is small compared with President Barack Obama's \$787 billion plan and China's \$560 billion plan. That's despite a surge in unemployment, which Barclays Capital estimates will reach 5.7%—more than the last peak of 5.4% in 2002. "In terms of job creation, the government isn't doing what it is supposed to do," says Kyohei Morita, Barclays' chief Japan economist. Room for maneuver is limited. At 173%, Japan's debt-to-GDP ratio is far higher than the U.S. level: Tokyo cannot afford a huge stimulus.

The second option is to slash interest rates. There's not much left to slash. The Bank of Japan pushed rates almost to zero to pull the country out of its last recession, then nudged them up as the recovery took off. As the economy has again slowed, Japan's base rates have fallen from a recent peak of 0.75% to 0.1%—not a lot to get companies and consumers spending.

The next option is to engineer a drop in the yen. One idea is that Japan use its reserves to help fund Washington's bailout and stimulus plans in return for a combined effort to reduce the yen. The U.S. has little to gain from such a deal, though. America is unlikely to need Japan's help to buy treasuries, particularly since Federal Reserve Chairman Ben Bernanke has said the Fed may make purchases. And despite some Beijing bashing by Treasury Secretary Timothy F. Geithner, China will likely remain a big buyer of treasuries. Such a deal would be political suicide as well: President Obama

cannot help out Japan's exports at the expense of America's. "Effectively, it would be a donation of U.S. growth to Japan," says Richard Jerram, chief economist at Macquarie Securities in Tokyo.

The final option is to restructure the economy so it depends more on local consumption and far less on exports. Yet the Japanese, with memories

of the lost decade still fresh and layoffs mounting once more, show no desire to open their wallets. In December, household spending fell 4.6%, the 10th consecutive monthly decline.

What's more, Japan's population is now shrinking. To boost consumption a nation needs young families: Japan does not have enough. There are now 10 million fewer Japanese age 20 or under than there were 30 years ago. The dearth of young adults and families is one reason car sales have dropped one-third from their peak in the 1990s. Many of these young people, squeezed by low-wage jobs, are saving far less than their parents did.

The needs of the old also make it hard for policymakers to cut taxes to spur spending. On Feb. 16, the day the government announced the grim economic data, Nippon Keidanren, Japan's biggest business lobby, called for a hike in the consumption tax to fund social security costs. Old, debt-ridden, and scared, Japan is in quite a fix. |BW|

—With Hiroko Tashiro in Tokyo



Finance Minister Nakagawa's departure comes at a critical time

the U.S. and Europe to China and other once fast-growing markets. Japan's exports fell 13.6% in the latest quarter. "In every planning scenario, our worst assumptions have been met or exceeded," Nissan Motor CEO Carlos Ghosn told the press on Feb. 9. Japan's woes are hurting global growth and depressing global bourses further.

Making matters worse is that the yen has soared as investors both domestic and foreign have sought the safety of an established currency and the security of a banking system relatively untouched

JAPAN'S BAD NUMBERS

173%

Gross debt as a share of GDP
Data: OECD

-12.7%

Annualized rate of growth
Data: Japanese Cabinet Office

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WHAT'S DRAGGING EUROPE DOWN

By Jack Ewing
Illustration by Brian Cronin

The Continent avoided the subprime loan mess, but now it's struggling to prop up subprime countries



As Prime Minister of the German state of North Rhine-Westphalia, Jürgen Rüttgers wanted to save one of his industrial state's biggest employers. So what did he do? He hopped a plane to Detroit, of course. On Feb. 18, Rüttgers met with General Motors Chief Executive Rick Wagoner in an effort to persuade him not to shutter a factory in the city of Bochum, where 5,000 workers make sedans

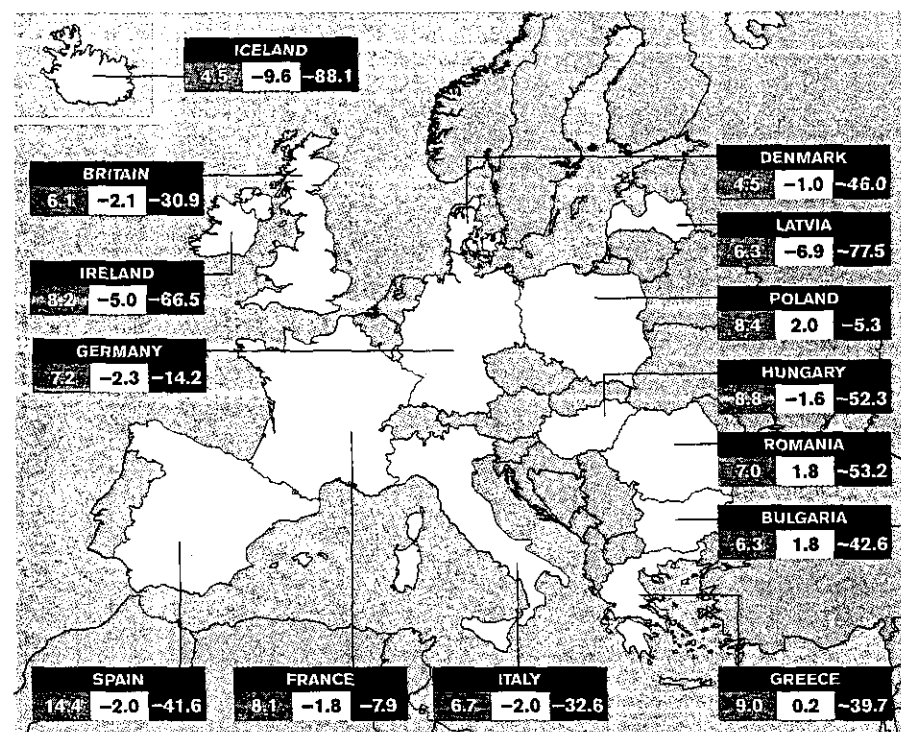
and minivans carrying GM's Opel badge. Rüttgers returned with little more than a weak assurance that GM has no plans to close any Opel factories—yet.

Rüttgers' pilgrimage to the Motor City says a lot about the way the global downturn has unfolded in Europe. In the U.S., the trouble started with subprime mortgages—a problem that barely exists in Europe. But that hasn't kept the region from falling hard and fast, exposing just how tightly Europe's fate is linked to events in the U.S. and the rest of the world.

Not so long ago, Europeans thought they had dodged the worst of the financial meltdown. Now the region is suffering its first recession since the introduction of the euro a decade ago. In Spain and Ireland, corporate bankruptcies have doubled since 2007, and they're up 11% on the Continent as a whole. Across the European Union, unemployment hit 7.4% in December, vs. 6.8% a year earlier. And output in the euro

THE CONTINENTAL DRIFT

Dramatically lower auto sales across Europe show the pessimism that follows high unemployment and declining GDP



Data: Unemployment—OECD, latest available figures; Change in GDP—European Commission estimates for 2009; Iceland unemployment and GDP figures from Ministry of Finance (Iceland); Autos—European Automobile Manufacturers' Assn., change in new car registrations, January 2009 vs. January 2008

zone countries could fall by 2% this year, the International Monetary Fund predicts—a bigger decline than the 1.6% contraction in the U.S. “No one, including us, expected the crisis to be so severe,” says Siemens CEO Peter Löscher.

The Continent's banks may not have written subprime mortgages, but it turns out they financed something worse: subprime countries. The former communist East is sinking into recession as Western banks choke off the easy credit that fueled Asian-style growth. Now, some pundits say, the former Soviet bloc countries are headed for a crisis on the scale of Asia's in 1997 and 1998.

And how about subprime companies? European corporations are deeply in hock, with \$801 billion in corporate debt maturing this year—nearly one-third more than in the U.S. Some, such as Munich-based chipmaker Qimonda and Swedish automaker Saab, say they are insolvent (page 5). A glut of debt-fueled private equity is proving to be a curse for others. Dutch petrochemical group LyondellBasell Industries sought bankruptcy protection for its U.S. operations on Feb. 9, just 14 months after buying Houston-based Lyondell Chemical in a \$19 billion debt-financed deal.

Just as in the U.S., the collapse of Lehman Brothers last August helped send Europe into a nosedive. Stock markets tumbled, credit markets seized up, and business confidence

aren't aware that monetary union requires new ways to adjust to a recession,” says Fernando Ballabriga, an economics professor at the ESADE business school in Barcelona.

Europe's woes are a big worry for the rest of the global business community. The European Union is by far America's largest trading partner and a key destination for Asian exports. And the Continent remains a crucial market for General Electric, Procter & Gamble, Toyota Motor, Sony, and thousands of other multinationals—many of them now facing hard times there. Honda Motor has closed its plant in the British city of Swindon for four months; Ford Motor says it will eliminate 850 jobs at factories across Britain by May; and aluminum maker Alcoa is laying off hundreds of European workers and selling operations in Germany, Hungary, and Italy.

WILDCAT STRIKE

That's not the way it was supposed to be. Europe's economy was built for stability more than speed, and policymakers scoffed at the reckless Americans and their greedy bankers. Slower growth was a price Europeans were willing to pay for job protection and a generous safety net. “The German social market economy is a good model” for balancing free markets and social protections, German Chancellor Angela Merkel told the World Economic Forum in Davos, Switzerland, on Jan. 30.

plummeted. But the crisis also demonstrates that the European Union's economic problems are almost as diverse as its 27 members, ranging from slumping exports in Germany and Eastern Europe to anemic consumer spending in France to property bubbles in Britain, Ireland, and Spain. “It's the first downturn that affects the whole world with such violence,” says Léo Apotheker, co-CEO of German software maker SAP.

Meanwhile, there's no single government to fashion a coherent rescue plan. Only the European Central Bank (ECB) has broad powers over the region's economy, and it has fewer policy tools than the U.S. Federal Reserve. Before the introduction of the euro a decade ago, a country such as Spain could have let its currency fall to make its cars, wine, olive oil, and other goods more attractive to foreigners. That's not an option anymore. Instead, as Europe's highfliers are laid low, companies must cut wages to regain competitiveness. “People

By some measures, she's right. Europe has averted bank failures on the scale of Lehman Brothers. While some British banks are deeply troubled, institutions such as Spain's Banco Santander and BBVA and Germany's Deutsche Bank are in better shape and have so far managed to avoid a government bailout. In most countries, unemployment has risen gradually, while consumer spending has proved resilient.

But it's not hard to find evidence of economic trouble. At a Renault plant in Sandouville, in France's Normandy region, about 150 workers staged a wildcat strike to protest plans to close assembly lines for several weeks this winter. Along Barcelona's fashionable Passeig de Gracia, the restaurants may be busy, but a Volkswagen showroom displaying the sporty new Scirocco is empty—no surprise considering that Spanish auto sales plunged 40% in January from a year earlier. And above street level, windows are festooned with signs advertising offices for rent and apartments for sale.

As a global financial hub, London has been particularly hard hit by the crisis. On Bromley High Street, a popular shopping area 10 miles south of the city center, tony home furnishings retailer Habitat has shut down, Gem's pawn shop sits in space recently occupied by a real estate agency, and Poundland—the British equivalent of a dollar store—has expanded. Area residents are scaling back their expectations, too. Tucked behind Bromley's train station is a red brick office building that's home to the local JobCentre Plus, a government agency for the unemployed. Inside, the job seekers include Bharat Mistry, a 46-year-old IT manager laid off by Morgan Stanley in London. He says

Employees of
steelmaker
Arcelor Mittal
protest in Marseille
on Jan. 29

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**"NO ONE, INCLUDING US,
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SIEMENS CEO PETER LÖSCHER

he's interviewing for jobs at half what he was making. "And even for those," Mistry sighs, "there's stiff competition."

Companies with substantial business in the U.S. have seen the crisis coming. Stephen Featherstone, managing director at London-based Llewelyn Davies Yeang, one of Britain's biggest architectural firms, has cut staff about 10% in the past year after cancellation of a major project in New York. "The design team was assembled and then the developer suddenly pulled the plug," Featherstone says.

Across Europe, weaker companies are going under. Waterford Wedgwood, the Anglo-Irish maker of crystal and china, filed for bankruptcy on Jan. 5. Germany's Märklin, the storied maker of model trains, on Feb. 4 asked a German court for protection from creditors. So anchored is Märklin in German culture that news of its insolvency seems to have shaken the country almost as much as if it were Daimler or Siemens, providing confirmation that these are extraordinary times. "Now the ravenous financial crisis wants to rob us of the memories of our youth," Germany's *Der Spiegel* magazine fretted.

Even healthy companies are preparing for the worst. Carl-Henric Svanberg, CEO of Swedish telecommunications equipment maker Ericsson, says sales have held up because carriers in emerging markets are still buying. All the same, "it's unrealistic to believe we won't be affected somehow,"



Svanberg said on Feb. 17 at the Mobile World Congress in Barcelona, where customers jostled for a view of the equipment on display at Ericsson's pavilion. But the din was deceptive: The show, the mobile industry's largest, drew 15% fewer visitors this year. Such warning signs have prompted Ericsson to eliminate 5,000 jobs as part of a plan to trim costs by \$1.2 billion this year.

Europe's auto sector may be facing the toughest times it has ever seen, and it's taking plenty of towns and cities down with it. Rüsselsheim, Germany, site of Opel's largest factory, wasn't exactly vibrant even before the crisis. The city of 60,000 on the banks of the Main River, 20 miles west of Frankfurt, has seen job cuts for years. In a kebab restaurant near a factory entrance, one laid-off worker is nursing a 9 a.m. beer. Down the street, the Eis Café San Marco is trying to woo customers by offering half-price on drinks and snacks. "We just have to pray Opel won't close," says Giuseppe Basile, the café's Italian-born manager.

EXPORT-DEPENDENT

Europe's economy is wired differently from America's. In the U.S., credit-card-happy consumers have long driven growth. In much of Europe, particularly Germany and the eastern countries, exports are the locomotive, making the region vulnerable to downturns elsewhere. Three-quarters of the cars made in Germany are exported, and many of the parts used in BMWs and Volkswagens come from Slovakia, Poland, and elsewhere in the East.

The eastern countries, in turn, depend heavily on Western European consumers. Swarzedz, a century-old furniture maker based in a town of the same name in central Poland, in January said it was going out of business after slumping home sales farther west undercut demand for its bedroom sets, dining tables, and other furniture. The liquidation of the century-old company is painful for the town of 30,000, home to five churches and a museum that boasts Europe's largest collection of beehives. "Workers are frustrated, and they have a right to be," says Lukasz Stelmazzyk, Swarzedz's 34-year-old CEO.

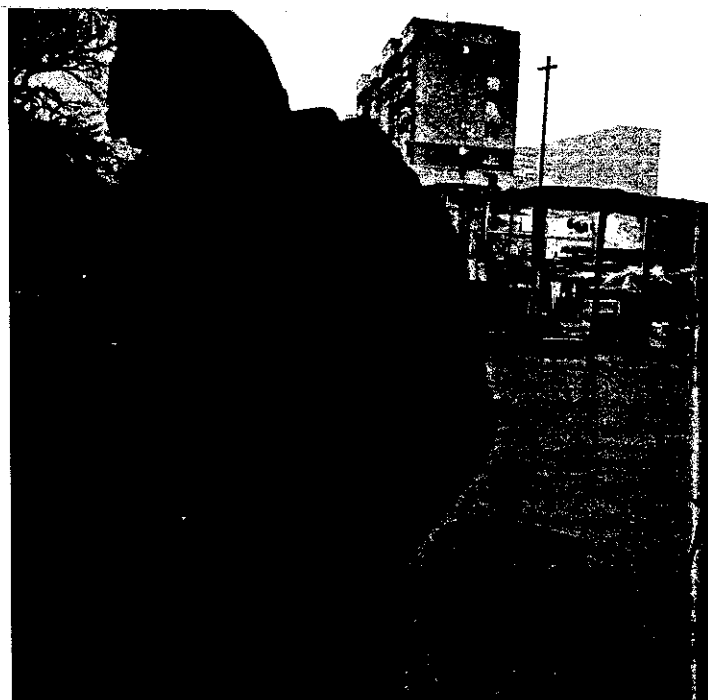


"IT'S UNREALISTIC TO BELIEVE [OUR COMPANY] WON'T BE AFFECTED SOMEHOW"

ERICSSON CEO CARL-HENRIC SVANBERG

Pain is deepest in Europe's poorest countries. Their huge growth was fueled by lending to companies and consumers by the likes of Italy's UniCredit Group, Germany's Commerzbank, and Belgium's KBC Group. As a result, some nations have run up massive current-account deficits. In Bulgaria, the shortfall equals more than 20% of gross domestic product. Adding to the risk: During the boom, banks issued low-rate mortgages and other loans in euros and Swiss francs. When the Hungarian forint, Romanian leu, and other weaker scrips began plunging last summer, the cost of repaying those loans skyrocketed.

Sofia, Bulgaria: Debt is skyrocketing, and much of it is in foreign currency



More than half of the private debt in Hungary, Romania, and Bulgaria is in foreign currency, according to Morgan Stanley. Today, customers in Eastern European countries owe foreign banks the equivalent of one-third of their combined GDP, according to the Bank for International Settlements.

The debt problem has been compounded by slumping exports and consumer spending. In Romania, the second-poorest EU member after neighboring Bulgaria, steelmaker Arcelor Mittal imposed a two-month shutdown, idling 1,200 workers at its plant in Hunedoara, a city nestled in the Transylvanian mountains where iron has been forged since Roman times. Dacia Group, a unit of France's Renault that produces the low-cost Logan sedan in Pitesti, 75 miles west of Bucharest, slashed production and cut investment by \$130 million.

Europe's political leaders and central bankers face unique constraints as they try to jump-start growth. Stimulus plans, such as a German initiative to give a \$3,200 rebate to people who trade in old cars for new ones, have a limited effect that doesn't stretch far beyond the border. A country such as Romania really needs Chinese factories to start buying German machinery again—which could boost demand for Romanian steel. But all the stimulus programs in the euro zone don't amount to even 1% of GDP, and they're focused on infrastructure, offering little relief to industries such as tourism, which employs millions of Europeans. "There are a lot less tourists, even those who are well off," says Catherine Castanier, manager of La Coupe d'Or, a café nestled among the luxury boutiques on Paris' swank rue Saint-Honoré.

National governments, meanwhile, face tough choices in shoring up their banks. After the fall of communism, Vienna financial houses such as Erste Group and Raiffeisen International grabbed state-owned institutions in Eastern Europe, and today Austria's banks hold assets in the region equal to at least two-thirds of their home country's total economic output. In backing its banks, Vienna is effectively propping up

their subsidiaries in the former Warsaw Pact countries.

Europe lacks institutions with a clear mandate to tackle such issues regionally. For instance, the ECB would have a hard time boosting lending via purchases of commercial paper and asset-backed securities, as the U.S. Fed has done, argues Mewael F. Tesfaselassie, an economist at Germany's Kiel Institute for the World Economy. Washington stands behind the Fed, but it's not clear who would pick up the tab if the

sity in Berlin. "It's a blessing the euro and the ECB are there."

Still, the crisis is forcing European leaders to rethink how they manage their economies. The European Union probably needs a single securities and bank regulator rather than the tangle of national bodies it currently has. There's talk of establishing a Europe-wide deposit insurance fund to prevent nervous Hungarians or Lithuanians from withdrawing their money from local banks and sending it to Germany. The European Commission could issue its own bonds backed by all members to help the likes of Spain, where borrowing costs have soared after a downgrade of the country's debt.

The Continent has some competitive advantages over the U.S. and could still emerge from the crisis more quickly. Thanks to decades of investment in nuclear, solar, and wind power as well as a history of energy conservation, Europe is less vulnerable to oil shocks than the U.S. Consumer debt is relatively low in most countries, helping to offset other risks to the banking system. And conservative lending practices mean that, outside of Britain and Ireland, European banks could recover their ability to lend more quickly than devastated U.S. institutions. Deutsche Bank Chief Executive Josef Ackermann argues that, by refusing state aid, he will have more freedom to operate internationally than weakened rivals subject to government intervention. "We can determine our own fate," Ackermann told reporters on Feb. 5.

Like the destiny of its companies, Europe's fate may depend on events outside its own borders. Germany and Eastern Europe won't recover until there is a revival in orders for cars and machinery from Russia, the Middle East, the U.S., and China. Britain and Ireland, with their huge banking sectors, must await a stabilization in worldwide financial markets. Just as the crisis began elsewhere, it may have to end elsewhere before Europe returns to health. | BW |

—With Carol Matlack and Tiffany Stecker in Paris, Kerry Capell and Mark Scott in London, Jason Bush in Riga, and Bogdan Turek in Warsaw



Angry Greek farmers held up international truck crossings for more than a week

ECB faced huge capital losses. The ECB has already broadened the securities it accepts as collateral for short-term loans, but that provides less relief to credit markets than outright purchase.

Economic tensions are beginning to spill into the streets. In January, Greek farmers demanding government aid blockaded border crossings with their tractors, holding up international truck traffic for more than a week. And on Jan. 13, 10,000 protesters gathered on Doma Square in the gothic Old Town of Riga, Latvia, demanding bolder government action to ease the pain of the financial crisis. The protest turned violent, and demonstrators battled with police, looted stores, and broke windows of several bank branches in the shadow of the Finance Ministry. "There's a huge amount of stress and tension," says Filip Klavins, a Latvian-American lawyer working in Riga.

LOW CONSUMER DEBT

As the situation deteriorates, some pundits even say a weaker member of the euro zone—perhaps Greece or Ireland—could pull out of the union rather than face the pain of lower wages and higher unemployment. But few mainstream economists really believe the monetary union will come apart. On the contrary, non-euro members such as Iceland and Denmark may try to join to protect themselves from sharp declines in their currencies. "Imagine what it would have been like with George Soros betting against the deutsche mark, lira, and franc," says Michael Burda, a professor of economics at Humboldt Univer-

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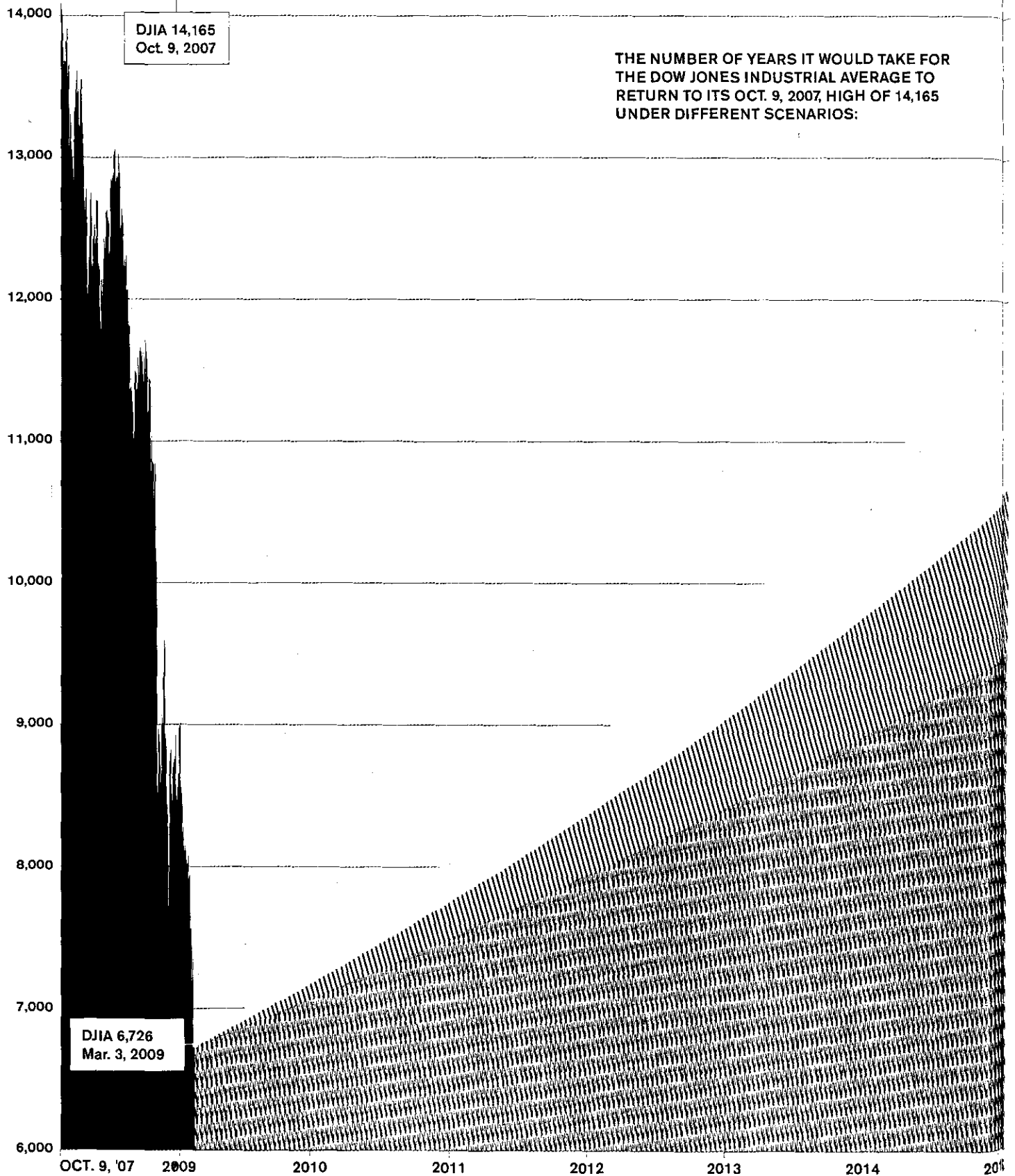
Reeling in Iceland

Fishing has long been the backbone of Iceland's economy, an industry so important that the nation's coins bear images of cod, crabs, and lumpfish rather than kings or presidents. Fishermen now fear that Iceland's financial meltdown could lead to their worst nightmare: membership in the European Union. *The Christian Science Monitor* reports. Icelandic fishermen have resisted joining the EU because that would almost certainly mean ceding control of the country's rich fishing grounds to EU bureaucrats, whom they say have a poor conservation record. But with Iceland's currency, the króna, on the ropes, the country wants to adopt the euro, which would likely require EU membership.

To read the story, go to bx.businessweek.com/european-financial-crisis/



024



8 years at an average annualized gain of 10%

10 years at an average annualized gain of 8%

13 years at an average annualized gain of 6%

WAITING FOR THE BULL TO RETURN

By David Henry

All signs point to more pain to come in the markets. Still, there are opportunities for very long-term investors

The stock market is crashing—slowly, and in plain view of the people who count on it most. The 53% plunge in the Dow Jones industrials since October 2007 has wrecked the college- and retirement-savings plans of millions of investors. It has permanently lowered the long-term investment projections of private endowments and pension funds. It has sent corporate compensation experts scrambling to figure out how to reward top employees. All told, more than \$10 trillion of stock market wealth has vanished, and with it the confidence that springs from financial security.

While 17 months may feel like an eternity, it could turn

out merely to be a prequel. The questions on the minds of investors, money managers, and corporate executives are threefold: How much longer will the bear market last?

How low will the averages go? And when might investors get their money back?

As Warren E. Buffett has said: "Beware of geeks bearing formulas." It's especially difficult to predict the direction of the markets

these days because the most popular gauges, from price-earnings ratios to measures of investor "capitulation," have stopped working. The peculiar nature of this bear market limits the kit of useful tools to just a handful of

HOW TO
PLAY IT
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2011 2016 2017 2018 2019 2020 2021

bond market and business confidence indicators.

Those signals, along with interviews with financial historians, market strategists, and economists, point mostly to painful scenarios. Stocks don't seem likely to fall much more from here—but market turmoil could continue for months or even years. Worse, by the time the market revisits its highs, so many years are likely to have passed that many older people will have gotten out of stocks, missing out on the rebound. The flip side is that new money put into the stock market now will likely do comparatively well over the long term. That's welcome news for twentysomethings and executive compensation consultants, but perhaps not for soon-to-be retirees.

SEARCHING FOR PRECEDENTS

History can't provide as many clues to the market's direction as usual. That's because while most bear markets more or less track the business cycle, this one began with a broken financial system. That makes the current bear more like the one that snarled from 1929-32 than others of the past 100 years. But that analogy doesn't fit perfectly, either. "We have no good precedents to help us," says Peter L. Bernstein, a 90-year-old market essayist and financial historian who was a teenager during the Great Depression. "What's breathtaking is the rapidity of the decline and its breadth."

The market anxiety is especially high now because of the raging fire in the economy. "The next six to nine months are going to be awful," says Desmond Lachman of the American Enterprise Institute. Waves of corporate defaults, home foreclosures, bank failures, and job losses are still to come.

Of course, the stock market already knows that for the rest of

2009 the economy will be a "shambles," to use Buffett's recent description. Today's low share prices may well reflect that. The Dow Jones industrial average has already fallen through the 7,000 level predicted earlier this year by Nouriel Roubini, the New York University economist nicknamed Dr. Doom for daring in 2006 to foretell the credit calamity. That's right, even Dr. Doom was too optimistic.

If recent history were a reliable guide, it would be just about time for the bear to retreat to his den, which nowadays might include a flat-panel TV and leather chair bought at a foreclosure sale. The market's average decline during bear markets since the 1929 market crash is just 30%. What's more, those past bears lasted an average of 13 months, making this one look not just mean but old.

But this is no ordinary slump. Even the most basic market gauge, the price-earnings ratio, which measures a company's share price relative to the earnings it generates, is unreliable. Historically, the overall market has traded at prices that average 15 times earnings, ranging from roughly 8 during the worst bear markets to 25 or greater during bull runs. At the start of the year, the market's p-e ratio was about 11, suggesting that stocks were already cheap and wouldn't drop much more. Instead, the Standard & Poor's 500-stock index fell 19% in January and February, the worst opening months on record.

Why did the p-e ratio get it so wrong? The "e" is plunging—by 18% in January and February alone, according to Thomson Reuters. As a result, even though the stock market has dropped, it hasn't gotten any cheaper relative to earnings. Sure, a lot of earnings vanished amid a fog of one-time charges that may say nothing about companies' future profit power. But analysts still

LAUREL DAUNIS ALLEN/BW

14,000

BIG, BAD BEARS

12,000

The current bear market is the worst since the Great Depression. Back then the Dow Jones industrial average lost 89% from 1929 to 1932. The stock market didn't completely recover until 1954, when the Dow returned to its 1929 peak. Here's a look at six severe bear markets.

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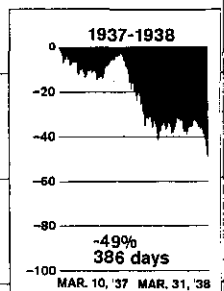
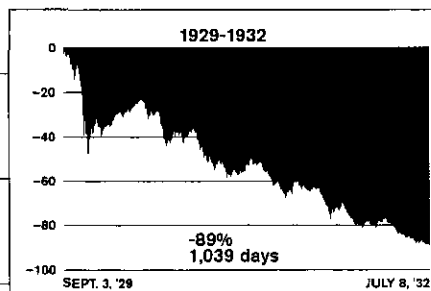
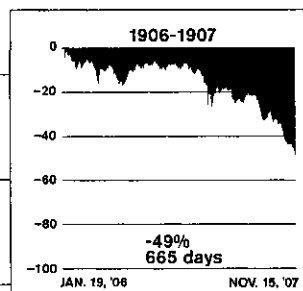
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IN EARLY JANUARY THE MARKET'S P-E RATIO WAS 11. HISTORICALLY THAT WOULD SUGGEST THE WORST WAS OVER. THEN THE S&P 500 PLUNGED 23%

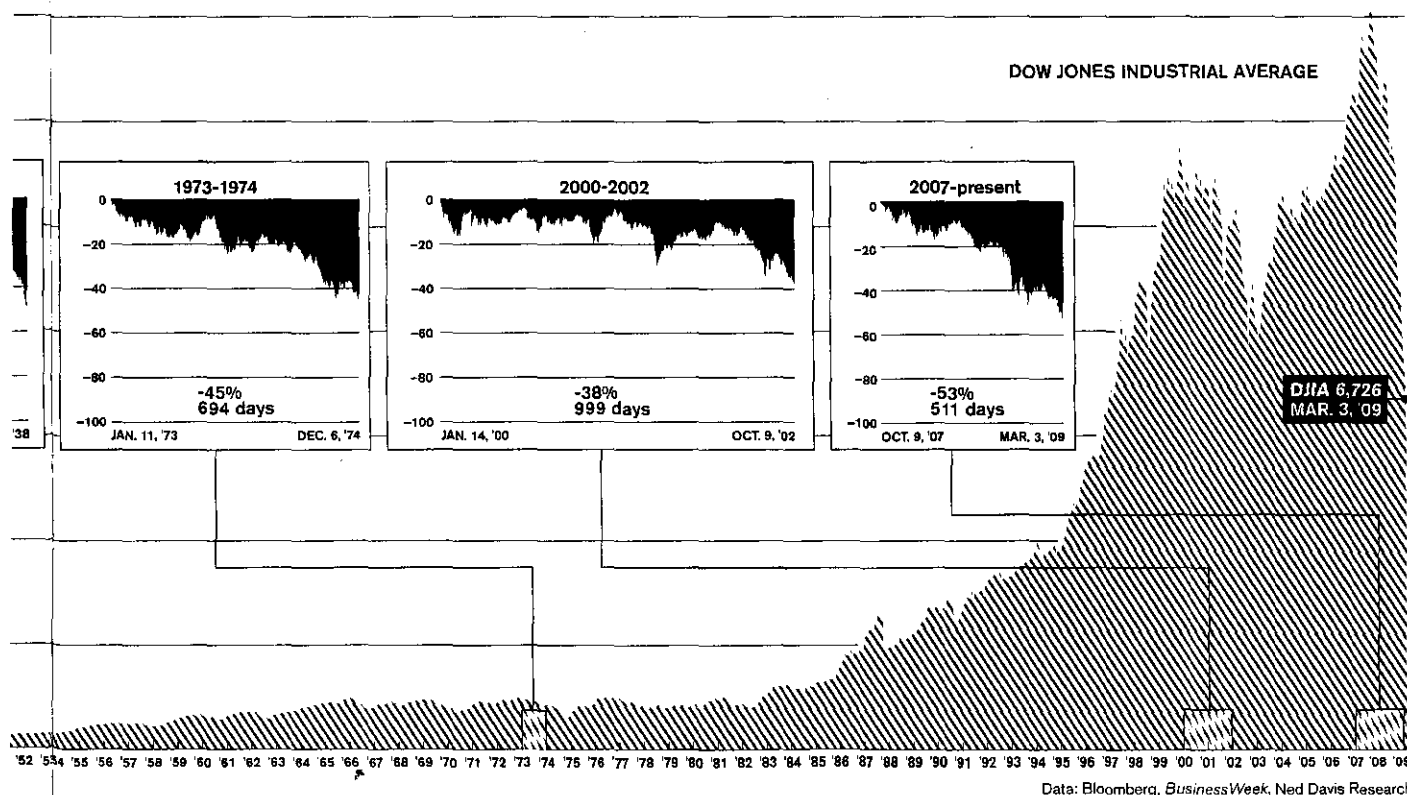
aren't seeing through that fog; their earnings projections are more scattered than they've been in two decades. "You don't know what the 'e' is because the economy is in free fall," says Charles Biderman, CEO of TrimTabs Investment Research.

The credit bust has rendered other trusted market indicators useless—most notably monetary policy, or the Federal Reserve's raising or lowering of its benchmark interest rate. Before the current slump, the federal funds rate was a reliable indicator in all but one bear market since World War II, says James B. Stack, president of InvesTech Research and Stack Financial Management. When the economy slowed, the Fed began cutting rates to turn the business cycle back up. After the second cut came, investors stepped in to buy, anticipating higher corporate earnings. But the Fed has cut rates 10 times since August 2007, to essentially zero, and yet the economy and stock market keep sliding. "The Depression is the only parallel for the lack of effectiveness in monetary policy," says Stack. It is failing because too many borrowers don't want to borrow and too many lenders don't have the capital or courage to lend.

Measures of capitulation, Wall Street's term for the final moment of a sell-off when the last weak investors give up on stocks, aren't working, either. The idea is that once the wobbly

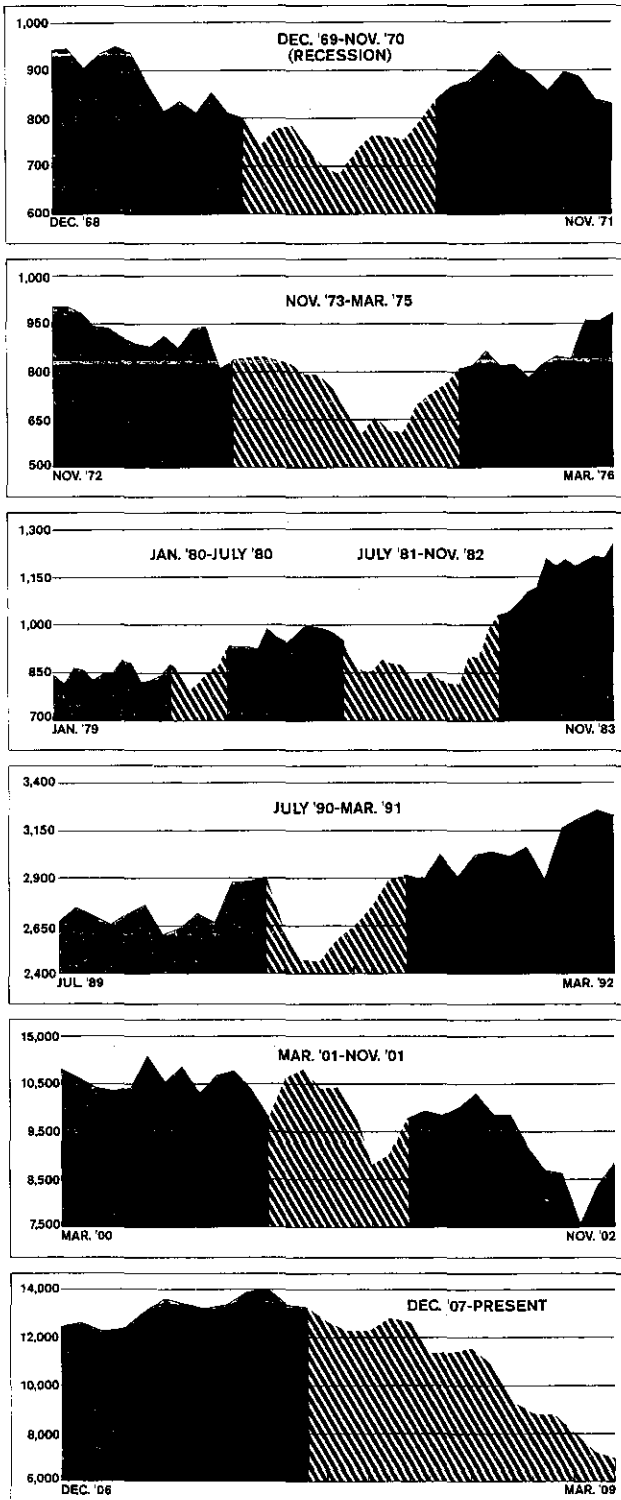
players are out, the ones left are strong enough to bid up stocks. Bull runs begin during those moments. Market mavens try to track capitulation by parsing statistics from days of heavy selling and comparing the intensity of past routs. Many thought they saw capitulation last September, says Eric C. Bjorgen, senior analyst with the Leuthold Group in Minneapolis. "But then the market kept going down," says Bjorgen. "Extreme fear was not a good indicator." The gauges became even more bullish with the selling in November, after which the market rallied 24%. Then it fell again. Biderman of TrimTabs says that's because much of the selling was by hedge funds that had been using borrowed money, not a major factor in previous bear markets.

Another signal that's turned out to be misleading is "cash on the sidelines," or the funds in money market and bank savings accounts. In normal times, strategists could look with some confidence to money in these accounts as buying power that investors were holding back from the stock market. The greater the cash compared with the value of the overall market, the more impact it could make on stocks. In January the reading reached its highest levels since 1984, says Bjorgen. Even so, he's dubious. As long as investors are worried about their own incomes, he says, the money seems most likely to stay right where it is. TrimTabs' Biderman, who tracks how investors move their money among asset classes, says he doesn't see much chance of this cash flowing into stocks with the job and housing markets so weak. He figures investors have been taking more money out of stocks than they've been putting



THE RECESSION REBOUND

Stocks often bounce back before the economy does—usually about halfway through a downturn, which lasts 10 months on average. One exception: the 2001 recession.



Data: National Bureau of Economic Research, Bloomberg

into their cash accounts. "Some people are being forced to sell stocks to eat," Biderman says. "They are certainly not going to buy Google here."

With the ordinary historical measures failing, experts are looking further back for clues. During the Great Depression, the Dow plunged 89% from the 1929 crash to July 1932. Then it went through some big swings before losing 49% in 1937-38 as the economy tanked again. World War II, which grew in part out of financial stress around the globe, followed. The Dow didn't get back to its 1929 high until 1954.

Much, of course, has changed in the U.S. since the Great Crash. Back then Washington made major policy mistakes, such as erecting trade barriers and letting too many banks fail without protecting depositors. This time, with a couple of exceptions, the government hasn't blundered so, even though it hasn't yet solved the economy's many problems.

So this bear market likely won't rival that of the Great Depression. But the bear markets during other banking crises have been brutal in their own right. In a recent study of 21 such episodes from around the world, including ones from Spain in 1777, Sweden in 1991, and Thailand in 1997, professors Carmen M. Reinhart of the University of Maryland and Kenneth S. Rogoff of Harvard University found that stocks fell an average of 56%—the same loss the S&P 500 had suffered through Mar. 3. Those bear markets also tended to be agonizingly slow, taking an average of 3.4 years to reach bottom. "Everything is protracted," says Reinhart. "In the best-case scenario, you are looking at six years or longer" to return to past highs. Bad as that sounds, it would compare favorably with Japan, whose Nikkei index reached 38,900 in 1989 and now trades at around 7,200.

Of course, just because investors have lost money in stocks doesn't mean equities are a bad choice from this point onward. "Stocks can't make up for the past 10 years, but they can do extremely well from our current position," says Jeremy J. Siegel, author of *Stocks for the Long Run* and professor at the Wharton School of the University of Pennsylvania. Siegel says that while stock returns have fallen behind government bond returns over the past 20 years, history says that's almost certain to reverse. He's found only one 30-year period when stocks returned less than bonds, and that one ended in 1861. "That tells us that once you are down 50%, those who are in stock markets for 10 to 15 years will get much better returns," he says. Lately, government bond prices have run up, boosting the odds that stocks will be the better play in the future.

So where to look for signs of an incipient upturn? One logical place is the corporate debt market, which understands the economy's core problem firsthand. Eventually, the pace of new defaults on corporate bonds will slow, and bad debts will be reduced or erased in financial reorganizations and bankruptcies. When those things happen, the economy and stock market should breathe easier.

Some quants see little evidence of that happening yet. "We are looking at a 60% to 70% chance that this bear market is not over," says Robert D. Arnott, chairman of Research Affiliates, a Pasadena (Calif.) firm that manages \$25 billion. Jeffrey E. Gundlach, chief investment officer of Los Angeles-based money manager TCW Group, says the junk-bond market,

THE TIMING OF THE BEAR'S RETREAT WILL HINGE ON THE UNMEASURABLE: PSYCHOLOGY. FOR NOW, PESSIMISM IS WINNING THE DAY

which often tracks the stock market, is headed for new lows.

Another critical factor is the health of the banking system. One measure to watch is banks' so-called net worth, or the difference between how much they owe and the value of their assets. Rebuilding the banking system's net worth will be monumentally difficult. "On average, this process takes about six years," says Joseph Mason, a banking professor at Louisiana State University who has studied past banking crises. So far, little has been accomplished—a big reason the stock market hasn't gotten up from its knees.

KEEP AN EYE ON CEOs

Government policy decisions could speed or slow the pace of rehabilitation for the banks and, in turn, the stock market. David A. Hendler, a New York-based bank analyst at Credit-Sights, says his job has shifted from financial analysis toward Washington analysis. Essentially, his task is to figure out how quickly the government will permit weak banks to consolidate. When investors believe they know which banks will survive, they'll buy their stocks. The process is so critical to the stock market that Richard Bernstein, chief investment strategist at Merrill Lynch, is tracking six signposts for financial industry consolidation. Among them: the extent to which the government carves up and sells bad banks rather than buying into them to prop them up.

Other strategists are keeping a close eye on the people who really know what's happening in the economy: business leaders. Biderman says he'll know corporations are getting confident once they start buying back their own shares and acquiring other companies. Right now they show no such bravado. Announcements of share buybacks are down 90% from a year ago, leaving that market thermometer so cold the mercury is off the scale.

In the end, the timing of the bear's retreat will likely hinge on that great market imponderable: psychology. How investors feel has a lot to do with whether they start seeing mixed signals as proof of a glass half-full. "The [market] stress causes the analytical part of our brains to shut down, and that makes us hyperreactive to bad news," says Michael A. Ervolini, CEO of Cabot Research, a consultancy catering to institutional investors. People become convinced conditions are worse than rock-bottom bad, he says. Only after they see that they've overreacted can things improve: "We look for the market to start [saying] tomorrow will be brighter."

For now, pessimism is winning the day. In the worst-case scenario, bad debts will continue to weigh on borrowers and lenders, causing the economy to slow even more, which will erode incomes and push more borrowers over the edge. Economies and corporations around the globe will weaken and rattle investors and business executives even more. Such fears

have prompted Ben McCoy, a 30-year-old software engineer, to swear off new stock investments. Instead, he's putting money into his own business ventures, such as writing software for real estate appraisers and a blog about personal finance called moneysmartlife.com. "With these investments, I feel like I

have more control," he says.

More Ben McCoys could signal the stirrings of an upturn. A market bottom, says Merrill's Bernstein, "generally occurs when everyone thinks it will never happen. You want to hear people giving up on the stocks-for-the-long-run theme."

But something positive must draw investors back. George A. Akerlof, a Nobel prize-winning economist at the University of California at Berkeley and co-author of a new book, with Yale professor Robert J. Shiller, on the importance of sentiment in moving markets, says investors will have to be offered a new story they can believe to get them to buy again.

That new story likely involves corporate and consumer debts being reduced to what borrowers can pay, freeing them of past mistakes so that new money can be put to productive use. Banks resume lending, and the stock market bottoms, signaling that the recession will be over soon. Budding optimism reverses the vicious cycle of losses. A bull is born.

A more probable outcome is the one drawn from the narrow history of bear markets that grew out of financial crises. In it, the bear scenario continues to play out until the bull takes over, with more debt busts and government trial and error until things get set right again. That could mean two more years of bouncing around and then another six or so before the Dow is back above 14,000. Not long ago, such an outcome would have seemed unimaginably bleak. Given the other possibilities, it doesn't seem so bad now. **BW**

—With Tara Kalwarski, Ben Levisohn, Amy Feldman, Peter Coy, and Mara Der Hovanesian in New York and Christopher Palmeri in Los Angeles

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The Pile of Cash

Investors have quietly squirreled away \$9.3 trillion in cash, which amounts to roughly 84% of the market value of U.S. companies. Stocks typically rise after that percentage peaks, according to a recent Bloomberg article. The last eight times the measure hit a high, the S&P 500 rose an average of 24% in six months.

\$

To read the full article, go to <http://bx.businessweek.com/us-stock-market/reference/>

A DOGFIGHT OVER THE RESCUE PLAN

Why economists can't decide whether massive stimulus will help—or drive America further down

By Peter Coy

Is the economy in a dangerous downward spiral, or is this a painful but ultimately healthy adjustment leading to a sustainable growth path?

Misdiagnosing this recession could lead to bad economic policy, with devastating consequences. If we're in a self-perpetuating spiral but don't respond with massive stimulus spending, the economy could fall into a trough that would rival the Great Depression. If, on the other hand, the economy is naturally finding a bottom, heavy spending could jack up inflation

dangerously and saddle future generations with a huge debt burden.

With the unemployment rate at a 26-year high of 8.1% and hopes for a second-half recovery waning, Congress is deeply split over how to interpret and cope with the crisis. On Mar. 10, House Speaker Nancy Pelosi (D-Calif.) said "we have to leave the door open" to even more spending than is in the Obama Administration's newly passed \$787 billion stimulus plan. But Senate Minority Whip Jon Kyl (R-Ariz.) warned the same day against wasteful government spend-

ing. Kyl earlier accused President Barack Obama of "rather casually throwing out some careless language" after the President warned Congress that failure to pass the original stimulus bill would jeopardize the nation's economy.

Unfortunately, economists aren't much help in this debate. They're tussling over stimulus like rival surgeons battling for the scalpel in an operating room. Nobel laureates took opposite sides in *BusinessWeek* interviews. Robert M. Solow of Massachusetts Institute of Technology (Nobel 1987)

says the only thing wrong with the Administration's fiscal stimulus is that it's too small. In contrast, Edward C. Prescott of Arizona State University (Nobel 2004) argued that Obama's stimulus measures "are depressing the economy."

Most economic forecasters, who are judged on accuracy rather than academic rigor, seem to think stimulus is necessary. (Of course, they've been wrong before.)

The median forecast of a

THEORIES ON THE ECONOMIC CRISIS: THE EXTREMES

DOWNWARD SPIRAL SCHOOL

THE PROBLEM

Job cuts lead to reductions in consumer spending and business investment, as well as more foreclosures and deeper losses at banks. In turn, these lead to even more job cuts.

THE SOLUTION

The federal government must rescue the economy by boosting spending to create jobs and compensate for the drop in private consumption, investment, and lending.

Data: BW

NATURAL EQUILIBRIUM SCHOOL

Poor government policy, including too-low interest rates, led to overconstruction of housing and too much debt. Today, the economy is in a messy and painful transition back to a sustainable growth path.

The economy will only find a bottom when falling prices and wages make consumer goods, investments, and labor more affordable. For long-term growth, government should cut taxes and regulations.



broad range of Wall Street economists surveyed by *The Wall Street Journal* in February was that the Obama stimulus plan would save about a million jobs over the next year.

That irks the stimulus skeptics, who doubt the wisdom of heavy-handed government intervention. About 250 economists, including Prescott and two other Nobel laureates, signed an open letter to Obama sponsored by the libertarian Cato Institute that said "it is a triumph of hope over experience to believe that more government spending will help the U.S. today." They favor cuts in tax rates and a rollback of regulation to promote long-term growth.

The dispute over spiral vs. stability goes back 75 years to the Great Depression and British economist John Maynard Keynes. Before Keynes, most economists believed that economies naturally tended toward full employment. But Keynes argued that an industrialized economy can spiral downward when job reductions depress consumer spending, causing businesses to cut more jobs and decrease investment, and so on. Only

government can break that spiral by spending to lift demand, he contended.

Keynesian views held sway well into the 1960s. But academia's fear of economic instability began to ebb in the 1970s as a new wave of economists argued that consumers and businesses are rational and farseeing, and not likely to be stampeded into recession. What's more, the argument went, government can't spend its way out of a recession because consumers realize that extra government spending now will necessitate higher taxes in the future. They'll save more to prepare for that day, offsetting the stimulus.

DEALING WITH ANIMAL SPIRITS

The current crisis has revived the debate, in intense form. Economists who advocate active government intervention to break a downward spiral have become much louder. George A. Akerlof of the University of California at Berkeley (Nobel 2001) and *Irrational Exuberance* author Robert J. Shiller of Yale University call for "truly aggressive measures" to deal with the current crisis in *Animal Spirits*, their new book

reviewed in this issue (page 095).

In contrast, the most extreme academic opponents of stimulus say that unemployment is mostly a case of workers asking for too much money—and will solve itself if wages are allowed to fall. Arizona State's Prescott, who has a reputation for being outspoken, is at least partly in that camp. "People are getting a little more hungry for jobs," he says. "It's great that I can get...some work done on my house." John H. Cochrane of the University of Chicago Booth School of Business agrees that "in the past, credit crunches like this when left alone have led to a sharp decline in output that did fairly quickly rebound." Cochrane opposes the Obama stimulus, while favoring careful interventions to get securitized lending flowing again.

The country can't wait for economists to agree. Right now, the risk of doing too little to stop the downturn probably outweighs the risk of doing too much, because if the economy gets too deep in a hole, it will be hard to climb out. There will be time for fights over theory when the crisis is past. | BW |

Why China Is Confident

The global financial crisis is far from over as world economic growth continues to decline. Can China stop the downward tendency of economic growth and reach an economic soft landing? Can China take the lead in getting out of the shadow of the economic crisis? Chen Huai, Director of the Economic Research Institute of China's Urban and Rural Development under the Ministry of Housing and Urban-Rural Development, discussed these questions in a recent article in the *Economic Information Daily*. Edited excerpts follow:

In taking the lead to get out of the shadow of the economic crisis, China is more confident than any other country in the world. Our confidence comes not only from our room for adjusting short-term macro-control policies such as monetary policy and fiscal policy and our huge market of 1.3 billion people, but also from our late-mover advantage as an emerging economy and the development stage that China is in.

Fast urbanization process

Among the engines of China's economic growth in 2009, urbanization will be the one that is the most independent of international capital compared with exports, small and medium-sized enterprises, manufacturing industries, finance and the capital market.

During the past 30 years, especially since the 1990s, the urbanization process has become one of the strongest driving forces for China's fast economic growth. In 1978, China's urban population was only 170 million, accounting for 17.92 percent of the country's total population. In 2007, the

above two figures reached 590 million and 44.9 percent.

The accelerated urbanization process is not only seen in the increased urban population, but also in the country's massive accumulation of fixed assets and infrastructure construction. For example, China's urban areas have expanded from 12,900 square km in 1990 to 35,500 square km in 2007, while the total road length in Chinese cities has increased from 95,000 km in 1990 to 246,000 km in 2007.

We have experienced the initial stage of urbanization when large input has not only driven up economic growth, but also rapidly assembled hundreds of millions of urban residents and produced huge amounts of fixed assets and infrastructure in urban areas. All these have provided a strong material foundation for future economic growth that has occurred more rapidly than investment growth.

Now China is in a development stage of a "fast increasing marginal effect" on the urban economy; that is, a small amount of

added input will produce much more economic output.

The ongoing global financial crisis fundamentally resulted from a surplus of capital. When industrialization and urbanization ended, developed economies had capital surpluses. Industrial sectors could not contain excessively large amounts of capital; hence, surplus capital became "hot money" and was poured into the stock market, bond market, foreign exchange market, futures market and oil market that are in a fictitious sense, as well as various complicated derivatives markets. The risks of accumulated surplus capital led to today's crisis. The problem of a capital surplus will absolutely not be easy to solve with the temporary rescue measures worked out by the governments of various countries.

China's urbanization process is still going on, so that there will not be capital surpluses in China. At present, more than 20 Chinese cities are building subway and light rail systems, showing that in cities, multilevel transportation services and other infrastructure are inadequate, and meanwhile the demand for housing is still urgent.

In short, the difference between China and developed countries is that we are facing an urbanization process that is emerging and vigorous, while developed countries are facing urbanization that is over-saturated, aging and declining. The vast room for investment and the continuously increasing marginal effect of investment in cities are important sources of China's confidence.

Upgrading the consumption structure

People have reached a consensus that expanding domestic demand is the primary way for China to take the lead in getting out of the shadow of the economic crisis. Can China realize its goal of expanding domestic demand?

First, we should note that the key way to expand consumption demand lies not in whether people are willing to spend their money in hand, but how they will dispose of the money they will earn in the future, especially the increases in their future income—not simply spending more money based on



A GOOD DEAL?: People in Harbin of Heilongjiang Province look at an economy car in an auto showroom. The rising number of automobile purchases nationwide is becoming a major force in China's efforts to upgrade its consumption structure

the old consumption structure, but upgrading the consumption structure by expanding the means of consumption and forming new lifestyles and new consumption demand when their income grows.

International experience shows that during the process of industrialization and modernization, there are four stages for changes in consumption structure: first, the stage of meeting basic demands, when people are spending most of their money on basic daily commodities; second, the stage of improving their quality of life, when home appliances become necessities; third, the stage of meeting demands after getting rich, when houses and cars become the new demands; and fourth, the stage of development-oriented demands such as travel, education, health care and property management.

Compared with developed countries, China has advantages because its consumption structure is in a period of fast upgrading. At present, the consumption structure of urban residents has passed the first and second stages and is in the third and fourth stages. For example, the number of domestic trips taken by Chinese citizens rose from 744 million in 2000 to 1.61 billion in 2007, up 116.4 percent. Their total travel expenses rose from 317.55 billion yuan (\$46.43 billion) in 2000 to 777.06 billion yuan (\$113.61 billion) in 2007, up 144.7 percent.

Besides the huge potential for consumption demand, China also has another advantage: the potential expressed by Engel's coefficient.

Engel's coefficient basically tells how much people spend on food out of their total income. The Engel's coefficient for China's urban residents stood at 57.5 percent, 54.2 percent, 39.4 percent and 36.3 percent in 1978, 1990, 2000 and 2007, respectively. In most developed countries, the Engel's coefficient is lower than 30 percent. In an economic sense, the consumption structures in these countries have been stable and fluctuations of social consumption levels can just rely on the business climate in the short term. On the contrary, the Engel's coefficient in China is in a period of obvious change. In other words, the measures to stimulate consumption by the U.S. Government can only produce a short-term expansion in consumption, but China's advantage is that its regulating measures to "ensure growth" have vast room to form new consumption points.

Therefore, we can sum up the difference between China and developed countries: The problem China faces is how to make people spend the money they must spend and guide society to move beyond the critical point in consumption structure upgrading. The problem developed countries face is how to repay the "debt" created by over-consumption and help consumers reduce the risks brought about by over-consumption. ■

CRISIS FOCUS

Lessons From The Crisis

The current worldwide economic recession is not the first of its kind and will not likely be the last.

But what should we learn from it? Vinod Thomas, Director General of Independent Evaluation Group at the World Bank Group, discussed the lessons from the crisis during a speech at Peking University in Beijing on February 18. Edited excerpts follow.

Effective actions in five areas, including financial, fiscal, trade, poverty and the environment, must comprise the means by which the current crisis is confronted. Whether it will be confronted effectively or not will presumably entail how well these instruments are employed—not only the pace or the quantity, but also the quality. Quantity and quality will determine whether this set of measures works or not. Not only the amount of money, but also how it is used are extraordinarily important.

What have all the different countries done? The United States has just approved tax cuts and priority investments, and China would be the second largest in terms of a fiscal package. But we have to be careful, because just spending money does not necessarily generate growth. It depends on how countries use the money, and the quality of the projects on which the money is spent. Those countries with low or negative savings need more than a sustained fiscal stimulus to emerge from the crisis, and that the countries with high savings rates can combine their short-term fiscal stimulus with a longer-term expansionary policy.

Monetary and fiscal policies are short-term responses. The long-term response is to focus on social welfare, job creation and issues related to social security.

It is reported that a 1-percent reduction in GDP traps another 20 million people in poverty. One hundred million more will be trapped in poverty with the global recession, so the social and poverty impacts of the crisis should be anticipated. The issue of poverty was ignored at the beginning of economic crisis, so addressing the problem later will be much harder. More measures should be taken to address unemployment and maintain social security.

Meanwhile, coordination is extremely important given the high degree of globalization. The experience with the Great Depression or the previous recession clearly indicates that cooperation and revival depend very much on trade not being restricted. Those who are more open to trade have made more significant recoveries after a crisis. So protectionism is the biggest threat to the revival of the world economy, and protectionism will worsen the global contraction.

More to the point, sustaining economic growth will not be possible without attending to environment. For many countries, there is a danger of backtracking on environmental policies when dealing with the financial crisis.

When we have more and more instruments, it is like a black box: We don't know how they are being used. The sophistication of regulations needs to catch up with the sophistication of the instruments. Thereby, the bottom line is to capture all the risks involved in securitized mortgage loans and derivatives.

During the period of high economic growth, many problems such as not having enough liquidity went unnoticed, because high growth hides many problems. But the problems emerge sooner or later and affect everyone. ■

COFCO has undertaken mergers and acquisitions not only to broaden its scale, but also to increase its strength and forge competitiveness. In 2007, it merged Sifang Sugar and Suozhou Sugar into Tunhe, making that company China's biggest beet sugar producer. In March 2006, COFCO acquired China Grains and Oils Group Corp. and turned it into the country's largest food and oil distribution group with a total assets of more than 60 billion yuan (\$8.8 billion).

Completing the industry chain

"In 2009, we need to answer some questions that in the past we did not have time to consider," Ning wrote in a memo to company staff earlier this year about his reflections on the economic crisis and how it could affect COFCO.

"The first question is, how long can our industry chain be and what are its advantages and disadvantages? In the past, these questions seemed to be not so important, but today, they are important, because we are being confronted with new challenges."

Building a complete industry chain has always been COFCO's first and foremost task and will continue to be so in the near future, Ning said. The purpose of COFCO's industry chain is to "turn the corn harvested in Jilin Province in northeast China into ham on the table of Shanghai residents," Ning said at the forum. "This industry chain comprises foodstuff manufacturing, cultivation, processing, marketing, packing and logistics."

COFCO's expansion and diversification has not occurred randomly, but has always centered on building a complete chain of foodstuff production and distribution. Last October, COFCO obtained the leasehold of more than 260,000 *mu* (17,300 hectares) in Ningxia Hui and Xinjiang Uygur autonomous regions to plant tomatoes. Prior to that, Tunhe had contracts with local farmers who grew tomatoes. But it was difficult for the company to control the use of fertilizer and pesticides on individual farms. And if the price of tomatoes rose, farmers did not always adhere to the terms of their contracts with Tunhe and sold their tomatoes to other companies instead.

By gaining the leaseholds, COFCO has been able to ensure a stable supply of tomatoes, said Zheng Qi, an agricultural industry analyst at China Securities Co., Ltd.

COFCO's latest acquisition attests to its efforts to enhance its downstream industry chain. This February, it purchased "The Cereal Way," the first instant noodle brand in China. COFCO is committed to being a whole-chain foodstuff company, and instant noodles are an important product in the food industry chain, said Qu Ze, the assistant to the company's president. ■

CRISIS FOCUS

Restructuring The IMF

Providing a financial lifeline to a string of crisis-hit countries such as Iceland and Ukraine, the International Monetary Fund (IMF) has played a positive role in cushioning the growth-retarding shock emanating from the United States. Moreover, the finance ministers of the G20 countries recently agreed to increase their funding for and push for the restructuring of the organization at their meeting in Horsham in Britain on March 14. Yi Xianrong, a researcher at the Institute of Finance and Banking under the Chinese Academy of Social Sciences, discussed this topic in an article published in the *Oriental Morning Post*. Edited excerpts follow:

Set up in 1945, the IMF used to be a pillar of the Bretton Woods system that helped rebuild the war-torn global financial landscape and contributed to world prosperity. For decades, it has been a key element of global trade and finance. But now Britain and U.S.-dominated organization is facing a looming restructuring as emerging economies seek a greater say in global policymaking to match their rising economic strength.

Meanwhile, the crippling financial crisis has exposed loopholes in the current global financial system and added urgency to the need to reorganize the IMF and the whole global financial system.

But the reorganization means more than just examining and strengthening its operations and management. More importantly, it entails a complete reform to redress an imbalance in its decision-making powers. For example, the developed countries have maintained an advantage of voting rights on the IMF board relative to the developing ones. And traditionally, the United States names the president of the World Bank while a European heads the IMF, which is, obviously, unreasonable.

As emerging markets gain more

clout in the world economy, it is imperative now to improve their representation in the IMF so that the organization can be more representative and influential.

At the G20 meeting in Horsham, the finance ministers of the BRIC countries—Brazil, Russia, India and China—publicly called for a greater say in the IMF and appealed for a revaluation of the IMF's role in global finance.

For China's part, it is also necessary to make efforts to push forward the IMF's restructuring efforts. China can take a closer look at the current global financial situation and then put forward a restructuring program that is acceptable to all IMF member countries. The program should reflect changes in global finance and at the same time serve the interests of all sides. China also can seek a firm foothold in the IMF through its efforts in combating the ongoing financial crisis.

After all, the restructuring of the IMF and the World Bank is imperative under the current situation. China is supposed to actively involve itself in the upcoming restructuring of these international financial organizations. But we should first ensure an economic recovery at home. ■



HUNGRY FOR WORK
CROWDS OF JOB
HUNTERS FEEL THE
CRUSH AS THEY
ENTER A RECENT
EMPLOYMENT FAIR IN
ZHENGZHOU, CHINA.

CHINA'S HARD LANDING

With exports shrinking and unemployment rising, China must find a way to recover. That will take longer than most think.

BY BILL POWELL

I**N THE EARLY EVENING LIGHT**, on a block that once bustled but is now deathly quiet, Li Zhong-he walks to the front gate of the factory where he used to work. There he looks for his name on a sheaf of papers. They are notices from a local administrative court, granting small unemployment payments to workers like Li and the hundreds of others who were left without jobs when their company, Hejun Toy Manufacturing, ceased operation. Nearly a decade ago he had come from the countryside to Dongguan, a sprawling manufacturing town in southeast China that for much of the past decade had boomed. Li had made decent money, the equivalent of about \$250 a month, worked his way up to shift supervisor on the factory floor, and unlike many of China's migrant workers—an army of an estimated 115 million people nationwide—he had asked his wife and young son to join him so that they could have what he calls a “normal life.” Now, he says quietly as he turns away, disappointed that his name was not





THE BIGGEST DIG CHINA IS EMBARKING ON A MASSIVE BUILDING PROGRAM LIKE THIS RAIL BRIDGE PROJECT IN HUBEI.

on the list, "I don't know what I'm going to do."

For most of this decade China lived up to its hype. This, we were told incessantly, was the Chinese century, when the world's most populated nation would eventually become its most prosperous and powerful. China grew at or near double-digit rates for the past five years and turned lots of people like Li from impoverished peasants into members of a surging middle class—people with "normal" lives. When Beijing joined the World Trade Organization in 2001, it was, for multinational companies worldwide, as if someone had fired the starting gun for the Oklahoma land rush: Multinationals raced to China, both to use it as an export platform and to tap the rapidly growing market. China's momentum was so powerful that a year ago straight-faced economists talked about "decoupling"; even if the U.S. went into a housing-led recession, the argument went, China could continue growing and perhaps even help much of the rest of the world avoid a slump.

CHINA HAS GROWN so fast for so long—and has generated such optimism from so many quarters—that some hard truths about its economic reality, both short and long term, can be hard to swallow. Time to grit your teeth and bear it: It is now obvious that China has no immunity from the vicious global slump (some economists contend that its economy actually contracted in the fourth quarter of last year). Moreover, the slowdown may be deeper and last longer than most had anticipated. The export sector is obviously moribund, shrinking 17% in the fourth quarter, and will remain so until the U.S., by far its biggest market, begins to recover.

Another key driver of growth, fixed-asset investment, is also weak and getting weaker. Companies both domestic and foreign have spent a fortune building out industrial capacity in China since the early part of this decade. In 2000, to take but one indi-

cator, there were 364,000 foreign-owned companies in China. By the end of last year that number had soared to more than 661,000, many of them small and medium-sized manufacturers. Total investment in new factories and other assets in China last year was no less than 40% of GDP, or about \$1.76 trillion, a thoroughly "ridiculous" figure, as Diana Choyleva, an economist at Lombard Street Research in London, puts it.

And because that number was so preposterously high, it will be a long time (if ever) before China comes anywhere close to reaching that level of investment. Indeed, in an increasing number of cases, companies that recently spent millions on new factories are now laying off the people who worked in them. The weak labor market, which has savaged low-tech toy and textile employees like Li Zhong-he, has now moved up the technology ladder. TMSC, the world's largest contract computer-chip maker, has a factory in suburban Shanghai that opened in 2003; last month it started "involuntary unpaid leaves" of a few days a month for the majority of its 1,500 workers.

Layoffs, of course, will mute consumer demand—precisely at a time when some economists still hold out the hope that China, as the last major economy still growing (albeit more slowly), could be a "global locomotive," as Choyleva puts it, helping drag the U.S. and others out of recession. "That's not going to happen," says Shanghai-based economist Andy Xie. A just-released survey by the American Chamber of Commerce in Shanghai showed that of the 108 foreign manufacturing companies it queried in November, fully 40% reported that their sales in China had plunged 10% or more year on year. Of course, the survey was taken right in the middle of a worldwide panic that brought buying to a halt everywhere. Demand has picked up a bit in China since then. Still, the "question now isn't 'Is China going to have a hard landing?'" says Xie. "It's 'Just how hard will China's hard landing be?'"

Those who believe the slump will be shorter and shallower

PREVIOUS SPREAD: BAI ZHOUFENG—MAGNETIC; THIS PAGE: CHINA PHOTOS—GETTY

in China than almost anywhere else put their faith in the Chinese government. Last November, as it became clear that the U.S. economy was cratering, Beijing wowed a lot of people by announcing a fiscal stimulus package it said was worth \$565 billion, or about 8% of GDP. (The U.S. stimulus, by contrast, is about 5.6% of GDP.) Economists since then have spent a lot of time trying to figure out how much of that headline number would be new, additional spending, and how much was already in the pipeline. Three months later that's still not clear, and the government is already talking about another round of stimulus.

The good news, for China and the world, is that the government can afford it. It came into this year with a slight budget surplus, and new spending on massive infrastructure projects will put a floor under steelmakers and other basic industries that desperately need it. It will also provide jobs for some of the 20 million or so migrant workers now jobless—without question the government's major goal. Ask anyone in China what keeps President Hu Jintao awake nights, and you'll get the same answer: the possibility of widespread social turmoil that massive unemployment could plausibly trigger. China probably has sufficient resources to "cushion the downturn," as Xie says, to avoid further unrest. Jun Ma, chief China economist for Deutsche Bank Securities in Hong Kong, sees government spending helping China to 7% growth in the current quarter before the economy weakens again later in the year. Still, that's not nearly enough growth to provide all the jobs that China needs.

THE REAL PROBLEM for the leaders in Beijing isn't just the here and now. Many large multinationals seem to think that once this global downturn ends, China will go back into hyperdrive, growing at 10% and moving millions of citizens a year from near poverty to something resembling middle-class status. That's probably a fantasy. Even absent the U.S.-led global crisis, China's leaders knew that the comparative advantages they leveraged into rapid growth—vast amounts of relatively well-educated low-wage labor, a welcoming attitude toward foreign direct investment, and exports, exports, and more exports—had pretty much run their course.

**THE
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China's current-account surplus hit a record 8% of GDP in 2008; going higher would probably have brought a serious backlash from its trading partners. The jig was up.

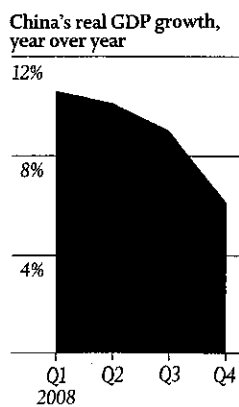
Now, however, the slump shines a harsh light on the significant economic vulnerabilities that the boom years managed mostly to obscure amid all the chatter about the Chinese century. The road ahead, says Dan Rosen, a China consultant and principal at Rhodium Group, based in New York City, "is terra incognita for the leadership." Over time the outlines were pretty clear as to where China needed to go: Just as the U.S. must save more and spend less, China has to do the opposite. China's personal savings rate is more than 20%, and while GDP growth has soared over the past ten years, per capita income growth has not. "Growing individual income is the key to unlocking the next phase of growth in China," says Huang Yasheng, a political economy professor at MIT's Sloan School and author of the just-published *Capitalism With Chinese Characteristics*.

How to do that was the question Beijing was dealing with when the crisis hit. It wasn't easy, and more to the point, it wasn't under any circumstances going to be quick. And ironically, one of the keys to rebalanced growth, as the economists call it, is further reform of the financial sector. China wastes a vast amount of capital to get the growth it currently has. Its savers are penalized by low interest rates at government-owned banks—and those banks dole their capital out in ways that often reflect political rather than economic judgments. In other words, huge state-owned enterprises are still first in line.

In the midst of the current global implosion, brought on by allegedly "efficient" Western financiers, it is fashionable now, inside China and out, to lament the Western banking system and praise China's for its relative health. There is, of course, an element of truth to that. But it's myopic, and if it prevents further reform in the financial sector (as it probably will), it will hurt China's transition to a more balanced economy. "One of the tragedies of the timing of this crisis," a former People's Bank of China official said recently, is that "we were on track to further reform the financial system, to offer more options for savers and investors, to move toward a more

BIG CHALLENGE

With exports softening, China needs new ways to grow.





GET 'EM BUYING BEIJING'S \$565 BILLION STIMULUS PACKAGE SHOULD BOOST SHOPPERS, LIKE THESE YOUNG WOMEN IN SHANGHAI.

efficient system. Now there will be a delay. The opponents of reform in the party look at those of us who have been pushing for these kinds of things, and they say, 'You see, look at what's happening in the West. They're nationalizing their banks.'"

Optimists say that finance may be the only phase of China's next stage of economic development that gets sidetracked by the crisis—and even then only temporarily. The nation also urgently needs to scale its way up the technological ladder, generating jobs and income growth via innovation. For all the gleaming high technology on display in industrial parks across China, most of it remains foreign owned and foreign generated. And Beijing needs to protect innovators, both foreign and domestic, from intellectual-property theft, which is rampant. On this score, no less an authority than Microsoft vice president Liu Fenming says the company has seen "real progress." In early January, in fact, Chinese officials busted a large ring of pirates who were ripping off Microsoft software and exporting it to a bunch of countries, the U.S. included.

THE PROBLEM for China's senior leadership is that all the changes needed to generate the next round of Chinese growth take time. Better intellectual-property protection, a national pension and health system, financial reform: It's nose-to-the-grindstone stuff, not the sort of policy changes that can come overnight. "Now," says the former central bank official, "everyone's running around trying to put out fires. You have to understand, no one in China ever expected that we'd be this badly affected [by the financial crisis]. No one. They are stunned at the depth of this."

Stunned and a little angry—which, since China is now by far America's largest creditor, is not an idle point. After a recent speech in New York—and, it must be said, with a smile on his

face—Luo Ping, an official at the China Bank Regulatory Commission, told a *Financial Times* reporter, "We hate you guys, but there is nothing much we can do." Except continue to buy Treasury debt. To repatriate China's foreign exchange, earned via its massive trade surplus, would only drive up the value of its currency, the renminbi, making the nation's exports more expensive in the midst of the biggest global slump since the early 1980s. That's the equivalent of throwing an anchor to a drowning man, and it won't happen.

China may continue to diversify its foreign-exchange holdings—buying more gold and euros—but there is as yet no sign that it has given up on Treasuries. And some in Beijing don't mind the political leverage being a creditor provides. No one in Hu Jintao's government was displeased to have Hillary Clinton play down human rights concerns in her maiden voyage to Beijing as Secretary of State. For America, Beijing's appetite for U.S. debt is about the only bit of good economic news coming out of China these days.

For ordinary Chinese, seeing so much money flow into a foreign country at a time of mounting economic pain at home is infuriating. They never expected to be in this position, and they don't think it's their fault. This was the era of China's rise, after all, and now it's floundering, trying not to sink, and the next era of solid, sustained growth—on which so many have bet so much—may not arrive anytime soon.

In the meantime, millions of men like Li Zhong-he are unemployed and headed back to their home provinces. Li was lucky. He ended up getting some money from the local government in Dongguan as unemployment compensation. Millions do not. This is what a hard landing in China looks like. And it's not clear how it ends. ■

FEEDBACK bill_powell@timeinc.com

► an alternative military base, but supply routes into Afghanistan, as convoys from Pakistan come under more frequent attack. It is stitching together a "northern distribution network" to bring non-lethal supplies such as water and fuel into Afghanistan through Russia and Central Asia. This week it claimed progress. A train of supplies from Latvia snaked through Russia to reach Kazakhstan. Russia has granted access to the rail network; but it dates from tsarist times, and is showing its age.

Moreover, sceptics say Russia's help for America is likely to prove highly conditional. Pavel Felgenhauer, an independent analyst in Moscow, says Russia wants concessions on issues such as missile defence and NATO enlargement. Since its war in

Georgia last year, Russia has had an extra choke-point on routes into Central Asia, thanks to tanks and artillery stationed near Georgia's main road-and-rail artery.

Russia itself is only part of the problem. Paul Quinn-Judge, a Bishkek-based analyst for the International Crisis Group, a think-tank, says America is "getting out of one logistical nightmare in Pakistan, but may be moving into another". General David Petraeus, the American commander in the region, paid a visit last month to Uzbekistan. Its president, Islam Karimov, agreed to the use of his country as a transit route for non-lethal supplies, and might offer America other facilities if Manas does indeed close. But that might force America into an awkward choice. Mr Karimov's Soviet-vintage

regime jails and tortures its opponents. When America complained in 2005 about the regime's bloody suppression of protests in the town of Andijan, Mr Karimov shut America's base at Khanabad.

He kept a German one at Termiz and is making new overtures to the West. The few human-rights activists in the region hope that renewed American engagement could help their cause. One, Surat Ikramov, says Uzbek jails now hold 300 political and 7,000-8,000 religious prisoners, and that the country is getting "more and more closed". It looks as if America may be heading for an awkward decision about what it cares about more: the logistics of its Afghan war or the state of human rights in other parts of Central Asia. ■

Japan's opposition

A bruiser bruised

TOKYO

A scandal for the opposition: Japan's political mess only gets worse

TO BREAK the lock of the Liberal Democratic Party (LDP) on power, the main opposition, the Democratic Party of Japan (DPJ), made a pact with the devil. It promises a modern, transparent politics. Yet in 2006 it chose as its leader a master of the dark arts, Ichiro Ozawa, a political heavy, whose politics were honed in the back rooms of the LDP itself.

This pact seemed to be paying off. Mr Ozawa engineered a brilliant victory in elections for the upper house of the Diet (parliament) in 2007. And recently it looked as if the government would plop into the DPJ's lap after a general election that must take place by September. The ratings of the prime minister, Taro Aso, only plummeted. Yet on March 3rd Mr Ozawa's political secretary was arrested and charged with taking illegal donations from Nishimatsu, a second-tier construction company, two of whose former executives were also arrested.

Mr Ozawa's supporters have rallied round him, calling the arrests a politically inspired conspiracy. Certainly, the Tokyo prosecutor's office has a thing against anti-establishment gadflies. Mr Ozawa says his aide is innocent and vows to stay on as leader. Yet even before the arrests, many DPJ members feared Mr Ozawa would be a liability as prime minister. Not only is his health poor, but he prefers life backstage to the limelight. The party executive backs him, but Mr Ozawa is fighting for his political life. Katsuya Okada, with a more co-operative streak, is ready to take over. He will first need to be forgiven for having led the DPJ into a resounding election drubbing in 2005.

Mr Aso is unlikely to use the DPJ's disarray to call a snap election. Voters

might punish such opportunism. And unlike the opposition, Mr Aso at least has a response to an economic crisis which has seen exports fall by more than two-fifths. Soon he will announce his third and possibly biggest fiscal stimulus. This time, a collaborative approach will be tried, with a weekend retreat of economists, prefectural governors and other groups to agree on broad points. The plan is that this stimulus will pass in June, allowing the Diet to be dissolved and Mr Aso to attend the July G8 summit in Italy. If tensions within the DPJ break out into the open, the prime minister may feel that time is on his side. On the other hand, who is to say that the Tokyo prosecutors are not after corporate donations to the LDP too?



Ozawa, backroom boy

Vietnam's economy

In need of some snake-blood

HO CHI MINH CITY

A rescue plan for exporters

BUSINESS is booming for at least one Vietnamese entrepreneur: an old lady in a traditional conical hat whose tiny roadside stall faces the infant Ho Chi Minh Stock Exchange. To make her wares she decapitates small green snakes with a pair of scissors and drains the blood into a plastic bottle. Many Vietnamese men believe that drinking snake-blood enhances both good fortune and sexual prowess. The vendor, who also peddles pet turtles, says she is selling more of the stuff these days. "People are so worried about the future."

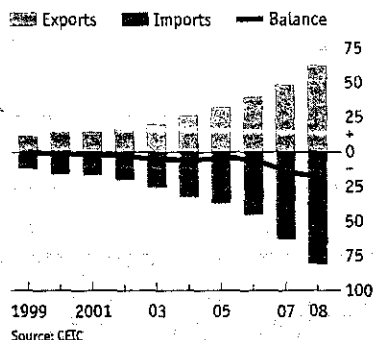
The global slowdown is casting a lengthening shadow over Vietnam's once-booming export-driven economy. Sales of more conventional consumer goods have slumped as the fast-growing middle class has stopped spending. Electronics shops say that Tet new-year holiday sales were down by as much as 50% compared with last year. The carmakers' trade association reports that sales tumbled by 68% year-on-year in January.

Like China, Vietnam has used manufacturing for export to transform a stale, closed economy. Last year it overheated. The government earned some plaudits for calming rampant inflation, which reached a year-on-year peak of 28% in August. But Vietnam is badly exposed to the sharp drop in demand in the West. Exports fell by 51% year-on-year in the first two months of 2009, with electronic goods down by 13.7% and shoes by 7.3%.

That is why government is now trying to relight the fire it had previously doused. It plans to boost spending this year by 23% (almost 100 trillion dong, or \$6 billion, ►►

Dependency culture

Vietnam's trade, \$bn



▶ about 6% of GDP). Of this about \$1 billion will subsidise loans to cash-strapped exporters. In the scheme's first month, commercial banks lent some 93 trillion dong, says the central bank.

An estimated 500,000 workers lost their jobs last year, and the government reckons a further 400,000 may be laid off in 2009. These are daunting numbers in a

young country that needs 1m new jobs every year to absorb its growing workforce, now around 45m people. Like China, Vietnam does not have much of a state social-safety net. Laid-off factory workers tend to return to the countryside and rely on their extended families. But farmers will find it harder to cope without the money factory workers have been sending home. The prices of their produce, such as rice and coffee, have been falling.

Many economists believe that what Vietnam, like China, needs are not measures to sustain supply but incentives to increase domestic demand: investment in infrastructure, but also in health care and education, saving for which suppresses consumer spending. Vietnam's GDP expanded by 6.2% in 2008, the slowest rate for nine years. Most observers, including the IMF, think it will be lucky to reach 5% this year. Yet the government's target is still 6.5% and Nguyen Tan Dung, the prime minister, has predicted that the economy will start to pick up as early as May. As weeks go by, that makes him sound more like a seller of snake-oil than of snake-blood. ■

The state of the Chinese nation

Yes, prime minister

BEIJING

Facing daunting problems, Wen Jiabao makes clear transparency is not the answer

IN HIS first state-of-the-nation speech since the global economic slump began battering China late last year, Wen Jiabao, the prime minister, painted a grim picture of the troubles ahead. With the help of massive government spending, China was still aiming for economic growth of 8% this year. But he revealed few new ideas about how this is to be managed.

At the opening on March 5th of the annual session of China's parliament, the National People's Congress (NPC), Mr Wen said China was facing "unprecedented difficulties". But his speech revealed nothing of any stimulus plans beyond the 4 trillion yuan (\$585 billion) in spending announced in November last year. Vain hopes for a new package had helped to buoy global stockmarkets.

Chinese leaders clearly do not want to be fettered by democratic debate as they pursue their dimly outlined efforts to keep the economy growing. The NPC is a rubber-stamp affair at the best of times. But this year China has in effect dropped any pretence that it has a serious role. To save money, officials say, it has been shortened to nine days. Its schedule is as leisurely as ever. The sparse official agenda makes no mention of any special discussion of stim-

ulus measures or of the big spending promised on health-care reform.

Mr Wen said the budget deficit this year would rise to 950 billion yuan. According to the official press, this would be nearly three times bigger than the previous record deficit in 2003. Mr Wen said that, at less than 3% of GDP, it would still be "safe" (America's budget deficit is likely to rise to more than 12% of GDP this year). But in spite of widespread calls, including even in some official newspapers, for more to be revealed of the government's budget and especially its stimulus plans, the Ministry of Finance's budget report to the NPC stuck to its usual broad-brush approach.

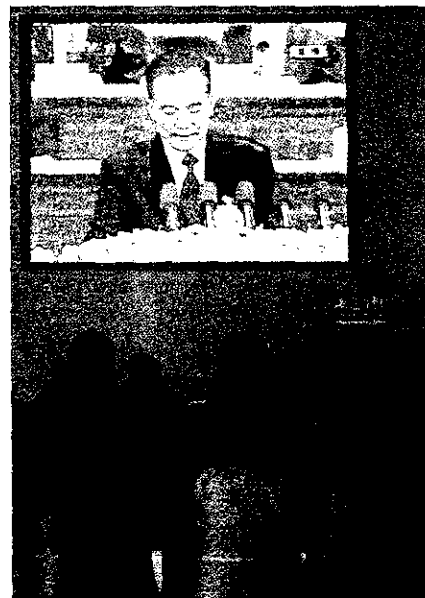
Many critics in China have complained that not enough has been earmarked for health care and other welfare programmes. The budget calls for a 38% increase in central-government spending on health care this year, compared with a 24% increase in total spending. In January the government said 850 billion yuan would be spent on health-care reforms over the next three years. In the long run it is hoped this will help stimulate the economy by reducing the tendency to save money for medical emergencies. As a share of GDP, government health-care spending has long

been very small by world standards.

China's armed forces, pampered by double-digit annual increases in spending for 19 of the past 20 years, get a raise of around 15%. This is down from nearly 18% last year and could be intended as a sign that in these hard times welfare-related programmes have a higher priority. But the defence budget is so opaque that the government's figures have to be treated with enormous scepticism. The army will stage a vast parade through Beijing in October to mark 60 years of Communist rule. A big naval review is also planned for April. The cost of these is secret.

The NPC meeting, and a parallel one of its 2,000 member advisory body, could see a few glimmerings of dissent, at least in the corridors. There have been numerous worries expressed on the internet and in some Chinese newspapers that the government's spending programme could lead to huge waste and corruption. Mr Wen said the government would ensure that spending would receive "proper oversight" and that government affairs should be made "more open and transparent". His speech, however, was not a promising start.

The government will be relieved if delegates keep debate to a minimum. It worries that a slowing economy might trigger an explosion of discontent among the fast-growing ranks of the unemployed. The fear is that open dissent in the ranks of party-picked legislators could make things worse. It also frets that, like last year, the NPC meeting could be overshadowed by unrest in Tibet. March 10th marks the 50th anniversary of an uprising against Chinese rule and security forces in Tibetan areas are on full alert for possible protests. The public-security budget is due to rise by nearly a third this year, up from 9% last year. Mr Wen is preparing for the worst. ■



Over their heads

Japan's economy

Rebalancing act

A long era of current-account surpluses may be ending

JAPANESE households used to be among the world's biggest savers and, as a result, the country ran a massive trade surplus. But no longer. They now save less of their income than American households, and Japan's trade balance moved into deficit last year (see left-hand chart). A long-overdue—and painful—economic rebalancing is under way.

The slump in global demand and a strengthening yen have crushed Japan's exports. In the six months to January, it had an annualised trade deficit of ¥4 trillion (\$39 billion), compared with a surplus of almost ¥11 trillion a year earlier. Japan's foreign-investment income is also shrinking, thanks to lower dividends and interest rates. As a result, its total current-account surplus plunged to only ¥125 billion in December, 92% less than a year ago. Figures due on March 9th may even show a deficit in January. Most economists still expect a surplus for the year as a whole, but a much reduced one of perhaps 1% of GDP, down from a peak of 4.8% in 2007.

Japan has had a current-account surplus in every year since 1981, because of a surfeit of domestic saving over investment. However, the saving rate of households has fallen from 18% of income in 1980 to an estimated 1% last year (see right-hand chart). It may have edged up slightly over the past few months, but it is almost certainly lower than in America, where the saving rate jumped to 5% in January as falling wealth and tighter credit caused consumers to pull back.

The fall in saving is exactly what the "life-cycle hypothesis" would predict. People like to smooth consumption over their lifetimes, so during their working years they spend less than they earn and accu-

mulate wealth, which they then draw down once they retire. The more retired folk there are relative to the number of workers, the lower the saving rate will be. The ratio of Japanese aged over 65 to those of working age rose from 14% in 1980 to an estimated 34% in 2008. It is forecast to increase to 49% by 2020.

The decline in the household saving rate and the current-account surplus would seem to be connected. But Japan's saving rate has been falling for years, so why did the external surplus still loom large until last year? The current-account balance is the gap between domestic investment and total saving—including that by companies and the government as well as households. Since 1990 Japanese firms have swung from being big borrowers to big savers as they have sought to repay debts. A large reduction in the government's budget deficit, from 8% of GDP in 2003 to 2% in 2007, also offset lower household saving. Meanwhile, since 1990, investment has fallen from 32% to 23% of GDP. As a result, the surplus of saving over investment remained large until recently.

As the population continues to age, household saving will decline further and may even go negative as the retired live off their large stash of financial assets. If investment rates do not change, Japan will move into current-account deficit.

Japan's excess saving has long been viewed as bad for its own economic health as well as for the rest of the world, so its disappearance might seem good news. It would be if the shrinking surplus had been caused by a surge in domestic spending, rather than a collapse in exports.

Despite some pick-up in consumption in recent years, Japan's growth has still been far too dependent on exports. Net exports accounted for over one-third of GDP growth in the five years to 2007. Adding in exporters' investment might push up that figure to half. Japan's failure to wean itself off exports sooner means that it now faces a more painful adjustment. The impact on the rest of the world, meanwhile, will not be nearly as beneficial as the headline figures suggest. ■



HSBC's rights issue

Household chores

Is HSBC's \$17.7 billion rights issue a sign of weakness or of strength?

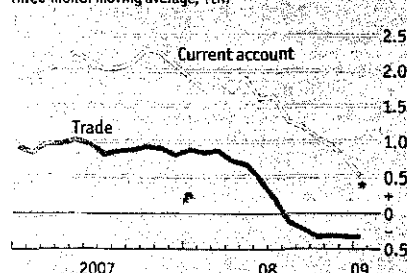
THERE are two radically different tales doing the rounds about HSBC, Europe's biggest lender by market value. The first says that HSBC, deep down, is still an emerging-markets operation run by rugged types who disdain the sorcery of modern finance. Under the temporary grip of an evil spell in 2003 they bought Household, an American consumer-credit firm that then haemorrhaged losses. On March 2nd they snapped out of it. HSBC's chairman acknowledged that it was "an acquisition we wish we had not undertaken", wrote off its cost and promised to run down its book of dodgy loans. Having opened its heart, HSBC felt able to lower its dividend and raise its core tier-one capital ratio to 8.5%, above those of JPMorgan Chase (6.4%) and Santander (7.2%), two more of the Western world's biggest banks also vying for the title of the safest one.

Against this there is a horror story. It says that HSBC's definition of capital excludes mark-to-market losses on asset-backed securities (ABS). Furthermore, particularly demanding critics say that it also excludes mark-to-market losses on its loan book. Like almost all banks, HSBC carries these at book value and impairs as customers default. However, include both these items and the core tier-one ratio would drop to just 2%. Treating loan books on the same basis, JPMorgan would be at 5% and many other banks would be insolvent.

This would suggest that HSBC is in fact ►►

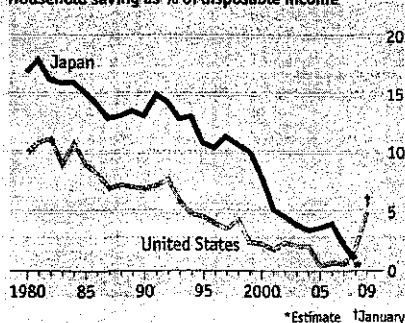
Sayonara to the surplus

Japan's external balances
Three-month moving average, ¥trn



Sources: CEIC; BEA; Goldman Sachs

Household saving as % of disposable income



*Estimate 1 January

poorly capitalised, and needs to raise even more equity. The alternative, advocated by, among others, Knight Vinke, an activist investor, would be to cut loose Household, which HSBC does not legally guarantee and which accounts for just over half of the additional mark-to-market losses. Household's credit spreads are much higher than HSBC's, suggesting that investors think this is possible, despite HSBC's verbal assurances to the contrary.

Which story is right? Given the risk of litigation, the reputational hit and the fact that HSBC has itself loaned Household some \$13.5 billion, its mark-to-market loss

would have to get a lot worse before HSBC was prepared to let it default. And like many banks, HSBC argues that there is at least some chance mark-to-market losses overstate the ultimate impairments it will face. The ABS loss has been very volatile, doubling in six months and stands at ten times HSBC's "stress test" estimate of the probable hit. The mark-to-market loss on Household's loan book is double what optimistic analysts think the likely ultimate impairment will be.

Pleading that fair-value accounting is cruel is hardly unique, but what makes HSBC's position more credible than most is

that it has the capacity to wait and see. Its funding position is excellent with deposits exceeding loans, reducing its dependence on wholesale markets. And the core business continues to generate lots of pre-provision earnings. If spread out over several years, the bank could absorb the hit from Household implied by the mark-to-market valuation without damaging its capital.

Indeed the real moral of the tale is different. Compared with other banks HSBC is protected by its big deposit base and its profitability. It looks therefore as if investors will back the rights issue. Others do not have even that comfort. ■

Buttonwood

How efficient-market theory has been proved both wrong and right

THE past ten years have dealt a series of blows to efficient-market theory, the idea that asset prices accurately reflect all available information. In the late 1990s dotcom companies with no profits and barely any earnings were valued in billions of dollars; and in 2006 investors massively underestimated the risks in bundling together portfolios of American subprime mortgages.

There is now widespread acceptance that investors can behave irrationally, creating very large anomalies. Take the momentum effect, the practice of buying the stockmarket's best performers over the previous time period. A study by the London Business School found that, since 1900, buying British stocks with the best momentum would have turned £1 into £195m (before costs and tax) by the end of last year; the same sum invested in the worst performers would have grown to just £31. In efficient markets, such an anomaly should be arbitrated away.

Belief in efficient-market theory made the authorities reluctant to restrain either the dotcom or the housing and credit bubbles. Perversely, the result has been much greater state interference in the markets than was dreamed of ten years ago, with commercial banks being nationalised or subsidised, and central banks acting as a buyer of last resort for financial assets.

But it is important not to throw out all the insights of efficient-market enthusiasts. Although it is theoretically possible to make money by outperforming the markets, it is extremely difficult in practice. That ought to have made investors suspicious of the smoothness of the returns of Bernard Madoff, who has been accused of a vast fraud. His strategy, as advertised, might have produced less volatile returns than the index, but the absence of negative months suggested

almost perfect market timing.

Some fund managers have beaten the markets over long periods. The problem is to identify them in advance. Picking them after they have outperformed may be too late, as those who backed Legg Mason's Bill Miller have recently discovered. Why is this? Fund managers are human too and subject to behavioural biases. In addition, the larger their funds become (as their reputation spreads), the more difficult it is to outperform.

The temptation has also been to assume that fees are positively correlated with performance—that if mutual fund managers charging 1.5% are good, hedge-fund managers charging 2% (and 20% of performance) are even better. Because investors cannot beat the market in aggregate, all this means is that money is transferred from investors to fund managers. Even David Swensen, the man who led the drive into alternative assets at Yale University, thinks most investors should rely on low-cost index-tracking funds.

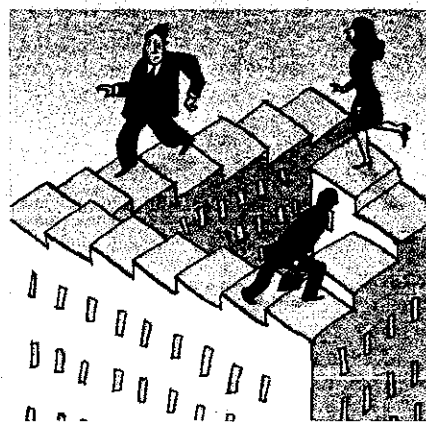
But perhaps the area where the efficient-market hypothesis should have had greater weight is at banks. Many lament

the demise of old-style banking, the "three-six-three" model where bankers borrowed money at 3%, lent it at 6% and were on the golf course at 3pm. That model broke down because markets were fairly efficient; the margins on lending to corporations became too low.

So banks were attracted to the higher-margin business of investment banking. Commercial banks could use their capital to back up their advisory operations and outmuscle old-style investment banks. The latter duly abandoned the partnership structure and raised money on the stockmarket, or were bought by commercial banks. The same logic required new trading desks to handle the banks' positions, and those desks quickly became profit centres of their own.

But how were those trading desks making money? Perhaps they were exploiting information gathered by the rest of the group, a tactic that, if not illegal, put them in conflict with their clients. Or they were taking advantage of an artificially low cost of capital. With commercial banks, that cost was low because of the implicit public subsidy provided by deposit guarantees. Without such guarantees, savers would have wanted higher interest rates from banks with trading arms to reflect the risk of a market-related loss. In the good years, when they randomly beat the market, the traders earned bonuses. In the bad years, the taxpayers have picked up the bill.

And that raises a fundamental question. If regulators thought markets were too efficient to interfere with, how come they allowed banks to get involved in an activity which, after bonuses, was a game they collectively could not win?



Buttonwood now writes a blog, which is open to comment at Economist.com/blogs/buttonwood

India's economy

Bridges to somewhere

GURGAON

The slowdown puts the onus on the government to start rebuilding India's rickety infrastructure

IN 1571 the Mughal emperor Akbar moved his court from Agra to Fatehpur Sikri, where he built a sandstone palace in the middle of nowhere. In the 1980s a similar urge gripped K.P. Singh, chairman of DLF, India's biggest developer. His father-in-law had built 23 neighbourhoods in Delhi. Mr Singh started work on a new city ten miles away, in the wheat fields of Gurgaon.

Nowhere in India embodies the country's aspirations as starkly as the town he founded. DLF's concoction has attracted copycat developers and almost 150 of the world's Fortune 500 companies. In the Aralias, the city's most exclusive apartment block, 6,000 square feet can cost up to 100m rupees (\$2m). That buys a view of Gurgaon's golf course, judged India's best, where members stir their fresh lime sodas with swizzle sticks shaped like long irons.

But just as Fatehpur Sikri was eventually abandoned for lack of water, so some of Gurgaon's developers are suffering from a lack of liquidity. Even DLF has suspended construction of 12m square feet of office-space across India and 4m square feet of retail space. Rajeev Talwar, the group's executive director, says it may also slow down some residential projects.

Reactions like this are taking their toll on India's economy. Output grew by 5.3% in the fourth quarter of 2008, compared with the same quarter a year ago, its slowest pace for four years. The figure was well below expectations. On March 4th the Reserve Bank of India (RBI) responded by cutting its rates by half a percentage point, on top of the 3.5 points cut since October.

India had felt one step removed from the global slowdown. Compared with its neighbours in Asia, it relies little on exports, which amount to only 21.2% of GDP. And it relies less than the overstretched economies of eastern Europe on foreign capital: its gross saving rate reached 37.7% of GDP in the past fiscal year.

But India does not mobilise its saving well. Households account for almost two-thirds of it. But they put more than half of their spare funds into physical assets, such as homes, rather than the financial system. Of the remainder, 11% is held in cash and 55% is deposited in the banks, which are now lending almost a third of their deposits to the government.

Thus despite India's prodigious thrift, its companies miss foreign investors now they have fled. Of the \$135 billion they raised in the fiscal year to March 2008, \$40



There is no escape, even in Gurgaon

billion came from foreign lenders and \$22 billion came from a stockmarket buoyed by foreign enthusiasm, according to Tushar Poddar of Goldman Sachs. DLF itself raised \$2.2 billion in June 2007 in what was then India's biggest initial public offering.

Those sources of funds have now dwindled, forcing companies to turn to the country's banks. In a report in January, the RBI calculated that the flow of credit from India's banks had increased by \$7.6 billion so far this fiscal year, compared with the same period of the previous year. But this failed to compensate for the \$26.8 billion shortfall in funds from other sources, such as foreign loans and public issues. "We are ourselves now changing over to public-sector banks," says DLF's Mr Talwar, but it is not easy. "You've got to convince the banks... It is a little time-consuming."

Fear and loathing

India's banks are flush with cash, but they are also cautious, fearing a rise in the non-performing loans that crippled them in the 1990s. They may also be tempted by "lazy banking", holding safe government securities, which should increase in price if the RBI keeps cutting rates.

If the banks insist on buying such bonds, then it will fall to the government to borrow and spend what is needed to keep

India's economy turning. It is doing its best. The central government had budgeted a fiscal deficit of 2.5% of GDP for this fiscal year. Last month it admitted the gap would be 6%. Add the red ink of the state governments and various expenses reported "below the line" and the deficit will exceed 11% of GDP this year. On February 24th Standard & Poor's put a negative outlook on India's credit rating (BBB-, the lowest investment grade). The same day, the government cut taxes again.

The economy is enjoying a fortuitous fiscal boost from measures taken long before the crisis ballooned. The central government's legions of employees, for example, have received a pay rise that will be matched by some of the state governments in the next fiscal year. Small farmers had their debts cancelled, and money has flowed to rural districts thanks to India's employment-guarantee act, which is supposed to offer 100 days of work to every household that needs it.

The government has also announced three stimulus packages. It will spend an extra 200 billion rupees this year on the schools, roads, power plants and other development priorities set out in its latest five-year plan. It has also told the India Infrastructure Finance Company Limited (IIFCL), a government-owned financial company, to sell bonds worth 400 billion rupees. The first tranches of bonds, offering 6.85% and a sovereign guarantee, were oversubscribed. The IIFCL will lend this money to banks, which will then pass it to infrastructure projects worth as much as 1 trillion rupees.

In other countries, fiscal stimulants are raising the spectre of "bridges to nowhere". But in India, extra infrastructure is sorely needed. During the boom, India's industry expanded faster than the electricity grid's capacity to power it; its air traffic outgrew its airports; and cars rolled off the production lines faster than the roads could accommodate them. In DLF's Aralias in Gurgaon, each flat is allotted three spaces in the car park underneath. But many residents buy more.

The company looks after the roads, storm drains, sewer system and the flora within "DLF City". But outside, the state authorities have struggled to keep pace. Gurgaon's roadsides are disfigured by deep trenches, where the trunk sewer line waits to be laid.

Now that India's economy is slowing and competition for men, materials and money is slackening, India's public infrastructure may have a chance to catch up. In Gurgaon the Delhi Metro Rail Corporation is building an elevated railway that will connect the upstart city to the capital. It is a public project backed by the governments of India, Delhi and the neighbouring state. It is also now the busiest construction site in the city. ■

tions are much less certain. Europeans are also much more suspicious of business. According to a Eurobarometer poll, 42% of them think that entrepreneurs exploit other people's work, compared with 26% of Americans.

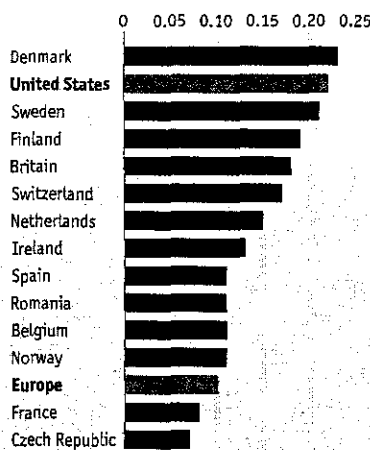
These cultural problems are reinforced by structural ones. The European market remains much more fragmented than the American one: entrepreneurs have to grapple with a patchwork of legal codes and an expensive and time-consuming patent system. In many countries the tax system and the labour laws discourage companies from growing above a certain size. A depressing number of European universities remain suspicious of industry, subsisting on declining state subsidies but still unwilling to embrace the private sector.

The European venture-capital industry, too, is less developed than the American one (significantly, in many countries it is called "risk" capital rather than "venture" capital). In 2005, for example, European venture capitalists invested €12.7 billion in Europe whereas American venture capitalists invested €17.4 billion in America. America has at least 50 times as many "angel" investors as Europe, thanks to the taxman's greater forbearance.

Yet for all its structural and cultural problems, Europe has started to change, not least because America's venture capitalists have recently started to export their model. In the 1990s Silicon Valley's moneybags believed that they should invest "no further than 20 miles from their offices", but lately the Valley's finest have been establishing offices in Asia and Europe. This is partly because they recognise that technological breakthroughs are being made in many more places, but partly also because they

Not very venturesome

Venture-capital investments across Europe and US
By country of portfolio firm, 2007, % of GDP



Source: Deutsche Bank Research

believe that applying American methods to new economies can start a torrent of entrepreneurial creativity.

Between 2003 and 2006 European venture-capital investment grew by an average of 23% a year, compared with just 0.3% a year in America. Indeed, three European countries, Denmark, Sweden and Britain, have bigger venture-capital industries, in relation to the size of their economies, than America. Venture-capital-backed start-ups have produced more than 100 "exits" (stockmarket flotations or sales to established companies) worth more than \$100m since 2004. Tele Atlas, a Dutch mapping outfit, was recently bought by TomTom for \$4.3 billion.

The success of Skype, which pioneered

internet-based telephone calls, was a striking example of the new European entrepreneurialism. The company was started by a Swede and a Dane who contracted out much of their work to computer programmers in Estonia. In 2005 they sold it to eBay for \$2.6 billion.

Several European universities have become high-tech hubs. Britain's Cambridge, for example, has spawned more than 3,000 companies and created more than 200 millionaires in the university. The accession of ten eastern European countries to the EU has also tapped into an internal European supply of scientists and technologists who are willing to work for a small fraction of the cost of their pampered western neighbours.

Slowcoach Japan

The Japanese can hardly be accused of aversion to long hours. Big Japanese companies have an impressive record of incremental improvement, particularly in the electronics business. But for the most part the Japanese have been less successful than the Europeans at adapting to entrepreneurial capitalism. The latest GEM global report gives Japan the lowest score for entrepreneurship of any big country, placing it joint bottom with Greece. The brightest people want to work for large companies, with which the big banks work hand in glove, or for the government. Risk capital is rare. Bankruptcy is severely punished. And the small-business sector is wrapped in cotton wool, encouraging "replicative" rather than "innovative" behaviour. Over the past quarter-century the rate at which Japan has been creating new businesses has been only one-third to half that in America. ■

The more the merrier

India and China are creating millions of entrepreneurs

GURCHARAN DAS, an Indian venture capitalist, consultant and author, tells a story about stopping at a roadside café in southern India and chatting to a 14-year-old boy who was waiting at tables. The boy said that he needed the money to pay for computer lessons. His ultimate ambition was to run a computer company just like his hero, Bilgay, the richest man in the world. He may have got the name slightly wrong, but the sentiment was spot on.

Over the past couple of decades India has been transformed from a licence Raj into a land of uncaged entrepreneurs. Everybody knows about companies like Infosys, but there is more to Indian entrepreneurialism than software. Bollywood produces 1,000 films a year that are watched by 3.6 billion people (the figures for Hollywood are 700 and 2.6 billion). The Narayana Hrudayalaya hospital, founded by Devi Shetty on the outskirts of Banga-

lore, is turning heart surgery into a Wal-Mart-like business. Kingfisher beer is popular wherever spicy curries are eaten. The global slowdown will no doubt pose serious problems for India. But the country's mood has changed fundamentally since the government began opening up the economy in 1991: fatalism has been replaced by can-do optimism.

India has drawn heavily on its expatriate population, particularly the 1m who



► live in America, to kickstart its entrepreneurial economy. Rajat Gupta, a former head of McKinsey, did as much as anybody to create the Indian Business School in Hyderabad. Gururaj Deshpande, who sold his company, Cascade Communications, to Ascend for \$3.7 billion, is a ubiquitous cheerleader for entrepreneurialism. Draper International, which in 1995 became the first foreign venture-capital fund to invest in India, relied on money from Silicon Valley's Indian community.

India has now begun to reverse the brain drain, summoning its prodigal children back home. In 2003-05 some 5,000 tech-savvy Indians with more than five years' experience of working in America returned to India. Such people have helped to fill some of the skills gaps created by the country's recent boom. They have also reinforced India's already numerous links with high-tech America.

India's other advantage is its higher-education system, the top end of which is very good at discovering and developing first-class brains. The British introduced the ideal of meritocracy to India; Jawaharlal Nehru gave it a technocratic twist by launching the Indian Institutes of Technology; and India's natural love of argument did the rest. These institutes, so oversubscribed that only one in 75 applicants gets in, are now as bent on producing entrepreneurs as they were once determined to produce Fabian technicians.

From knock-off to innovation

Communist China's conversion to entrepreneurialism is even more surprising than Fabian India's. When Wu Yi, the country's then vice-premier, visited America in 2006, she took more than 200 entrepreneurs with her. About 60 Chinese companies are now traded on NASDAQ. The Central Party school even offers special

courses for entrepreneurs, known as red capitalists.

In some ways China has had a more difficult task than India. The Cultural Revolution destroyed the country's intellectual and managerial capital. Few Chinese speak good English. The state is more interested in grand projects—from state-owned companies to giant infrastructure schemes—than in letting a hundred flowers bloom. But China shares one important advantage with India: the army of overseas Chinese who have made their home in America, particularly Silicon Valley. China has used them well.

The Chinese authorities are fully aware of the part that the overseas Chinese played in Taiwan's economic take-off. Since the late 1990s they have been doing everything they could to tempt expats back, upgrading their universities, often working with foreign institutions, setting up science parks and welcoming foreign companies. So many Chinese expats have returned in the past few years that Valley-slang has given them a special name, B2C (back to China).

Many of China's most successful entrepreneurs have done little more than produce knock-offs of American companies, mostly those they studied when they first went to America. Baidu is a Chinese Google; Dangdang is a Chinese Amazon; Taobao is a Chinese eBay; Oak Pacific Interactive is a mishmash of MySpace, YouTube, Facebook and Craigslist; Chinacars is a Chinese American Automobile Association. But even producing knock-offs takes skill, particularly when the original companies are determined to colonise the Chinese market. And imitative Chinese entrepreneurs can bring innovative management methods to China. Baidu's founder, Robin Li, raised funds from American venture capitalists and offered stock

options to his earliest employees.

China is also producing some genuinely innovative entrepreneurs. Jack Ma uses a website, Alibaba, to sell goods from China's thousands of corner shops to other businesses. Mr Ma has also created a college for entrepreneurs. Jeff Chen has developed an internet browser which has attracted venture capital from Denmark and is available in 20 languages.

Some of the most innovative entrepreneurs are working with mobile telephony, which is even more important in China than it is in the West. Liu Yingkui is selling insurance, mutual funds and bank services over the mobile internet. Charles Wang is trying to get subscribers addicted to his free text-messaging service, PingCo, so that he can start signing them up for premium services such as backing up address books, selling astrological charts and providing weather updates.

Watch this space

Both India and China have a long way to go. The Indian government is a lumbering elephant riddled with favouritism, the country's legal processes move at glacial speed, much of the infrastructure is a mess and over a third of the people are illiterate.

As for China, Yasheng Huang, of the Massachusetts Institute of Technology, has shown how Chinese capitalism is being distorted by the influence of politics. Some 40% of entrepreneurs are members of the Communist Party. State-backed businesses receive a disproportionate share of capital. Even sound businesses are frequently opaque: the Chinese reportedly maintain three sets of books, one for their bankers, one for their accountants and one for the government. Businessmen often neglect their firms because they spend so much time cultivating political connections.

But both countries have already come a long way. HBS's Tarun Khanna points out that the entrepreneurial spirit is beginning to breathe new life into India's public sector. Bangalore has replaced its dilapidated airport with a splendid new one, with the help of some private money. As for China's red capitalists, however much they are being held back by the party, they in turn are forcing the party to change.

The opening up of China and India is releasing millions of new entrepreneurs onto the world market. Many of them have already shown themselves able not just to translate Western ideas into their local idioms but also to drive technological advance of their own. The world has only just begun to feel the effects. ■

Lands of opportunity

Israel, Denmark and Singapore show how entrepreneurialism can thrive in different climates

DOV MORAN'S desk is littered with the carcasses of dismembered phones. Mr Moran has already had one big breakthrough: inventing the now ubiquitous memory stick. But he dreams of another one: he wants to separate the "brains" of the various gizmos that dominate our lives from the "bodies" to enable people to carry around tiny devices that they will be able to plug into anything from phones to cameras to computers. Mr Moran sold his memory-stick business to SanDisk for \$1.6 billion, creating a thriving technology cluster near his office. This time he wants to build an Israeli business that will last, challenging the giants of the camera and phone businesses.

Israel is full of would-be Dov Morans. It is home to 4,000 high-tech companies, more than 100 venture-capital funds and a growing health-care industry. Innovations developed in the country include the Pentium chip (Intel), voicemail (Comverse), instant messaging (Mirabilis, Ubuque), firewalls (Checkpoint) and the "video pill", which allows doctors to study your insides without the need for invasive surgery.

Even more than other countries, Israel has America to thank for its entrepreneurial take-off. A brigade of American high-tech companies, including Intel and Microsoft, have established research arms there. And a host of Israelis who once emigrated to America in search of education and opportunity have returned home, bringing American assumptions with them. Many Israeli entrepreneurs yo-yo between Silicon Valley and Tel Aviv; almost 70 Israeli companies are traded on NASDAQ.

The Israeli government helped by providing a ready supply of both human and physical capital. Israel has the world's highest ratio of PhDs per person, the highest ratio of engineers and scientists and some of the world's best research universities, notably Technion. The country's native talent was supplemented by the arrival of 400,000 well-educated Jewish refugees from the former Soviet empire.

However, Israel's main qualification for entrepreneurialism is its status as an embattled Jewish state in a sea of Arab hostility. The Israeli army not only works hard to keep the country at the cutting edge of

technology, it also trains young Israelis (who are conscripted at 18) in the virtues of teamwork and improvisation. It is strikingly common for young Israelis to start businesses with friends that they met in the army. Add to that a high tolerance of risk, born of a long history and an ever-present danger of attack, and you have the makings of an entrepreneurial firecracker.

Danish dynamism

Compared with a lion like Dov Moran, Frederik Gundelach is a mere cub, but he has some of the same sense of purpose about him. Sitting in one of Denmark's "growth houses" (incubators for entrepreneurs), he



places a flask on the table and launches into an elaborate explanation.

Mr Gundelach claims that he and his father have discovered a novel way of boiling water that does not require the application of heat. He hopes to sell the flask to outdoor types and soldiers, but that is not the limit of his ambition. The chemical reaction that heats the water can also be used to heat or cool houses, he claims, radically reducing the cost of domestic heating and the threat of global warming.

It is too early to say whether Mr Gundelach's flask will turn out to be a miracle in a bottle or a pipedream, but the Danish government is doing everything it can to give him the support he needs. Denmark is en-

gaged in a social experiment to test whether it can embrace capitalist globalisation yet continue to preserve its generous welfare state. The Danish economy has traditionally been divided between big multinational companies (such as Carlsberg, a brewing behemoth) and a welter of small family firms. The government now wants to add a third economic force: start-ups with the potential for rapid growth.

The government has done everything a tidy-minded Scandinavian country can to cultivate these start-ups. The World Bank ranks Denmark fifth in the world for ease of doing business. There is a network of growth houses—ready-made offices that provide start-ups with many of the advantages of large companies such as consulting advice, legal services and conference rooms. The government has created a public venture-capital fund, the Vaekstfonden, and is now trying to change attitudes to entrepreneurs and promoting "education for entrepreneurship".

When Muslim countries boycotted Danish goods in 2005 after a Danish newspaper published some disrespectful cartoons of the prophet Muhammad, wags joked that this hardly mattered because the only things that Denmark produced were beer and bacon. But the government's embrace of entrepreneurialism is clearly changing the economy. Denmark is already home to about 20% of Europe's biotech companies. It also has thriving clean-technology, fashion and design industries. As a proportion of GDP, Danish companies attract more venture capital than any other European country.

Sizzling Singapore

At first sight Denmark and Singapore do not have much in common, yet they share not only the same official enthusiasm for entrepreneurialism but also many of the same policies. Singapore's government has invested heavily in digital media, bio-engineering, clean technology and water purification, creating huge incubators and enticing foreign scientists with fat pay packets, as well as setting up a public venture-capital fund that has in turn brought in lots of private venture capital. More than 5% of Singapore-based companies are ▶▶

► backed by venture capital.

The government has done everything in its power to make life easy for entrepreneurs, which has earned it first place in the World Bank league table for ease of doing business. It is also trying hard to encourage a traditionally passive population to become more innovative. Schools teach the virtues of entrepreneurialism. The universities put ever more emphasis on business education and links with industry. The Nanyang Technological University (whose chairman, like that of the National University of Singapore, is an alumnus of Hewlett-Packard) offers a graduate degree in technopreneurship and innovation.

Singapore sees entrepreneurialism as a prerequisite to future growth. It has spent the past few decades climbing up the "value chain" from manufacturing to services and from trade to finance. Its biggest test yet may be to create knowledge industries and produce companies that can commercialise intellectual breakthroughs.

All three countries have both advantages and disadvantages when it comes to embracing entrepreneurship. Israel depends too heavily on America and is being hit hard by the downturn there. Denmark is too egalitarian. A top personal-income-tax rate of 63% drives the most successful entrepreneurs out of the country.

Singaporeans have even deeper cultural problems with entrepreneurship. The best and brightest have little appetite for risk-taking entrepreneurship, and most people suffer from an excessive fear of bankruptcy, according to Monitor. The country's consumers are anything but venturesome: for all the island's cultural diversity, they remain obsessed by Western brand names. The country is paying a heavy price for this. A Singapore-based company, Creative Technology, invented a digital music player, the *NOMAD*, two years before Apple launched the iPod, but Creative's *NOMAD* looked like a clunky CD player rather than a miniature fashion

accessory. It received \$100m from Apple for patent infringement, but that did not make up for the loss of a mass market.

Still, the governments of all three countries remain enthusiastic supporters of the entrepreneurial idea. The Danes and the Singaporeans regard it as their ticket to success in a global economy and the Israelis as a matter of survival. All three are also helping to spread the creed in their regions. Arab countries are beginning to realise that the best way to deal with Israel is to copy its vibrant economy. Denmark serves as a model to European leaders such as France's Nicolas Sarkozy who want to combine dynamism with social protection. The Chinese regard Singapore as a useful laboratory for reform. In the 1980s China asked Goh Keng Swee, Singapore's former finance minister, to advise on the development of its special economic zones; today it is keeping a watchful eye on the city-state's model of state-sponsored entrepreneurship. ■

Magic formula

The secrets of entrepreneurial success

KING MIDAS wished for everything he touched to turn to gold, which turned out to be a bad idea. His modern equivalents hope that everything they touch will turn to Silicon, which may not be such a good idea either. The world now glories in dozens of would-be Silicon Valleys: Silicon Alley in New York, Silicon Glen in Scotland and even, depressingly, Silicon Roundabout in London.

Siliconitis is the most common example of what is now an almost universal search among policymakers, local as well as central, for the secrets of entrepreneurial success. It is also the most instructive. A few attempts to replicate Silicon Valley, most notably in Israel, have succeeded. But most are embarrassing failures.

The most basic mistake politicians make in trying to foster entrepreneurship is to assume that there is only one model of a successful entrepreneurial cluster. There is no point in trying to create the next Silicon Valley without the Valley's remarkable resources: two world-class universities, Stanford and Berkeley, and a big financial centre, San Francisco. Instead, would-be emulators should concentrate on their own particular strengths.

In addition to the classic Silicon Valley model, Monitor identifies three other successful entrepreneurial ecologies. One is the anchor-firm model. Alfred Marshall, one of the first economists to write about entrepreneurship, said that successful entrepreneurs are like large trees in a forest, towering over their neighbours and depriving them of light and air. In fact, the big trees usually produce lots of little ones. They spin off subsidiaries, provide experience to employees who then decide to go it alone, and nurture dozens of suppliers.

The research triangle in North Carolina was a successful exponent of the anchor-firm model, recruiting big companies such as IBM, Alcatel and Union Carbide which then either spawned or attracted lots of smaller operators. Hindustan Unilever, a food and personal-care giant, is another, less self-conscious exponent. The firm employs 45,000 women across India to market its goods to 150m consumers in rural areas. These saleswomen not only earn an income, they also learn about products, prices and marketing, sending a ripple of entrepreneurship throughout rural India.

A second, currently topical, model is driven by crisis. People become entrepre-

neurs when the economy stops supplying jobs. This happened in the San Diego region in the 1990s when the end of the cold war threw hundreds of highly trained military scientists out of work. Local start-ups such as Qualcomm hoovered up the talent and put it to new uses.

A third is the local-hero model in which a local entrepreneur sees an opportunity, starts a business and turns it into a giant. When Earl Bakken founded Medtronic in Minneapolis in 1949, he was creating a local industry as well as a company. Having developed the world's first heart pacemaker, Medtronic grew into the largest medical-technology company in the world, spawning huge numbers of smaller ones.

A matter of luck

Two other things complicate the search for success—the role of chance and the importance of culture. The Indian Institutes of Technology were designed to create technocrats rather than entrepreneurs. It was more a matter of luck than good planning that they were churning out exactly the sort of people that the Indian software industry needed.

David Landes, an influential economic ►►

Charlemagne | Beware of breaking the single market

European governments are turning against the European Commission, with mischief in mind



THE European Commission, say the grumblers of Brussels, is adrift in this economic crisis. Euro-fundamentalists sigh for Jacques Delors, the pugnacious Frenchman who ran the commission—the EU’s executive authority—from 1985 to 1995. Amid economic disarray, it is said, the commission should be seizing its chance to set the agenda for Europe.

One can hear similar complaints about an inactive commission from national leaders, notably President Nicolas Sarkozy of France. At a mini-summit earlier this month, he declined to repeat his previously explicit support for giving José Manuel Barroso, the commission’s president, a second term. Mr Sarkozy’s outburst cheered the anti-Barroso camp in Brussels. Yet in truth, the critics often have contradictory grievances.

The federalist hardcore yearns for the commission to use the crisis to grab power from national governments. Many would like a new, pan-European financial regulator. Others would cheer if the commission moved to harmonise labour and fiscal policies across Europe. That is not an idle threat: if lots of eastern and central European countries need European rescue funds, expect to hear calls for them to be forced to raise tax rates or impose an EU minimum wage.

When leaders say that the commission is being too passive, they actually mean the reverse: they think it is too zealous about enforcing Euro-rules on free competition. They want it to stand aside so interventionist governments can create “European industrial champions” through measured doses of protectionism, privileged access to public contracts or cosy collusion between firms in different bits of Europe. Some new members would like the EU to ease rules on how they may spend regional aid, or those that make joining the single currency slow and difficult. Even key supporters of free competition, like Britain and Ireland, are going wobbly. Senior figures say that as more and more banks need saving, the British and Irish appear more fussed about financial stability than about EU rules on market shares or state aid.

At an EU summit last December, Mr Sarkozy berated the commission for applying its rules too rigidly. All around the table, heads were nodding. If a show of hands had been called, a senior figure now says, an “overwhelming majority” of EU leaders would have voted to suspend the internal market’s rules.

Since then, EU leaders have reaffirmed their loyalty to the internal market. But many countries, among them Germany and France, wish that the market were not so free. Astonishing as it may seem to British critics of Europe, in Brussels the chief complaint is that the dominant ideology of the European Commission, especially in the financial sector, is British-style liberalism. Angela Merkel, the German chancellor, is said to deliver “rants” about the “Anglo-Saxon” system. Many leaders on the continent would love to regulate the City of London down to size, for reasons of both ideology and commercial rivalry.

So Mr Barroso will face a bumpy few months. In June, EU leaders are due to choose the next European Commission president, who would hand out portfolios to commissioners nominated by national governments a few months later. France is determined to claim a big economic portfolio. So are the British, but their stock is low. Mr Sarkozy has thrown the timing into doubt, suggesting that a vote on the commission boss should be delayed. In France, Socialist party leaders say their campaign for June’s European Parliament elections will denounce the supposed “Barroso-Sarkozy axis” of wicked “ultraliberalism”.

And yet Mr Barroso will not be easy to shift. He has incumbency on his side, and is a member of Europe’s largest centre-right political grouping, the European People’s Party, which is expected to retain its majority in the European Parliament. Other names are mentioned as rivals, such as François Fillon, the French prime minister; Jan Peter Balkenende, the Dutch prime minister; and Jean-Claude Juncker, the veteran Luxembourg leader. However, all have counts against them. Senior French officials admit to some irritation with Mr Barroso, who stands accused of stubbornly pursuing unpopular causes in the name of free trade—trying to force Europeans to grow genetically modified corn from America, for example. But they insist that France has no rival candidate for his job. Mr Balkenende, for his part, is another broadly Atlanticist free-marketeer. Mr Juncker, a federalist, would risk a British veto, and is not favoured by Mr Sarkozy.

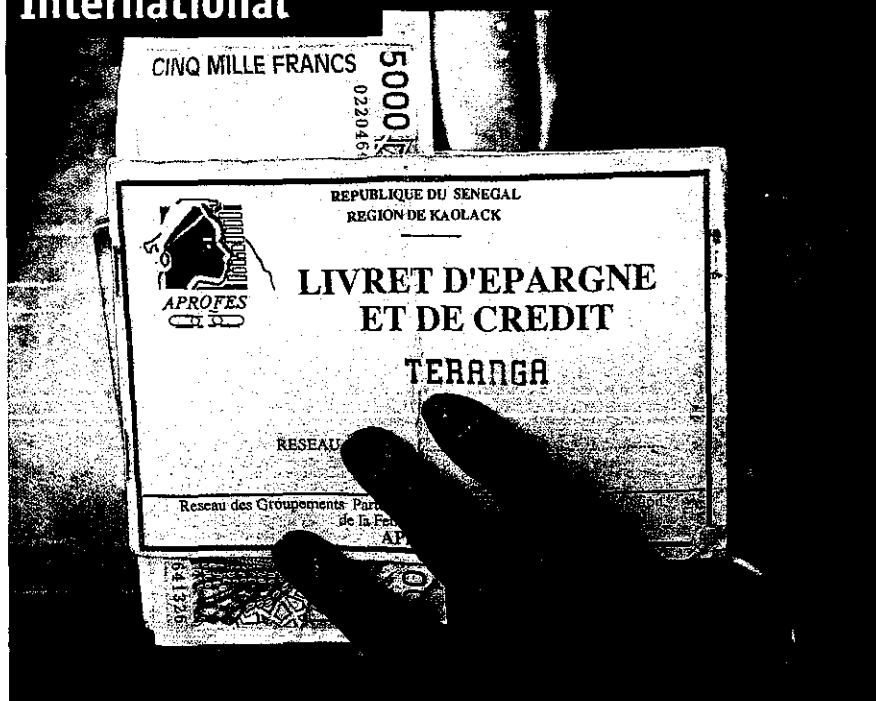
What price President Blair of Europe?

French officials say they want Tony Blair, the former British prime minister, to land a big new job that will be created if the Lisbon treaty is finally ratified this year: that of full-time president of the European Council. That would involve Mr Blair representing Europe’s 27 national leaders and chairing their meetings.

Yet in an economic crisis as broad and deep as this one, the horse-trading becomes unpredictable. Could there yet be a bargain in which Britain would allow an economic non-liberal to take over the commission, in exchange for a President Blair of Europe? If so, it is a bargain Britain should resist, even if that means sacrificing Mr Blair. Saving the internal market is the EU’s biggest ideological fight for a generation, and the commission is the body that matters most on this.

A British government ditching its own to save the European Commission president? When Europe’s free markets are under attack, the strangest alliances can make sense. Similarly, lest they end up encouraging economic nationalism, Europhiles who loathe Mr Barroso should beware of egging on the national leaders carping at the commission. If that spreads, it could sink the whole project, not just leave it adrift. ■

Charlemagne now writes a blog, which is open for comment at Economist.com/blogs/charlemagne



The global crisis and the poor

The toxins trickle downwards

DAR-ES-SALAAM

A downturn that began in the rich world is hurting those who can least afford it

POOOR countries are innocent," says Ngozi Okonjo-Iweala, the Nigerian managing director of the World Bank. They did not contribute one jot to the global credit crunch, and their banks and firms have few links to global capital markets. For a while, it seemed as if the rich world's mess might even pass them by. The oil-price fall of 2008 benefited oil-importing developing countries to the tune of 2% of their national incomes. As recently as January, the IMF thought emerging and developing countries would grow 3.3% this year, compared with a predicted fall of 2% for rich economies.

But innocence, it seems, will not protect anyone. A financial crisis that began in New York and London and spread to manufacturing in rich, then industrialising countries, has now hit the "bottom billion": the poorest people in 60-odd countries who have seen only halting gains from globalisation, but will feel its reverse, perhaps precipitously.

Many live in sub-Saharan Africa, where the IMF has just cut its forecast for growth this year to 3.3% from an original 6.7%. The figure may fall further. Dominique Strauss-Kahn, the IMF's managing director, told a conference in Tanzania that millions could be thrown back into poverty by the crisis. Piling on gloom, he saw a "threat of civil

unrest, perhaps even of war" as a result.

The poor are being hit not by the financial tsunami itself but by second-order waves of trouble. So the impact has been delayed—but it may also be prolonged.

The global meltdown affects poor countries in three ways. First, capital: as investors in the West rebuild balance sheets, private capital flows dry up, hurting marginal borrowers like the poor. According to the Institute of International Finance, a think-tank in Washington, DC, net private capital flows to poor countries will slump from almost \$1 trillion in 2007 to \$165 billion in 2009. The main victims are big emerging markets in East Asia and eastern Europe. But African countries have been turning to private capital too. In 2007 they raised \$6.5 billion in international bonds, trivial in global terms but not to Africa. In 2008, they raised nothing.

For the poor, the other kind of external capital is aid. Britain's Overseas Development Institute reckons that official aid may fall by about a fifth, or \$20 billion, this year, after being more or less flat in 2005-07. The fall is partly a product of the recession in donor countries (some give a certain share of their GDP as aid) and partly a result of currency changes which make aid in pounds and euros worth less in local terms. Italy and Ireland are cutting their aid

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effort. Others are "front-loading" it (borrowing from future years to keep steady now), so aid could fall further after 2009.

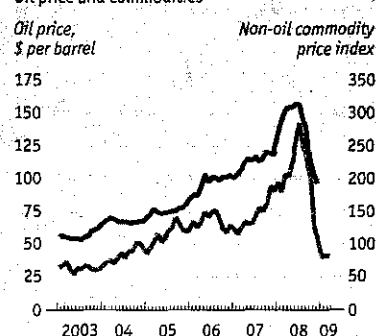
As capital flows dry up, investment is being slashed. ArcelorMittal has mothballed an iron-ore project in Liberia. Malawi is losing a uranium project that the government had hoped would account for a tenth of national income. The World Bank estimates that new private activity in infrastructure was 40% lower in August-November of 2008 than a year before.

The second effect of the meltdown is the dive in commodity prices (see chart 1). Most poor states still rely on commodities for big shares of their foreign exchange and tax revenues. Cocoa generates a fifth of Côte d'Ivoire's revenues, for instance.

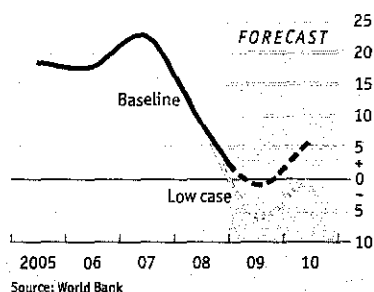
For such places, price volatility has been a curse. The drop in oil and commodity prices in 2008 benefited oil- and food-importers. But this followed a sharp price rise and, for many, relief has come too late. The food crisis of 2007-08 increased the

Big dippers

Oil price and commodities



Sources: DEC Prospects Group; World Bank

Fewer happy returnsRemittance flows to developing countries
% change on year earlier

number of people suffering from malnutrition by 44m. Farmers and oil exporters benefited then. No longer.

Now, falling export earnings are exacerbating poor countries' woes. In theory, the poorest should be cushioned from declining world trade. Even so, the latest data look dire. American imports from middle-income countries fell 3% in the year to November 2008. But imports from poor countries fell 6%; those from sub-Saharan Africa, 12%. The African Development Bank says African current accounts, in surplus by 3.8% of GDP in 2007, will be 6% in the red this year.

The fall in commodity prices puts further pressure on budgets, already hit by declining aid (which can substitute for taxes). African budgets have swung from a healthy surplus of 3% of GDP in 2007 to a forecast deficit of the same amount in 2009. This leaves no room for economic stimulus. On one estimate, only one-quarter of vulnerable countries have any scope to raise their budget deficits and boost spending—in contrast with the West.

The third area where the meltdown is being felt is labour. Those poor countries that do make things for export are suffering from the fall in world trade. India lost 500,000 export jobs in the last quarter of 2008, for example. Many countries also export workers who send back remittances. These were worth \$300 billion in 2008, more than aid. Some countries depend on them. They account for 45% of GDP in Tajikistan, 38% in Moldova and 24% in Lebanon and Guyana. Remittances had been rising fast in 2005-07; now they are falling (see chart 2). Malaysia recently revoked work visas for 55,000 Bangladeshis in order to boost job prospects for locals. Countries which send workers to Russia are doubly hit: many work in the crisis-affected oil industry and send money back in fast-depreciating roubles.

The overall picture is dire. As capital inflows and export earnings vanish, poor countries face a mountain of debt: \$2.5 trillion-3 trillion of emerging-market debt falls due in 2009—as much as the American and European budget deficits, plus Eu-

rope's bank bail-out costs. The World Bank puts emerging markets' financing shortfall between \$270 billion and \$700 billion.

Tragically, these problems follow a decade of growth that has lifted millions out of poverty. According to Martin Ravallion of the World Bank, roughly one person in six in emerging markets had raised themselves above the \$2-a-day poverty line in 2005, though they still got less than \$3 a day. Many may now slip back. Mr Ravallion thinks that 65m people will fall below the \$2-a-day poverty line this year, 12m more than he had expected a month ago; 53m will fall below the level of absolute poverty, which is \$1.25 a day—compared with 46m expected last month.

The consequence will be dreadful. The World Bank reckons that between 200,000 and 400,000 more children will die every year between now and 2015 than would have perished without the crisis. Progress towards a richer, more equitable world has been set back years. ■

Banks, graft and development**Dancing with despots****When bankers are pimps**

DESPITE all the aid, investment and remittances that flow from richer economies to poorer ones, too much capital sloshes right back. That is one big reason why parts of Africa and Central Asia, for example, remain chronically poor, even—indeed, especially—where abundant natural resources could in theory be used to finance roads, schools and local enterprise.

If capital often flees poor countries, that is not only because higher, or more secure, returns might be obtained elsewhere. Too frequently it is shovelled abroad by political leaders who have tapped treasuries, pocketed aid money and collected bribes. The double whammy of graft in the poorest countries is that state funds are first diverted into private hands and then sent overseas. By contrast, in much of Asia, also blighted by graft, leaders more often keep ill-gotten gains in local accounts.

Who is to blame for such looting? A new report* by Global Witness, a group that studies links between resource exploitation and war, accuses several prominent Western banks of helping it. The activists cite links with the leaders of five west African countries and with a late president-for-life in Turkmenistan. By taking dictators' cash, the banking system is "complicit" in

perpetuating misrule and poverty, claim the authors. Separately, Paul Collier, an economist with a populist turn of phrase, calls such banks "pimps". If they rejected stolen money, says the report, ordinary people would benefit "in a way that aid flows will never achieve".

The authors note some striking cases of financiers colluding with tyrants. In 2001 Britain's banking regulator found that 23 banks in London had handled \$1.3 billion of some \$3 billion-5 billion looted by Sani Abacha, a Nigerian despot. Five years ago a venerable American institution, Riggs Bank (where Abe Lincoln once banked), collapsed after a Senate inquiry revealed that Augusto Pinochet of Chile and Obiang Nguema, the long-serving president of Equatorial Guinea, had stashed millions in private accounts, with no proper questions asked. Mr Nguema admitted he had put state funds in a private account, but said he did so to keep it "safe" from thieves.

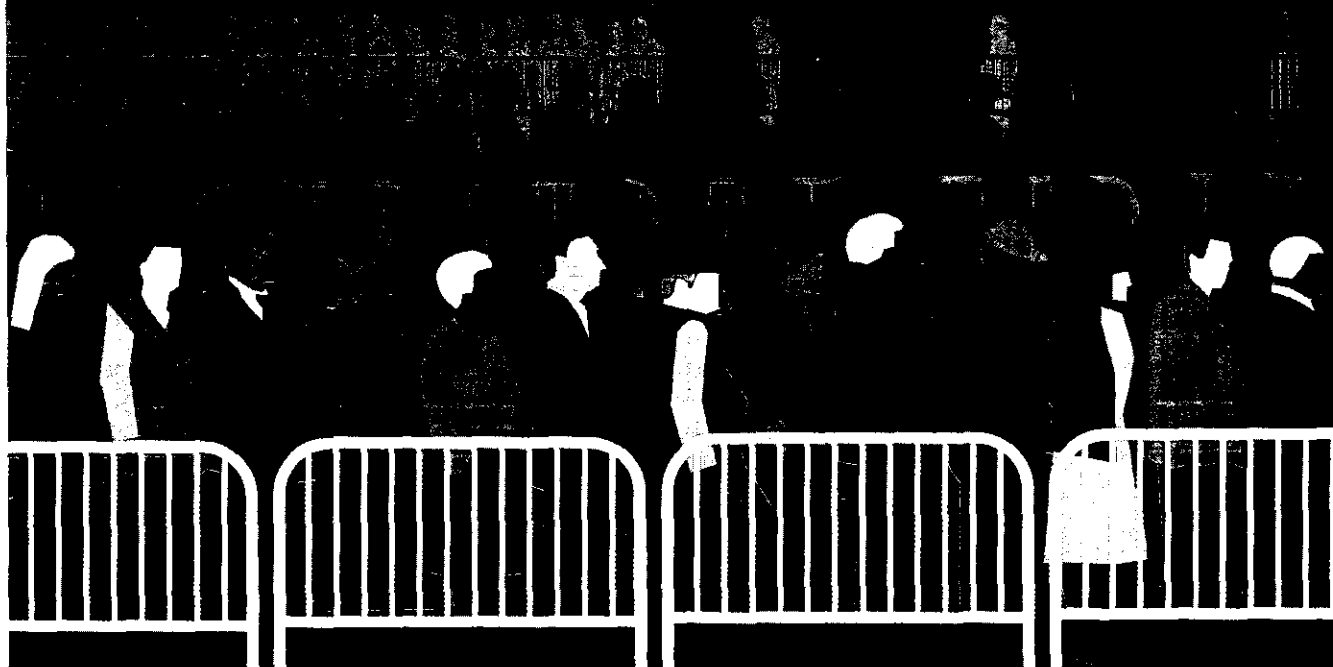
Barclays, which was shown by the report to be doing business with members of Mr Nguema's family, told Global Witness that it was not prepared to discuss its dealings with individual clients; the bank added, however, that it always takes care to follow "globally applicable anti-money laundering policies".

The activists are not claiming that banks who deal with despots are breaking laws, but they want more effort to check where clients have obtained their cash, and tougher regulation of dealings between banks and "politically exposed persons"—in other words, government officials, their relatives and associates. Banks have proved capable, in some degree, of stanching the flow of funds linked to terrorism, money-laundering or tax evasion. More regulation might possibly deter them from handling the proceeds of misrule. ■



Nguema: a president on a pedestal

*"Undue Diligence: How banks do business with corrupt regimes". Global Witness; March 11th 2009



When jobs disappear

LONDON, TOKYO AND WASHINGTON, DC

The world economy faces the biggest rise in unemployment in decades. How governments react will shape labour markets for years to come

LAST month America's unemployment rate climbed to 8.1%, the highest in a quarter of a century. For those newly out of a job, the chances of finding another soon are the worst since records began 50 years ago. In China 20m migrant workers (maybe 3% of the labour force) have been laid off. Cambodia's textile industry, its main source of exports, has cut one worker in ten. In Spain the building bust has pushed the jobless rate up by two-thirds in a year, to 14.8% in January. And in Japan, where official unemployment used to be all but unknown, tens of thousands of people on temporary contracts are losing not just their jobs but also the housing provided by their employers.

The next phase of the world's economic downturn is taking shape: a global jobs crisis. Its contours are only just becoming clear, but the severity, breadth and likely length of the recession, together with changes in the structure of labour markets in both rich and emerging economies, suggest the world is about to undergo its biggest increase in unemployment for decades.

In the last three months of 2008 America's GDP slumped at an annualised rate of 6.2%. This quarter may not be much better.

Output has shrunk even faster in countries dependent on exports (such as Germany, Japan and several emerging Asian economies) or foreign finance (notably central and eastern Europe). The IMF said this week that global output will probably fall for the first time since the second world war. The World Bank expects the fastest contraction of trade since the Depression.

An economic collapse on this scale is bound to hit jobs hard. In its latest quarterly survey Manpower, an employment-services firm, finds that in 23 of the 33 countries it covers, companies' hiring intentions are the weakest on record (see chart 1 on the next page). Because changes in unemployment lag behind those in output, jobless rates would rise further even if economies stopped contracting today. But there is little hope of that. And several features of this recession look especially harmful.

The credit crunch has exacerbated the impact of falling demand, pressing cash-strapped firms to cut costs more quickly. The asset bust and unwinding of debt that lie behind the recession mean that eventual recovery is likely to be too weak to create jobs rapidly. And when demand does revive, the composition of jobs will change. In a post-bubble world indebted consum-

ers will save more and surplus economies, from China to Germany, will have to rely more on domestic spending. The booming industries of recent years, from construction to finance, will not bounce back. Millions of people, from Wall Street bankers to Chinese migrants, will need to find wholly different lines of work.

For now the damage is most obvious in America, where the recession began earlier than elsewhere (in December 2007, according to the National Bureau of Economic Research) and where the ease of hiring and firing means changes in the demand for workers show up quickly in employment rolls. The economy began to lose jobs in January 2008. At first the decline was fairly modest and largely confined to construction (thanks to the housing bust) and manufacturing (where employment has long been in decline). But since September it has accelerated and broadened. Of the 4.4m jobs lost since the recession began, 3.3m have gone in the past six months. Virtually every sector has been hit hard. Only education, government and health care added workers last month.

So far, the pattern of job losses in this recession resembles that of the early post-war downturns (starting in 1948, 1953 and 1957). Those recessions brought huge, but temporary, swings in employment, in an economy far more reliant on manufacturing than today's. As a share of the workforce, more jobs have been lost in this recession than in any since 1957. The pace at which people are losing their jobs, measured by the share of the workforce filing for weekly jobless claims, is much quicker ►

▶ than in the downturns of 1990 and 2001 (see chart 2).

The worry, however, is that the hangover from excess debt and the housing bust will mean a slow revival—looking more like the jobless recoveries after the past two downturns than like the vigorous v-shaped rebounds from the early post-war recessions. Ominous signs are a sharp increase in permanent-job losses and a rise in the number of people out of work for six months or more to 19% of the labour force, near a post-war high.

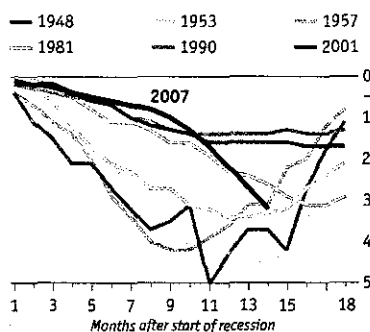
Official forecasts can barely keep up. In its budget in February the Obama administration expected a jobless rate of 8.1% for the year. That figure was reached within the month. Many Wall Street seers think the rate will exceed 10% by 2010 and may surpass the post-1945 peak of 10.8%. Past banking crises indicate an even gloomier prognosis. A study by Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard University suggests that the unemployment rate rose by an average of seven percentage points after other big post-war banking busts. That implies a rate for America of around 12%.

Moreover, the official jobless rate understates the amount of slack by more than in previous downturns. Many companies are cutting hours to reduce costs. At 33.3 hours, the average working week is the shortest since at least 1964. Unpaid leave is becoming more common, and not only at the cyclical manufacturing firms where it is established practice. A recent survey by Watson Wyatt, a firm of consultants, finds that almost one employer in ten intends to shorten the work week in coming months. Compulsory unpaid leave is planned by 6% of firms. Another 9% will have voluntary leave.

Europe's jobs markets look less dire, for now. That is partly because the recession

Compare and contrast

US non-farm employment
Cumulative % decline since start of recession



began later there, partly because joblessness had been unusually low by European standards and partly because Europe's less flexible labour markets react more slowly than America's. The euro area's unemployment rate was 8.2% in January, up from 7.2% a year before. That of the whole European Union was 7.6%, up from 6.8%. For the first time in years American and European jobless rates are roughly in line (see chart 3 on the next page).

Within the EU there are big variations. Ireland and Spain, where construction boomed and then subsided most dramatically, have already seen heavy job losses. Almost 30% of Ireland's job growth in the first half of this decade came from the building trade. Its unemployment rate has almost doubled in the past year. In Britain, another post-property-bubble economy, the rate is also rising markedly. At the end of last year 6.3% of workers were jobless, up from 5.2% the year before. Figures due on March 18th are likely to show unemployment above 2m for the first time in more than a decade.

In continental Europe's biggest economies, the consequences for jobs of shrivelling output are only just becoming visible. Although output in Germany fell at an annualised rate of 7% in the last quarter of 2008, unemployment has been only inching up. The rate is still lower than it was a year ago. Even so, no one doubts the direction in which joblessness is heading. In January the European Commission forecast the EU's jobless rate to rise to 9.5% in 2010. As in America, many private-sector economists expect 10% or more.

Structural changes in Europe's labour markets suggest that jobs will go faster than in previous downturns. Temporary contracts have proliferated in many countries, as a way around the expense and difficulty of firing permanent workers. Much of the reduction in European unemployment earlier this decade was due to the rapid growth of these contracts. Now the process is going into reverse. In Spain, Europe's most extreme example of a "dual"

labour market, all the job loss of the past year has been borne by temps. In France employment on temporary contracts has fallen by a fifth. Permanent jobs have so far been barely touched.

Although the profusion of temporary contracts has brought greater flexibility, it has laid the burden of adjustment disproportionately on the low-skilled, the young and immigrants. The rising share of immigrants in Europe's workforce also makes the likely path of unemployment less certain. As Samuel Bentolila, an economist at CEMFI, a Spanish graduate school, points out, the jump in Spain's jobless rate is not due to fewer jobs alone. Thanks to continued immigration, the labour force is still growing apace. In Britain, in contrast, hundreds of thousands of migrant Polish workers are reckoned to have gone home.

Despite having few immigrants, Japan is also showing the strains of a dual labour market. Indeed, its workforce is more starkly divided than that of any other industrial country. "Regular" workers enjoy strong protection; the floating army of temporary, contract and part-time staff have almost none. Since the 1990s, the "lost decade", firms have relied increasingly on these irregulars, who now account for one-third of all workers, up from 20% in 1990.

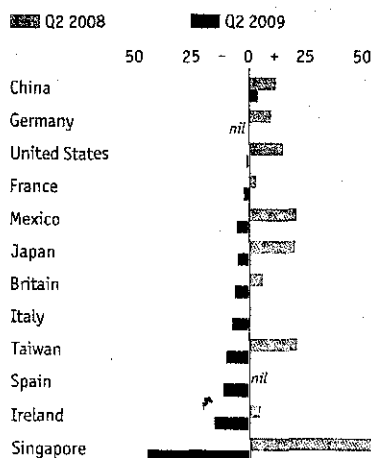
As Japanese industry has collapsed, almost all the jobs shed have been theirs. Most are ineligible for unemployment assistance. A labour-ministry official estimates that a third of the 160,000 who have lost work in recent months have lost their homes as well, sometimes with only a few days' notice. Earlier this year several hundred homeless temporary workers set up a tent village in Hibiya Park in central Tokyo, across from the labour ministry and a few blocks from the Imperial Palace. Worse lies ahead. Overall unemployment, now 4.1%, is widely expected to surpass the post-war peak of 5.8% within the year. In Japan too, some economists talk of double digits.

In emerging economies the scale of the problem is much harder to gauge. Anecdotal evidence abounds of falling employment, particularly in construction, mining and export-oriented manufacturing. But official figures on both job losses and unemployment rates are squishier. Estimates from the International Labour Organisation suggest the number of people unemployed in emerging economies rose by 8m in 2008 to 158m, an overall jobless rate of around 5.9%. In a recent report the ILO projected several scenarios for 2009. Its gloomiest suggested there could be an additional 32m jobless in the emerging world this year. That estimate now seems all too plausible. Millions will return from formal employment to the informal sector and from cities to rural areas. According to the World Bank, another 53m people will be pushed into extreme poverty in 2009.

History implies that high unemployment ▶▶

The jobs crunch

% of employers expecting an increase in hiring activity minus % expecting a decrease



ment is not just an economic problem but also a political tinderbox. Weak labour markets risk fanning xenophobia, particularly in Europe, where this is the first downturn since immigration soared. China's leadership is terrified by the prospect of social unrest from rising joblessness, particularly among the urban elite.

Given these dangers, politicians will not sit still as jobs disappear. Their most important defence is to boost demand. All the main rich economies and most big emerging ones have announced fiscal stimulus packages.

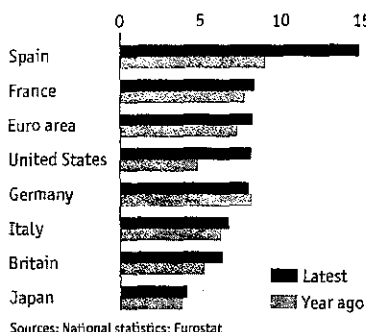
Since most emerging economies lack broad unemployment insurance, the main way they help the jobless is through labour-intensive government infrastructure projects as well as conditional cash transfers for the poorest. China's fiscal boost includes plenty of money for infrastructure; India is accelerating projects worth 0.7% of GDP. However, a few emerging economies have more creative unemployment-insurance schemes than anything in the rich world. In Chile and Colombia formal-sector workers pay into individual unemployment accounts, on which they can draw if they lose their jobs. Many more countries have created prefunded pension systems based on individual accounts. Robert Holzmann of the World Bank thinks people should be allowed to borrow from such accounts while unemployed. Several countries are considering the idea.

In developed countries, governments' past responses to high unemployment have had lasting and sometimes harmful effects. When joblessness rose after the 1970s oil shocks, Europe's governments, pressed by strong trade unions, kept labour markets rigid and tried to cut dole queues by encouraging early retirement. Coupled with generous welfare benefits this resulted in decades of high "structural" unemployment and a huge rise in the share of people without work. In America, where the social safety net was flimsier, there were far fewer regulatory rigidities and people were more willing to move, so workers responded more flexibly to structural shifts. Less than six years after hitting 10.8%, the post-war record, in 1982, America's jobless rate was close to 5%.

Policy in America still leans towards keeping benefits low and markets flexible rather than easing the pain of unemployment. Benefits for the jobless are, if anything, skimpier than in the 1970s. Unemployment insurance is funded jointly by states and the federal government. The states set the eligibility criteria and in many cases have not kept up with changes in the composition of the workforce. In 32 states, for instance, part-time workers are ineligible for benefits. All told, fewer than half of America's unemployed receive assistance. The benefits they get also vary a lot from state to state, but overall are

Sooner or later

Unemployment rates, %, latest



among the lowest in the OECD when compared with the average wage.

America's recent stimulus package strengthened this safety net. Jobless benefits have increased modestly, their maximum duration has been extended, and states have been given a large financial incentive to broaden eligibility. The package also includes temporary subsidies to help pay for laid-off workers' health insurance. Even so, benefits remain meagre.

Housing is a far bigger drag on American job mobility. Almost a fifth of American households with mortgages owe more than their house is worth, and house prices are set to fall further. "Negative equity" can lock in homeowners, making it hard to move to a new job. A recent study suggests that homeowners with negative equity are 50% less mobile than others.

Europe's governments, at least so far, are trying hard to avoid the mistakes of the 1970s and 1980s. As Stefano Scarpetta of the OECD points out, today's policies are designed to keep people working rather than to encourage them to leave the labour force. Several countries, from Spain to Sweden, have temporarily cut social insurance contributions to reduce labour costs.

A broader group including Austria, Denmark, France, Germany, Hungary, Italy and Spain, are encouraging firms to shorten work weeks rather than lay people off, by topping up the pay of workers on short hours. Germany, for instance, has long had a scheme that covers 60% of the gap between shorter hours and a full-time wage for up to six months. The government recently simplified the required paperwork, cut social-insurance contributions for affected workers, and extended the scheme's maximum length to 18 months.

Britain has taken a different tack. Rather than intervening to keep people in their existing jobs, it has focused on deterring long-term joblessness with a package of subsidies to encourage employers to hire, and train, people who have been out of work for more than six months.

Of all rich-country governments, Japan's has flailed the most. Forced to con-

front the ugly reality of its labour market, it is trying a mixture of policies. Last year it proposed tax incentives for companies to turn temps into regular employees—a futile effort when profits are scarce and jobs being slashed. The agriculture ministry suggested sending the jobless to the hinterland to work on farms and fisheries. As Naohiro Yashiro, an economist at the International Christian University in Tokyo, puts it: "Although temporary and part-time workers are everywhere in Japan, they are thought to be a threat to employment practices and—like terrorists—have to be contained."

Recently, a more ambitious strategy has emerged. The government is considering shortening the minimum work period for eligibility to jobless benefits. It is providing newly laid-off workers with six-month loans for housing and living expenses. It is paying small-business owners to allow fired staff to remain in company dorms. It is subsidising the salaries of workers on mandatory leave. It is paying firms for rehiring laid-off staff, and offering grants to anyone willing to start a new business.

Whether these policies will be enough depends on how the downturn progresses. For by and large they are sticking-plasters, applied in the hope that the recession will soon be over and the industrial restructuring that follows will be modest. Subsidising shorter working weeks, for instance, props up demand today, but impedes long-term reordering. The inequities of a dual labour market will become more glaring the higher unemployment rises. Politicians seem to be hoping for the best. Given the speed at which their economies are deteriorating, they would do better to plan for the worst. ■





The G20

Talking-shop-on-Thames

BERLIN, LONDON AND WASHINGTON, DC

Transatlantic tensions suggest that there will be no grand bargain at next month's grand summit

LIKE King Charles II, the Economic Conference is taking an unconscious time to die," lamented *The Economist* in 1933, halfway through an epic—and ultimately fruitless—gathering of world powers in London to prevent the spread of protectionism in the depths of the Depression. That conference lasted more than a month, with the dollar sinking and tempers rising the longer it dragged on.

At least there is no danger of interminable drift when leaders of the Group of 20 gather in London next month to address the worst economic crisis since the 1930s. They have set themselves just one day, April 2nd, to do what their predecessors failed to accomplish in weeks: tackle the crisis and consider ways to remake the rules of finance. This weekend G20 finance ministers and central bank governors attending a preparatory meeting in London may well attempt to limit expectations. More pressingly, they will have to heal an awkward sense of transatlantic disunity that has emerged in the run-up to the meeting.

The tensions were exposed at an assembly of European finance ministers on March 9th and 10th. The ministers responded sharply to a call by Lawrence Summers, the White House economic adviser, for everyone in the G20 to focus on boosting global demand. Such calls were "not to our liking," sniped Jean-Claude

Juncker, Luxembourg's prime minister and the chairman of the meeting. The cause of harmony may not have been helped when Britain's most senior civil servant was quoted as saying the shortage of staff in Barack Obama's two-month-old Treasury was making preparations for the summit "unbelievably difficult". (Tim Geithner, the treasury secretary, disputes that.)

In reality, the tensions appeared more symptomatic of the opening of bargaining than of a disastrous rift. The G20's agenda focuses on three broad areas: sorting out the crisis through fiscal and monetary means and by encouraging banks to lend; medium-term regulatory reforms; and strengthening multilateral bodies such as the IMF so that they can give more help to

crisis-hit developing countries. Everyone has different priorities.

America feels its counterparts are not doing enough to boost demand. It would like them to pledge a fiscal stimulus equal to 2% of global GDP this year and next, and for the IMF to monitor compliance. Some countries would also like the European Central Bank to make better use of its monetary arsenal, as the Federal Reserve and the Bank of England have. America has indeed done a lot to stimulate growth (see table). The IMF, however, notes that taking into account automatic stabilisers, such as welfare payments to the unemployed, Germany's fiscal response is not as far behind America's as it appears. Not only does Germany feel its spending package is big enough, it is pressing for a quick return to balanced budgets when the crisis is over.

Although transatlantic differences have emerged over fiscal policy, they are narrowing over regulation. Germany and France have long battled to persuade America and Britain to regulate hedge funds, which are clustered in the financial centres of New York and London. America is now prepared to countenance regulation of systemically important ones.

Since the G20 leaders first met in November, their deputies have laboured on reforms to the stricken global financial system, in particular through the Financial Stability Forum (FSF), a Basel-based group that met in London this week. These include reforms that would affect bank regulators, supervisors and accounting standard-setters, and cover bankers' pay, derivatives trading and rating agencies. America, chastened by its own regulatory failures, is now more supportive of tougher, co-ordinated global regulatory standards but only to a degree: it is unenthusiastic about uniform standards for ex-▶

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Let's get fiscal

Stimulus packages as % of GDP

	2008	2009	2010	Total*
Canada	0.0	1.5	1.3	2.7
France	0.0	0.7	0.7	1.3
Germany	0.0	1.5	2.0	3.4
India	0.0	0.5	—	0.5
Italy	0.0	0.2	0.1	0.3
Japan	0.4	1.4	0.4	2.2
Britain	0.2	1.4	-0.1	1.5
United States	1.1	2.0	1.8	4.8

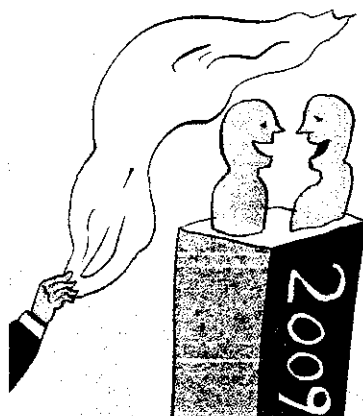
Source: IMF estimates

*Subject to rounding

▶ executive pay pushed by Britain.

In addition, the FSF is expected to propose to the G20 ways to make bank regulation less pro-cyclical, by making forward-looking provisions against bad loans rather than the "incurred-loss" method now in use—though not so that banks can use the provisions to massage earnings (see box). It will suggest incorporating a leverage ratio into bank-capital requirements, to supplement the existing risk-weighting of assets. It is also helping set up cross-border supervisory colleges to share information about 30 global banks.

There is general support for doubling the IMF's resources to \$500 billion, but America would like it to have even more. It is not clear how the increase would be funded. Reserve-rich countries like China could contribute more, as Japan did with a \$100 billion pledge in February. But some fear that strings might be attached to such money, such as less criticism of China's exchange-rate policy. Mr Geithner has proposed the IMF's credit line with 26 rich



member countries be dramatically raised to \$500 billion from \$50 billion.

Some of the trade-offs will be driven by political considerations. French and German voters, for example, lay part of the blame for the crisis on hedge funds and tax havens, even though both played minor roles compared with the highly regulated

banking system. Likewise, Mr Geithner is pressing for higher global capital standards for non-bank financial firms (such as American International Group, a big insurer), in part to reassure taxpayers that this sort of crisis and the accompanying bailouts will not be repeated.

Given the importance of the summit to the reputations of Gordon Brown, its British host, and Mr Obama, on his first overseas trip since taking office, every effort will be made to trumpet such progress. Few expect a 1933-style fiasco, though participants believe that given the tensions exhibited this week, a narrowing of differences is more likely than any "grand bargain" to put the world to rights.

The best that might emerge from the summit is proof that leaders of the world's biggest economies continue to talk to each other. Given the urgency of the situation, and the immense capital that Mr Obama still holds abroad, the world might have hoped for more. Talk, like so much else in this financial crisis, is cheap. ■

Regulating banks

Inadequate

A spat looms over reforming bank capital-adequacy rules

SOMETIMES the only thing people can agree on is a mediocre idea. Ahead of the G20 meeting, some regulators are pushing to introduce dynamic provisioning for banks. Under this system, in boom years banks make provisions against profits which then sit on their balance-sheets as reserves against unspecified potential losses. In the bad years they draw down on these reserves. This smooths banks' profits over the cycle, making their capital positions "counter-cyclical". Supporters point to Spain, which uses this approach and whose lenders are in relatively good nick.

Banks should be encouraged to save more for a rainy day. But the importance of Spain's system has been oversold. Going into the credit crisis, its two big banks had an extra buffer equivalent to about 1.5% of risk-weighted assets. Banks like UBS or Citigroup have had write-offs far beyond this, equivalent to 8-15% of risk-weighted assets. Whether dynamic provisions influenced managers' behaviour is also questionable. Spain's BBVA was run using an economic-capital model that, according to its 2007 annual report, explicitly replaced the generic provision in its income statement with its "best estimate of the real risk incurred".

Accounting standard-setters, meanwhile, are not amused. They support the objective of counter-cyclical capital rules but think dynamic provisioning is a bad

way to achieve this. Why not simply require banks to run with higher capital ratios, rather than go through a circuitous route by smoothing profits, which investors tend to dislike? Accountants worry their standards are being fiddled with needlessly, after a decades-long fight to have them independently set to provide accurate data to investors.

Is there a solution? If anything, the crisis shows that accounting and supervision should be further separated to break the mechanistic link between mark-to-market losses and capital. Investors should get the information they want. Supervisors should make a judgment about the likelihood of losses and set the required capital level accordingly. Warren Buffett, an astute investor, has endorsed this approach.

Sadly, bank supervision is as dysfunctional as the banks. The Basel 2 accords took five years to negotiate. Local regulators interpreted them differently and many failed to enforce them. Confidence in their integrity is now so low that many investors and some banks and regulators have abandoned Basel as their main test of capital. Given this mess, it is easy to see why policymakers might view tweaking accounting standards as an attractive short cut: with some arm-twisting, the rules can be changed quickly and are legally enforceable. But this is a matter where short cuts are not good enough.

China's stimulus

Got a light?

HONG KONG

China's big fiscal package may be starting to work

"ONLY when all contribute their firewood can they build up a strong fire," says a Chinese proverb. With the world economy in its worst crisis in 70 years, every country needs to do its bit to rekindle global demand. The American government, which plans to run a budget deficit of 12% of GDP this year, has called on its Group of 20 partners to do more. Is China one of the misers? Its budget, published last week, showed that it plans to run a deficit of only 3% of GDP. Was the 4 trillion yuan (\$586 billion) infrastructure package unveiled last November, worth 14% of GDP, a sham?

Beijing's stimulus is smaller than the number announced last year, but it is still the biggest in the world. The fact that America is set to run a budget deficit four times the size of China's as a share of GDP does not mean its demand stimulus is bigger; America started this year with a much bigger deficit. America's deficit will increase by more than China's this year, largely because it is suffering a deeper recession which will depress tax revenue. The correct measure of a fiscal stimulus is the change in the budget deficit adjusted for the impact of the economic cycle.

In China, however, even this would understate the true stimulus, because some public-infrastructure investment will be done by state-owned firms or local govern- ▶

Buttonwood

THE BEAR NECESSITIES

The market may have been terrible but investors' odds are improving

HURRICANES, volcanic eruptions and tornadoes have a savage beauty that takes the breath away, even as one laments their destructive power. And bear markets can also be awe-inspiring in their scale and scope.

There has been no hiding place for equity investors. Standard & Poor's points out that all the major bourses are at least 50% below their peaks. Most of them are 60% down. It has been no use buying smaller stocks, or value stocks (those that look cheap in terms of earnings, assets or dividends); all have fallen by a similar amount. Diversification has been a wash-out: stockmarkets have been almost perfectly correlated with each other.

Rob Arnott, the former editor of the *Financial Analysts Journal*, says that the S&P 500's decline in the six months to March 6th was the fastest since 1932. The fall in real terms from the high of 2000 has been exceeded only three times: in 1852-57, 1905-21 and 1929-32.

There are striking similarities between the downturns. Bear phases are generally preceded by great booms: the railroad mania of the mid-19th century, the Roaring Twenties, and the internet bubble. The early 20th-century bear market came after stockmarket valuations reached a new peak, as measured by the cyclically adjusted price-earnings ratio (which averages profits over ten years). In his book *"Irrational Exuberance"*, Robert Shiller of Yale University notes how the era was marked by "a turn-of-the-century optimism associated with expansion talk about a prosperous and high-tech future."

As Charles Kindleberger recounted in his classic book *"Manias, Panics and Crashes"*, the busts tend to be accompanied by great swindles, from Robert Schuyler in the 1850s to Ivar Kreuger in the 1930s. Bernard Madoff looks destined to

be today's swindler-in-chief (see page 71). The result has often been financial reform—the prime examples are the introduction of the Federal Reserve in 1913 and the founding of the Securities and Exchange Commission in 1934.

For investors, bear markets crush the spirit. They are often marked by sharp rallies that seem to indicate the worst is over; the Nikkei 225 Average rose by 37% in 1999, for example, a decade into the Japanese bear market. But it was a false dawn. The Nikkei is now under half its end-1999 level.

The really big bear markets seem to take prices well below levels that investors would consider "cheap" in normal circumstances. In a way, it is a mirror of the "irrational exuberance" that occurred in the late 1990s. In Britain and America the dividend yield is now well above the yield on government bonds, something not seen since the 1950s.

But that has not helped the market at all, nor has the fact that investors can get a dividend income from equities (even allowing for the likelihood of reduced payouts) that is a multiple of the returns available from cash deposits. Return of

capital has become more important than return on capital.

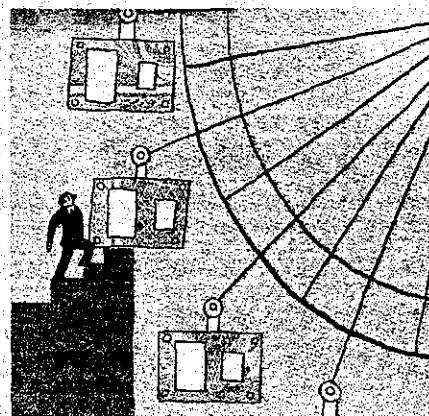
But it is possible for investors to take advantage of bear markets, even if they do not get their timing exactly right. Investors who bought American equities at the end of 1931, well before the market hit the bottom the next year, would have earned an annual real return of 6.9% over the following ten years. That is almost bang on the historic average.

In Britain those who bought equities at the end of 1973 suffered through the three-day week of 1974, inflation of nearly 25% in 1975 and the humiliating bail-out by the IMF in 1976. But they still earned 5.2%, after allowing for inflation, from equities over the next ten years, again in line with historic returns.

Of course, those examples are cherry-picked, in the knowledge that bear markets did come to an end. Still no one knows when the Japanese bear market will be over. In some markets (Russia in 1917, China in 1949) investors have been wiped out completely. However, if you look at the most extreme examples, you might as well give up; all private property rights were damaged by the Russian and Chinese revolutions.

The best way of thinking about market values is in terms of odds. Back in 1999-2000, they were against investors making money in equities over the long term, because of the likelihood that valuations would revert to the mean. Now the odds are more in investors' favour.

Goldman Sachs reckons the American equity market is around 32% below its "fair value" and 58% below its "equilibrium" level, which assumes a return to normal risk appetites. Today's prices might not be rock-bottom, but they do provide a margin of safety for investors who can afford to be patient.



ments and financed by banks. Tao Wang of UBS estimates that new infrastructure investment, tax cuts, consumer subsidies and increased spending on health care will amount to a stimulus by the central government of about 3% of GDP in 2009. Adding in bank-financed infrastructure spending might lift the total to 4% of GDP.

Chinese investment in railways, roads and power grids is already booming. In the first two months of this year, total fixed investment was 30% higher in real terms than a year earlier, and investment in railways tripled. China has been much criticised for focusing its stimulus on invest-

ment, rather than consumption, but in China in the short term this is the quickest way to boost domestic demand.

What about the other tool for boosting domestic spending, namely monetary policy? Since the start of last year, China has cut its interest rates by only half as much as America's Federal Reserve has. New figures showing that consumer prices fell by 1.6% in the year to February have brought the first whiff of deflation, suggesting that China has not done enough to boost demand. But this is not true deflation, where falling prices are accompanied by shrinking money supply and credit.

Bank lending grew by 24% over the past year. The true gauge of monetary easing is not the cut in interest rates, but whether it succeeds in spurring new lending. China is one of the few countries in the world where credit has accelerated since the start of the global credit crunch—though some of the lending is of the state-directed sort.

China has not only accomplished considerable fiscal and monetary easing. By allowing the yuan to rise by 18% in trade-weighted terms over the past 12 months, Beijing is passing on some of that boost to the rest of the world.

The real question is whether China's »

► stimulus is big enough? Exports fell by a sharper-than-expected 26% in the year to February and may yet drop further. The 12-month rate of growth in industrial production also dropped to only 3.8% in the first two months of 2009, and retail-sales growth slowed to 15%. But there are some tentative signs of a recovery in domestic demand. As well as the increases in investment and bank lending, car sales and electricity consumption have picked up. Mingchun Sun of Nomura reckons that the stimulus will be enough to achieve 8% growth this year. But the government has made it clear that if the economy remains feeble, it will supply another fiscal boost.

Such injections may be able to drag growth back to 8% this year, but they cannot keep the economy running at this pace if global demand remains depressed. The need for China to shift the mix of growth from exports to consumption has become more urgent. Chinese officials are right to say that it will take years for higher public spending on health care and a social safety net to reduce household saving—all the more reason to speed up such policies. If not, even China's fire could burn out. ■

Credit markets

Unsavoury spread

The market for corporate bonds is struggling again

TEN years ago Warren Buffett and Jack Welch were among the most admired businessmen in the world. Emerging markets were seen as risky bets, to be avoided by the cautious. But now the credit-default swaps market indicates that Berkshire Hathaway, the conglomerate run by Mr Buffett, is more likely to default on its debt than Vietnam, whereas GE Capital, the finance arm of the group formerly run by Mr Welch, is a worse credit risk than Russia.

The contrast highlights the sorry state of the corporate-bond market. A turn-of-the-year rally was founded on hopes that spreads (the excess of corporate-bond yields over risk-free rates) more than compensated investors for the economic outlook. That has now petered out.

The weakness has been much greater in speculative, or high-yield, bonds than in the investment-grade part of the market. This is hardly surprising. First, economic prospects are so dire that companies already in trouble will have difficulty surviving. Banks are trying to preserve their own capital and do not need to own any more toxic debt. Even if refinancing were available for endangered firms, it would be prohibitively dear. It is only a matter of time



Jack Welch in winning times

before some go under.

Moody's cites 283 companies at greatest risk of default, including well-known outfits like Blockbuster, a video-rental chain, and MGM Mirage, a casino group. A year ago just 157 companies made the list. Standard & Poor's says 35 have defaulted this year, against 12 in the same period in 2008. That translates into a default rate over the past 12 months of just 3.8%.

The rate is likely to increase sharply. Charles Himmelberg, a credit strategist at Goldman Sachs, forecasts that 14% of high-yield bonds will default this year, with the same proportion going phut in 2010. Worse, creditors will get back only about 12.5 cents on the dollar. All told, Goldman thinks the combination of defaults and low recovery rates will cost bondholders 37 cents on the dollar in the next five years.

A second problem for the corporate-bond market is that optimism about the scope for an imminent end to the financial crisis has dissipated. "People have given up hope that the new [Obama] administration will be able to do anything to make things better quickly," says Willem Sels, a credit strategist at Dresdner Kleinwort.

Banks are still the subject of heightened concern. Credit Derivatives Research has devised a counterparty-risk index, based on the cost of insuring against default of 15 large banks; the index is now higher than it was after the collapse of Lehman Brothers. Jeff Rosenberg, head of credit strategy at Bank of America Securities Merrill Lynch, says investors are uncertain about the impact of government intervention in banks. Each successive rescue, from Bear Stearns to Citigroup, has affected different parts of the capital structure in different ways.

A third problem for the high-yield market is that plans for quantitative easing (purchases by the central bank of government and private-sector debt) are focused on investment-grade bonds. As well as reviving the economy, governments are con-

cerned about protecting taxpayers' money, and so will not want to buy bonds at high risk of default. If the government is going to support the investment-grade market, investors have an incentive to steer their portfolios in that direction.

The relative strength of the investment-grade market even permitted the issuance of around \$300 billion of bonds in the first two months of the year, albeit largely for companies in safe industries such as pharmaceuticals. Circumstances suited all the market participants. "Spreads were wide, which attracted investors, but absolute levels of interest rates were low, which suited issuers," says Mr Rosenberg.

Although the Dow Jones Industrial Average jumped by nearly 6% on March 10th, it is hard to see how the equity market can enjoy a sustained rebound while corporate-bond spreads are still widening. Bondholders have a prior claim on a company's assets; if they are not going to be paid in full, then shareholders will not get a look-in. However, credit investors say their market often takes its lead from equities. If each is following the other, that hints at a worrying downward spiral. ■

Global insurance

The next domino?

Insurance firms teeter on the brink

IF BANKS go bang, life insurance firms sputter. That was the theory going into the crisis. Both hold financial assets, like corporate debt, that have incurred losses, but the nature of insurers' liabilities should allow them to ride out short-term volatility. Banks depend on nervy depositors and wholesale lenders. Life insurers typically have low gearing, and the policyholders who fund the bulk of their assets are "sticky", with long-term contracts that incur penalty charges if they are cancelled. As a result regulators and credit-rating agencies promised to avoid knee-jerk reactions to mark-to-market losses. They were further reassured by the shift of insurers in the past decade from equities into supposedly safer credit investments, and their low exposure to the toxic structured-credit assets that blew up many banks.

Yet a year and a half into the financial crisis, this defence looks hollow. America's life insurers are now under siege, as fears mount about the losses on the non-government debt that forms about three-quarters of their assets. The symptoms are all too familiar: the firms' share prices have collapsed (see chart on next page), their credit spreads have opened up and the ►►

Economics focus | A Plan B for global finance

In a guest article, Dani Rodrik argues for stronger national regulation, not the global sort

THE clarion call for a global system of financial regulation can be heard everywhere. From Angela Merkel to Gordon Brown, from Jean-Claude Trichet to Ben Bernanke, from sober economists to countless newspaper editorials; everyone, it seems, is asking for it regardless of political complexion.

That is not surprising, perhaps, in light of the convulsions the world economy is going through. If we have learnt anything from the crisis it is that financial regulation and supervision need to be tightened and their scope broadened. It seems only a small step to the idea that we need much stronger global regulation as well: a global college of regulators, say; a binding code of international conduct; or even an international financial regulator.

Yet the logic of global financial regulation is flawed. The world economy will be far more stable and prosperous with a thin veneer of international co-operation superimposed on strong national regulations than with attempts to construct a bold global regulatory and supervisory framework. The risk we run is that pursuing an ambitious goal will detract us from something that is more desirable and more easily attained.

One problem with the global strategy is that it presumes we can get leading countries to surrender significant sovereignty to international agencies. It is hard to imagine that America's Congress would ever sign off on the kind of intrusive international oversight of domestic lending practices that might have prevented the subprime-mortgage meltdown, let alone avert future crises. Nor is it likely that the IMF will be allowed to turn itself into a true global lender of last resort. The far more likely outcome is that the mismatch between the reach of markets and the scope of governance will prevail, leaving global finance as unsafe as ever. That certainly was the outcome the last time we tried an international college of regulators, in the ill-fated case of the Bank of Credit and Commerce International.

A second problem is that even if the leading nations were to agree, they might end up converging on the wrong set of regulations. This is not just a hypothetical possibility. The Basel process, viewed until recently as the apogee of international financial co-operation, has been compromised by the inadequacies of the bank-capital agreements it has produced. Basel 1 ended up encouraging risky short-term borrowing, whereas Basel 2's reliance on credit ratings and banks' own models to generate risk weights for capital requirements is clearly inappropriate in light of recent experience. By neglecting the macro-prudential aspect of regulation—the possibility that individual banks may appear sound while the system as a whole is unsafe—these agreements have, if anything, magnified systemic risks. Given the risk of converging on the wrong solutions yet again, it would be better to let a variety of regulatory models flourish.

Who says one size fits all?

But the most fundamental objection to global regulation lies elsewhere. Desirable forms of financial regulation differ across countries depending on their preferences and levels of development. Financial regulation entails trade-offs along many dimensions. The more you value financial stability, the more you have to sacrifice financial innovation. The more fine-tuned and complex the regulation, the more you need skilled regulators to implement it. The more widespread the financial-market failures, the larger the



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potential role of directed credit and state banks.

Different nations will want to sit on different points along their "efficient frontiers". There is nothing wrong with France, say, wanting to purchase more financial stability than America—and having tighter regulations—at the price of giving up some financial innovations. Nor with Brazil giving its state-owned development bank special regulatory treatment, if the country wishes, so that it can fill in for missing long-term credit markets.

In short, global financial regulation is neither feasible, nor prudent, nor desirable. What finance needs instead are some sensible traffic rules that will allow nations (and in some cases regions) to

implement their own regulations while preventing adverse spillovers. If you want an analogy, think of a General Agreement on Tariffs and Trade for world finance rather than a World Trade Organisation. The genius of the GATT regime was that it left room for governments to craft their own social and economic policies as long as they did not follow blatantly protectionist policies and did not discriminate among their trade partners.

Fortify the home front first

Similarly, a new financial order can be constructed on the back of a minimal set of international guidelines. The new arrangements would certainly involve an improved IMF with better representation and increased resources. It might also require an international financial charter with limited aims, focused on financial transparency, consultation among national regulators, and limits on jurisdictions (such as offshore centres) that export financial instability. But the responsibility for regulating leverage, setting capital standards, and supervising financial markets would rest squarely at the national level. Domestic regulators and supervisors would no longer hide behind international codes. Just as an exporter of widgets has to abide by product-safety standards in all its markets, global financial firms would have to comply with regulatory requirements that may differ across host countries.

The main challenge facing such a regime would be the incentive for regulatory arbitrage. So the rules would recognise governments' right to intervene in cross-border financial transactions—but only in so far as the intent is to prevent competition from less-strict jurisdictions from undermining domestic regulations.

Of course, like-minded countries that want to go into deeper financial integration and harmonise their regulations would be free to do so, provided (as in the GATT) they do not use this as an excuse for financial protectionism. One can imagine the euro zone eventually taking this route and opting for a common regulator. The Chiang Mai initiative in Asia may ultimately also produce a regional zone of deep integration around an Asian monetary fund. But the rest of the world would have to live with a certain amount of financial segmentation—the necessary counterpart to regulatory fragmentation.

If this leaves you worried, turn again to the Bretton Woods experience. Despite limited liberalisation, that system produced huge increases in cross-border trade and investment. The reason is simple and remains relevant as ever: an architecture that respects national diversity does more to advance the cause of globalisation than ambitious plans that assume it away. ■

For a discussion of this article, see Economist.com/freexchange

How China sees the world

And how the world should see China



IT IS an ill wind that blows no one any good. For many in China even the buffeting by the gale that has hit the global economy has a bracing message. The rise of China over the past three decades has been astonishing. But it has lacked the one feature it needed fully to satisfy the ultranationalist fringe: an accompanying decline of the West. Now capitalism is in a funk in its heartlands. Europe and Japan, embroiled in the deepest post-war recession, are barely worth consideration as rivals. America, the superpower, has passed its peak. Although in public China's leaders eschew triumphalism, there is a sense in Beijing that the reassertion of the Middle Kingdom's global ascendancy is at hand (see pages 25-28).

China's prime minister, Wen Jiabao, no longer sticks to the script that China is a humble player in world affairs that wants to focus on its own economic development. He talks of China as a "great power" and worries about America's profligate spending endangering his \$1 trillion nest egg there. Incautious remarks by the new American treasury secretary about China manipulating its currency were dismissed as ridiculous; a duly penitent Hillary Clinton was welcomed in Beijing, but as an equal. This month saw an apparent attempt to engineer a low-level naval confrontation with an American spy ship in the South China Sea. Yet at least the Americans get noticed. Europe, that speck on the horizon, is ignored: an EU summit was cancelled and France is still blacklisted because Nicolas Sarkozy dared to meet the Dalai Lama.

Already a big idea has spread far beyond China: that geopolitics is now a bipolar affair, with America and China the only two that matter. Thus in London next month the real business will not be the G20 meeting but the "G2" summit between Presidents Barack Obama and Hu Jintao. This not only worries the Europeans, who, having got rid of George Bush's unipolar politics, have no wish to see it replaced by a Pacific duopoly, and the Japanese, who have long been paranoid about their rivals in Asia. It also seems to be having an effect in Washington, where Congress's fascination with America's nearest rival risks acquiring a protectionist edge.

Reds under the bed

Before panic spreads, it is worth noting that China's new assertiveness reflects weakness as well as strength. This remains a poor country facing, in Mr Wen's words, its most difficult year of the new century. The latest wild guess at how many jobs have already been lost—20m—hints at the scale of the problem. The World Bank has cut its forecast for China's growth this year to 6.5%. That is robust compared with almost anywhere else, but to many Chinese, used to double-digit rates, it will feel like a recession. Already there are tens of thousands of protests each year: from those robbed of their land for development; from laid-off workers; from those suffering the side-effects of environmental despoliation. Even if China magically achieves its official 8% target, the grievances will worsen.

Far from oozing self-confidence, China is witnessing a fierce debate both about its economic system and the sort of great power it wants to be—and it is a debate the government does not like. This year the regime curtailed even the perfunctory annual meeting of its parliament, the National People's Congress (NPC), preferring to confine discussion to back-rooms and obscure internet forums. Liberals calling for greater openness are being dealt with in the time-honoured repressive fashion. But China's leaders also face rumblings of discontent from leftist nationalists, who see the downturn as a chance to halt market-oriented reforms at home, and for China to assert itself more stridently abroad. An angry China can veer into xenophobia, but not all the nationalist left's causes are so dangerous: one is for the better public services and social-safety net the country sorely needs.

So China is in a more precarious situation than many Westerners think. The world is not bipolar and may never become so. The EU, for all its faults, is the world's biggest economy. India's population will overtake China's. But that does not obscure the fact that China's relative power is plainly growing—and both the West and China itself need to adjust to this.

For Mr Obama, this means pulling off a difficult balancing act. In the longer term, if he has not managed to seduce China (and for that matter India and Brazil) more firmly into the liberal multilateral system by the time he leaves office, then historians may judge him a failure. In the short term he needs to hold China to its promises and to scold it for its lapses: Mrs Clinton should have taken it to task over Tibet and human rights when she was there. The Bush administration made much of the idea of welcoming China as a "responsible stakeholder" in the international system. The G20 is a chance to give China a bigger stake in global decision-making than was available in the small clubs of the G7 and G8. But it is also a chance for China to show it can exercise its new influence responsibly.

The bill for the great Chinese takeaway

China's record as a citizen of the world is strikingly threadbare. On a host of issues from Iran to Sudan, it has used its main geopolitical asset, its permanent seat on the United Nations Security Council, to obstruct progress, hiding behind the excuse that it does not want to intervene in other countries' affairs. That, sadly, will take time to change. But on the more immediate issue at hand, the world economy, there is room for action.

Over the past quarter-century no country has gained more from globalisation than China. Hundreds of millions of its people have been dragged out of subsistence into the middle class. China has been a grumpy taker in this process. It helped derail the latest round of world trade talks. The G20 meeting offers it a chance to show a change of heart. In particular, it is being asked to bolster the IMF's resources so that the fund can rescue crisis-hit countries in places like eastern Europe. Some in Beijing would prefer to ignore the IMF, since it might help ex-communist countries that have developed "an anti-China mentality". Rising above such cavilling and paying up would be a small step in itself. But it would be a sign that the Middle Kingdom has understood what it is to be a great power. ■



A time for muscle-flexing

As Western economies flounder, China sees a chance to assert itself—carefully

THE room is stuffy on a sunny spring afternoon, and many of those packed into it (see above) must have regretted bringing their coats. The lucky ones have taken the few seats available. The rest are crammed shoulder-to-shoulder in this hotel-room office, listening intently to an hour-and-a-half rant on the threat of American imperialism and how the global economic crisis will result in growing confrontation between China and the West.

Sitting in front of a large portrait of a young Mao Zedong, Zhang Hongliang knows how to play to his nationalist, liberal-despising audience. His rambling discourse ranges from adulation of Mao to scorn of America (it has neither history nor culture), to warning of a “white terror” if rightists (liberals) prevail. The economic crisis is entirely the West’s fault, and as it deepens the West will turn on China. Now is the time to build an aircraft-carrier. A war with America would be “lose-lose”, but China should not be afraid of it.

China’s “leftists” are becoming more active as the global economy sputters. Mr Zhang belongs to an extreme fringe that pines for Maoist egalitarianism, state ownership and the certainty that America is an enemy. His seminar was organised by Maoflag, one of a clutch of like-minded websites in China whose nationalist, pro-

communist rhetoric is suffused with a sense of their country as victim, yearning for revenge. Frequenters of these forums took heart from a flurry of spontaneous celebrations around the country in December to mark Mao’s 115th birthday. The government preferred to play it down.

Few would suggest that radical Maoists are poised to make a comeback. But their nationalism has a broad appeal. As China surveys the world, with the West in financial turmoil and its leaders seemingly desperate for cash-rich China to come to its aid, it sees strategic opportunities. Even before the financial crisis began to hit the country late last year, nationalism had been boiling up. It was evident in public responses to the turmoil in Tibet in March, the West’s support for the Dalai Lama, and China’s sporting triumph at the Olympic games in Beijing in August. Now a battered West presents a gratifying target for pent-up contempt. Even the normally cautious government is beginning to flex a little muscle on the world stage.

For most of the past two decades (flare-ups with Taiwan in 1995-96 and with America in 2001 excepted) China has played a cautious game internationally. Its approach was summed up in the pithy four-character phrases into which Chinese policymakers love to distil their thinking.

The late Deng Xiaoping came up with a string of them: China should keep a low profile, not take the lead, watch developments patiently and keep its capabilities hidden. Now the global economic crisis and the West’s obvious weakness are causing officials to think again.

In public Chinese leaders still try to reassure. During a visit to Europe in late January and early February, China’s prime minister, Wen Jiabao, stressed that China’s development was no threat to anyone. It would be, he said at Cambridge University (an event better remembered for the shoe lobbed in his direction by a protesting German student) a peaceful and co-operative great power. Some sensitive Western diplomats pricked up their ears at the phrase “great power”, but it is one Mr Wen has used to describe China since well before the current crisis. In deference to foreign feelings, an English text released by the government news agency, Xinhua, used the word “country” instead.

On the issue of Tibet, however, China has been digging in its heels. Having conceded a little to Western opinion last year by holding three rounds of talks with representatives of the Dalai Lama in the wake of the unrest in March, China has lost interest. A massive security clampdown has been imposed on the Tibetan plateau to prevent any protests during this month’s 50th anniversary of the uprising that caused the Dalai Lama to flee into exile in India. Foreign journalists (despite pleas for access) have been shut out altogether.

In late February China gave a warm welcome to America’s secretary of state, Hillary Clinton. It had reason to feel proud. Here was an important American official ►►

clearly looking for China's help. Mrs Clinton—who once boasted how strongly she had emphasised human rights during a visit to Beijing in 1995—was now suggesting that China's bad record should not get in the way of co-operation on the financial crisis and global warming. Mr Zhang at the Maoflag seminar certainly enjoyed her new, soft tone.

Two weeks after Mrs Clinton's departure, Chinese boats (according to the Pentagon) harassed an unarmed American ship, the *Impeccable*, in the South China Sea. The ship was a mere 75 miles (120km) off China's coast and was probably on the lookout for Chinese submarines. But much as China objects, the American navy frequently deploys in international waters off China to monitor military activities. In this case Chinese responded more aggressively than usual, surrounding the American ship and trying to stop it from withdrawing. America later sent a guided-missile destroyer to protect the *Impeccable*.

A cautious poke

China clearly does not want to push this too far, mindful perhaps of the huge crisis in relations that occurred in 2001 when a Chinese fighter jet crashed into an American spyplane, forcing it to land at a Chinese airbase. The American crew was held for 11 days. This time China's response was to send a fishery patrol ship (hardly a match for a destroyer) to the area. But Shi Yinhong of Renmin University says the latest incident is a sign of new robustness in China's dealing with the West.

Though China may be unwilling to give America more than a cautious poke, it is a different story with Europe. Its abrupt decision to cancel a summit with the European Union scheduled for last December showed that, even amid the global crisis, it was prepared to deliver a powerful snub to leaders of its biggest trading partner. The reason was a meeting between France's president, Nicolas Sarkozy, and the Dalai Lama (France then held the EU presidency). The EU and China have agreed to re-schedule their summit for later this year, but Mr Sarkozy is not yet forgiven. Wen Jiabao, the prime minister, avoided France during his recent European tour. "I looked at a map of Europe on the plane. My trip goes around France," he said.

Deng's advice on avoiding taking the lead has by no means been jettisoned. China has reacted coolly to suggestions that a solution to the world's economic problems lies essentially in the hands of two powers, China and America—what some call the G2. Fred Bergsten, of the Peterson Institute for International Economics, raised the idea in an article in *Foreign Affairs* last July. China, he argued, was continuing to act "like a small country with little impact on the global system at large and therefore little responsibility for it". Even

well before the current crisis, China had been posing an increasing challenge to international rules and institutions, Mr Bergsten said: blocking progress in the Doha round of global trade talks, aiding foreign countries without regard to human rights or the environment and resisting adoption of a flexible exchange-rate policy. Better, he suggested, that China and America work together as a G2 "to provide joint leadership of the global economic system".

The head of the World Bank, Robert Zoellick, and its chief economist, Justin Yifu Lin, warmed to the G2 idea in an article in the *Washington Post* on March 6th. Though they did not repeat Mr Bergsten's criticism of Chinese "recalcitrance", they said that "without a strong G2, the G20 will disappoint". But some Chinese officials see a trap. *Liaowang*, a magazine published by Xinhua, said Chinese scholars believed the idea "would do harm rather than good". America would never cede control of the world order, and in any case China would never seek to exert hegemony.

China certainly delights in the notion that its global power is growing. As one Western diplomat put it, the meeting between President Barack Obama and his Chinese counterpart, Hu Jintao, in the margins of the G20 summit in London on April 2nd will be far more important than the G20 meeting itself. China stole the limelight at the last G20 summit by announcing a 4 trillion yuan (\$665 billion) stimulus package just before it. Rumours continue to circulate that it has another up its sleeve. That would please everyone.

But China is not (yet, anyway) seeking to knock America off its perch. It is pushing for a greater say for itself and other developing countries in the IMF, over which the Americans, in effect, wield a veto. But it is not demanding a veto of its own. At a press conference on March 13th Mr Wen avoided saying whether China would give more funding to the IMF to strengthen its ability

to deal with the financial crisis. How much China gives, diplomats believe, will depend on how much of a say it gets. An article in the official *China Daily* newspaper on March 17th quoted an influential Chinese economist, Yu Yongding, as saying China should not give much to the IMF—not least because certain countries on the IMF's rescue list, particularly some from Europe, had an "anti-China mentality".

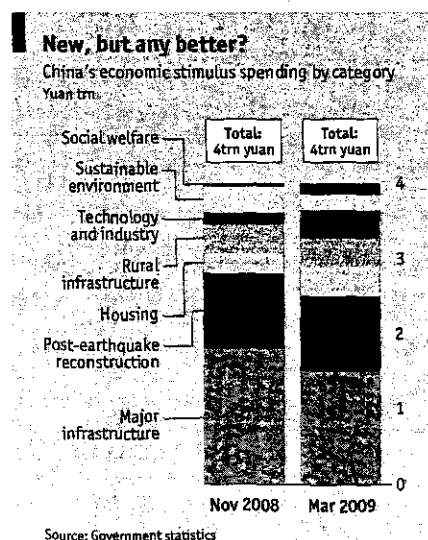
Buying into America

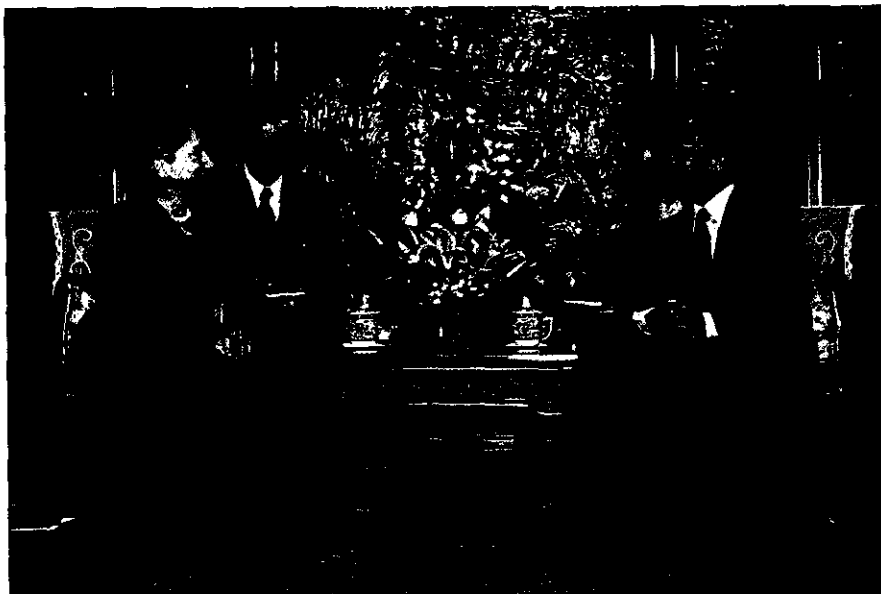
Some Chinese scholars and commentators have been circulating more radical visions of how China should use the current crisis to boost its strategic influence. A recent article in *Economic Reference*, a journal published by a government think-tank, said the crisis would severely weaken the economic, political, military and diplomatic power of developed countries. This would create an "historic opportunity" for China to strengthen its position. China should export capital to South-East Asian countries to strengthen their economies. By so doing, it would help prevent political turmoil and win strategic influence in the region.

In America, the article suggested, China should buy up businesses in order to acquire sophisticated know-how. If the American government balks at this, "the Chinese government absolutely can use its American dollar savings as a bargaining chip to force the American government to agree to China's acquisitions." Diplomats say threats have even been heard from lower-ranking Chinese officials that China might sell off American Treasury bills if Washington angers China on Tibet; a meeting between Mr Obama and the Dalai Lama, for example, could be a tripwire. Few believe that China would actually risk such a self-damaging tactic, but the airing of views like this suggests that some officials are acquiring more swagger. China's decision on March 18th to use anti-monopoly legislation to block Coca-Cola's \$2.4 billion bid for Huiyuan, a Chinese juice manufacturer, will be seen as evidence of this by some in America (see page 60).

This self-assurance was on show, too, during a visit to Latin America by Vice-President Xi Jinping in February. During a meeting in Mexico with overseas Chinese, Mr Xi, who is widely believed to be the heir-apparent to President Hu Jintao, accused "well-fed foreigners with nothing better to do" of "pointing fingers" at China. His country, Mr Xi said, was not exporting revolution or poverty or hunger or "messing around" with other countries, "so what else is there to say?" Mr Xi's more diplomatic colleagues thought this was an outburst too far; though nationalist websites exulted, the domestic media were banned from reporting his comments.

Chinese leaders have been at particular pains to avoid giving the impression that China is wavering in its commitment to





Hillary and Wen, great powers co-operating

► market capitalism (albeit with a heavy admixture of government control). But China's own economy is being battered by the turmoil. Officials estimate that some 20m migrant workers have lost their jobs as labour-intensive industries, churning out cheap products for export, put up their shutters. White-collar workers are beginning to suffer, too. Some are being laid off and many more having their bonuses and wages cut. China's leaders still say the country can achieve 8% growth this year, down from 9% last year; the World Bank, forecasting growth of only 6.5%, still notes that China is "a relative bright spot in an otherwise gloomy global economy". But the boom times are definitely over.

Adam Smith's disciples

Throughout the crisis China's leaders have railed against the dangers of protectionism, knowing that trade with the West is vital. Much to the chagrin of China's online leftists, Mr Wen has repeatedly sung the praises of Adam Smith in speeches and meetings with journalists. In London he revealed to the *Financial Times* that he was carrying Smith's "The Theory of Moral Sentiments" in his suitcase.

As Mr Wen explains it, an important message of this book is that if the fruits of economic development are not shared by all, that is "morally unsound", as well as a threat to social stability. This view resonates powerfully among the many Chinese who are embittered by the very uneven distribution of the fruits of China's own rapid growth. Chinese leaders may be able to score points at home for standing up to their Western counterparts. But they know they are vulnerable to criticism that they are not doing enough to help Chinese victims of the economic slowdown. By emphasising this aspect of Smith's philos-

ophy, Mr Wen is trying to show he cares.

The government, however, does not want China to be roiled by the same debate that is plaguing Western governments over how to handle the crisis. This month's annual session of the National People's Congress, China's parliament, was convened for only nine days instead of the usual two weeks. Although even the official media wanted more details of spending plans, the government-set agenda was strikingly sparse. The parliamentary chairman, Wu Bangguo, used the occasion to launch a lengthy tirade against Western-style democracy. "Leadership by the Party can only be strengthened and in no way weakened," he told the delegates. For Mr Wu to get so worked up, serious voices must have been suggesting otherwise.

But few new details of the stimulus measures were revealed at the congress. The government airily said that details of a separate massive spending programme on health-care reform (850 billion yuan over three years) would be finalised only after the parliamentary session. In a cursory nod to public concern, it revealed that spending on welfare projects would be increased from 1% to 4% of the stimulus package (see chart). Spending on infrastructure would drop from 45% to 38%. But spending on environmental projects would also be cut from 9% to 5%. China's commitment to greenness appears to be ebbing.

The left does have some cause for celebration. State-owned enterprises (SOEs) will be huge beneficiaries of the stimulus spending (Maoflag's supporters are still in uproar about the dismantling of many of China's SOEs a decade ago). But liberal economists in China fret that state-owned banks and their SOE cronies will carve up the spoils, leaving small and medium private enterprises by the wayside. They also

worry that reforms may stall.

The China Institute for Reform and Development, a prominent liberal think-tank, has just published a 171-page report entitled "The International Financial Crisis Challenges Reforms in China". It describes the economic crisis as the biggest problem the country has faced in the 30-year history of its reform-and-opening policy (and it has faced some big ones, not least the Tiananmen protests of 1989, the Asian financial crisis of 1997-98 and the SOE restructuring which threw millions out of work).

The report says that, without further market-oriented reforms, the stimulus package will not only fail to achieve its goal but will also store up long-term problems. In need of change, it says, are government controls on prices of water and power and government monopolies in industries such as telecoms, railways and aviation. It calls for faster financial reforms such as encouraging the development of non-state financial institutions, freeing controls on interest rates and allowing the yuan to float.

On March 13th, at the end of the parliamentary session, Mr Wen said that to counter the crisis China "would rather speed up reforms". He said it should "give full play to market forces in allocating resources" and encourage the development of the private sector. It must also, he said, carry on with political reforms in order to "guarantee people's freedom and rights". But the economic crisis will not have increased officials' appetite for change. Many will be all the more convinced that the government's big role in the economy (not least its ownership of the banks) and the country's one-party system (where else could a government announce such big spending plans without time-wasting debate?) are a help, not a hindrance.

It is more likely that, as the crisis deepens, the government will become increasingly cautious in its approach to domestic policy. But if protectionism grows in Western countries, Chinese nationalists will be all the more inclined to demand that their government stand up to them. A book published in China this month, "Unhappy China" (with an initial print-run of 70,000, says a publicist), aims to tap into what the authors believe is a widespread public feeling of disgruntlement with the West. One of the essays argues that the financial crisis could result in an envious West going to war with China to keep it down.

Few are quite that gloomy. One of the book's authors (speaking in a branch of Starbucks in a luxury mall) says the government worries about books like this because they fuel suspicions in the West that China is a threat. The publishers removed one part about India's annexation of Sikkim in 1975 because they thought it might upset India. China would like to be number one, but it would still rather get there without making big enemies. ■

Face value | Cheap, but not nasty

In AirAsia, Tony Fernandes has created an airline in his own image



IN 1976 Tony Fernandes, aged 12, found himself being put on a plane to London from Kuala Lumpur by his father, who wanted his son to become a doctor and had enrolled him at a fancy boarding school associated with the medical profession. Mr Fernandes did not become a doctor. Instead, his father's decision to send him to school in London ended up shaping his career in a rather different and unexpected way. When his pleas to be allowed home at half-term were rejected because of the cost of the flight, the young Mr Fernandes opted for what seemed like the next best thing: hanging out at Heathrow airport at weekends, planespotting. Unlike most boys of his age, Tony was not very interested in becoming a pilot. Inspired by Freddie Laker's heroic efforts to launch his SkyTrain service to America, Mr Fernandes decided that what he really wanted was his own low-cost airline.

This month AirAsia x, the long-haul sister of AirAsia, the airline acquired by Mr Fernandes in 2001, began a five-day-a-week service from Kuala Lumpur to London, with an average ticket price of £179 (\$250). AirAsia x's first plane, an Airbus A330, was christened "Semangat Sir Freddie" (Spirit of Sir Freddie)—both a tribute to a fellow aviation entrepreneur and a reminder that few budget long-haul airlines have survived for very long.

Mr Fernandes has finally achieved his boyhood dream, albeit by an unusual route. After graduating from the London School of Economics with a degree in accounting, he spent 14 years in the music business, working first for Richard Branson's Virgin Records and then running Warner Music in his native Malaysia. Deeply apprehensive about the merger between Time Warner and AOL in 2001, Mr Fernandes left Warner Music soon after the disastrous deal was finalised, cashing in his shares just in time. Returning to London, he happened to see a television interview with Stelios Haji-Ioannou, the founder of easyJet. The next morning he took himself off to easyJet's base at Luton airport to see, at first hand, how the no-frills airline operated. The next day he returned with a video camera. If easyJet could make money flying people from Luton to Barcelona for £8, he asked himself, could he transplant the same model to Malaysia?

Already Mr Fernandes was thinking about applying the low-cost approach to long-haul—he even went to see GE Capital, to ask if he could lease a Boeing 747. But on the advice of Conor Mc-

Carthy, a hard-nosed former head of operations at Ryanair, he agreed to start with a short-haul business. To that end, he approached Malaysia's then prime minister, Mahathir Mohamad, in June 2001 to see whether he would get official backing for his plan to challenge Malaysia Airlines's local monopoly. The canny Mr Mahathir said that he would grant his blessing, but on condition that Mr Fernandes took over an existing airline: AirAsia, a struggling subsidiary of a government-owned conglomerate.

AirAsia had a couple of elderly Boeing 737s, 40m ringgit (\$11m) of debt and not much else. Mr Mahathir told Mr Fernandes he could have it for one ringgit. The deal was signed just three days before the world's airline industry was convulsed by the events of September 11th. By putting in the money from his Time Warner shares, remortgaging his home and bringing in a handful of outside investors, including Mr McCarthy, Mr Fernandes scraped together just enough working capital to run the business, but only if it could be made profitable from the first day.

There was no shortage of sceptics. Not only did it seem to be a terrible time to be starting out, but it was also widely assumed that the low-cost model would not work in Asia, where customers expect high levels of service. Mr Fernandes, however, reckoned that Asia would be spared the worst of the downturn and that he could take advantage of good deals on aircraft that other airlines no longer wanted. He was also convinced that the offer of ticket prices 50% below those of his rivals would speak for itself.

So it proved. In its first full year of operation, AirAsia carried just over a million passengers. This year, with its associate airlines in Thailand and Indonesia, it expects to fly 22m passengers (or "guests", as Mr Fernandes calls them). The number of destinations it serves has risen from six to 110. With a nearly all-Airbus fleet of 80 aircraft and 175 more A320s on order, AirAsia has become one of the European planemaker's best customers. AirAsia x, in which Mr Fernandes's old boss, Mr Branson, has a 20% stake, wants 25 of the new A350s to add to the handful of A330s and the (London-bound) A340 it already operates. As well as the new London route, it flies to Australia, China and India. Unlike other long-haul budget operators that have crashed and burned, AirAsia x has the advantage of economies of scale with its short-haul sister airline, which also acts as a regional feeder network.

Doing it differently

AirAsia has been profitable for all but the second half of 2008, when Mr Fernandes decided to unwind fuel hedges before most other airlines took the plunge. After taking an initial hit, AirAsia is now getting the full benefit of oil at \$40 a barrel while some rivals are still paying \$100. That decision is typical of Mr Fernandes's willingness to break ranks. When other airlines slashed advertising during the SARS scare in 2003, AirAsia tripled its spending.

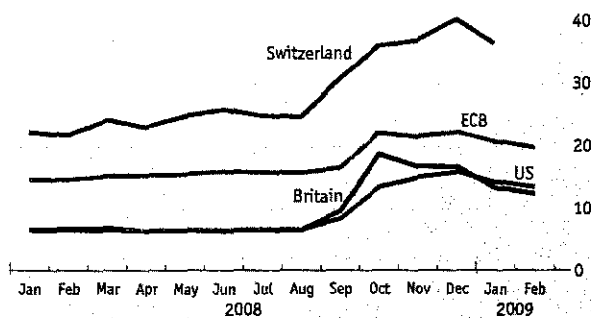
Mr Fernandes says that he came to the industry with no preconceptions, but found it rigidly compartmentalised and dysfunctional. He wanted AirAsia to reflect his own unstuffy, open and cheerful personality. He is rarely seen without his baseball cap, open-neck shirt and jeans, and he is proud that the firm's lack of hierarchy (very unusual in Asia) means anyone can rise to do anyone else's job. AirAsia employs pilots who started out as baggage handlers and stewards; for his part, Mr Fernandes also practises what he preaches. Every month he spends a day as a baggage handler; every two months, a day as cabin crew; every three months, a day as a check-in clerk. He has even established a "culture department" to "pass the message and hold parties". ■

Economics focus | Money's muddled message

Today's fattened central-bank balance-sheets evoke fears of inflation. Deflation is the bigger worry

Extra-strong mints

Central-bank assets, % of GDP



Source: UBS

BACK in 2002 Ben Bernanke, then still a Federal Reserve governor, declared that "under a paper-money system, a determined government can always generate higher spending and hence positive inflation." That does not mean it is easy.

On March 18th America's inflation rate was reported at 0.2%, year on year, in February. The same day the Fed said "inflation could persist for a time" at uncomfortably low levels. Yet some economists and investors insist high inflation, even hyperinflation, is lurking in the wings. They have two sources of concern. The first is motive: the world is deleveraging, ie, trying to reduce the ratio of its debts to income. Policymakers might secretly prefer to do that through higher inflation, which lifts nominal incomes, than through the painful processes of cutting spending and retiring debt, or default. The second is captured by the Fed's announcement that it plans to purchase \$300 billion in Treasury bonds and an additional \$850 billion of mortgage-related debt, bringing such purchases to \$1.75 trillion in total, all paid for by printing money. It is not alone: around the world, central-bank balance-sheets have ballooned (see chart).

This is scary stuff to those who swear by Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon." But the role of the money supply in creating inflation is less obvious than monetarism suggests.

The quantity theory of money holds that the money supply, multiplied by the rate at which it circulates (called velocity), equals nominal income. Nominal income in turn is the product of real output and prices. But does money supply directly boost nominal income, or does nominal income affect velocity and the demand for money? The mechanism is murky.

Central banks control the narrowest measure of the money supply, called the monetary base—typically, currency plus the reserves that commercial banks hold with the central bank. But the relationships between the monetary base, broader monetary aggregates and nominal income is highly unstable.

Central banks have mostly given up trying to target inflation via the money supply. Instead, they study the "output gap" between total demand and the economy's potential to supply goods and services, determined by such things as the labour force and capital stock, as well as inflation expectations. When demand exceeds supply, inflation rises. When it falls short, inflation falls, and in the extreme becomes deflation. To influence demand, the central banks move a short-term interest rate up or

down by adjusting the supply of bank reserves. Changes in the policy rate ripple out to all interest rates paid by borrowers.

The financial crisis has bunged up that transmission mechanism. Risk aversion, fear of default and depleted bank capital have caused private borrowing rates to deviate sharply from policy rates. Central banks have responded by expanding loans to financial institutions, purchasing private securities and buying government debt. They have financed this growth in their assets through increased liabilities such as commercial-bank reserves, swaps with central banks and other ways of printing money.

Is this monetarism? It depends on whom you ask. The Fed calls its policy "credit easing" to emphasise that, though its policy rate is almost zero, it is using different channels to ease credit and boost spending. Even its Treasury purchases are to "improve conditions in private credit markets". That these actions expand the money supply is secondary. Similarly, the Bank of Japan is buying stocks and may make subordinated loans to banks to boost their capital and lending capacity; the money supply is not a consideration. The Bank of England, on the other hand, calls its purchases of government and private debt "quantitative easing" and explains it in monetarist terms. It expands investors' holdings of money, encouraging them to shift to other assets, boosting wealth and investment. It acknowledges this may not work. Indeed, merely the news that it would purchase government debt drove down long-term interest rates, just as the Fed's announcement did, an entirely conventional stimulus to demand. The rhetoric may be different but the policies are largely the same.

If the unprecedented monetary and fiscal stimulus works, output gaps will eventually close. Then central banks will have to reverse their unconventional policies and raise interest rates. They may hesitate in the face of political pressure or an explicit decision to err on the side of inflation rather than deflation. In that case, inflation will rise.

Go forth and multiply

But for the moment deflation is a bigger threat. If the Fed's current policies fail, fiscal policy can be employed to boost demand. There, too, the Fed has a role: it could buy the bonds needed to finance tax cuts or government spending, thereby limiting the impact on long-term rates. Such debt monetisation evokes fears of hyperinflation. But inflation would result only if monetisation boosted aggregate demand enough to exceed aggregate supply. Laurence Meyer of Macroeconomic Advisers, a consultancy, reckons America's output gap will reach 9% of GDP by next year. To eliminate that he says the Fed would have to monetise more than \$1 trillion of additional stimulus over two years, assuming standard multiplier effects.

The obstacles are primarily political, not economic. Finance ministers are averse to debt and central banks even more so to monetising it for fear of becoming a tool of the government. That aversion is usually healthy but not when deflation looms. The option should be on the table, as long as there are safeguards for the Fed's independence. Frederic Mishkin, a former Fed governor now at Columbia University, says the important thing is that the Fed, not the Treasury, be the initiator of such purchases, and only after stating that it is consistent with price stability.

On March 15th Mr Bernanke said that the biggest risk facing the economy now is that "we don't have the political will, we don't have the commitment to solve this problem." At least for the moment, it is not the Fed chief's gumption that is lacking. ■

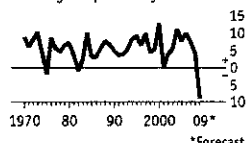
The G20 summit

London calling

Trade is collapsing and protectionism is on the rise. Time for the G20 to get going

World trade

% change on previous year



row over how to run the IMF. And spare us a tirade against "market fundamentalism".

The second task is to do something useful. Ideally, the G20 would boost government spending, partly by giving the IMF more money. And it would take five minutes to shunt the re-regulation of finance into groups that can deliberate now and act later, when there is more time and less ire: the last thing to fear from Wall Street today is irrational exuberance.

It is the third task that is being neglected. Publicly, the G20's leaders would be shocked, *shocked* if anyone were to turn against open markets. Even so, trade is collapsing and an insidious protectionism is on the rise (see page 65). As the storm rages, the London summit looks like offering nothing but pieties. The trading system needs more than that.

Do as I say, not as I do

On March 23rd the World Trade Organisation (WTO) predicted that global trade will plunge by 9% this year—the steepest drop since the second world war. Japan's exports in February were half what they had been a year earlier; yet its imports had fallen so much that the country still recorded a surplus.

This collapse is partly due to globalisation. The days are gone when something was made in one country and exported. Products now contain parts from all over the world. Trade statistics look at value, not value-added, so they include a lot of double counting as parts move across borders and back.

THE first task for the leaders of the Group of 20, who will meet in London on April 2nd, will be to do no harm. Don't fall out over whether Germany and China are spending enough public money to get the world economy going. Let's not have a

When the economy shrinks, trade will shrink faster.

But that is not the full story. The World Bank says that, since the G20 leaders last met in November in Washington, D.C., 17 of their countries have restricted trade. Some have raised tariffs, as Russia did on second-hand cars and India did on steel. Citing safety, China has banned imports of Irish pork and Italian brandy. Across the world, there has been a surge in actions against "dumping"—the sale of exports, supposedly at a loss, in order to undermine the competition. Governments everywhere are favouring locally made goods.

Some take comfort from the world's interdependency. Producers in Brazil rejected protection, because Brazilian tariffs would have raised their own prices. Neither of France's car-makers wanted to have to guarantee jobs at home as a condition for state aid, as President Nicolas Sarkozy had stipulated.

But interdependency is a slender reed. Plenty of people argued against the Smoot-Hawley bill, which raised tariffs at the onset of the Depression. One danger today is that, under WTO rules, some countries have scope to put tariffs up without breaching their legal limits. Countries can indeed justify protection using safety or dumping, even if that breaks the spirit of open markets; and when protection reaches some (unknown) level, global supply chains will break down. If that happens, they will not be rebuilt for many years.

After they met in Washington last November, G20 leaders said that they had united to support open markets. But promises alone will no longer do. In London they need to limit the scope for tariff increases—ideally by finishing the Doha round of trade talks; they should agree to put aside anti-dumping actions and the rest of the apparatus of legal trade protection; and should ensure that subsidies do not discriminate against foreign firms. Leaders were counting on trade to be the straightforward part of the summit, but if they think fighting protectionism is easy work, then they aren't doing enough. ■

Saving America's banks

Only halfway there

Tim Geithner's toxic-asset scheme will not work unless banks are forced to sell their problem loans



IT WAS a measure of the desperation for a plan—any plan—to tackle the paralysis in the American banking system that stockmarkets soared on March 23rd when Tim Geithner, the treasury secretary, detailed his proposals to purge toxic debt

from the banks' balance-sheets. In fact, the effort to recruit private investors into a government-led campaign to buy bad assets from the banks is still, at best, half a plan. It is better than Mr Geithner's woeful false start in February and may one day even prove to be inspired. But it will work only if the Obama

administration accompanies it with a cast-iron determination to get to the bottom of America's banking mess. So far the president has shown little stomach for going the whole way.

As it stands, Mr Geithner's Public-Private Investment Programme looks like an ungainly political and financial fudge and far from the market solution the government claims it is (see page 69). It aims to buy \$500 billion–\$1 trillion of the loans and hard-to-value securities that have swamped the banks' balance-sheets since the collapse of America's mortgage market in 2007. Ideally, the government would have raised that money from Congress and parked the toxic assets in a discrete "bad bank", or offered to guarantee them. But Congress has bail-out fatigue. Bonus-bashing scores immeasurably higher ▶

► been driven into Pakistan, but it would return re-energised the moment the insurgents regained power, which they could well do if NATO fled before building an Afghan government and army capable, like Iraq's, of standing on its own feet.

Some advocates of leaving say the presence of Western infidels in Afghanistan is so provocative that it makes Pakistan itself likelier to succumb to the jihadists. The opposite is true. America's bombing raids inside Pakistan probably are counterproductive, and should stop. But giving the jihadists another victory over another superpower would boost their ambitions to the skies, making it even harder for Pakistan to pacify its tribal regions. As for the claim that the Afghans themselves want the Westerners out right away, there is little evidence of this. The ability of jihadists with guns to control territory is no proof of popularity. Not long ago, remember, millions of Af-

ghans voted for the country's present government and constitution, and for simple rights, such as that of girls to go to school.

In war, of course, victories do not come just by wishing for them. That is why NATO needs to fine-tune its campaign in all sorts of ways. Some of the new ideas look eminently sensible. These include recognising that Afghanistan and Pakistan are a "single theatre", enlisting help from neighbours (including Iran), ending the uncritical support George Bush gave Mr Karzai, handing a bigger share of combat missions over to a larger Afghan army and reviving the drive for political reconciliation that started after the invasion of 2001 but withered on the vine. However, no strategy will work unless Mr Obama makes it completely plain to both his allies and his enemies that he is not giving up. Victories may not come just by willing them, but prophecies of defeat are often self-fulfilling. ■

Emerging-market multinationals

Not so nano

The financial crisis may have strengthened the hand of the developing world's emerging giants



THE world's cheapest car, the Tata Nano—launched this week in Mumbai in a burst of flashbulbs and national pride—has turned the spotlight once again on the developing world's emerging multinationals. From ArcelorMittal in steel to ZTE in telecoms, ambitious companies from India, China and other developing nations have marched onto the global stage in recent years, spooking the rich world's established multinationals with innovative products and bold acquisitions. The Nano is a symbol of the ambition of these emerging giants.

But much has changed since Tata Motors first took the wraps off the tiny car in January 2008. The financial crisis, collapsing stockmarkets and plunging commodity prices have hit companies in rich and poor countries alike. Tata Motors, which bought Jaguar Land Rover, a British premium carmaker, from Ford last year for \$2.3 billion, now faces the difficulty of refinancing its debt, and was downgraded this week by Standard & Poor's (see page 59). Does this mean that the threat to established giants from emerging-market giants has receded?

Far from it. The crisis has strengthened the relative position of the emerging giants, for several reasons. First, as companies and consumers around the world cut costs and trade down, the emerging giants' low-cost production models, based on cheap local labour, provide even more of an advantage. Second, even though growth in developing countries has slowed, it has not vanished altogether, so the emerging giants can fall back on their domestic markets. Car sales have collapsed in the rich world, for example, but are still growing in many developing countries: they are expected to increase by 10% this year in China, for instance.

Third, many rich-country multinationals have become much more inward-looking as they struggle to cope with the recession, and are less able to invest to defend their market positions, providing opportunities for disruptive new entrants. Again, a good example is that of carmaking, where the convulsions of the established giants, and the switch to greener tech-

nologies, give newcomers an opening. Ratan Tata, the boss of the Tata Group, spoke this week of his ambitions to sell the Nano not just in Europe, starting in 2011, but eventually in America, too. The electric car made by BYD, a Chinese battery-maker that branched into carmaking a few years ago, was the talk of the Detroit motor show in January.

Furthermore, many cash-strapped multinationals in the rich world are now trying to sell bits of themselves to raise capital, giving buyers in the developing world a chance to pick up technology, brands and other assets, says Harold Sirkin of the Boston Consulting Group, whose book "Globality" charts the rise of the emerging giants. Two Chinese carmakers, Chery and Geely, are interested in buying Volvo from Ford. Mahindra & Mahindra, an Indian maker of utility vehicles, is in the running to buy LDV, an ailing British truckmaker; there is also talk of a possible Chinese bid. Vale, Brazil's mining giant, recently picked up a clutch of assets from Rio Tinto, its debt-laden Anglo-Australian rival. And ZTE, a fast-growing Chinese telecoms-equipment company with customers in over 60 countries, has been mooted as a possible buyer of the handset division of Motorola, the ailing American firm that ZTE is on the verge of evicting from the industry's top five.

They're behind you

There are, of course, weak points among emerging-market giants. Some, including Tata Motors, overextended themselves when commodity prices were high and credit was easy to come by. Mexico's Cemex, the world's third-largest cement firm, is selling assets around the world as it struggles to meet its debt repayments. ArcelorMittal, the world's biggest steel-maker, which grew into a global giant from its roots in Indonesia, Trinidad and Mexico, launched a \$1.5 billion convertible-bond issue this week to refinance some of its debt. But plenty of rich-world multinationals made the same mistakes and face similar problems, or worse.

The emerging giants of the developing world are still a rising force during the good times. The launch of the Nano serves to remind rich-world bosses that they still need to keep an eye on their rear-view mirrors. ■

► the loans?

This problem is less acute in mortgage-backed securities, which holders of all stripes have been more willing to write down. Indeed, those banks, such as Goldman Sachs and Morgan Stanley, that have been most assiduous in marking to market expect to be able to sell some of their holdings for a higher price, boosting their bottom line. They may use these gains to repay TARP investments: Goldman is reportedly keen to pay back its \$10 billion as early as next month.

The key to encouraging selling could be

the "stress tests" being conducted on the 19 largest banks, which are due to conclude in late April. Regulators might use these to force over-optimistic banks to write loans down to levels at which they would find takers in "shotgun sales", in the process topping them up with fresh capital in return for a bigger government stake. Sheila Bair, the FDIC's chairman, indicated this week that banks would be given a nudge.

Still, some fear that the plan may not be big enough. Firepower of up to \$1 trillion may sound a lot, but much more than that amount is in danger of souring in America

as consumer credit deteriorates and more companies default. With little chance of wringing more bail-out money from Congress, barring a stunning change of mood, the new plan could hit a funding wall.

To date, just under half of the TARP's \$700 billion has been disbursed. Add in the toxic-asset plan, and the total climbs to as much as \$608 billion. With large dollops needed to plug banks' capital holes once the stress tests are completed, and other industries clamouring for help, the remaining \$92 billion may fall short of what is required. One hope of topping up the pot may lie in an expansion of the FDIC's emergency credit line, from \$30 billion to as much as \$500 billion, though that would require congressional approval.

So Mr Geithner faces hard choices. He will desperately want the new plan to succeed, not least because its failure could unseat him. He is already reeling from criticism that he was slow to respond to the AIG handouts. Now, at least, he has provided a detailed scheme, even if there is still devil in the details. America can claim to be tackling its troubled assets.

Whether it has picked the right approach is another matter. The alternative chosen by Britain, to leave the assets in place and insure them for a fee, has many proponents—indeed, America did just that with the worst assets of Citigroup and Bank of America, but rejected it as a system-wide solution. Others continue to push the nationalise-and-recapitalise option, though this remains politically unpalatable in America. World leaders must hope that, in banking as in narcotics, there are numerous paths to rehabilitation. ■

American banks

It takes two to tango

Are America's banks prepared to sell their toxic assets?

AMERICA'S government is a willing buyer of bad assets, but are its banks willing sellers? If a lender flogs a loan or security for less than the value at which it is booked on its balance-sheet, it suffers a loss, depleting its capital. It follows that if banks' carrying values are still above those that state-sponsored bidders want to pay, they will not sell voluntarily.

Just how optimistic are banks' books? Two-thirds of the Treasury scheme's purchasing power will be directed towards legacy loans. America's ten biggest banks had plenty of these—\$3.6 trillion at the end of 2008, or about a third of their assets. However by global convention loans are not marked to market, but carried at cost and impaired gradually. Some categories of risky loans, for example to private-equity firms, have been written down. But the vast majority of loans have not. In aggregate the carrying value of the top-ten banks' loan books was 3% above the market price in December. That gap may not seem much, but it

amounts to over \$100 billion; if it were crystallised, it would wipe out a quarter of these banks' tangible common equity, their purest form of capital. The loss is also likely to be concentrated on the dodgiest loans, making them hard to sell.

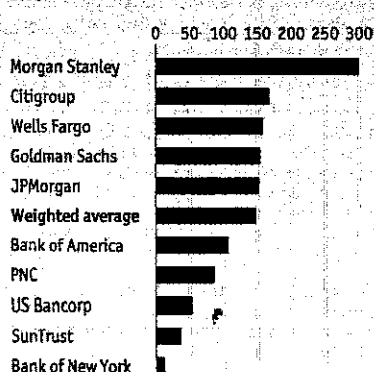
The remainder of the scheme's firepower will be directed at securities, which at \$3.7 trillion comprise another third of the top-ten banks' assets. These are marked to market and have been the main source of the savage write-downs that banks have suffered.

Many fear that banks are still being over-optimistic about their nastiest assets. For the top ten banks, 16% of securities were classified as "Level 3", equivalent to 1.5 times their equity (see chart). Level 3 means there are no reliable market prices available, leaving the banks free to use models. The assumptions in these may not be particularly pessimistic: at the end of 2008, \$12 billion of Citigroup's Level 3 structured-credit exposures were valued according to a fall in house prices of 33% from the peak—a smaller drop than the one in the government's own "stress test". Those banks with the least capital probably have more generous valuations. And the scheme will buy only securities that originally had an AAA credit rating, which rules out the nastiest stuff.

That still leaves about \$3 trillion of securities that are marked to market using more reliable direct or indirect price inputs. But banks may be reluctant to sell their loans and their most toxic securities—exactly what the scheme is meant to target. The obvious remedy is to force banks to write down their assets further as part of the governments' continuing stress tests. But with capital ratios tight and the Treasury's bail-out kitty now almost depleted, that could push several big banks towards insolvency.

The great leveller

Level 3 assets as a % of tangible common equity 2008



Sources: The Economist estimates and companies' Proforma for announced deals and capital raisings

The dollar as a reserve currency

Handle with care

China suggests an end to the dollar era

IN FUTURE, changes to the international financial system are likely to be shaped by Beijing as well as Washington. That is the message of an article by Zhou Xiaochuan, the governor of the People's Bank of China. Mr Zhou calls for a radical reform of the international monetary system in which the dollar would be replaced as the main reserve currency by a global currency. It is a delicate issue, however. When Tim Geithner, America's treasury secretary, discussed the proposal in New York on March 25th, his remarks sent the dollar tumbling before he made clear that, naturally, he thought the greenback should remain the dominant reserve currency.

Mr Zhou's proposal is China's way of ►

► making clear that it is worried that the Fed's response to the crisis—printing loads of money—will hurt the dollar and hence the value of China's huge foreign reserves, of which around two-thirds are in dollars.

He suggests that the international financial system, which is based on a single currency (he does not actually cite the dollar), has two main flaws. First, the reserve-currency status of the dollar helped to create global imbalances. Surplus countries have little choice but to place most of their spare funds in the reserve currency since it is used to settle trade and has the most liquid bond market. But this allowed

America's borrowing binge and housing bubble to persist for longer than it otherwise would have. Second, the country that issues the reserve currency faces a trade-off between domestic and international stability. Massive money-printing by the Fed to support the economy makes sense from a national perspective, but it may harm the dollar's value.

Mr Zhou suggests that the dollar's reserve status should be transferred to the SDR (Special Drawing Rights), a synthetic currency created by the IMF, whose value is determined as a weighted average of the dollar, euro, yen and pound. The SDR was

created in 1969, during the Bretton Woods fixed exchange-rate system, because of concerns that there was insufficient liquidity to support global economic activity. It was originally intended as a reserve currency, but is now mainly used in the accounts for the IMF's transactions with member countries. SDRs are allocated to IMF members on the basis of their contribution to the fund.

Mr Zhou's plan could win support from other emerging economies with large reserves. However, it is unlikely to get off the ground in the near future. It would take years for the SDR to be widely accepted as ►

Buttonwood | Searching for a bottom

Where might the bottom for shares prove to be?

EVERY time the stockmarket rebounds, as it has recently, commentators wonder whether this at last marks the bottom for share prices. The danger is that bear markets are pitted with "suckers' rallies" that break investors' hearts.

Valuation ought to provide a clue. Given the speed of last autumn's collapse and the terrible performance of equities over the past decade, you might think that shares were dirt cheap. Alas, history suggests they have been a lot cheaper.

Start with the obvious measures. The historic dividend yield on the American stockmarket is around 3%. That may be higher than it has been since the mid-1990s, but it is a long way short of the 8.7% the market was offering back in 1950. Anyway, payouts are likely to be slashed this year.

How about the price/earnings ratio, the measure that compares share prices with profits? The latest p/e for the S&P 500 is around 10.5 (based on reported historic earnings). That is a long way above the low for the ratio of around six, recorded back in 1949. And this is probably a generous measure; reported earnings ignore write-offs, which have recently been huge. On a more conservative calculation, the historic p/e is around 42.

But these measures need not necessarily be a good guide at extremes. Wall Street traded on a high p/e in 1932, because earnings had collapsed so far during the Depression. Profits and share prices rebounded strongly in 1933. Robert Shiller (see Economics focus) uses a cyclically adjusted p/e that averages profits over ten years to smooth out fluctuations. On that basis, the American market is now trading on a p/e of 12; that is a long way below the 44 recorded in 1999, but is well above the 1921 low of around 5. Similar calculations prompt Andrew Smithers of the



consultancy Smithers & Co to reckon that Wall Street is only around "fair value".

You have to turn to relative valuations to make shares look cheap. This is a controversial subject. Clearly, investors have a choice between holding their portfolios in shares, bonds or cash, and can switch to the cheapest asset. But such approaches assume that low bond yields are good news for equities.

The reasoning is usually based on a discounted-cashflow model; a lower bond yield means a lower discount rate and thus a higher present value for shares. But that approach fails to consider why bond yields have fallen. The answer is normally that expectations for inflation or economic growth have declined. And that means expectations for nominal or real profits growth should be falling in line. In Japan the very low bond yields of the past 15 years have not been good news for equities at all.

A more sophisticated argument revolves around the equity risk-premium, the extra return investors should demand for holding shares. Since 1900 this has been around 4% a year, according to Elroy Dim-

son, Paul Marsh and Mike Staunton at the London Business School. A rough calculation for the forward-looking risk premium would add the dividend yield of 3% to expected long-term nominal dividend growth (in line with GDP) of 5% and then subtract the ten-year bond yield of 2.7%. The result is a risk premium of 5.3%. That may be higher than the historical average but may simply reflect the expectation that dividends may be cut sharply this year, and will thus rebound from a much lower base.

Chris Watling of Longview Economics points to another measure, the relation between the earnings yield and the real return on cash. Over the past 50 years, the earnings yield has averaged around five percentage points higher than the return on cash. The gap is now around eight points and has only ever briefly been in double digits.

Part of the aim of central banks in driving down interest rates is to encourage a greater risk appetite among investors. One of the bulls' hopes for the equity market is that American investors simply get tired of earning virtually zero on the estimated \$13 trillion they hold in money-market mutual funds.

Again, Japan's example is not encouraging—zero rates have coincided with dismal equity performance for years. But Larry Kantor of Barclays Capital argues that the global authorities have been a lot more active than Japan's were, supplying everything from quantitative easing to huge fiscal packages in the first 18 months of this crisis. Just as the Greenspan put buoyed investors in the 1990s, investors must trust in a Bernanke/Geithner put that keeps shares from falling to the lows seen in the past.

Buttonwood now writes a blog, which is open for comment at Economist.com/blogs/buttonwood

► a means of exchange and a store of value. The total amount of SDRs outstanding is equivalent to only \$32 billion, or less than 2% of China's foreign-exchange reserves, compared with \$11 trillion of American Treasury bonds.

There are also big political hurdles. America would resist, because losing its reserve-currency status would raise the cost of financing its budget and current-account deficits. Even Beijing might want to rethink the idea. Mr Zhou praised John Maynard Keynes's proposal in the 1940s for an international currency, the "Bancor", based on commodities. But as Mark Williams of Capital Economics says, central to Keynes's idea was that a tax be imposed on countries running large current-account surpluses, to encourage them to boost domestic demand. ■

The European Central Bank

Liquidity carrier

The ECB may soon embark on a mild form of quantitative easing

ERIC CANTONA, a temperamental footballer, once derided Didier Deschamps, his colleague in the French national team, as a mere "water-carrier". The implication was that Mr Deschamps, a tireless midfielder, could not provide the spark and creativity of players such as Mr Cantona. That contrast between flashy inspiration and stolidity may now apply to the world's big central banks. The Federal Reserve's plan to buy up to \$300 billion of government bonds makes efforts by the European Central Bank (ECB) seem plodding by comparison. Many believe that ferrying liquidity to commercial banks is no longer enough: the ECB should follow the Fed and the Bank of England in using central-bank money to buy assets, including public debt.

That is something the ECB is not rushing into. Its policy-setting council meets on April 2nd, and seems likely to cut the bank's benchmark "refi" rate to 1% from 1.5%. In the past, that rate would set the level of overnight interest rates in money markets and serve to measure how tight or loose the monetary-policy stance was. But the ECB's policy of funding banks for up to six months at that rate means there is lots of cash sloshing around money markets. That has driven the charge for overnight loans below the official refi rate, closer to the cost of such borrowing in America or Britain. Indeed it is now cheaper for banks to borrow for six or 12 months in euros than in either dollars or sterling (see chart).

Jean-Claude Trichet, the ECB's chief, has defended the bank's water-carrying ap-

proach. Firms and households in Europe, unlike in America, rely more on banks than capital markets for their debt finance. So it makes more sense for the ECB to lend freely to banks, in order to help cap lending rates, than to lower the cost of capital in securities markets, by buying assets directly. By one measure of policy activism, the ECB can still claim bragging rights. Its balance-sheet is bigger than the Fed's as a share of GDP, mostly reflecting the relative sizes of their banking industries. That lead won't last long. The Fed's assets are likely soon to exceed the ECB's, as the reach of its operations extends far beyond liquidity support for banks.

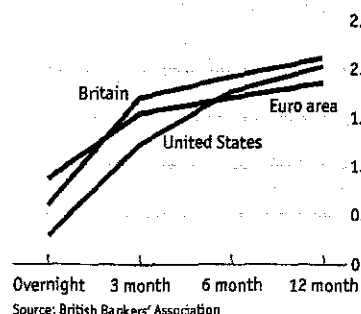
Added to the peer pressure to do more is the risk of a much stronger euro. The ECB is also running out of room to ease policy by conventional means. The deposit rate it pays to banks on their excess cash is one percentage point below its policy rate, and provides a floor for overnight interest rates. Once the refi rate is cut to 1%, the deposit rate will go to zero unless the ECB narrows the gap. If recovery is not in sight and deflation threatens, the clamour for more monetary stimulus will be hard to resist.

Mr Trichet has said that fresh "non-standard" measures are being studied. The ECB also has the option of extending some existing schemes. It could, for instance, provide unlimited funding to banks for up to 12 months or even longer. It could reduce the "haircuts" it subtracts from the market value of collateral, allowing banks to borrow more cheaply. Or it could choose to accept riskier collateral.

A plan to buy assets directly is unlikely to emerge on April 2nd. But with the economy showing few signs of recovery, the ECB may start to buy commercial paper and longer-term bank bonds fairly soon. The bank, jealous of its independence from government, will be loth to go further and buy public debt, as the Fed plans to. Yet the ECB's liquidity support may help lower euro-area bond yields: commercial-bank purchases of government debt have risen sharply recently. The ECB will hope that a less flashy form of quantitative easing will suffice, at least for now. ■

Not so different

Interbank interest rates, %, March 25th 2009



Japanese stocks

Wide girls

TOKYO

Mrs Watanabe is tiptoeing back into Japan's stockmarket

"NOT trusted" is how Japan's Prime Minister Taro Aso described stockbrokers this month, before calling them *ka-buya*, or "wide boys". And with the Tokyo stockmarket scraping 26-year-lows in mid-March before soaring 20% in the past fortnight, the reputation of equities as an investment is shoddy at best. Yet some Japanese investors are throwing caution to the wind and beginning to buy.

New trading accounts are being opened at an unusually quick pace. Monex, the biggest online broker, doubled the number of new accounts in the last three months of 2008 to 210,000, as the market hit a two-decade trough. Nomura, the biggest broker, had a sudden 20% surge in new accounts. For the first time in 18 years, Japanese retail investors ended the year having bought more shares than they sold. They have been net buyers so far this year as well.

The trend is not nearly powerful enough to call a market bottom. Although the number of retail accounts has increased, their trading activity has not, suggesting many are still being cautious. Those who have taken the plunge have suffered; even after the recent rally, the Nikkei 225 Stock Average has fallen by 7% this year. The difference between sellers and buyers is small—5-10% since November—and trading activity among individuals was low to start with, so only a small shift in trading volumes can tip the trend from net seller to net buyer.

A lot rests on Mrs Watanabe, the fabled retail punter who plays the markets while ►►

Economics focus | An economic bestiary

Macroeconomists need to apply some new lessons and relearn some old ones



NO TWO economic crises are identical. But the same questions recur. How did we get into this mess? How can we get out of it? How do we avoid another? Some answers repeat themselves too. You can be pretty sure that sooner or later someone, quite possibly an anguished economist, will declare that economics itself has gone astray. The wisdom of some past master, whether celebrated (John Maynard Keynes, for example) or neglected (Hyman Minsky, perhaps), has been forgotten, and the economy is paying the price.

A new book*, "Animal Spirits", by George Akerlof of the University of California, Berkeley, and Robert Shiller of Yale, follows this rule to the letter. The authors seek to answer the first of those three old questions and thus to provide some pointers about the other two. They do indeed believe that economics has lost its way. And their chosen economist is Keynes.

So far, so familiar. But this book is rather more than the usual lament about the failings of economics. Its authors are two of the discipline's leading lights. Mr Akerlof won a Nobel prize in 2001, in part for a classic paper explaining how, if sellers know more than buyers, markets may fail. (It was turned down by three leading journals before finding a home.) Mr Shiller sounded a warning about the "Irrational Exuberance" of the tech-boom stock market in a book of that name—and did the same for the housing market in a second edition. With a collaborator, Karl Case, he drew up a widely cited set of indices of American home prices.

The lesson that Messrs Akerlof and Shiller draw from Keynes is not just the standard one, of the usefulness of deficit finance in recessions. They borrow their title from "The General Theory of Employment, Interest and Money":

Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of the weighted average of quantitative benefits multiplied by quantitative probabilities.

Too much economics, say Mr Akerlof and Mr Shiller, has been built on the premise that humans are rational calculators. That is not a new criticism, even from economists. Over the past couple of decades *Homo economicus* has evolved into a being more like

H. sapiens, as economics has drawn on psychology, biology and even neuroscience. "Behavioural" economics has shaped public policy—for instance, in encouraging people to save or in shaping the choice of investments in their pension pots. Behavioural economists have earned Nobel prizes. Mr Akerlof and Mr Shiller, however, complain that this evolution has been confined mainly to microeconomics. It is time for macroeconomics to catch up.

One, two, three, four, five

Keynes mentioned animal spirits only twice, in a paragraph on what motivates people to invest and speculate. From this single thread, Messrs Akerlof and Shiller spin five classes of spirit. First and closest to the original is confidence. This goes beyond a rational estimate of next week's share price, or the price in ten years' time of what a new factory might produce. And confidence, or the lack of it, builds on itself—in a way similar to Keynes's multiplier, but defying easy quantification. Second is fairness. Even if economists know that fairness matters, too little of their work reflects it. Third is corruption, or bad faith: what explains a Charles Ponzi or an Enron? Fourth is money illusion: economists have come to assume that people see through inflation, but they don't, especially when it is low. The fifth they call "stories". Economists are loth to suppose that people are irrational enough to latch onto plausible tales and forecasts—for example, that house prices will never go down. So their models won't spot the consequences of misplaced belief until it is too late.

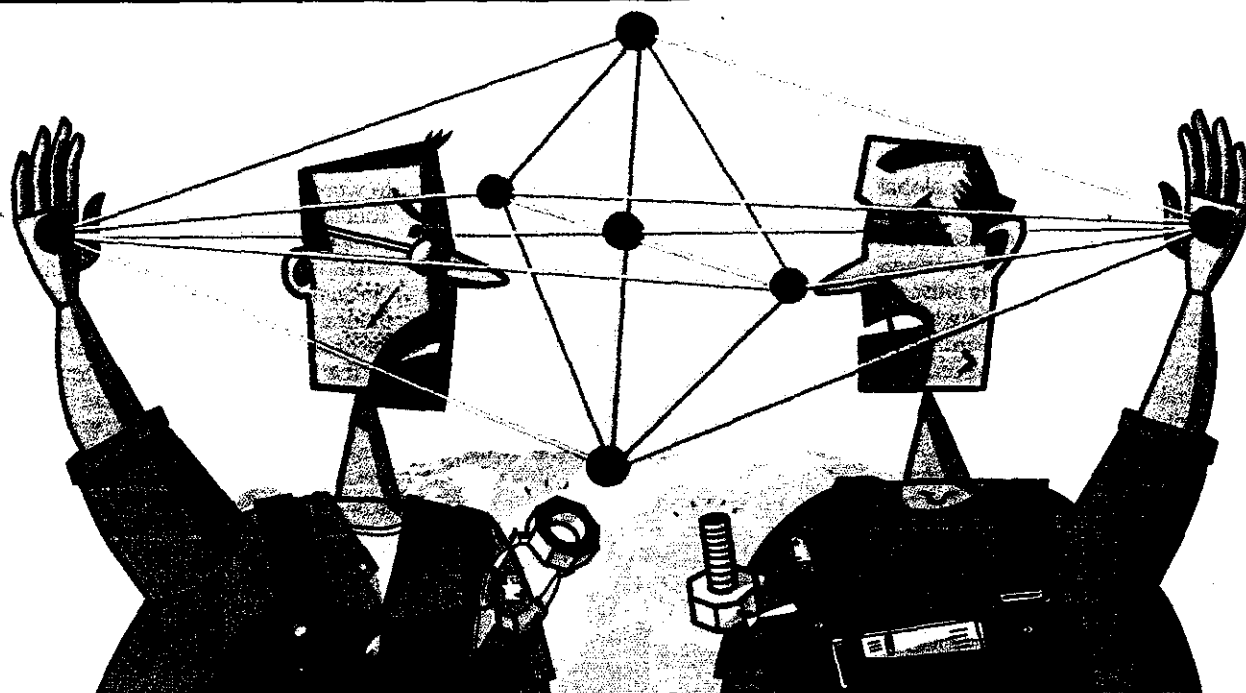
Messrs Akerlof and Shiller list eight questions which, they say, cannot be well explained without an appeal to animal spirits—but can be tackled with them. These range from why markets for housing and shares swing wildly (a combination of confidence, stories and bad faith) to why, contrary to standard theory, there appears to be a long-run trade-off between inflation and unemployment (mainly, a mix of money illusion and fairness).

The most topical of the eight, however, is the power of central banks. The animal-spirits version of the credit crisis is a mixture of bad faith, a collapse of confidence and a change from a happy economic "story" to a thoroughly miserable one. Credit has dried up—so that applying the fiscal and monetary stimulus consistent with full employment is not enough. The Federal Reserve should also have a target for credit. Unless credit flows again, fiscal and monetary measures will not suffice: companies can't borrow to build factories and consumers can't borrow to buy cars. The Fed was set up, Messrs Akerlof and Shiller point out, to maintain confidence after the financial crisis of 1907. That, rather than the fine-tuning of interest rates in steady times, is its most important task.

How much do animal spirits help? Most of the time, the unrealistic assumption of rationality serves economists fairly well. They should, however, be more prepared to depart from it, especially in times like these—even if that makes behaviour more difficult to describe in elegant equations. Messrs Akerlof and Shiller have therefore done their profession a service.

Yet their ideas carry risks too. To a politician seeking to rein in free markets, animal spirits are a gift. The authors sum up their view of the role of government thus: "The role of the parent is to create a *happy home*, which gives the child freedom but also protects him from his animal spirits." For liberals (in the European sense) that is not a wholly comforting thought. ■

* "Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism". Princeton University Press, March 2009.



The nuts and bolts come apart

As global demand contracts, trade is slumping and protectionism rising

COMPARISONS to the Depression feature in almost every discussion of the global economic crisis. In world trade, such parallels are especially chilling. Trade declined alarmingly in the early 1930s as global demand imploded, prices collapsed and governments embarked on a destructive, protectionist spiral of higher tariffs and retaliation.

Trade is contracting again, at a rate unmatched in the post-war period. This week the World Trade Organisation (WTO) predicted that the volume of global merchandise trade would shrink by 9% this year. This will be the first fall in trade flows since 1982. Between 1990 and 2006 trade volumes grew by more than 6% a year, easily outstripping the growth rate of world output, which was about 3% (see chart 1 on the next page). Now the global economic machine has gone into reverse: output is declining and trade is tumbling at a faster pace. The turmoil has shaken commerce in goods of all sorts, bought and sold by rich and poor countries alike.

It is too soon to talk of a new protectionist spiral. Nevertheless, errors of policy risk making a bad thing worse—despite politicians' promises to keep markets open. When they met in November, the leaders of the G20 rich and emerging economies declared that they would eschew protec-

tionism and will doubtless do so again when they meet on April 2nd. But this pledge has not been honoured. According to the World Bank, 17 members of the group have taken a total of 47 trade-restricting steps since November.

Modern protectionism is more subtle and varied than the 1930s version. In the Depression tariffs were the weapon of choice. America's Smoot-Hawley act, passed in 1930, increased nearly 900 American import duties—which were already high by today's standards—and provoked widespread retaliation from America's trading partners. A few tariffs have been raised this time, but tighter licensing requirements, import bans and anti-dumping (imposing extra duties on goods supposedly dumped at below cost by exporters) have also been used. Rich countries have included discriminatory procurement provisions in their fiscal-stimulus bills and offered subsidies to ailing national industries. These days, protectionism comes in 57 varieties.

There are good reasons for thinking that the world has less to fear from protectionism than in the past. International agreements to limit tariffs, built over the post-war decades, are a safeguard against all-out tariff wars. The growth of global supply chains, which have bound national

economies together tightly, have made it more difficult for governments to increase tariffs without harming producers in their own countries.

But these defences may not be strong enough. Multilateral agreements provide little insurance against domestic subsidies, fiercer use of anti-dumping or the other forms of creeping protection. Most countries are able to raise tariffs, because their applied rates are below the maximum allowed by their WTO commitments. They may choose to do so despite the possible disruption to global supply chains. And because global sourcing amplifies the effect of tariff rises, even action that is permissible under WTO rules could cause a lot of damage. The subtler variants of protection may be similarly disruptive.

The gears of globalisation

The immediate cause of shrinking trade is plain: global recession means a collapse in demand. The credit crunch adds an additional squeeze, thanks to an estimated shortfall of \$100 billion in trade finance, which lubricates 90% of world trade.

Just as striking as the speed of the downturn in trade is its indiscriminate nature. The World Bank has January trade data for 45 countries (available figures for G20 countries are shown in chart 2). These are values, expressed in American dollars, and so have been depressed not only by lower volumes but also by falling prices and a stronger dollar. The exports of 37 of these 45 countries were more than a quarter lower than in January 2008. Countries as diverse as Ecuador, France, Indonesia, the Philippines and South Africa saw exports drop by 30% or more. Commodity ►►

► exporters, such as Argentina, have suffered with sellers of sophisticated manufactures, such as Germany and Japan.

Kei-Mu Yi, an economist at the Federal Reserve Bank of Philadelphia, argues that trade has fallen so fast and so uniformly around the world largely because of the rise of "vertical specialisation", or global supply chains. This contributed to trade's rapid expansion in recent decades. Now it is adding to the rate of shrinkage. When David Ricardo argued in the early 19th century that comparative advantage was the basis of trade, he conceived of countries specialising in products, like wine or cloth. But Mr Yi points out that countries now specialise not so much in final products as in steps in the process of production.

Trade grows much faster in a world with global sourcing than in a world of trade in finished goods because components and part-finished items have to cross borders several times. The trade figures are also boosted by the practice of measuring the gross value of imports and exports rather than their net value. For example, a tractor made in America would once have been made from American steel and parts; it would have touched the trade data only if it was exported. Now, it may contain steel from India, and be stamped and pressed in Mexico, before being sold abroad. As a result, changes in demand in one country now affect not just the domestic economy but also the trade flows and economies of several countries.

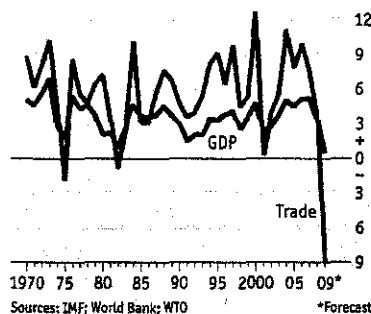
This mechanism can be seen at work in recent data—for instance, says Mr Yi, in American automotive-trade figures for the last three months of 2008. Imports from everywhere fell by about 20%. On the export side, sales to America's partners in the North American Free Trade Agreement (NAFTA) fell by 20% whereas those to non-NAFTA countries rose slightly. This, he argues, is because three-quarters of exports to non-NAFTA countries consist of finished vehicles, whereas 60% of exports to NAFTA partners consist of parts and components, most of which return to the United States embodied in imported vehicles. So American exports to other NAFTA countries are to a large extent determined by America's own demand for cars.

By making trade flows more sensitive to falls in output, vertical specialisation may provide some insurance against widespread protectionism. Manufacturers that rely on imported inputs may resist higher tariffs because they push up the prices of those inputs, making domestic industry less competitive.

Governments using tariffs as trade weapons now have to calculate the consequences far more carefully. This is borne out, for example, by Mexico's response this month to the suspension by America of a NAFTA programme that allowed some Mexican truckers to carry goods north of

Over the edge

World trade and GDP, % change on previous year



the border. Mexico raised some tariffs, but by less than NAFTA rules allowed, and chose the goods carefully in order to limit the damage to its own industries.

Nevertheless, there is plenty of evidence that developing countries, at least, continue to use tariffs extensively. In the World Bank's study, tariff increases accounted for half of the protective measures by these countries. Ecuador raised duties on 600 goods. Russia increased them on used cars. India put them up on some kinds of steel. Developing countries have more scope for raising tariffs without breaking WTO rules than richer ones do, because the gap between their applied rates and the ceilings they agreed to is greater than for developed countries.

When governments do impose tariffs, vertical supply chains amplify their ef-

fects. Because tariffs are typically levied on the gross value crossing the border (with some exceptions, such as exports from Mexican *maquiladoras*), trade responds more to changes in tariffs—down or up—with global supply chains than without.

But there is another, more subtle reason to worry about even small rises in tariffs. Theoretical models that incorporate vertical specialisation find that it takes off only when tariffs fall below a threshold level. Once this happens, however, trade explodes, so that a slight lowering of trade barriers can cause a huge increase in trade. By the same token, if tariffs rose above a certain point—which might be below the maximum agreed on at the WTO—global supply chains would disintegrate. Trade would drop even more steeply than it has in recent months.

That said, supply chains need not snap so easily. Even if tariffs go up, other costs that determine the viability of supply chains may go down: the price of oil (and hence the cost of transport) has fallen a long way in the past year. Firms have invested a lot in their supply chains and will be loth to abandon them. And if global supply chains do survive, vertical specialisation could help trade recover speedily when demand returns.

Although increased tariffs are a cause for concern, they are far from the only form of protection being used in this crisis. Two-thirds of the trade-restricting measures documented by the World Bank are non-tariff barriers of various kinds. As with tariffs, developing countries are the principal wielders of these weapons.

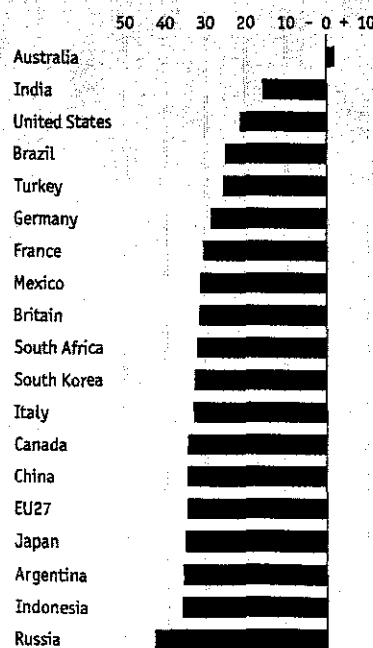
Indonesia has specified that certain categories of goods, such as clothes, shoes and toys, may be imported through only five ports. Argentina has imposed discretionary licensing requirements on car parts, textiles, televisions, toys, shoes and leather goods; licences for all these used to be granted automatically. Some countries have imposed outright import bans, often justified by a tightening of safety rules or by environmental concerns. For example, China has stopped imports of a wide range of European food and drink, including Irish pork, Italian brandy and Spanish dairy products. The Indian government has banned Chinese toys.

In addition, anti-dumping is on the increase. The number of anti-dumping cases initiated at the WTO had been declining, but it started to pick up in the second half of 2007. The data for 2008 are not yet complete but Chad Brown, an economist at Brandeis University, estimates that the number was 31% higher than in the previous year. The number of cases ending with extra duties went up by 20%. India was the biggest initiator of anti-dumping action, and America and the European Union imposed duties most frequently.

Rich countries' weapon of choice so far ►►

Australia fair, others foul

Merchandise export value in the G20*
January 2009, % change on a year earlier, \$ terms



Sources: World Bank; National statistics

*Data for Saudi Arabia not available

is neither tariffs nor non-tariff barriers to imports. They have been keen users instead of subsidies to troubled domestic industries, particularly carmakers. Some economists, such as Gene Grossman, of Princeton University, cite this as evidence that global sourcing has changed the political economy of protection. The American automotive industry no longer lobbies for direct protection, as it used to, because it imports much of its value-added and competes with foreign firms that assemble their cars in America. Carmakers now prefer explicit subsidies, and the world is replete with examples. Besides America, Argentina, Australia, Brazil, Britain, Canada, China, France, Germany, Italy and Sweden have all also provided direct or indirect subsidies to carmakers. The World Bank reckons that proposed subsidies for the car industry amount to \$48 billion. Nearly 90% of this is in rich countries, where it can easily be slipped into budgetary packages to stimulate demand.

The worry about such subsidies is that they could cause production to switch from more efficient plants (eg, in central and eastern Europe) to less efficient ones in rich countries with deep pockets (eg, in western Europe). Whether the location of output is shifting is not yet clear, but politicians plainly hope it will. On March 19th Luc Chatel, the French industry minister, boasted that Renault's plans to create 400 jobs at a factory near Paris by "repatriating" some production from Slovenia was the result of government aid. Renault has denied this, saying that it was at full capacity in Slovenia.

There are some international rules to prevent distorting subsidies. The EU has regulations to limit state aid, and is looking into its members' assistance to carmakers. Gary Hufbauer, of the Peterson Institute for International Economics in Washington, DC, argues that American subsidies transgress WTO norms.

Helpful ambiguity

However, WTO action against subsidies is not straightforward. To complain successfully, a country has to show that a subsidy meets several criteria. Then there is a pots-and-kettles problem: having subsidies of your own does not stop you from challenging someone else's, but if you pick a fight they may have a go at yours. This uncertainty and ambiguity only adds to subsidies' attraction. Governments can aid their carmakers and at the same time criticize others for their protectionist ways.

Protectionist urges are also being bolstered by countries' seeming inability to co-ordinate their fiscal stimulus programmes. Some countries have been reluctant to work the budgetary pump for fear that their extra demand will leak abroad to the benefit of foreigners. To stop the seepage, some governments have inserted dis-

criminatory conditions into their fiscal programmes, the prime example being the "Buy American" procurement rules. These were weakened after protests and threats of retaliation from abroad, but not before the prospects for global co-operation had been dented. Greater co-ordination of fiscal expansion would ease governments' worries about leakage, because everyone else would be leaking too: all would gain from each other's spending.

What should world leaders do to stop protection fraying the threads that tie the world economy together? The pious declaration at the previous G20 meeting has had



little effect. There is a risk that another such promise on April 2nd will prove to be just as empty. The difficulty lies in devising something comprehensive and detailed enough to address the variety of protectionist measures that are being deployed in the crisis, and doing it quickly enough to maintain open trade.

Many argue that the most important thing for world leaders to do is to pledge a quick completion of the Doha round of trade talks, which stalled for the umpteenth time last summer. By reducing tariff ceilings, this would place tighter limits on countries' ability to increase tariffs. It would also ban export subsidies in agriculture, which are being used with greater vigour, especially as prices of farm goods fall. The EU, for example, has announced new export subsidies for butter, cheese and milk powder. Most important, completing Doha would be the clearest and most tangible evidence possible of a commitment to consolidating and building on the gains from more open trade secured in successive rounds since the second world war.

Some economists disagree. Aaditya Mattoo, of the World Bank, and Arvind

Subramanian, of the Peterson Institute, argue that the Doha round is too ambitious given the state of the world economy, because it seeks to open markets for rich countries' manufactured goods just when the politics are against it. At the same time, they point out that Doha would not restrict the use of some non-tariff measures causing most concern, such as the Buy American provisions or subsidies for failing industries. Messrs Mattoo and Subramanian suggest a new "crisis round" of world trade talks. In the first instance, WTO members could commit themselves to a standstill on all forms of protectionism.

Several other economists have also proposed a standstill. However, Messrs Mattoo and Subramanian suggest that in order to give governments a political reason to agree to this, they should also be allowed to postpone further liberalisation for the duration of the crisis. They would then embark on a new round instead of Doha, which would address the forms of protection that now look most pressing.

But the appetite for starting yet another series of talks is likely to be limited. Even if the crisis round's agenda were more realistic than Doha's (which isn't obvious), there would be no guarantee that it could be concluded quickly enough to stop the bleeding in global trade.

Whatever they think about Doha or about the idea of a crisis round, most economists will agree that a simple promise to resist protectionism will not suffice. Some thing more specific is needed. A good start would be for governments, beginning with the leaders of the G20, to draw up a comprehensive list of protectionist measures that goes beyond tariffs and export subsidies. They could then agree to go no further with these than they have already.

Next, an agreement on co-ordinating fiscal policy would go a long way towards making such a standstill commitment credible, because it would alleviate worries about leakages abroad. Finally, empowering the WTO to name those who break the standstill would help to underpin it. The threat of embarrassment may make some countries think twice.

During the Depression, the volume of world trade shrank by a quarter. Nothing like that has been seen or forecast so far. Yet one lesson from the worldwide economic distress of three-quarters of a century ago is that once trade barriers come up, they take years of negotiation to dismantle. Preventing protectionism from getting worse is preferable to having to repair the damage afterwards. And even if a full-blown trade war can be ruled out, death by a thousand cuts cannot. The costs of myriad piecemeal measures could still add up to damaging protectionism. And when demand does eventually revive, if the world economy is supported by an open system of trade, it will recover all the faster. ■

ENVIRONMENT

GREENEST NATION

A laggard no longer, America could soon out-innovate Europe and Japan.

By STEFAN THEIL

THIS IS A TRICK QUESTION. WHAT BIG COUNTRY IS, BY MOST MEASURES, greener than Japan and Germany and produces more geothermal energy than all of Europe combined? It might help to know that this nation is also a pioneer in environmental stewardship, having passed many of the world's toughest regulations on vehicle emissions, energy efficiency and nature conservation.

It couldn't possibly be the United States. By now all the world knows that America, with its cheap gas, plentiful coal and eight years of a Kyoto-treaty-bashing president in the White House, is the world's biggest environmental villain. After all, America emits 50 percent more greenhouse gases than the European Union for each dollar of GDP. Per capita it's even worse: 20 tons of carbon dioxide for each American per year versus just 8.4 for a citizen of Europe.

And yet, if you were to answer the United States, you'd be more right than wrong. The statistics for the country as a whole obscure tremendous differences among the individual states—several of which, on their own, would rank as major “green” countries in their own right (which gets us to the trick). California, with its 37 million people, emits 20 percent less CO₂ per dollar of GDP than Germany. It generates 24 percent of its electrical power from renewable fuels like wind and solar, compared with only 15 percent in Germany and 11 percent in Japan. It also has the world's largest solar-power plant (550 megawatts in the Mo-

jave Desert), the largest wind farm (7,000 turbines at Altamont Pass) and the most powerful geothermal installation (750 megawatts at The Geysers north of San Francisco). Although California isn't immune to the economic crisis—its finances are on the brink of collapse, which could translate into growing support for those who argue that green measures cost jobs—its green accomplishments put it at the head of the pack. If California were a country, its economy would rank as the world's 10th largest and could lay claim to be one of the world's greenest.

The significance of California's green credentials goes beyond Trivial Pursuit. With a new U.S. administration that has pushed energy security, climate change

and a job-creating “Green New Deal” to the top of the policy agenda, experts believe that America could emerge as the world's green leader—out-innovating and out-competing Europe and Asia in environmental policy and technology. Not only has Barack Obama moved quickly to unblock states' initiatives—most notably California's plan to introduce some of the world's strictest limits on auto emissions, which Bush had used his federal powers to obstruct—but Obama also comes in with an extremely ambitious agenda of his own, including a pledge to cut America's CO₂ emissions by one third by 2020 and 80 percent by 2050. If Obama's 2020 target becomes policy, it will require the United States to cut emissions from current levels by more than twice as much as the European Union—even more if the faster growth of the U.S. population is taken into account. More than \$80 billion of the \$787 billion economic-stimulus bill signed by Obama last week goes to spending and tax breaks for green projects, including \$20 billion for renewable energy, \$22 billion for conservation and efficiency measures and \$17 billion for public transport. With Washington turning into an ally of America's green states and fast-growing clean-tech industry, the United

FARMING WIND: *Altamont Pass in California*

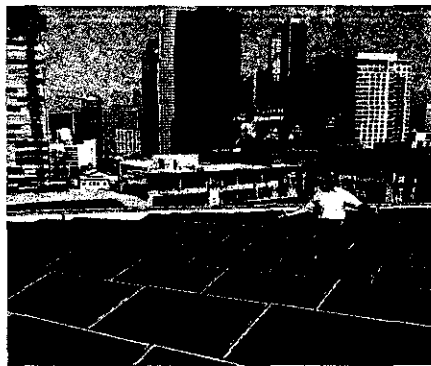
States could start giving the European Union, Japan and other green leaders a run for their money. "What hasn't been happening in Washington, D.C., has obscured what's been happening all over the country," says Nicholas Parker, chairman of San Francisco-based Cleantech, an industry advisory group. "Watch out for the Americans—they're coming."

Indeed, California may be the greenest state in the Union, but it's not the only one. New York, with a population of 19.5 million, has even lower emissions (though that has a lot to do with much of its population living in one big city with close-knit public transport). All told, 11 U.S. states are already cleaner than Germany. America clearly has too many emissions-spewing "brown" states like energy-guzzling Texas and Florida, and Rust Belt-industrial Pennsylvania and Michigan. But neither is Europe evenly green. Twenty-three of the 27 EU members score worse than California, and several, such as Poland and the Czech Republic, spew out more emissions per dollar of GDP than big U.S. polluters like Pennsylvania. Look behind America's overall numbers and public image—no doubt dragged down by the obstructionist environmental policies of ex-president George W. Bush—and a much more progressive picture emerges. "Despite all the hollowing-out of environmental policy in Washington, there has been tremendous leadership at the state and municipal level," says Amory Lovins, director of the Rocky Mountain Institute in Boulder, Colorado.

California may have gotten recent headlines with Washington's permission to set de facto emissions standards for the nation (still subject to formal approval from the Environmental Protection Agency), but other states have moved just as aggressively. On Jan. 1, 10 Northeastern states, including New York and Massachusetts, started their own regional carbon-trading system, with the aim of cutting the region's CO₂ output from power generation—roughly the same as Germany's—by 10 percent by 2020. Utilities in those states now have to buy a permit for each ton of carbon they emit; the states will, in turn, invest the proceeds in efficiency projects that cut power use. Seven Western states, including California, have joined with four Canadian provinces to launch their own cap-and-trade system by 2012. Both groups of states have bypassed Washington and entered talks with the European Union with the aim of creating a global carbon-trading regime. Last year the United States soared past Germany as the world's biggest generator of wind power, thanks

to a surge in wind-farm investment led by Texas, where 5,000 megawatts have been installed in the past three years. Iowa, the third-biggest U.S. producer of wind power after Texas and California, now generates more than Japan.

If America now moves forward, as seems likely with the change of power in Washington, it would be a return to the environmental leadership of the 1970s and '80s. During the latter, for example, 90 percent of the world's wind-power installation took place in just one U.S. state: California. The 1970 Clean Air Act, the 1972 Clean Water Act and the 1980 Superfund Act (which forced companies to clean up toxic waste) were revolutionary at the time and only later adapted by other countries. California invented the vehicle-emissions regulations that were later copied in Europe and elsewhere. U.S. companies like



SUN KING: California's governor in Los Angeles

If California were a country in its own right, it would rank among the most progressive.

Du Pont first commercialized substitutes for ozone-depleting coolants and aerosols. And America invented and set up the world's first cap-and-trade program to cut the sulfur and nitrogen emissions that cause acid rain. At international conferences on the environment, America pushed while big European polluters like Germany routinely dragged their heels in the name of saving jobs and profits.

It wasn't until Ronald Reagan slashed energy regulation in the 1980s that the roles reversed. But even today, the United States still leads in several areas of environmental policy, such as land conservation, biodiversity protection and clean-water laws. And unlike Europe, where environ-

mental offenders often get away with a slap on the wrist, the United States has strict penalties for companies caught flouting regulations—including the threat of jail time for corporate officers and punitive class-action damages, says Andreas Kraemer, head of Ecologic, a Berlin-based green-issues think tank.

America could easily turn the last two decades of lagging on environmental policy and performance to its advantage. Obstructionism from the Bush administration has prodded states and communities to press ahead on their own, creating a fertile ground for new ideas. Twenty-four states, which together produce more than half of America's electrical power, have adopted so-called renewable portfolio standards forcing utilities to generate a minimum share of their power (usually 20 or 25 percent) from alternate fuels by certain target dates, as early as 2010 in California. That has fed a building boom for wind farms, geothermal generators and massive solar arrays, but leaves it up to the utilities to decide which technology they prefer. More than 900 U.S. cities have agreed to abide by the Kyoto Protocol, each coming up with its own schemes to cut emissions by retrofitting buildings, improving public transport or replacing municipal car and bus fleets with hybrids and other less-polluting vehicles. "We may look back and realize that George W. Bush and his friends did more for the environment by what they didn't do," says Parker.

Europe's centralized style means negotiating a new policy can take years, and then once it's done it may as well be cast in stone. That has benefits in predictability but America is often a more flexible laboratory for policy innovation. The vast and lively experimentation among state and local governments means that good policies can be quickly copied and bad ones adapted. Now that Obama is removing the federal veto for California's ambitious plan to cut tailpipe emissions, 13 other states have announced they will copy the same tough standard, which will effectively require automakers' vehicle sales in those states to reach an average fuel economy of 43 miles per gallon (six liters per 100 kilometers) by 2020. That would get California drivers closer to the 44mpg standard the European Union is phasing in.

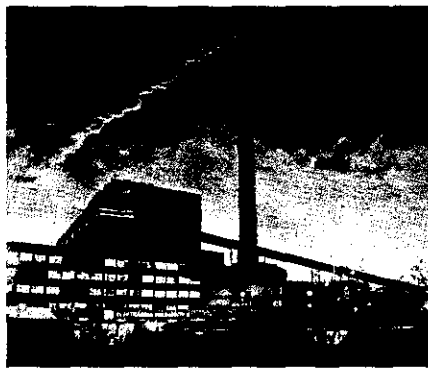
With these states covering 40 percent of the world's largest car market, major automakers will be pushed to come up with new models, just as they did when California first regulated emissions in the 1970s. Other states may also follow California's

newest plans: a sweeping efficiency initiative announced in September that calls for all new residential construction to be "zero net energy" by 2020, generating at least as much energy from rooftop solar panels and other on-site renewable sources as it consumes. "Thanks to this creative competition at state level, America may very well come up with a better system to limit emissions or a better system to promote the development and financing of alternative-energy technologies than Europe," says Miranda Schreurs, an expert on comparative environmental policy at the Free University in Berlin. One prerequisite, of course, would be for Obama to use national legislation to make sure the dirty states are onboard as well.

America has also been greening fast in its laboratories and startups. Year after year the nation funnels five to seven times as much venture capital into green tech than all of Europe combined, according to Michael Liebreich, CEO of London-based New Energy Finance, which tracks global green investments. Europe and Japan, says Liebreich, excel in lower-tech engineering and perfecting existing technologies—German and Danish manufacturers dominate the global market for wind turbines, for example. But U.S. companies are fast advancing in what they do best: inventing and commercializing radical, game-changing technologies. For instance, First Solar of Tempe, Arizona, has quickly grown into the world's biggest solar company, by market capitalization, by building thin-film modules that have cut the unsubsidized cost of generating solar energy to roughly the retail price of conventional power. Dozens of venture-funded startups are developing technology for energy storage and a digitalized "smart grid" that would transform the way energy is distributed. Better Place, a Palo Alto, California-based firm, has allied with Nissan and Renault to build electric-car infrastructure in California and Denmark. American biotech companies have refocused on the energy sector with such innovations as algae-based biofuels and organic solar generators that mimic the photosynthesis of plants. America's strength is pushing entirely new technologies onto the market, while Europeans tend to tinker at the edges. "If America ever manages to unleash its full entrepreneurial prowess on green energy," says Kraemer, "Europe will likely be left behind."

With the new drumbeat on environmental issues coming out of Washington, that could happen faster than you think. "We tend to think of European consumers

as green, buying more organic food, putting up with subsidies for solar energy or public transport," says Cleantech's Parker. But American consumers are much faster to adopt new products and shift their habits in response to price signals or changing trends, he says. They bought more than 1 million hybrid cars in the past four years, compared with barely 200,000 sold to skeptical Europeans. Last June, when gas hit \$4 a gallon, Americans slashed their driving by 12 billion miles (or 4.7 percent compared with the same month in 2007) and switched to public transport, taking 9.5 percent more trips. In what Edmunds.com called a "seismic shift" in buying habits, sales of SUVs and trucks collapsed while compacts and hybrids gained market share. (That kind of responsiveness works both ways, of course. Recently hybrid sales have col-



LAGGARDS: Europe isn't uniformly green

Should America speed ahead, it would be a return to its leadership of the 1970s.

lapsed with the rest of the market. And the market share of big cars has risen due to the drop in gas prices and rebates of up to \$10,000 on some SUV models.)

When Nissan comes to market with the first mass-produced all-electric car next year, much of the marketing push will be in the United States. Giant retailers such as Wal-Mart and Whole Foods have the market power to produce big, far-reaching changes in buying habits—as Wal-Mart has done by popularizing energy-efficient light bulbs, cold-water laundry detergents and less-toxic cleaning products among the 100 million customers it gets each week. That in turn, has forced its suppliers, from General Electric (light bulbs) to

Procter & Gamble (detergents) to produce more ecofriendly products. In their power to affect both consumers and global supply chains, says Kraemer, they are unmatched by most of their European or Japanese competitors.

Europe, however, is ahead in some areas where America is unlikely to catch up soon. These include public transport, recycling, and waste and landfill management. This lead has much to do with geography and history: Europe's ancient cities and dense population simply leave less room for big cars and lots of driving. The new "smart growth" ordinances many U.S. states and cities have recently passed—requiring higher-density planning, sidewalks and public-transportation links for all new subdivisions—only begin to get the United States on track toward the less suburban, car-based lifestyle that comes as second nature to most Europeans.

It's unclear, too, how far the continued economic crisis—as well as the sharp drop of the price of oil—will shift the debate away from climate change, energy security and environmental protection. Financing for everything from new green-tech ventures to big offshore wind farms has dried up (though the same is also true for oil exploration and coal-plant construction). Low gas prices cut America's incentives to go green more than they do Europe's, for two reasons: the high oil price wasn't as painful for Europeans because it was partially offset by a rising euro, and Americans get more relief from the decline since they pay a much lower fixed tax per unit of fuel. But priorities are shifting in Europe, too. Germany, once a poster child of environmental-mindedness, now lobbies hard in the European Union to protect its automakers and other hard-hit industries from new regulations.

The world's (and many Americans') negative view of the U.S. environmental record won't change overnight. One key element—a national program to limit emissions, such as the cap-and-trade system the Northeastern states just started—could be stalled even before the debate has begun; in January, Speaker of the House Nancy Pelosi warned that it might take until the next Congress, in 2011, to write a law that stands a chance of passing. No doubt there will be other setbacks as the nation, and the world, struggle to get the economy back on track. What's certain is that the days of America as a hopeless environmental laggard are over, and a new debate and competition between the United States, Europe and Asia has begun. If it wants, America has everything in place to lead again. ■

By MARY HENNOCK

OVER THE LAST 30 YEARS, AS ITS ECONOMY HAS RACED ahead, China has witnessed the world's largest internal migration, with some 250 million farmers and others abandoning its impoverished heartland in search of factory work and a better life on the coast. Now, as the economy slows—exports for January plunged 17.5 percent compared to the same month last year—many of those factories (including nearly half of the toymakers in the Pearl River Delta) have shut down, and unemployment is thought to have hit 10 percent. That's sending threatening waves throughout Chinese society.

Among the most worrisome effects: some 20 million migrant workers have returned home, flooding areas where able-bodied youngsters were recently a rarity.

Perhaps hardest hit is hardscrabble Henan province, whose population is thought to account for a full 10 percent of China's newly jobless. Local officials say some 2 million unemployed workers (out of a total population of 94 million) came home to stay during late January's Chinese New Year holiday, the traditional time for paying off—and laying off—workers. The

province's depleted workforce and develop new businesses.

One way to do this is through massive infrastructure projects. Using its share of the national \$586 billion stimulus package, the province hopes to create 650,000 new jobs in the next two years, according to Henan's labor bureau. Plans include a high-speed rail link between the provincial capital, Zhengzhou, and the tourist city of Luoyang. Henan's highway system will also be expanded.

Then there is a raft of more creative

Going Back To the Farm

As China's economy slows, millions of out-of-work rural migrants are being forced to return home.

real number is probably much higher, and it's sure to grow further as layoffs mount. Already it's producing great anxiety among Chinese officials, who have begun warning of civil unrest in unusually stark terms. The fear is that jobless workers—many of them young men—will band together and turn to violence or crime.

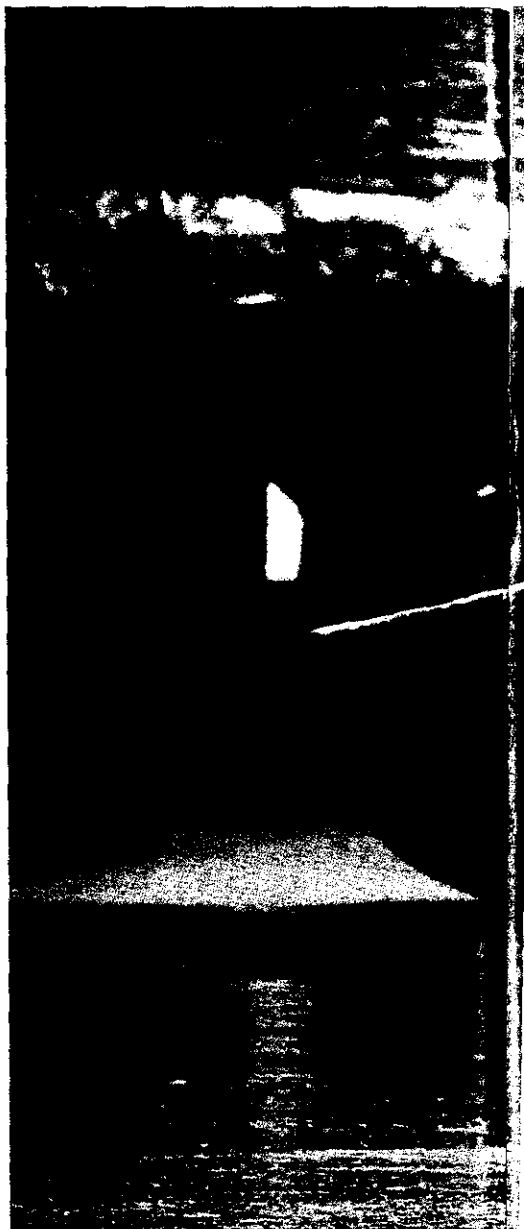
Avoiding those dangers by reabsorbing and redirecting these masses won't be easy. But if Henan is a guide, local governments are off to a good start, and may even manage to turn the infusion of new (or returning) blood to their advantage. Henan officials are working on a two-track strategy: first, finding jobs for as many returnees as possible, which generally means reexporting them by posting ads and hosting recruiters from elsewhere. Second, Henan is looking for ways to retain the best-qualified returnees in order to boost the

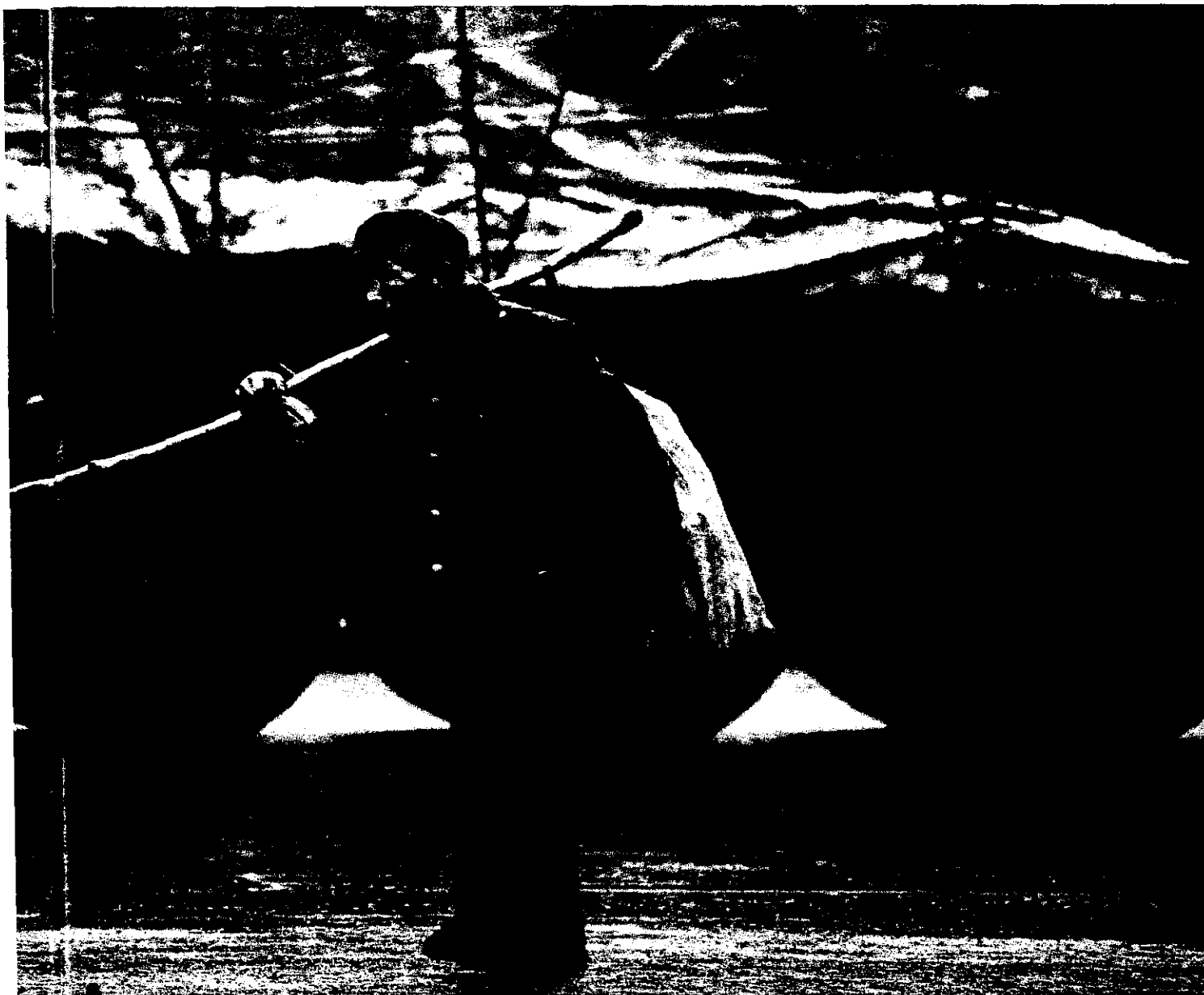
measures. One plan involves spending \$219 million on government-backed low-interest microloans to laid-off migrants, in order to help them to open agricultural and food-related businesses in rural areas—capitalizing on skills they may have learned in the boomtowns. "Many returned peasants [worked] in sales and in management. As they've returned it's a good opportunity for them to ... employ others," says Liu Tao, deputy director of the Henan labor bureau. Liu says even more money could be spent if there turn out to be worthy recipients.

The province has also doubled its skills-training program this year to target 2 million migrants, at a cost of \$146 million, and will allow workers to claim training grants annually, rather than once only. And it's begun creating financial incentives for colleges to place their graduates, hoping to

stimulate schools to strike up alliances with local firms. The province's 1,000 training colleges now only receive payment for teaching those students who find work. So far, the effort is proving effective: only 40,000 out of 680,000 trainees failed to land jobs last year.

Creative as they are, none of these efforts may prove up to the challenge of accommodating millions of unemployed new returnees. In addition to the direct problems caused by out-of-work migrants moving back home, rising unemployment is causing other hardships like a steep decline in remittances sent back to farming families, who can often barely survive on what they coax out of the ground. Henan officials estimate that remittances represent a third of farmers' household income. But migrants say that underestimates the truth; Gao Yang, a 28-year-old





warehouse worker, says the real figure is more like 50 to 60 percent.

Government aid programs are also poorly publicized. Yang Xinguo, 55, was recently searching for work at an informal roadside labor exchange on Zhengzhou's Erma Road, a Dickensian place where down-on-their-luck locals show up seeking short-term jobs. Even these are in short supply. Yang used to work as a crane driver, and once ran a small electronics shop. He'd love to return to that work but had no idea that a new microcredit scheme that could help him do so existed. And such a program could make all the difference for a man like him; Yang says all he'd need to get going again is about \$4,000.

Not everyone is convinced it can work. "Globally, programs [like Henan's lending scheme] don't have a very high success rate because even in the U.S., small and

medium-sized businesses tend to go out of business rather rapidly," says Andy Rothman, China macroeconomic strategist at brokerage CLSA. But China has had a different experience. Mass layoffs of workers in loss-making and unwieldy state companies in the 1990s led to the creation of a wave of nimble small firms. These private companies have been responsible for 70 percent of new job creation in the last five years, and policymakers are hoping to reproduce this pattern now. To encourage it, Henan officials are extending lending through the creation of township banks, which will dish out loans under the guidance of the People's Bank of China (the equivalent of the Federal Reserve).

Still, they and other leaders face an uphill battle. Even if local production can be kick-started, Henan-made goods, while cheaper than those from the Pearl River

HEADED BACK: *An unemployed migrant worker in Xichuan, Henan province*

Delta, will remain more expensive than Vietnamese or Indonesian products. That means success in kick-starting local manufacturing will ultimately depend on whether the state can stimulate local consumption. However, in the meantime it's important that the government be seen to be trying. Its efforts are "clearly the right thing to do right now, both because some of the firms will gain traction and because it will make the right impression on people," says Rothman. State-run programs won't solve all the problems, in other words. But they're a start, and they just might help avoid Beijing's worst nightmare: mounting public anger that bursts into the streets. ■

Keeping Stability at All Costs

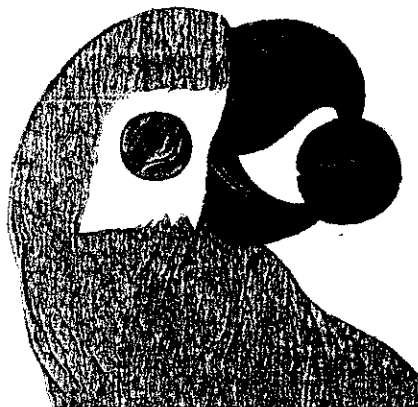
THE CURRENT GLOBAL ECONOMIC CRISIS HAS BEEN TRAUMATIC ENOUGH to throw many countries into a deep funk. But in Brazil, life is still a beach. No, it's not as if Brazil is completely unaffected by the worldwide collapse in economic growth. After expanding at an average of nearly 4 percent over the past five years, the Brazilian economy is set to slow to a crawl in 2009. Capital flows are shrinking and credit is harder to come by in the country as well. But given

its long history of crises, Brazil's reaction to the current shock is more along the lines of "we have seen this movie before"—and its past experience has seasoned the nation to weather such storms. There's also a sense of relief that the latest episode is centered around a global growth meltdown and is not homegrown in nature.

This mood is perhaps best reflected in a record-high approval rating for President Luiz Inácio Lula da Silva. With an 80 percent rating, he must be the most popular leader in the world, and he has achieved this in part by assigning all blame for the sudden stop in the country's growth to developments in the United States while continuing to capitalize on the five years of unprecedented stability he has presided over. But another reason for the divergent reaction in Brazil compared with many emerging markets in Eastern Europe and Asia is the country's main policy objective this decade of seeking stability above all else, rather than the "growth at any cost" mantra in several other emerging markets.

Brazil had good reason for doing so. Since 1980, the country has typically suffered some sort of crisis every five years. The last one was in 2002-03, when markets feared Brazil might cave under its huge debt burden. Since then, it has made remarkable progress in reducing its dollar debt, building up a large war chest of foreign exchange and anchoring inflationary expectations. Brasília's policy initiatives—including targeting a low inflation rate and increasing spending on social programs—were also guided by this desire to achieve stability. Result: an annual growth rate of 2 percent in the 1980s and '90s, and nearly 4 percent during the global boom period stretching from 2003 to 2007—but still well short of the average 7 percent growth across the developing world during the same period.

While the importance of stability in fostering sustainable growth cannot be underestimated, it's safe to say that it would have



The global crisis has thrown most states into a funk, but life's still a beach in Brazil, thanks to shrewd management.

been difficult for Brazil to achieve any of its objectives without the support of the roaring bull market in commodities. Therein lies the key to Brazil's growth. Commodities such as iron ore and soybean make up 55 percent of Brazil's exports. And even though exports, at 15 percent of GDP, form a not-too-large share of the economy, evidence from the past few decades shows that Brazil's growth rate has oscillated around an average 2 percent, and variations from that trend are largely explained by commodity price swings.

Commodity prices have indeed fallen sharply over the past few months but remain well above the average levels of the past two decades, thereby providing the economy with some cushion. Furthermore, since Brazil never recorded the gangbuster growth rates of other commodity exporters such as Russia and parts of the Middle East, it finds itself better able to cope with the present dire external funding environment. Brazil does not have a significant amount of

debt to roll over this year. To fund growth, Brazilian companies did not leverage their balance sheets as aggressively as other companies did during the liquidity boom of the past few years.

In effect, the Brazilian economy has managed to move to a lower-volatility regime, whereby it will be able to avoid the boom-bust cycles of the past—especially compared with other major commodity-exporting nations—after long being considered the soft underbelly of the emerging-markets world. But the low ambition on the growth front also implies that it will be a very long time before Brazil can break out of its middle-class existence. That means that the country's policymakers can no longer be content with just achieving stability. They will now have to think more in terms of how to put the country on a faster growth track.

Brazil's productivity growth over the past two decades has averaged an abysmal 1.5 percent, as businesses have been stifled by a prohibitive tax structure. The government has been compelled to maintain high taxes to fund its huge spending, which, at 37 percent of GDP, is extremely high for a developing country. And for all the work done toward promoting stability, little has been done in the way of structural reforms, such as reducing the inordinately large share of taxes in the economy or amending cumbersome labor laws. These changes are required to fully unleash the entrepreneurial energy in the country and boost Brazil's long-term economic growth trajectory.

Brazil must then stop soaking in the glory of its last victory, get off the beach and work toward moving higher on the development plane. Otherwise, the country's growth profile will remain relatively unimpressive and vulnerable to commodity price swings. And if commodity prices fall further, even Brazil's much-heralded stability could come under threat.

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

By BARRETT SHERIDAN

IF THERE IS A SINGLE LESSON TO have emerged from the current financial crisis, it is that lending got out of control. The West needs less of it—not less compared with today's levels, of course, because right now virtually no one is lending, but less than was sloshing around over the past decade, when banks borrowed \$26 for every \$1 they owned, and the average American family owed \$121,000 on their house.

The stereotype of the gentleman banker who makes plain-vanilla loans and retires to the golf course at 3 p.m. is no longer a source of scorn but, in some quarters at least, an ideal. Yet while this new conventional wisdom makes sense for the West, it ought to be flat-out ignored in China. As New York and London learn to embrace the new ethos of thrift, China's banks need to borrow a page from the Citigroup and JPMorgan of old (while avoiding their worst excesses, of course). What this means is they need to start handing out cash, and lots of it. More loans for more people will help China navigate the current economic crisis. It might even benefit the West.

The problem with China's banks isn't their size—the Industrial and Commercial Bank of China is the world's sixth largest corporation, with a market value greater than Microsoft. It's that, despite their wealth, they don't lend enough. And what loans they do make go mostly to large companies and state-owned businesses. According to research by Morgan Stanley, just 7 percent of the loans made last December went to households.

This isn't an accident, but the fruit of a deliberate government policy, a war on lending that Beijing has waged to help keep inflation in check. To keep prices stable during China's years of torrid growth, Beijing set quotas on how many loans could be issued. Now that the global economy is cooling (some might say freezing), inflation is no longer a worry, according to Brad Setser, an economist at the Council on Foreign Relations, Beijing's policymaker ought to "unshackle the banks."

Setser and other experts think this shift is essential because the Chinese government's war on lending has had a lot of unintended consequences. For one, banks offer pretty terrible interest rates to savers, since the government bars them from re-

lending much of their deposits (a bank's chief way of making money). As a result, though Chinese businesses were "raking in fairly significant profits while the economy was doing well," says Eswar Prasad, an economist at Cornell University, they chose not to bank them, and instead spent them quickly, sometimes on frivolous investments. "Any rate of return [on a new investment] is better than something near zero," says Prasad.

The war on lending has had an equally negative effect at the household level. Chinese families save a lot—about a quarter of their income, according to estimates. A major reason for this is the lack of a social safety net; families keep a healthy nest egg

Ordinary Chinese are well aware of the needs for more loans, which is why they've created a shadow banking system of their own. Underground banks can be as informal as an extended network of friends and family, or something more concrete, such as a pawnshop or an agricultural cooperative. Analysts agree that the underground banking system serves a desperately needed function. "These guys are very flexible," says Stephen Green, head of China research at Standard Chartered bank in Shanghai. One study estimates that informal lending countrywide reached \$290 billion in 2007. Yet underground banks are less efficient and can charge usurious rates of 60 percent or more, compared with a legal maximum of 26 percent at formal banks, and the court system is ill-equipped to deal with disputes.

Fortunately, there are signs that Beijing has started to take the hint. To combat the deepening slowdown, Chinese officials have taken steps to let cash flow a bit more freely by abolishing credit quotas, cutting interest rates and lowering deposit ratios. According to Morgan Stanley, Chinese banks made more than \$110 billion in new loans in December—a 14-fold increase over the previous year's level.

Still, more than half of this lending went to short-term uses like paying bills and almost none of it went to households, so the shadow banking system remains popular. And thus Beijing must come to grips with it. Legitimizing the underground banks would be one possible solution. Beijing has taken tepid steps in this direction, which, according to Green, have been greeted with little enthusiasm. Going legit means abiding by government restrictions, including caps on interest rates, which underground money men have resisted. They steer clear of the formal sector "because the regulation is still quite limiting," says Green.

Beijing should heed those concerns, and take the proper steps to legitimize the informal banks, regulating a practice that often amounts to loan-sharking. Persuading the large, formal banks to transmogrify into something more like Citibank—a people's bank for the People's Republic—is another option. Whatever the particulars, the general fix remains clear. The West may need to rein in its borrowing right now. But China needs all it can get.

With LAUREN HILGERS in Shanghai

Bring On The Credit

Too much lending is bad, right? Maybe in the West—but China has the opposite problem.

on hand to pay out-of-pocket expenses. If China had its own Citibank to issue loans and credit cards to all, some of the need for this nest egg would be reduced, because families in a tight spot would have access to credit when it was most needed. The result would be more money to spend on consumer goods, providing a boost to the deflating economy.

Increased lending in China could also have an impact in the West. China has long kept its currency artificially depressed in order to make its exports cheaper for Western buyers. That policy also made Western goods too expensive for most Chinese to afford, however, and led to U.S. complaints of currency manipulation. If more lending in the Middle Kingdom increased consumer spending there, which has historically accounted for just a third of GDP, it would allow China's famously productive exporters to rely more heavily on the home market, and potentially allow Beijing to let its currency appreciate, boosting imports and removing a sticking point in Chinese-American relations.

The Coming China Meltdown

ECONOMIC CRISES HAVE A WAY OF CONCENTRATING MINDS. IN THE MIDST OF RECESSION, the United States and China have an unprecedented opportunity to rebalance their economies, one that they must seize in order to mitigate further global economic fallout from the downturn. American policymakers—and, it seems, significant parts of the Chinese policymaking establishment—do not yet fully appreciate the impact of the global crisis on Chinese economic prospects.

Although official estimates put urban unemployment in China at just over 4 percent of the workforce, most unofficial estimates are much higher—closer to 8 percent—and nearly everyone agrees that the figure is set to rise significantly in the next few months. Some credible estimates suggest that even if China were able to achieve the 7.5 percent growth projected in 2009 by the World Bank, unemployment would nonetheless double before the end of the year.

Things will get worse. China has a huge overcapacity problem, with total production exceeding consumption by about 10 percent of GDP. In the past China has been able to export this excess; now markets in the United States, Europe and elsewhere are contracting rapidly, and it will be all but impossible for rising domestic demand to plug the gap. In addition, collapsing corporate profits will put a sharp dent in new investment, nearly two thirds of which has been funded, in the past, out of retained earnings. Exports and investment have been two of the biggest sources of Chinese growth, and the outlook for both is poor.

China needs to achieve two major objectives. Domestically, it needs to increase employment. Globally, it needs to reduce the amount of overcapacity it is exporting to the rest of the world. But these two goals are at loggerheads in the short run. For example, in order to boost employment, Chinese policymakers have forced banks to increase their lending so rapidly that it will almost certainly lead to a future explosion in bad loans. But because of the structure of the Chinese financial markets, all this new lending is being channeled into the manufacturing and infrastructure sector. Although this will naturally contribute to global demand if it takes Chinese workers off the unemployment line, the consequent increase in production may easily counter this gain. China would thus continue to export too much to a world struggling with collapsing demand.

Within China, policymakers have so far been unable—some would say unwilling—to recognize China's role in the global imbalance. Policymakers who see the crisis as part of a necessary transition toward a more consumer-led economy are ferociously opposed by policymakers who want to combat unemployment by accelerating the existing, and deeply flawed, development model. They seek to maintain an undervalued currency, suppress wage increases and shift credit and resources to manufacturers and other producers of additional capacity. All this has the effect of increasing production and suppressing consumption.

But if China continues to force overcapacity onto a struggling world economy, it could easily lead to trade war. Already China is squabbling fiercely with Asian neighbors as protectionist talk around the world rises alarmingly. Protectionism would be disastrous for China. It would force the country to absorb all its production domestically and, given the limitations of its development model and its financial system, the only way it could reasonably hope to do so would be by closing

factories and firing millions of workers. The social consequences could be disastrous, and could give political hard-liners a leg up.

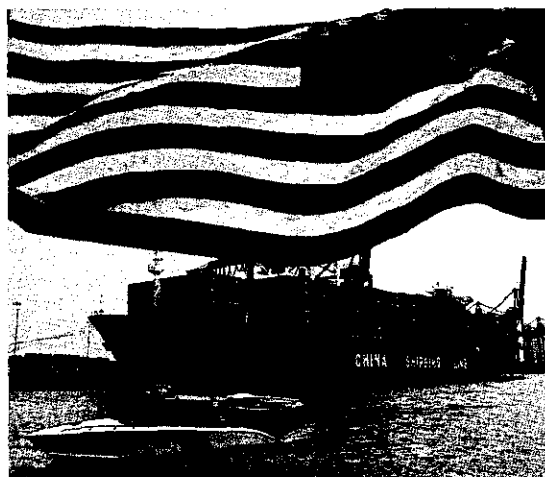
The United States can help China and its reform faction avoid this nightmare scenario. Rather than demand that China immediately revalue its currency and stop subsidizing producers in order to cut its overcapacity, the United States should work with China over a four- to five-year period to achieve a sustainable rebalancing of both economies. For its part, the United States should continue its own fiscal expansion at a measured pace to ensure an orderly savings decline. It should also avoid protectionist trade measures at all costs.

In return, China should gradually continue to revalue its currency and allow the central bank to regain control of monetary policy. It should also continue to reform financial markets, liberalize interest rates, raise minimum wages and improve its social safety net—in particular by increasing health and education spending—in order to free up domestic savings.

If China continues to force excess capacity onto a struggling world, it could result in a trade war.

All this will be difficult, but it would be much better than a catastrophic adjustment. At the end of the day, the U.S. trade deficit must decline, and Chinese domestic consumption must increase in order for the global economy to be healthy. If the two countries can work this out intelligently, the result would be a foundation for global cooperation for decades to come. If not, the world faces decades of hostility and mistrust.

PETTIS is a professor of finance at the Guanghua School of Management at Peking University.



MUTUAL INTERESTS: A Chinese freighter pulls into Miami

A Generation of Destruction

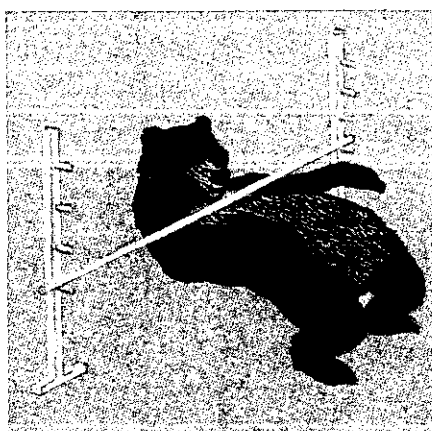
I DON'T BELIEVE THAT AN EVEN MORE DRAMATIC ECONOMIC OR STOCK-MARKET apocalypse is nigh, but many, many wise people do, and I must admit I am more worried now than I was a few weeks ago. I have attended two large conferences of global investors in the last few weeks, and it was clear that at both more than half of the participants believed that the Obama administration has stumbled badly, that its programs are too little and too late and that the president's halo is disappearing.



Since late last week, confidence indexes in the U.S., Europe and Japan that had seemed to level out were once again showing growing consumer concern about the economy. The most highly regarded economists and strategists now expect a long, deep, global recession, with stock markets falling another 20 to 30 percent. A vocal hard core warns of years of hard times comparable to the Great Depression at worst or the Japanese lost decade at best.

Here is their argument. The world's governments and central banks are implementing stimulus programs that have fatal flaws. The synchronized collapse in global final demand was caused by the reckless, speculative expansion of money and credit, and now we are in a vicious supercycle of liquidating debt such as the world has never known. Throwing money at the problem and propping up the greedy banks that created the speculation is, as Jim Walker of Asianomics says, like trying to put out a fire by pouring gasoline on it. The result will be an even bigger, more searing fire. Walker argues that the stimulus programs will only prolong and worsen the credit excesses, and that the massive deficits and reckless expansion of the money supply will unleash hyperinflation, a more painful and socially dangerous threat. Think of Germany's hyperinflation experience in the 1920s or more recently of Brazil's or Zimbabwe's. He is predicting a long, deep, global depression with soaring, paralyzing inflation.

Walker is an economist of the so-called Austrian School. Hayek, Hegel and Schumpeter are its forebears, and they disdain Keynes. The Austrians believe that debt supercycles can only be cured by allowing the world economy to fall into a short but very steep and severe depression, which liquidates the debt, bankrupts the sick banks and companies, and causes soaring unemployment, but also lays the foundations for a new era of healthy



Throwing money at the problem and propping up greedy banks is like trying to put out a fire by pouring gasoline on it.

growth. They call this process "creative destruction," and they concede the pain will be intense but maintain it will be concentrated over a short period of time. Booms can only be corrected by busts.

George Soros points out that the history of financial panics is that the authorities must move quickly and risk overkill. To do too little means that a crisis develops a momentum of its own, which can result in a death spiral that takes decades to reverse, à la the 1930s. By this logic, Obama's stimulus program does not get enough fiscal adrenaline into the economy's bloodstream fast enough. Soros and others maintain it should have been north, not south, of a trillion dollars and that too much of it won't hit until 2010 and 2011.

In his philosophical moments, Soros says that for several millennia in different civilizations, great cycles of wealth creation have usually lasted about two generations, or 60 years. Inevitably, unequal riches corrupt and create envy, and they

are always followed by a generation of enormous wealth destruction. The greatest cycle of wealth creation of all time began after World War II in the late 1940s. He believes it peaked in 2007 and that now the world is in for a generation of wealth destruction that will be very painful. Not a cheery thought.

As for the remedies for the banking system, many wise strategists believe the solution is to be found in the so-called Swedish model. In the early 1990s, Sweden had a huge speculative housing bubble. The Swedes moved aggressively, forcing banks to transfer their toxic loans to a "good bad bank," thus bankrupting most of them. The government then nationalized the remaining banks, installed new managements and cut taxes. The Swedish economy recovered and some years later the nationalized banks were sold back to the public, with the government making a profit. Many were hoping Secretary Timothy Geithner and the Treasury would adopt this model. Instead the Treasury labored with much fanfare and then produced a mouse. Geithner's presentations have been vague and uninspiring.

The bears argue that the Great Depression and the Japanese lost decade were deepened and prolonged by policy errors by the authorities. President Hoover raised taxes; the Bank of Japan raised interest rates and then dillydallied for years. The lesson of Japan is that fiscal stimulus programs alone are not enough. The bank-rescue program will determine the fate of the economy. Bad banks must be nationalized, and the U.S. and Europe should get on with it promptly or we will have our own lost decade and a stock market that falls yet another 25 percent.

These are some of the bear scenarios that are plaguing investors and leading them to believe new lows and a depression lie ahead.

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



EMERGING MARKETS

THE WEAKEST LINK

Commodity-rich Africa profited when the world was growing. Now that it's not, it will be the hardest hit.

By SCOTT JOHNSON

FOR THE LAST DECADE OR SO, AN ECONOMIC UPLIFTING IN AFRICA has brought millions out of poverty. Democracy spread farther and faster than ever before. In December, the World Bank reported that sub-Saharan Africa's 2008 economic growth was 5.4 percent, equaling Europe and higher than Latin America (Africa finally ceded to Latin America its place as the world's slowest-growing region). Even now, many Africans imagine they will escape the global credit crisis relatively unscathed.

They're in for a rude shock. Recent IMF forecasts predict growth of 3 percent

this year, compared to 4 percent in low-income countries. There are three main factors at work. Commodities are Africa's bread and butter and commodity prices have been dropping fast thanks to falling demand due to the global downturn. A second factor is that many African countries are largely aid-dependent, and big Western

donors with slumping economies are less likely to want to give. Similarly, declines in foreign direct investment and remittances will hammer African economies. Finally, the specter of economic collapse, while scary for well-to-do countries, can wreak political havoc in unstable ones. As revenues decline, companies and govern-

ments are likely to have to scale back development plans, which could infuriate populations who had only recently gained some hope that living standards in Africa could rise. "Most Africans believed they'd be untouched," says Greg Mills of the Brenthurst Foundation, an independent think tank in South Africa. "But they underestimated the scale and the intensity of this crisis."

The first thing to implode has been commodity prices. Excluding gold and cocoa, raw-material prices have dropped across the board. Following a historic five-year boom during which energy prices soared by 320 percent, metals and minerals prices rose by nearly 300 percent and food prices were up by 138 percent, commodities plunged in late 2008. In December the World Bank predicted that real food prices would fall by 26 percent between 2008 and 2010, oil prices by 25 percent and metals prices by 32 percent.

For African countries reliant on oil or metals and minerals, this spelled economic disaster. Botswana's economy is almost wholly dependent on diamonds.



De Beers, which has largely financed Botswana's growth, last month shut down its mining operations for several weeks and said it would reduce production by about 50 percent through April. Several large coal-mining projects in Mozambique recently shut down as the bottom fell out of fuel production. In South Africa, annual gold production plummeted 13.6 percent to levels last seen in 1922. A plummeting copper price—down by about 60 percent—has led to mine closures and thousands of job losses in the Copperbelt region of Zambia, where copper accounts for 80 percent of foreign earnings and has been the major driver of economic growth. Few African governments were competent enough to use the good times to spur development. Now, prospects will dim further.

Next to be affected will be the aid-dependent countries like Rwanda and Tanzania (Mozambique, which, aside from being commodity-dependent, gets 20 percent of its GDP from aid, will suffer a double blow). Barack Obama has already retreated from his election-era promise to double the U.S. aid budget in the face of the crisis. Göran Holmqvist, an economist at the Nordic Africa Institute in Uppsala, Sweden, says it's a safe bet that rich Western nations won't honor commitments to double the \$40 billion international aid flow to Africa by 2010.

Investment is also shrinking. The Insti-

The continent's biggest engine for growth, South Africa, is hurtling into a downward spiral.

tute of International Finance estimates that investment flows to developing countries, many of which are in Africa, could drop by as much as 80 percent in the next year. Last week the IMF said that if the global crisis deepened, the number of most vulnerable economies could nearly double to just under 40—and the majority of them will be in sub-Saharan Africa, which is expected to grow by just over 3 percent this year, compared with 4 percent for low-income countries overall.

The economic crisis will also heighten an ever-present risk in Africa: political instability. Even before the crisis hit, Kenya was descending into ethnic conflict. A year later, tourism revenues are down by 35 percent, and its prized agriculture industry of high-end coffees, teas and tropical flowers is suffering badly because scared farmers can't or won't return to their home plots for fear of being killed. Other parts of Africa are also at risk. Liberia and Sierra Leone both rely heavily on a demand for rubber that has been steadily dropping over the last several

CONFLICT ZONE: Sudan will suffer badly

months. When oil prices were \$140 a barrel, there were still low levels of violence in Nigeria. Now that they're at \$40, the threat of instability goes up. And while the West looks for increased state intervention in times of crisis, in Africa the state is often the problem. The implosion of Zimbabwe's economy is the result of misguided policies; the last thing it needs is stronger guidance from a state led by Robert Mugabe.

All this is compounded by the fact that the continent's single biggest engine for growth, South Africa, is hurtling into a downward spiral. South Africa was the only nation on the continent that was really plugged into world financial markets, and it is now suffering from the fallout. South African businesses, heavily invested across the rest of the continent, help spur growth further abroad—the country generates nearly half of Africa's gross domestic product and it has been estimated that for every 1 percent increase in South Africa's per capita GDP growth sustained over five years, the rest of Africa experiences growth of about half that rate. Now, after more than a decade of economic boom, South Africa stands on the brink of recession. The economy contracted by 1.8 percent in the last quarter of 2008. Last month, new vehicle sales plunged by 36 percent year-on-year, and car manufacturers asked government for a \$1 billion bailout. This week Bank of America Corp.-Merrill Lynch & Co. predicted that South Africa's economy would shrink by 0.6 percent in 2009 as global recession reduces demand for its exports and domestic consumption drops. Despite all this, there may be some upside to the crisis. A drop in oil and food prices has brought relief to the poorest countries hit by the food crisis last year. Antoinette Sayeh, Africa director for the IMF, also points out that African economies are better prepared for global economic shocks than in the past thanks to some fairly comfortable levels of foreign-exchange reserves. The question now is what Africa is going to do about it. The downturn has called attention to the inadequacies of donor-driven aid and development policies established by the West; after literally hundreds of billions of dollars spent, more Africans live in poverty today than 60 years ago. But the crunch has also highlighted the failures of African governments to develop coherent economic policies. Doing so will be harder in tough economic times. But if ever the time has come, it's now.

With KAREN MACGREGOR in Durban

\$919_{/oz}
MARCH 2009

WORLD AFFAIRS

Cash in a Mattress? No, Gold in the Closet.

With prices setting new records, the worried wealthy are piling up ingots in home safes. NEWSWEEK goes shopping for precious metal.

By LISA MILLER

A HUNDRED-OUNCE GOLD BAR, WHEN YOU HOLD IT IN YOUR hand, is surprisingly small and even more surprisingly heavy. It's somewhat longer and fatter than a Hershey bar, but it weighs six-plus pounds—as much as your old calculus textbook. Its color is unforgettable. Pure gold is *gold*. It's not like your wedding ring or your grandmother's bracelet. It's a deep, dense yellow, the way the ocean is deep blue, and it sparkles. You can understand at last why the Bible says the streets of heaven are paved with it.

On the day I held the gold bar in my hand, it was worth nearly \$100,000. My companion—an established, accomplished, affluent businessman of retirement age—had bought it as a hedge against the sinking Dow and his fear that Obama's stimulus package will inevitably trigger wild inflation. We had picked it up in the basement of an HSBC bank branch in midtown Manhattan. When I handed it back to him, he put it in his briefcase. We went upstairs, past guards, through metal doors. Out on the street, we said goodbye and I watched him go, a tall, thin man carrying a \$100,000 briefcase. He doesn't want me to tell you his name—or, really, anything about him—because he's keeping the gold in a safe in his basement. His friends, he says, are doing the same thing. "There is an increase in the number of wise, reasonable, well-read, well-intentioned people who are buying some gold and putting it aside," says Dennis Gartman, editor of *The Gartman Letter*, a daily analysis of financial news.

John Wynocker, a hydraulics inspector, lives in Cincinnati and has been buying gold and silver coins and bars for 15 years, but since the passage of Obama's stimulus bill, he has been motivated to buy more. He is hiding the precious

metal in places where not even he can find it, he jokes. Are you burying it? I ask. "Perhaps," he says. "Our country is so far in debt, it's staggering. I'd like to retire someday. What else am I going to do to protect myself?"

Is this madness? Here is a respectable and buttoned-down suburbanite, behaving like an end-of-the-world paranoiac. Here is Wynocker, a working man, trying to get a grip on his own financial future with a shovel. The price of gold is near an all-time high—it topped \$1,000 an ounce on March 13—yet the number of Americans who are taking delivery of gold coins and bars is rising. According to the World Gold Council, Americans bought 600 tons of gold bars and coins in 2008, a 42 percent increase over 2007. That's not as much as in Europe, where gold mania has become epidemic—but significant given the metal's high price. An uptick in the U.S. economy, and buyers are likely to find they've been part of a giant, golden bubble.

But analysts say that if stock markets continue to spin out of control and real-estate values continue to sink, more people will want to take shelter in an investment with a reputation for being safe, reliable and not dependent on governments for its value. "Back in November, when the credit crisis really started getting out of hand, people started to pull the trigger on gold," says Scott Thomas, president of American Precious Metals Exchange. "It's primarily moms and

\$806_{/oz}
OCTOBER 2008

pops, people who have seen their 401(k)s deteriorate over time." Bullish investment advisers, meanwhile, are hyping gold, some promising that it will reach as high as \$2,300 an ounce. "We say, 'Panic now. Avoid the rush,'" jokes Addison Wiggin, who publishes the online financial newsletter *The Daily Reckoning*.

There are, traditionally, two kinds of gold investors: speculators and hoarders. The first group trades on the futures market, which establishes the price of gold. The money they make—or lose—usually has nothing to do with taking possession of gold: like most modern-day investments, their gold acquisitions are blips on a computer screen. Hoarders are different. They buy gold, the real stuff, and save it for a rainy day. Hoarders have always existed, but their numbers increase during financial crises. To generate liquidity during the Depression, President Franklin Roosevelt outlawed hoarding in 1933. He demanded that everyone who owned gold coins (except collectibles) or bars turn them in and receive \$20-plus an ounce in exchange. That law was rescinded in 1975, and since then retailers that sell actual, physical gold to individuals have sprung up.

Their business models vary, but all gold retailers charge a premium over the spot price and all will deliver it where you want it—usually through the U.S. mail. The *mail*? I asked Michael Maroney, who is vice president of sales for the Newport Beach, Calif.-based retailer Monex, as I imagined my own postal carrier slipping a gold bar in my apartment's group boxes. The post office offers low insurance rates on precious metals, Maroney explains. "We can never tell you when you're going to get it, but it doesn't disappear."

The last time gold sales spiked so dramatically was the year before Y2K, when Armageddon-minded Americans stashed gold—along with guns and cans of beans—in their basements and backyards. Keeping a lot of gold in your house makes you a target, it's costly to insure and, once stolen, gold, which is easy to melt and recast as something else, becomes nearly impossible to retrieve. That's why Nick Bruyer, the president of First Federal Coin, says he always recommends "a safe-deposit box in a good bank." Nevertheless, the mentality of gold hoarders is that they want it close by; in an emergency, they don't trust the banks. Sales at Cannon Safe were up 43 percent in 2008, and CEO Aaron Baker estimates that 30 percent of new safe buyers are holding precious metals. The company is developing a new ad

campaign—"The bank that never closes. You're Cannon safe"—and hopes it will appear on billboards near Wall Street soon.

In times of stress, gold's unique properties and its long history as a valuable asset make it an appealing buy. Gold is gold, its boosters say. Its monetary value may rise and fall, but its intrinsic value remains constant. Gold-industry people like to give this illustration: in the Middle Ages, a one-ounce gold piece bought a full suit of men's clothes. Today, a one-ounce gold piece—about \$950—buys a full suit of men's clothes. The ballast it provides, then, is both psychological and financial. "It looks like the sun and reflects terrifically," says Robert Hoge, a curator at the American Numismatic Society. "It can be beaten into dust or foil; it can be drawn into a wire that's the finest of any substance known. It is relatively soft and can be melted

Gold appeals to our survivalist instincts, offering protection if the system collapses.

at a low temperature." Hoge pauses. "Even birds pick up glittering attractive objects."

At least since the sixth century B.C., when King Croesus of Lydia (of "richer than Croesus" fame) decided to melt gold lumps into standard shapes and weights, gold money has been spent, traded, hoarded—and valued above all other coins. For much of modern history, government currencies were backed by gold, an economic practice (known as the "gold standard") meant to limit inflation. But there's a rational aspect to buying gold now. Historically, the price of gold has been inversely correlated to fluctuations in the dollar; that's why it is seen as the ultimate inflation hedge. "Gold," says Jon Nadler, the bearish gold analyst for Kitco, "is life insurance for the rest of your portfolio."

Nadler knows whereof he speaks. When he fled communist Romania in 1972, "my clothing was full of four-ducats and one-ducats coins." He has dipped into that stash three times in his life: once to leave Romania; once to buy a small piece of property; and once, more recently, when his older son was accepted at Harvard: "I thought, OK, here it is." In North America, where democratic governments and financial markets generally function, the idea that a person might have to flee with hard assets is still considered somewhat freakish. But to refugees of real cataclysms,

whether the Holocaust or the civil war in Rwanda, owning hard assets to trade or barter is not only sensible, it can save your life. "That's why people see gold as the currency of ages," Nadler says.

Geoff Farnham is clear-eyed about his investment in gold. It's a hedge, not a love affair. A retired software engineer from California, he started collecting gold when he inherited some rare coins from an uncle, but over the past year he's bought a lot more. He now has 15 percent of his portfolio in gold coins, he says, which he keeps in a safe-deposit box. He has never seen the attraction of gloating over his gold, like Gollum over his "precious." "It's just metal in the end," he says. "It's not as thrilling as I thought it would be." At the same time, Farnham believes that all gold bugs—regardless of who they are—at some level fear the worst. "There is a survivalist element to buying gold. Period. I think that's why my uncle had the gold in the first place. I would hate to see the day when you need it."

There's the rub. In the event of global collapse and inflation, in a world in which paper currency is worthless, what good will gold actually do? How do you take your gold bar to the 7-Eleven and buy a gallon of milk? Mark Albarian, chief executive of Santa Monica, Calif.-based Goldline, says that when dollars are worthless, a gold bar will buy a whole lot of dollars, which you can then use to go buy milk. "We buy gold in case the unimaginable happens," he says. James Turk, who runs a company called GoldMoney, takes this doomsday scene one step further: in a financial calamity, entrepreneurs will emerge who will melt and mold your gold into coins or exchange it for a currency that does have value.

Nadler shakes his head. First of all, it's disingenuous of the owners of gold retailers to stoke fears of systemic collapse for their own gain, he says (though he works for a retailer himself). Second, there are reasons to be optimistic. "Things tend to go in cycles; ingenuity, resourcefulness and human resolve solve problems. There's fresh management in the White House, really determined to address the immediate problem." In any event, Nadler says, gold bars and coins won't save your life in an apocalypse. "I say you're better off with Cipro and bullets on that day." Gold, he cautions, is at an all-time high—and we've seen what happens when too many people buy high. The best thing to do, says Nadler, is buy a little gold—"for your last airplane ticket to Fiji if you have to go"—and hope the price goes down. If gold goes down, your 401(k) will likely go back up—and you won't have to dig for treasure in your own backyard.

With JESSICA RAMIREZ

N See which companies are cutting jobs in a gallery at xtra.Newsweek.com

The Recession's Green Lining

A global downturn is doing what activists couldn't: closing dirty factories.

By SHARON BEGLEY

TO SAVVY SNOWBOARDERS, Baikalsk has long been the beautiful resort where visitors are so few you can feel as though you own the mountain, at least temporarily: for about 5,000 rubles (\$175), you can have exclusive use of one of the six long runs for the day and never see another soul as you schuss through forests. Of course, you've had to tolerate a smell that seemed to be a blend of rotten cabbage and New Jersey Turnpike. For in addition to the resort, this town on Siberia's Lake Baikal—the oldest, largest and deepest freshwater lake in the world—is home to the Baikal Pulp and Paper Mill, which has been belching foul-smelling sulfates into the air and chlorides, phenols and other chemicals into the lake since it was built during the Cold War. The pollution killed plants, crabs and fish and threatened the world's only freshwater seal, the earless nerpa. Environmentalists have been trying to shut down the mill since 1964, getting precisely nowhere. But where greens failed, the global recession succeeded all too well. In November, the plant ceased production. "The economic crisis," says Marina Rikhvanova, the head of the environmental group Baikal Wave, worked "like magic."

It is no coincidence that some of the dirtiest industrial operations are falling victim to the global recession. Over the past two decades, much of the world's manufacturing moved to where pollution standards are little more than mild suggestions. Since small, corner-cutting, inefficient facilities tend to both flout pollution laws and be most vulnerable to a sudden drop in demand, the global recession has hit such operations especially hard. Thousands of factories in China's Pearl River Delta have shut their doors since late last year, for instance; output of autos, electronics and other goods from factories in Mexico's Ciudad Juárez, Monterrey and Toluca has fallen so sharply that the amount of cargo trucked across the U.S. border has dropped 40 percent. In India, enough small steel-rolling mills around Delhi have closed that levels of sulfur dioxide (which forms acid rain) fell 85 percent in October

2008 compared with a year earlier. The recession is bringing a green dividend in the developed world, too. Reduced economic activity is projected to cut Europe's emissions of carbon dioxide, the chief man-made greenhouse gas, by 100 million tons in 2009, and the United States' by about the same amount.

At Baikal, the post-recession economy is poised to undergo a more radical shift, from pulping trees to serving tourists. One weekend in February the mountain was packed with skiers and snowboarders. Resort manager Yury Shiriak says that in December they had 7,000 visitors, compared with the usual 1,000. "Baikalsk will



COW PROD With the price of beef down by half since last year, Brazil's cattle ranchers are bowing to government efforts to protect the Amazon

Recession is not exactly a long-term environmental strategy, obviously. The challenge is to use the downturn to de-emphasize manufacturing in favor of cleaner economic activity, and to reengineer what survives so that when the economy revs up it's not at the environment's expense. Even world-class polluters get it. In China, as factories seek lines of credit to see them through the downturn, local governments are "less likely to help companies that are considered major polluters," says economist Deng Yupeng of Dongguan University.

slowly transfer from an industrial place hated by ecologists into a tourist paradise," he predicts. It will help that the air and water are already cleaner. Only three months after the mill closed, locals already noticed a change. "We are so used to pollution, to the smell of rotting cabbage," said Andrei Pylukh, an artist. "The fresh air feels unusual. I see so many more birds on the lake and in my garden." The challenge for Baikalsk is to invest in hotels, restaurants and other labor-intensive, less-polluting businesses so the mill remains a perma-

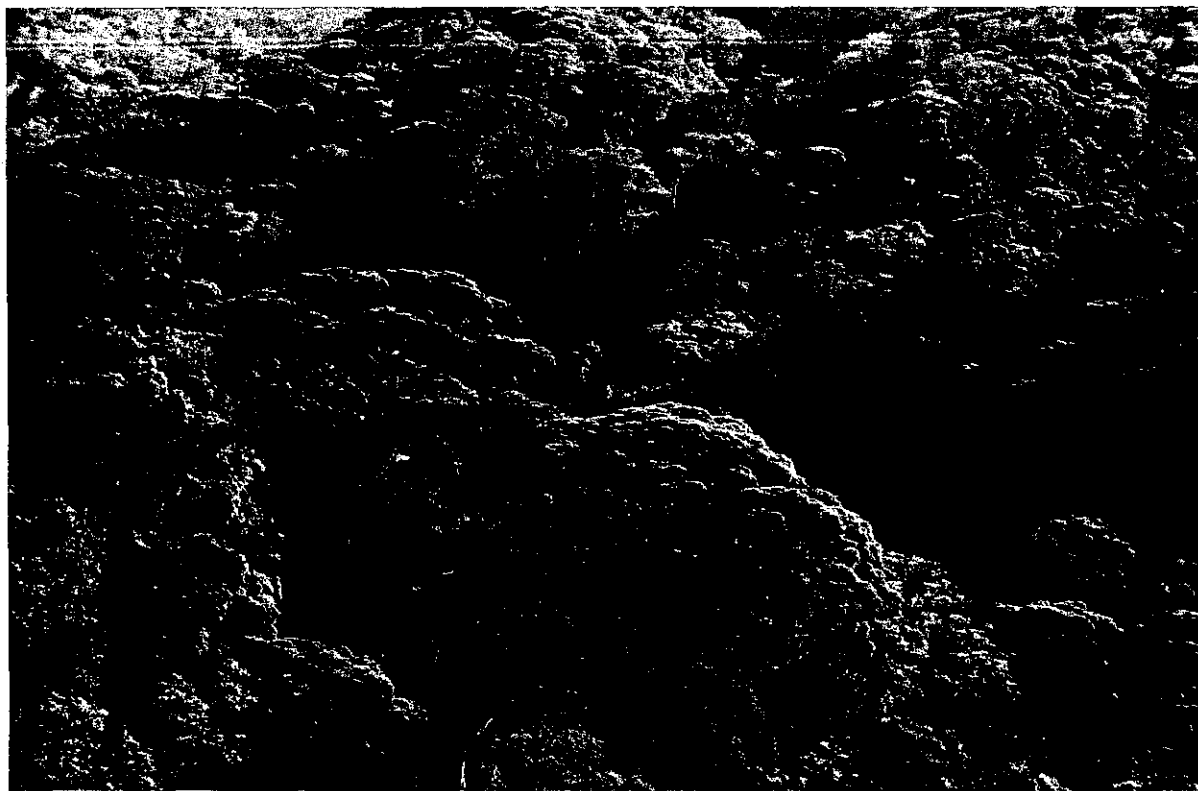
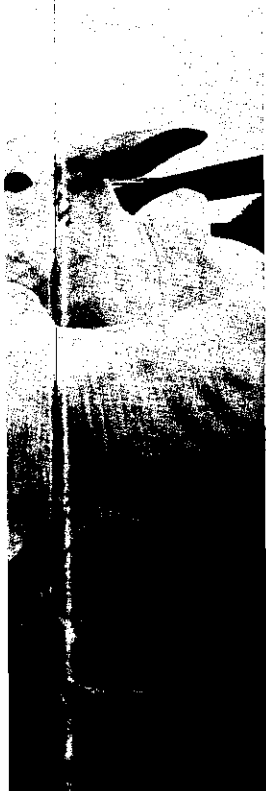
nent victim of the green recession but the town—which lost 2,300 jobs when the mill closed—doesn't.

The impact of China's slowing economic growth (6.8 percent in the fourth quarter last year but 13 percent in 2007) has hit hardest in cities in the export-heavy south such as Dongguan. There, roughly 10 percent of the 22,000 factories have closed since last year. In Zhejiang province, just south of Shanghai, at least 60,000 small factories are shuttered. Survivors have slashed production and grounded fleets of diesel-fume-belching trucks. As a result, streams where factories dumped their waste are getting cleaner

preservation, and that spending money on pollution controls or switching to renewable energy has to wait. In Guangdong province, factory owners are lobbying the government to roll back environmental standards that, they argue, have made them uncompetitive with Southeast Asia. And factory managers, under pressure to cut costs, know they can reap easy savings by turning off smokestack scrubbers and dumping waste rather than treating it.

But these may be the last gasps of dying industries. There are also signs that China, which has acknowledged that environmental damage had become a drag on the economy, may use the reces-

practices is more of a challenge. About two thirds of Brazil's 200 million head of cattle graze in the Amazon where virgin forest once stood, making cattle the single biggest cause of deforestation there. Now falling beef prices (down 51 percent over the past 12 months) plus the shortage of farm credit have done what "save the rainforest" campaigns didn't: give Amazonia a reprieve. "The economic downturn is a natural brake on forest destruction," says Carlos Nobre, a climatologist at Brazil's National Institute for Space Research. The rate of deforestation from last November through January, the institute just announced, fell 70 percent from the



and the air is less smoggy. In 2008, the number of days with dangerous levels of air pollution in Dongguan fell by 65 from the year before, mostly in the final months of the year. "When there's less work, there's less release of sewage and trash, so environmental pressures have eased," says environmental scientist Liu Zhiming of Dongguan University of Technology.

But as in Baikal, the challenge is what to do when orders pick up again. If factories ramp up to 2007 production and pollution levels, the time-out offered by the green recession will have been wasted. There are hints that that might happen. Factory owners in China and elsewhere argue that their top priority should be job

IN RETREAT *Near Brazil's Serra dos Órgãos National Park and throughout Amazonia, rainforest loss is down 70 percent from a year earlier*

sion to retool part of its manufacturing sector. Some of a 4 trillion-yuan (\$585 billion) stimulus package is targeted at projects that will improve energy efficiency, including wind and solar energy to power the "green economy" that Prime Minister Wen Jiabao called for. The Ministry of Environmental Protection reportedly rejected 11 projects because they consumed too much energy or would have caused too much pollution.

For some victims of the recession, using the downturn to institute greener

same period a year before. The environment minister believes that's a result of greater enforcement, however, not of the recession's effect on ranchers. But you can say this for the downturn: it's much easier to enforce forest-protection laws when ranchers aren't all that eager to chop down the jungle.

With ANNA NEMTSOVA in Baikal, CRAIG SIMONS in Dongguan, DUNCAN HEWITT in Shanghai, MAC MARGOLIS in Rio de Janeiro, SUDIP MAZUMDAR in Delhi and MALCOLM BEITH in Mexico City

Newsweek

A legendary Wall Street bull makes the case for how aggressive government rescue efforts and super-cheap stocks could revive markets, fast.

CALMING THE BEAR

By Barton Biggs

I recently laid out in NEWSWEEK the bearish argument for why we should be very gloomy about the global economy, bearish about stock markets and deeply depressed about the world in general. I told readers

■ FOR YEARS WALL STREET'S TOP STRATEGIST, BIGGS NOW HEADS TRAXIS PARTNERS HEDGE FUND.

it was my belief that there was a 50 percent chance that the world was facing a long cycle of recession, depression and wealth destruction. I maintained that the bears believe that the best-case economic scenario is Japan's agony since the



GET YOUR MOTORS RUNNING: *Some auto dealers are increasing their assembly-line production*

1990s, and the worst is a replay of the 1930s.

Since I wrote that piece, two things have happened. The first is that the global economic outlook has deteriorated—the market consensus now is that the angle of descent of the U.S. economy, as well as that of Europe and the major emerging markets, has steepened. Second, and even more disconcertingly, President Obama has announced what many investors consider to be a populist redistributionist tax agenda, which increases the tax rate on capital gains and dividends and gives tax reductions and distributions to the middle class and the poor. Neither event has buoyed investor mood.

Despite this, I still believe that there is a 50 percent probability of a happier outcome. The world is having the most severe recession of the postwar era, and the recovery will be sluggish and plagued by inflation. Nevertheless, the doomsday scenario of depression and deflation, with 5000 on the Dow Jones industrial average and 500 on the S&P 500, is farfetched. Markets could be on the brink of a major rally, and the U.S. economy may begin to recover later this year. Here are the reasons, in no particular order.

First, the financial panic and the collapse of the world economy caught the so-called Authorities (i.e., the central banks and the governments of the world) by sur-

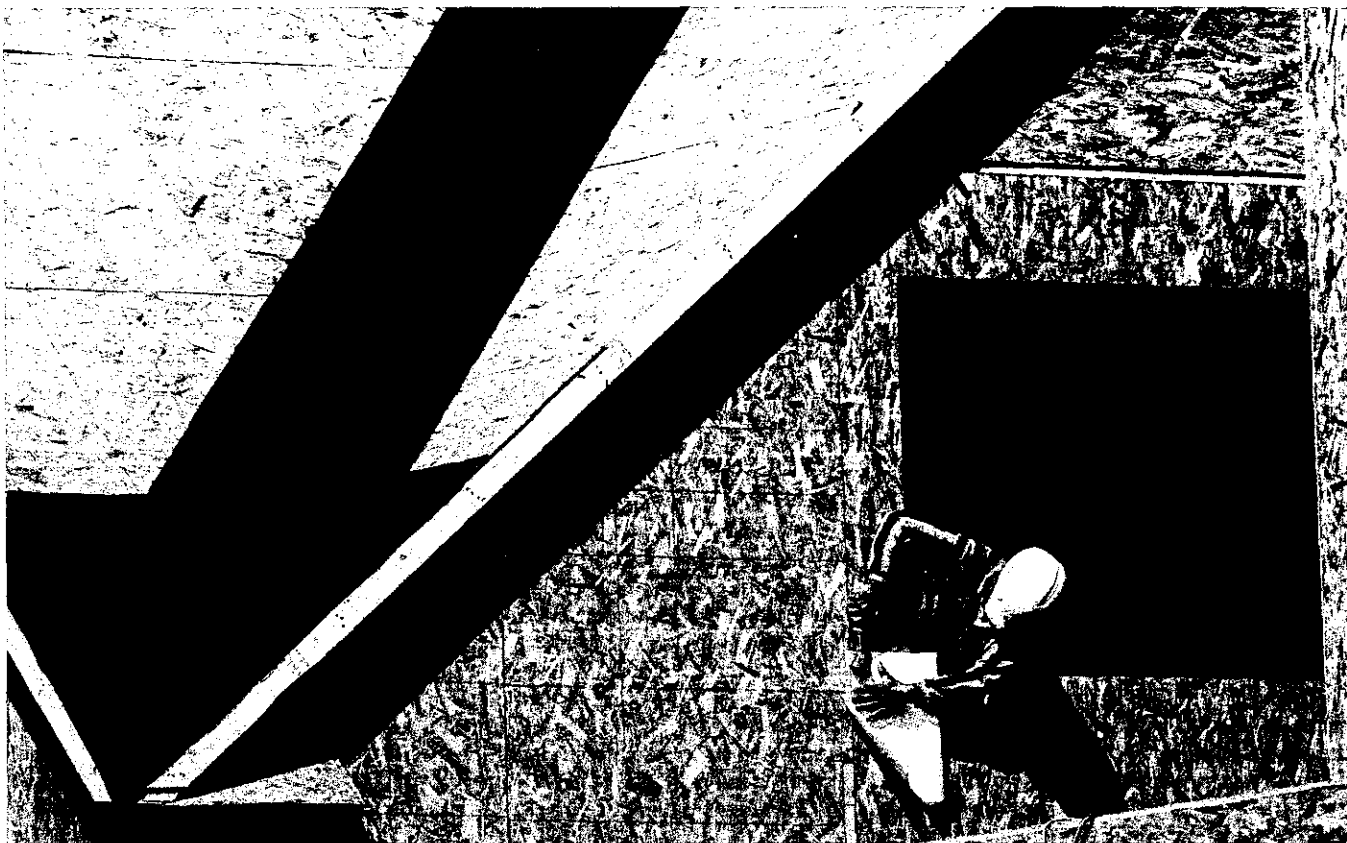
prise. They reacted slowly, but nevertheless far faster than the Authorities in the U.S. in the 1930s or Japan in the 1990s. In both those cases, the Authorities were not only tardy, but they also made serious policy errors, such as raising tax rates, imposing tariffs and not curing the banking systems. These mistakes are now well understood—the current Fed chairman has written a book on the subject.

This time around—and this is very important—the Authorities have unleashed powerful fiscal and monetary stimuli that are totally unprecedented in size and scope. Interest rates have been dramatically cut everywhere, and every week more countries announce new fiscal-stimulus programs. It takes time for these actions to affect economic activity. Rate cuts and expansion of the money supply are powerful medicine, but won't make a difference for at least a year. Fiscal programs are quicker, but also take time to implement. The actions of the Authorities should begin to boost activity by the late spring, and their uplifting effect will grow as the year progresses. In the United

States, the fiscal-stimulus program is expected to add 4 percentage points to real GDP growth in both the second and third quarters of this year. In other words, the world economy should begin to level out and improve as time goes on. We are not in a hopeless death spiral, as the bears say.

Second, the bourses of the world have been falling since 2000 and, adjusted for inflation, are down 60 to 70 percent. The sorry state of the world economy is front-page news. Therefore, it stands to reason that the bad news is extremely well known and must be pretty thoroughly priced into the markets. Treasury bonds have vastly outperformed stocks for 10 years, and the relationship between the two is back to the level of the early 1980s, which was a fabulous buying opportunity for stocks; 1982 was the takeoff point for the greatest bull market in history. Bear in mind that for the entire 20th century, a turbulent 100 years, the annual real return for stocks in the U.S. was 6.9 percent, versus 1.8 percent for Treasury bonds. In Sweden the relevant figures were 8.2 percent per year versus 2.3 percent for bonds; in Germany, 3.7 per-

Over 40 years, my experience has been that when everyone is bearish, it's invariably right to gradually buy.



IF YOU BUILD IT, THEY WILL COME: *Surveys of home builders show some pick-up in demand*

cent versus minus 2.3 percent; and in Japan, 5 percent versus 1.6 percent. Why would you want to be a lender to the U.S. government rather than an owner of real assets or the means of production at a moment when the government is printing more paper than at any time in its history? Rolling more money off the printing presses always eventually means higher inflation and interest rates, which is of course bad for bonds.

Third, depending on your frame of reference, stocks are either cheap or very cheap, in absolute terms as well as versus inflation and interest rates. In America, the price-to-earnings ratio of the S&P 500 when it is calculated on a market-capitalization-weighted basis is about nine times already depressed earnings. At the height of the bubble in 2000 that ratio was close to 20 times, and at the peak of the recovery in the fall of 2007, it was around 15. In addition, the yield on stocks in both the U.S. and Europe is higher than that on government bonds. Over the long run, the ratio of a company's stock price to its book value (a measure of the retained earnings of a company) and the ratio of its stock price to sales have been the best predictors of performance, and they show exceptional value at the moment. Buy low, sell high!

Fourth, sentiment is just incredibly depressed. I have never seen anything like it,

not even in 1974 when the outlook was very grim indeed. Back then, America had just lost a war in Vietnam and nearly impeached a president, it was suffering hyperinflation and a recession, and its cities were on fire. Still, the gloom wasn't at the levels that we are seeing today. Money-market cash is equivalent to 43 percent of the total capitalization of U.S. stocks, an all-time high. The return on cash is zero! Hedge funds hold more cash than ever before. Private-equity funds are literally being given away because their owners don't want the risk. All of it shows how bearish everyone is.

Over 40 years, my experience has been that when everyone is bearish and has acted accordingly, it is invariably right to be gradually buying. Being a contrarian works. The bottom of a stock-market cycle by definition has to be the point of maximum bearishness. The news doesn't have to be good for prices to rally; it just has to be less bad than what has already been factored into the market.

Already there are some glimmers of hope. In the oil-consuming countries, the huge drop in oil prices is similar to a massive tax cut. The fall in consumption is beginning to level out. Inventories have been reduced to levels so low that production will have to be increased even to meet the current depressed level of demand. The

Japanese car companies have announced assembly-line increases, and in the U.S. auto dealers and home builders' surveys have looked up. Last week, the purchasing managers index (PMI) in China rose for the third consecutive month. JPMorgan's global manufacturing PMI posted a second consecutive gain in February, and its new-orders index has turned and is rising. These indexes are still in recession territory, but the rate of change, the so-called second derivative, has turned up. U.S. house prices are still falling, and mortgage foreclosures are rising. However, the affordability of housing has soared and existing home sales are rising. The Obama administration is proposing major mortgage-term restructuring.

The final antidote to despair was captured by Bernard Baruch in his 1932 foreword to a reprint of Charles Mackay's classic book "Extraordinary Popular Delusions and the Madness of Crowds." "If in the lamentable era of New Economics that preceded the crash of 1929, primitive investors had only chanted to themselves 'two plus two still equals four,' then the disaster might have been averted," wrote Baruch. Similarly, he said amid the gloom that had descended by 1932, "when many begin to wonder if declines would never halt, the appropriate abracadabra may be: 'They always did.' And they always will." ■

GLOBAL INVESTOR
Holger Schmieding

Is the Euro at Risk?

IS THE DEATH OF THE EURO POSSIBLE? AS THE GLOBAL RECESSION DEEPENS, investors are certainly starting to worry that Europe's most ambitious integration project to date, the common currency shared by 16 sovereign nations, could break apart under the strains. The fact that the euro zone, far from decoupling from a U.S. recession, is now contracting at least as fast as the U.S. and the U.K. has added to the concerns. But the notion of a full-scale euro breakup looks vastly overblown.



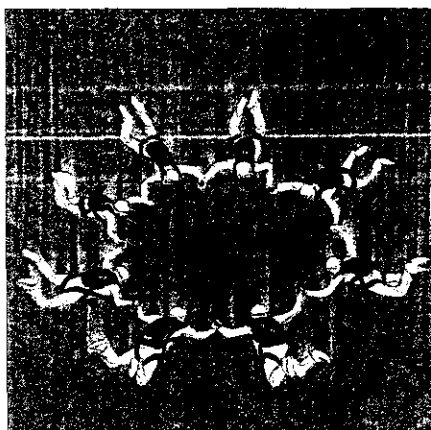
The key reason the euro zone is not doing well is external, not homemade. Because companies around the world can slash their investment plans in times of uncertainty much faster than households can scale back their expenditures, the traditional exporters of top-quality machinery such as Germany are now suffering the brunt of the global downturn. This, in turn, weakens the euro. At some point, however, the worst of the global crisis will be over—with luck, sometime later this year. Once that happens, trading nations with a focus on investment goods, like Germany, should be able to recover lost ground.

The medium-term outlook for core Europe is still encouraging. German consumers had never joined in the credit-fueled party thrown by U.S. and U.K. consumers. While these consumers will probably need to restrain their consumption for years after the crisis, core continental Europe, as well as China and Japan, could enjoy an almost normal consumer upswing once the crisis is over.

Of course, we have to get to the medium term first. The global turmoil has hit the euro zone as a symmetric shock. All economies in the region are now contracting. In this sense, the euro area looks more and not less cohesive than it did a year ago, when regional real-estate booms were already turning to busts in some euro-member countries such as Spain, Greece and Ireland, while Germany was still enjoying strong export growth.

That said, markets are still shunning all kinds of perceived risks, and thus drawing a much clearer distinction between supposedly strong countries such as Germany and supposedly weak euro members such as Greece, Ireland, Italy and Spain, whose governments now have to pay much more than Germany to borrow on global capital markets.

This has led to speculation that some weaker nations might drop out of the euro, perhaps even solving funding prob-



All economies in Europe are now contracting. In that sense, the euro area looks more and not less cohesive.

lems the Zimbabwean way, by printing all the money the government wants in a new national currency. But Zimbabwe, which has taken this tactic to its extreme and is now reeling under hyperinflation and economic collapse, proves that this strategy doesn't work. Any country leaving the haven of the euro would risk devaluing its new national currency, and bond markets would demand very hefty risk premiums. These countries would thus find it much more expensive to borrow.

The occasional speculation in corners of the financial markets that a strong country like Germany might abandon the euro makes little sense either. Just imagine what would happen if Germany reintroduced its old Deutsche mark amid the current turmoil. Foreign-exchange markets would probably bid the independent German currency up quickly and strongly, further crippling the growth prospects of a country that exports half of what it produces. Given the extreme economic envi-

ronment, a German currency might soar even more than in past crises.

The political logic also argues very strongly against a demise of the common currency. All member countries have invested a lot of political capital into the European venture. European leaders meet almost once a month to discuss a huge range of issues. If one country had to ask for urgent help in a particular financial crisis, it would be very difficult for its partners to refuse such a request. After all, that country's vote may soon be needed again in decisions on other matters.

Skeptics have expressed doubt that the euro zone has a pot of money large enough to bail out multiple European member states simultaneously. Yet there are various ways in which euro-zone members could help each other. For example, some European institution backed up by the member states may temporarily guarantee issues of new government bonds by a euro country in trouble. In a similar way, many national governments are already guaranteeing new bank bonds against a fee and for a limited number of years. A similar guarantee to another euro nation would give that member time to ride out the crisis and put its own house in order.

The bottom line: global investors have bigger things to worry about at the moment than a breakup of the euro zone. In the medium term, the crisis may even enhance the position of the euro. Many European countries outside the euro, like Poland and Hungary, are now suffering as their currencies are battered badly. They are trying to get as close as they can to the protective umbrella offered by the euro. The lesson for them is that they should work harder to qualify for Europe's most exclusive club. If they can meet the requirements, their entry will eventually strengthen the common currency.

SCHMIEDING is chief European economist at Bank of America-Merrill Lynch.



BUSINESS

CITIES BEYOND THE PAIN

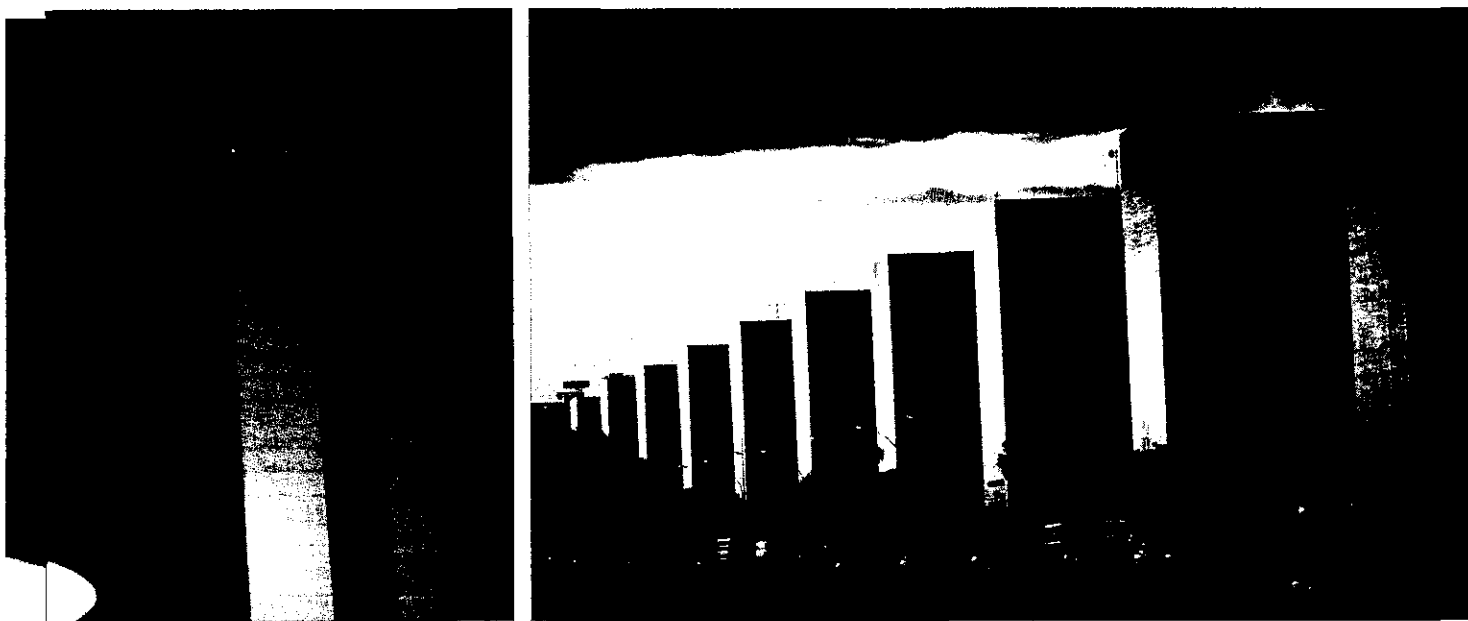
As government gets bigger, so does a whole new class of public-sector boomtowns.

By MAC MARGOLIS

REMEMBER COMPANY TOWNS? FROM DETROIT TO WOLFSBURG, GERMANY, HOME TO VOLKSWAGEN, they used to be places where you could count on a job for life. Now, they are mostly places where you count your unemployment checks. But as the global economy shrinks (we should brace for “the worst performance in most of our lifetimes,” said IMF managing director Dominique Strauss-Kahn last week), and the public sector expands to cope with the fallout, there’s a new kind of boomtown—the government town.

In places like Brasília, Ottawa, Brussels and Washington, not only are new jobs being created, but home sales are rising, incomes are up, car dealerships are full, and new malls, shops, luxury hotels and gyms can’t be built fast enough. “High wages and job stability make the market in a public-sector city like Brasília look irresistible and practically recession-proof,” says Carlos Jereissati Filho, chef of the São Paulo-based Iguatemi Shopping Center Company, which is building a new \$80 million high-end mall in Brasília with 200 shops, including Louis Vuitton and Zegna.

Other developers agree and are voting with their feet. Even though commercial-real-estate projects in Belgium



CRISIS? WHAT CRISIS? In government towns like Brasília (above), Ottawa, Washington, D.C., Brussels and Edinburgh, happy days are still here

are faltering, bureaucrats in Brussels just gave the thumbs-up to a new €8 million aqua gym and fitness studio to be used by European Commission members. The commission this month also announced plans for an architectural revamp, funded by its own coffers, of the entire EU quarter where it occupies more than 50 buildings.

Similar trends are brewing in North American government towns. Last year, home building nose-dived throughout Canada—except in Ottawa, where industry is scant and one in five workers draws a government paycheck. In the Canadian capital the resale price for condos jumped nearly 12 percent in 2008 and 5.7 percent for single-family homes. No wonder, given that federal employees enjoy a 41 percent wage premium over private-sector workers. As Toronto Star columnist Jim Travers wrote recently, “Hard times arrive here in mink slippers.”

Ditto Washington, where 28 percent of the District’s paychecks are cut by the various layers of the federal bureaucracy. While the private sector has shed 4.6 million jobs since December 2007, when the economic contraction began, the federal government has hired 200,000 workers, according to the Bureau of Labor Statistics. The new administration will likely create another 400,000 temporary jobs and 180,000 permanent ones. No wonder D.C., without a factory in sight, was the nation’s second-fastest-growing job market (after Alaska) in 2008.

Perhaps the biggest prosperity bubble of all is in Brasília, where more than 50 per-

cent of jobs depend directly or indirectly on the state. The Brazilian economy will be lucky to grow at all this year, but Brasília is booming. Wages are already four times the national average and are predicted to grow again this year. In December and January, as national car sales were flat, new car sales in Brasília jumped 20 percent. Home sales rose 25 percent last year and are expected to climb another 20 percent in 2009 compared with a 15 percent drop nationally.

Of course, no one claims that government towns provide some sort of pathway out of recession. If that were the case, Iceland and the Baltic states would be in the black instead of on their knees. In fact, worries over fiscal bloating are stoking debate in boardrooms and policy circles

eral level, the premium is 41 percent,” says the Federation’s Danielle Smith. “That plus 100 percent job stability is why people prefer to seek jobs in the public sector.”

All this may come to a crashing halt as High Street’s crisis eventually reaches government coffers, bleeding the tax base and forcing officials to tighten belts. It’s worth remembering that the last time Britain sank into depression back in the 1930s, every staffer in the entire public sector, from cabinet ministers on down, was forced to take a pay cut of between 10 and 20 percent.

But don’t tell that to those facing today’s wintry job market. If once every grad student dreamed of becoming a derivatives-slinging financial cowboy, now many ache to become bureaucrats. In

In Brasília, where one of every two jobs depends on the state, wages are four times the national average, and predicted to grow.

across the world. While most private companies are slashing or freezing wages, public servants are looking forward to increases of 2 percent or above this year. The distortions are particularly glaring in Canada, where the few industries that are still hiring (high tech and energy) compete on unequal terms for talent with government, where wages, pensions and perks are still growing. A recent survey by the Canadian Federation of Independent Businesses showed that local, provincial and federal governments offered far better wage and benefits packages than the private sector for equivalent jobs. “At the fed-

China, where the state has long played a central role in employment, there’s a growing bull market in civil-service exams. A record 775,000 people sat for civil-service exams in China in 2008—130,000 more than in 2007. “My classmates want to join the public sector,” admitted Yu Shui, who takes night classes at Beijing’s premier business academy, the School of Economic Management. “It’s safer than the private sector.” As Deng Xiaoping said, to get rich is glorious, no matter how you do it.

With WILLIAM UNDERHILL in London, MANUELA ZONINSEIN in Beijing and DINA FINE MARON in D.C.

N View photos of the world’s government boom towns at xtra.Newsweek.com.

WORLD AFFAIRS

By MELINDA LIU

EVEN IF YOU FOLLOW NEWS ABOUT CHINA, IT'S POSSIBLE THAT you've never heard of Chongqing, a sprawling municipality of 32 million people on the Yangtze River. A major industrial center and logistics base, Chongqing bills itself as the "Gateway to Western China." Seventy percent of its citizens are peasants. Per capita income levels, while growing, have never reached those of better-known cities such as Shanghai or Beijing. Yet Chongqing and a host of smaller inland cities like it are central to China's economic-recovery hopes. Chongqing is already outperforming not just the depressed coast but the rest of China, too. The city's GDP is slated to grow at an eye-popping 12 percent in 2009—beyond the wildest dreams of most Western countries, or indeed beyond China's own 2009 national target of 8 percent, which even Premier Wen Jiabao now admits will be "arduous" to achieve.

This unusual record is due largely to billions of dollars in government money. More than 60 percent of China's two-year, \$586 billion economic-stimulus package will go to inland regions, and some \$34 billion is earmarked for Chongqing—more than double the per capita share for China's 1.3 billion people. Ambitious rail- and road-expansion projects—such as the

new facility, as has the major Chinese electronics manufacturer Jiangsu Baixue.) It's a shift sanctioned by Beijing, which sees the city as the centerpiece of its newly reinvigorated "Go West" campaign, which aims to shift China's future growth from the coasts to the vast hinterland. Now, with the coastal export model well and truly broken, Beijing has political license to move full steam ahead with the plan, which is focused on bettering the lives of China's 750 million farmers in more than 400,000 villages, mostly in the interior—and, eventually, turning them into consumers.

The goal was front and center at

China's Money Flows West

As exports plummet and coastal factories close, Beijing looks inland for a new economic model.

Chongqing-Lanzhou rail line—will help connect the Yangtze port and other inland cities to markets farther west as well as to big cities back east: \$220 billion of stimulus money is for such projects. This accelerated spending will, in turn, drive up demand for coal and iron ore—two major commodities shipped along the Yangtze. In January the river's ports saw their first monthly increase in cargo in half a year. "Chongqing has entered a new growth cycle," predicts Mayor Wang Hongju.

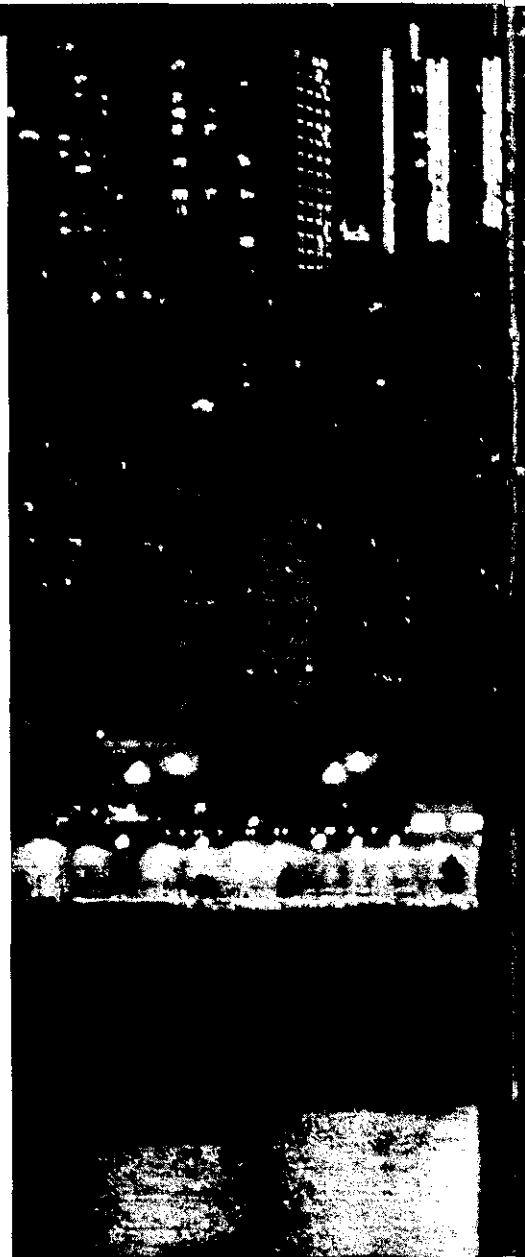
The numbers back him up. Investment in infrastructure and other types of construction in 2009 has jumped 35 percent from the same period last year. And, with labor and property costs still relatively low, companies that once built factories on the coasts are relocating to Chongqing. (HP has begun building a

China's parliamentary session in early March, during which Wen revealed plans to increase spending on agriculture and social programs in rural areas by 20 percent, to US\$104.6 billion, and to boost a nationwide campaign to "send electronics down to the countryside" by giving a 13 percent rural sales rebate on TVs, cell phones and computers. The government is even offering farmers a one-time grant to upgrade farm vehicles to light trucks and cars. At the same time, new shopping centers, cinemas, sports halls and other entertainment venues are going up in Chongqing and other inland areas.

It's all designed to loosen the wallets of China's rural residents, whose incomes have risen 6 percent annually for five years, as well as to tap the wealth of the 20 million migrants returning home to inland

provinces from coastal areas after losing factory jobs. There is money to spend—the average migrant returning to Chongqing brings \$32,000 per household after working for five years on the coast, according to Prof. Pu Yongjian of the Chongqing University School of Management. But getting them to spend it has always been an uphill battle; the average Chinese savings rate is 20 percent, in large part because the lack of a social safety net means that citizens hoard for rainy days.

Chongqing has been scrambling to address such worries ever since grassroots tensions flared a few years back. Now more than 85 percent of its farmers have basic medical insurance. More recently, 9,000 taxi drivers went on strike, blocking roads and setting vehicles on fire to protest their lack of medical insurance, among





other things. Chongqing Party Secretary Bo Xilai quickly met in person with the taxi drivers' representatives—a daring move for a top cadre—to hear their grievances. Right after the meeting, says taxi driver Tang Zhirong (who took part in the meeting), she and her colleagues began receiving monthly allowances and company-subsidized medical care.

Even as government officials try to bolster consumption, they are also trying to boost production in the hinterland, which still has the advantage of lower wages and less frothy real-estate prices. As a center for the automobile, aluminum and chemical industries, Chongqing is keen to prosper the way manufacturers in the east had done for so long. "For decades, the coast got more help from the government," says Yin Mingshan, the private entrepreneur

who heads the Lifan motorcycle and car maker. "Now companies like us will get more government support." Indeed, this past December, Premier Wen visited Yin in Chongqing to announce Beijing's \$733 million bankrolling of 13 percent discounts on rural motorcycle sales, a campaign titled "Motorcycles Down on the Farm."

It's one of many incentive programs already underway in the area. Lifan already receives government funding to develop a hybrid clean-energy car, which is slated for launch this year. Yin will also benefit from Beijing's decision to halve the sales tax on cars with engines smaller than 1.6 liters. Such incentives for the auto industry were part of Beijing's stimuli to 10 specific sectors, from metals to electronics. Lifan makes sedans—60 percent for the domes-

RIVER OF DREAMS: *Chongqing is growing fast*

tic market, 40 percent for export to places like Russia and Algeria—and soon it'll roll out a new model with a 1.4-liter engine: the Lifan 320, a kind of poor man's Mini. Likely price tag: less than \$7,500—just right for a first-time car owner, which many Chinese aspire to be, but also well suited to a host of other increasingly frugal consumers in markets around the world. "I'm more optimistic than I've been for more than a year," says Yin. It's an optimism that's tough to square with the continual stream of bad news still coming out of China's major coastal export hubs, but one that China's leaders hope will reflect its economic future.

With CRAIG SIMONS in Dongguan

POINT OF VIEW
Jim O'Neill

The New Shopping Superpower

CHINA'S FEBRUARY TRADE SURPLUS PLUNGES, INDUSTRIAL PRODUCTION FALLS TO record lows, electricity consumption slows dramatically, millions flee Shenzhen and other cities in the east as factories close. These are just a few recent news items that have prompted client e-mails requesting my latest forecasts for the BRICs, the term we at Goldman Sachs coined back in 2001 to encapsulate the excitement about Brazil, Russia, India and China, the world's most promising emerging markets. What everyone wants to know

is whether this is the end for what we called the BRIC "dream."

The simple answer is no. While I predicted a few years back that the BRIC economies would together be larger in dollar terms than the G7 by 2035, I now believe that this shift could happen much faster—by 2027. Take the gloomy prognostications for China, the biggest and most important of the BRICs. What the China doomsayers don't report is that through February retail sales growth rose by 15 percent. Consumer prices have fallen sharply, providing a big boost in real income. The government is stimulating demand through infrastructure spending, and Beijing has announced major plans to strengthen medical coverage, something that could eventually release a tremendous amount of pent-up Chinese savings. The Chinese A-share market, which fell more than 60 percent in 2008, hit bottom on Nov. 10. It's no coincidence that this was the day Beijing announced a stimulus package of 4 trillion yuan. Since then, Chinese stocks have rallied by more than 30 percent, outperforming U.S. stocks by close to 50 percent.

Who said decoupling was dead? The decoupling idea is that, because the BRICs rely increasingly on domestic demand, they can continue to boom even if their most important export market, the United States, slows dramatically. The idea came into disrepute last fall, when the U.S. market collapse started to spread to the BRICs, but there's now lots of evidence that decoupling is alive and well.

What many casual observers of our BRIC projections never realized is that we used extremely conservative assumptions about real GDP growth. Our forecasts assumed growth in China of just 5.8 percent from 2001 to 2050, including a slowdown to 5.2 percent from 2011 to 2050. Until recently, China had been growing at more than double this rate. Even now, the consensus for 2009 is 7 percent (we are below consensus at 6 percent), rising to more than 8 percent next year. For the period from 2011 to 2050, we project 2.8 percent growth in Russia, the BRIC that is suffering most from the global turmoil, and 6.2 percent growth in India, the BRIC with the most rapidly growing population.

This year the BRICs as a whole will grow only about 4 percent. But compare that with the truly bleak forecasts for the rest of the world. Our latest global GDP forecast for 2009 shows a decline of 1.1 percent. We forecast a decline for the U.S. of 3.2 percent; an even worse fall-off for the euro area, negative 3.6 percent; and for Japan, an astonishing decline of 6.1 percent. The good news is

that things will get better. In 2010, we expect world growth to be near 3 percent, with China, stimulated by growing domestic demand, back at 9 percent, and India at 6.6 percent.

Within this overall picture, there is clear evidence of a major rebalancing, as BRIC shoppers account for an increasingly large share of global consumption. When we track retail shoppers from 2004 to 2008 (using data adjusted for inflation and the relative size of national economies), it becomes clear that European and Japanese shoppers were barely contributing anything to real consumption growth. American shoppers gradually contributed less up to 2007 before completely zipping up their wallets in

2008. BRIC shoppers slowly contributed more, and, importantly, their contribution continued to increase into 2008, despite the collapse of the U.S. shopper.

While many now say decoupling was a crazy idea, this evidence suggests very strongly that it was working in a big way. What confuses people is that because of the sheer dollar figures accounted for by the U.S. shopper, everyone's exports collapsed, and this meant lower GDP growth across the board.

Projecting forward over the next few years, we expect some slowdown in the BRICs' consumption because of Russia primarily, but their global contribution will continue to grow strongly, relative to the U.S. What the trend lines clearly show is the ascent of the BRIC consumer, and a continued trend toward economic decoupling.

At the heart of this shift in consumer power is China. Its total economy already equals that of the other three BRICs put together, and

what happens to China is critical for the BRICs, and the world. With the authorities announcing plans to introduce medical insurance to 90 percent of the rural community by 2011, a huge infrastructure-spending program and a massive easing of monetary and financial conditions, the only debate in my mind is exactly when China will restore its growth rate back above 8 percent. When that happens, I suspect I'll be getting far fewer worried e-mails asking what our new BRIC projections look like!

O'NEILL is chief economist at Goldman Sachs.



STILL BUYING: Consumers in Chongqing flex their muscles

The BRICs rely increasingly on domestic demand and can boom even if export markets like the U.S. slow.

GLOBAL INVESTOR
Jeffrey E. Garten

We Need a G20 Reality Check

WHEN I WAS A TRADE OFFICIAL IN THE CLINTON ADMINISTRATION, I discovered that the British government was unusually talented at writing summaries after difficult negotiations. Their communiqués were not just eloquent, but managed to brilliantly paper over major differences among the participants. It is a skill that will be vital on April 2 when the heads of state of the G20 meet in London to coordinate policies for the worldwide economic crisis.

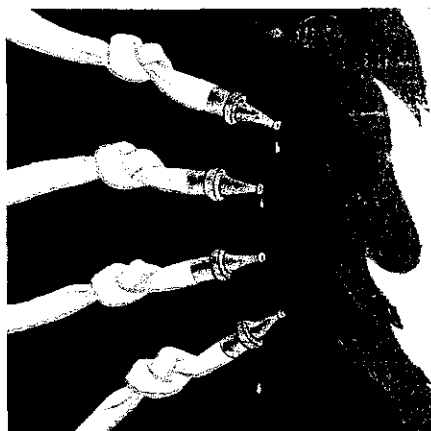


Whatever happens at this summit, it will be light-years away from the expectations that have been building. British Prime Minister Gordon Brown has been calling for a global New Deal. French President Nicholas Sarkozy and German Chancellor Angela Merkel have talked about "remaking capitalism." IBM CEO Sam Palmisano has called for the summit to unleash a new wave of long-term investments, and Fred Bergsten, a prominent economic commentator, says the meeting is the best and last hope for significant policy coordination.

Yet in today's highly fragile global economy, any disparity between the hype and the reality is bound to upset financial markets, investors and consumers. It could exacerbate the already dangerous rise of economic nationalism. It could also damage essential collaboration among key governments that will be necessary long after the one-day summit. That is why officials in London, New York and Brussels in particular should work this week to lower—rather than raise—expectations of what the G20 will accomplish.

In ordinary times, deep cross-border collaboration is problematic. Today it is even more so, with political leaders facing excruciating domestic pressures of plummeting growth, shrinking credit, contracting trade, soaring unemployment and rising political demonstrations. Conducting international diplomacy was difficult enough when the G7 was the central institution, but it is far more complex with the addition of China, Saudi Arabia, Argentina, Turkey, South Africa, etc., all with their divergent interests and political processes.

Beyond that, decision making is made tougher by massive economic and political uncertainties. No one knows how long and deep the downturn will be. No one knows the true state of the banking system. No one knows whether the stimulus measures that have been implemented are adequate.



Against high expectations, the truth is the G20 is not capable of the breakthroughs that the times demand.

Most important are the deep-seated differences among the major G20 participants. The U.S. doesn't want its gigantic stimulus package to become a free ride for Europeans, so it is pushing for the EU to further gun its fiscal engines. The EU wants Washington to take a tougher and more comprehensive line on global financial regulation. Both the U.S. and EU are concerned that Beijing will expand its export subsidies. Brazil is focused on reopening global trade negotiations, something President Obama has all but ruled out. And so it goes.

The best the G20 can do on April 2 is announce a few feasible and concrete goals that fall far short of any claim of revamping the global financial system à la Bretton Woods. To help developing countries, they should announce a major increase in funds for the IMF, including a precise dollar amount and a very short timetable for producing the money. To offset the evaporation of trade credit, they

should create a new trade finance fund, attached to the World Bank. To combat protectionism, they should direct the WTO to name and shame anyone taking antitrade measures, starting the following week.

They should ask a working group of ministers to make proposals within three months for a stronger regulatory regime, indicating guiding principles such as the need to subject every category of financial institution, including hedge funds and sovereign wealth funds, to greater supervision. And they should agree to meet in July and every quarter thereafter to show that coordination isn't an occasional photo op.

The key challenge is to give the markets and the public a sense of hope that some important actions will be taken balanced by a sense of reality that the summit can accomplish only a very limited number of objectives. The good news is that this meeting will not be anything like the disaster of the London Economic Conference of 1933, which collapsed amid nationalist pressures and U.S. neglect. This time around, no government is unaware of the dangers and futility of go-it-alone policies. But the fact is also that governments are a long way from the kind of collaboration necessary to remake the global financial system. In terms of new institutions, they are, for example, simply unprepared to accept the need for a global monetary authority with regulatory powers. In terms of mindset, the major nations are still not ready to make fundamental changes in their domestic policies to accommodate international needs.

The truth is that our public officials are doing the best they can amid massive domestic constraints imposed by the crisis, but they are not capable of the major breakthroughs in global coordination that the times really demand.

GARTEN is the Juan Trippe Professor of International Trade and Finance at the Yale School of Management.

WORLD AFFAIRS

By KENNETH ROGOFF and CARMEN REINHART

THE GOOD NEWS FROM OUR HISTORICAL STUDY OF eight centuries of international financial crises is that, so far, they have all ended. And we confidently predict this one will end, too. We are just not quite so sure it will be nearly as soon as the chirpy forecasts coming from policymakers around the globe. The U.S. administration, for example, is now predicting that growth will renew in the latter part of this year and continue at a brisk pace of 4 percent for several years thereafter. Is this a fact-based forecast or wishful thinking?

A careful look at the international evidence on severe banking crises suggests a far more cautious assessment. The recessions that follow in the wake of big financial crises tend to last far longer than normal downturns, and to cause considerably more damage. If the United States follows the norm of recent crises, as it has until now, output may take four years to return to its pre-crisis level. Unemployment will continue to rise for three more years, reaching 11-12 percent in 2011.

The news on housing prices and the stock market is arguably a little better, mainly because there has been so much damage already. The typical fall in inflation-adjusted stock prices is 55 per-

cent, an incredible conceit of Anglo-American policymakers that their gold-plated financial systems were invulnerable.

British and U.S. financial regulatory frameworks did, in fact, have many strengths. But even a person who can handle a lot of stress will have a heart attack if she takes on too much. And that is exactly what happened under the weight of massive external borrowing. It is too bad, because had policymakers looked at standard warning signs of past financial crises, including the episodes we listed above, they would have realized the extent to which their economies were likely headed for a calamity.

Assuming the U.S. continues going down the tracks of past financial crises, perhaps the scariest prospect is the likely evolution of public debt, which tends to soar in the aftermath of a crisis. A base-line forecast, using the benchmark of recent past crises, suggests that U.S. national debt will rise by \$8.5 trillion over the next three years. Debt rises for a variety of reasons, including bailout costs and fiscal stimulus. But the No. 1 factor is the collapse in tax revenues that inevitably accompanies a deep recession. Eight and a half trillion dollars may sound like a lot. It is more than 50 percent of U.S. national income. But if one looks at the Obama administration's stunning budget-deficit projections, with exceedingly optimistic projections on

Don't Buy The Chirpy Forecasts

The history of banking crises indicates this one may be far from over.



THIS TOO SHALL PASS: An artist's rendering of the Panic of 1907

cent, a benchmark the U.S. has more or less achieved. The typical decline in housing prices is 36 percent. According to some indicators, inflation-adjusted housing prices have already fallen roughly 30 percent. The bad news is that these down price cycles typically last for several years. So, even if the big hit on stocks and house prices has come already, the bottom might not be reached until the end of 2010.

These forecasts may seem somber, but so far the U.S. experience has mirrored past deep banking crises around the world to a remarkable extent. In our forthcoming book, "This Time Is Different: Eight Centuries of Financial Folly," we compare the U.S. crisis with earlier banking-crisis episodes in Spain, Norway, Finland, Sweden, Japan, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Thailand, Colombia and Argentina over the past three decades. It may seem like hyperbole to compare the United States with emerging markets, but hard evidence suggests it is not. True, rich countries are far less likely to face the prospect of sovereign default. (Why bother? Since rich countries can generally issue public debt in their own currency, they always have the option of reducing its value through inflation.) But, contrary to popular belief, banking crises tend to be far more of an equal-opportunity menace. Indeed, a failure to recognize the historical vulnerability of rich countries to financial crises lies behind the

growth and bank-bailout costs, we think the U.S. is right on track.

We have focused on the United States, because it is the epicenter of the crisis, and because the quantitative comparisons are so striking. But one could just as well have been looking at a host of other countries around the globe, most of which are swept up in the maelstrom.

Might things be better than our historical benchmark? Should we, like the group of 20 finance ministers meeting in London last weekend, keep believing in the possibility of sustained strong growth by the end of the year? Today's fiscal and monetary policies are certainly a lot better than what the world saw in the Great Depression of the 1930s. On the other hand, the current crisis is far more global than any seen since the '30s, when most countries took a decade to grow back to where they had started.

Financial crises don't last forever. But this one could last a lot longer if policymakers don't start basing their actions on more realistic assessments of where we are and what is likely still to come.

ROGOFF is the Thomas D. Cabot professor of public policy and professor of economics at Harvard University. REINHART is a professor of economics at the School of Public Policy at the University of Maryland.



Back against the wall Nakagawa had no choice but to resign after his G-7 performance

ASIA

Crunch Time

With the Japanese economy in free fall, the country's leaders are facing monumental challenges. They may not be up to the task

BY JIM ERICKSON AND COCO MASTERS

IF YOU ARE GOING TO TAKE TO THE global stage at a critical time in history, you had better be on your game. Japanese Finance Minister Shoichi Nakagawa certainly wasn't at his best at a recent meeting of the G-7 group of industrialized nations in Rome. During a Feb. 14 news conference, Nakagawa went before the press in what appeared to be an inebriated state. While the cameras rolled, Nakagawa slurred out halting answers to questions, yawned and seemed on the verge of dozing off. He later said he wasn't drunk, blaming his bleary, wobbly performance on jet lag, cold medication and a sip of wine. But the damage was done. Beset by international ridicule and an

The perception is that Aso has failed to deliver the fiscal and monetary steroids Japan needs to avert a deep recession

outraged Japanese public, Nakagawa was forced to resign from his Cabinet post.

The self-destruction of Japan's Finance Minister provided YouTube-quality evidence of what most Japanese already suspect: its current leaders are looking increasingly unprepared to deal with what may be the country's greatest challenge since the end of World War II. Japan's economy, the world's second largest, is contracting at the fastest rate among all developed nations. GDP growth in the last quarter shrank at an alarming annualized rate of 12.7%, Japan's worst showing since the 1974 oil shock. But instead of taking vigorous steps to counteract a worsening recession, Prime Minister Taro Aso is lurching from one embarrassing gaffe to the next, and seems in imminent danger of losing control of his Liberal Democratic Party (LDP)—and control of the government.

Indeed, the only thing falling faster than Japanese industrial output is Aso's popularity, which according to a recent Nippon Television survey has sunk to a 9.7% approval rate, the worst for a Japanese Prime Minister since 2001. Even fellow LDP stalwart Junichiro Koizumi, the influential former Prime Minister, has publicly criticized Aso's blunders, calling them "appalling" and "laughable." Nakagawa's Yeltsin-like meltdown "is one more nail in

KIM KYUNG HOON—REUTERS

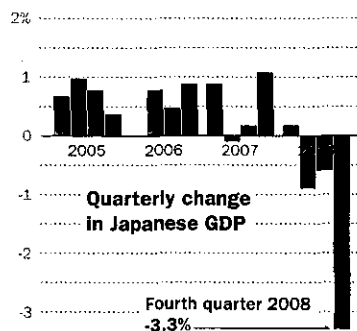
Aso's coffin," says Robert Dujarric, director at Temple University's Institute of Contemporary Japanese Studies. "It shows that he's incompetent and so is his administration."

Aso did what he could to quickly mop up the mess by naming current Minister of the Economy Kaoru Yosano, 70, as Nakagawa's replacement. A fiscal conservative, Yosano will now wear three hats in Aso's government: running the ministries of economy and finance and the Financial Services Agency, which oversees banking. If things get much worse for the Prime Minister and he is forced to resign, there is even talk that Yosano, who was runner-up to Aso in the LDP elections in September, could replace him as the new head of the party and lead it in upcoming general elections against Japan's resurgent opposition party, the Democratic Party of Japan (DPJ).

It's doubtful that Yosano will be able to turn things around. Yosano claims he taught Ichiro Ozawa, the leader of the DPJ, the chess-like game of go. But the last time that Yosano and Ozawa played a match, Ozawa won. With the LDP reeling, it appears Ozawa now holds the political advantage as well—and this will affect whether the government is able to take more decisive action to combat the economic downturn. While Aso's Cabinet in December approved \$811.9 billion in stimulus spending, little of that money has been put into action. Other measures are seen as piecemeal and ineffective, leading to the perception that Aso has failed to deliver the fiscal and monetary steroids Japan needs to avert a deep recession.

Breathtaking Descent.

Japan's recession is getting ugly



Source: Thomson Reuters

The latest economic indicators are dire: exports were down nearly 14% in the fourth quarter, a record three-month drop; with U.S. consumers shutting their wallets, the big guns of corporate Japan—among them Toyota and Sony—are forecasting historic losses and firing thousands of workers; Japan's unemployment rate has spiked to 4.4%, a level not seen in more than five decades. "We have a once-in-a-hundred-year crisis and the policy response is not even average," says Jesper Koll, president and CEO of Tantalum Research Japan. "The people running the show are not politicians, not independent or accountable political leaders. The policies are run by bureaucrats."

The fear is that additional recession-fighting measures planned by the Aso government will be sidetracked by Japan's chronic legislative infighting and revolving political leadership (the country is now on its fifth finance chief and third Prime Minister in two years). Japan's parliament, the Diet, has for the past several weeks been debating legislation surrounding a supplementary budget package that includes a controversial \$21.7 billion handout to the Japanese public aimed at boosting consumer spending. But DPJ politicians—smelling blood in anticipation of general elections, which must be held by September but could come before then—might choose to take advantage of Aso's weakness by blocking passage of additional stimulus measures, no matter how pressing the need, says Credit Suisse chief economist Hiromichi Shirakawa. DPJ politicians "can now argue that the government has already lost their ability to get back on a path to recovery," Shirakawa says. "I think the messy situation could get messier."

Absent an economic miracle, it's possible Japan's political landscape will change dramatically in the next several months. The LDP has been Japan's ruling party for most of the past 50 years. But if deteriorating conditions force Aso to dissolve the Diet's lower house soon, an exasperated Japanese electorate could hand the DPJ enough seats in a general election to take control of the Diet and choose a new Prime Minister. Aso may not survive as the nation's chief long enough to suffer that humiliation, though. "There's no optimistic short-term scenario for Japan," says Gerald Curtis, professor of political science at Columbia University. Aso "is going to have to quit."

The embattled PM may yet have one last hurrah. As the Nakagawa fiasco was playing out in Rome, Hillary Clinton was visiting Tokyo on her first overseas tour as U.S. Secretary of State. Clinton announced that Aso on Feb. 24 will visit Washington to meet with U.S. President Barack Obama. That Aso was selected as the first foreign leader to visit Obama's White House offers a ray of hope that the world's two largest economies are cooperating to solve the economic crisis. But the honor was hardly an unvarnished vote of confidence. During her Japan stopover, Clinton took an unusual side trip by also meeting with Ozawa, the DPJ chief. Is Washington expecting a sea change in Japanese politics? During a period of unprecedented economic turmoil, it's wise to hedge your bets.

Dim future Job seekers like these Tokyo students are facing the toughest market in decades



TOMOHIRO OHSUMI—BLOOMBERG NEWS/LANDOV

KIM KYUNG-HOON—REUTERS

ASIA

Losing Traction. Asia's formula for economic success is failing. How can the tigers get back their bounce?

BY MICHAEL SCHUMAN

THE DEVELOPING WORLD HAS had no shortage of dictators who made lofty promises to uplift the poor and build powerful nations. Few ever delivered.

But then there is South Korea's Park Chung Hee. A general who took control of South Korea after a coup in 1961, he ruled, often with an iron fist, for 18 years. Yet he was also deeply moved by South Korea's destitution. In the early 1960s, the country's per capita national income was just over \$100 and the economy depended on American aid. Park, a virulent nationalist, vowed to do something about this. "I had to break, once and for all, the vicious cycle of poverty and economic stagnation," he later wrote.

The solution Park divined was to hitch South Korea's future to an expanding global economy. The country took advantage of its cheap labor to manufacture necessities like shoes and clothes to sell to consumers in the developed world, particularly those in the U.S. The strategy proved to be wonderfully efficient. It drew investment capital into the country, generating factory jobs for impoverished farmers, infrastructure to supercharge commercial development, and otherwise produced wealth

South Korea could never have generated on its own. Eager to raise living standards in their own countries, Asian policymakers and businessmen to varying degrees adopted the same fast-track formula. The economies of South Korea, Taiwan, Hong Kong and Singapore did so with such success they became known as the Asian tigers. Their growth model produced miracles—and as Park said in a 1965 speech, exports were "the economic lifeline."

Today, the tigers are being tripped up by that same lifeline. As consumer and industrial demand dries up in recession-wracked Western countries, East Asia's export-led nations are proving to be extremely vulnerable to a synchronized global slowdown. Among the tigers, overseas trade is shrinking with frightening speed: Taiwan's exports in January plunged 44% from the same month a year earlier, while Singapore's fell 35% and South Korea's 33%. Overall economic growth is following suit. In the fourth quarter of 2008, Taiwan's GDP contracted 8.4% from the same period a year earlier, the worst quarter on record. South Korea's GDP shrunk 3.4% in the fourth quarter, Singapore's fell 3.7% and Hong Kong's dipped 2.5%.

'We've never seen an external shock like this in Asia.'

—ERIC FISHWICK, HEAD OF ECONOMIC RESEARCH AT CLSA IN HONG KONG

Eric Fishwick, head of economic research at brokerage CLSA in Hong Kong, predicts these dismal numbers will persist. He sees Singapore's GDP contracting 10% this year, while South Korea's will decline 7%, Hong Kong's will slide 5% and Taiwan's will drop, stunningly, by double digits. "We've never seen an external shock in Asia like this," says Fishwick.

Too Much of a Good Thing

THE PROBLEM WITH THE TIGER ECONOMIES is that, four decades on, the spirit of Park Chung Hee is alive and well. While the mix of products may have changed from sneakers and stuffed toys to microchips and flat-panel TVs, the tigers remain heavily reliant upon exports to power growth. And like any addict, they're now experiencing the pain of rapid withdrawal as factories close and millions of workers across the region lose their jobs. Homelessness is on the rise in South Korea's capital, Seoul, where at 2 a.m. each night the city's largest train station becomes a makeshift hostel as scores of 6-ft.-long benches are taken up by dozing men and women seeking shelter from Korea's icy winter nights.

Once booming businesses are resorting to desperate discounting to try to keep customers coming. In Hong Kong, 1,000 restaurants have joined together to offer dishes such as dim sum and roast pigeon for one Hong Kong dollar (about 13¢). In Taipei, Taiwan's capital, fast-food chain KFC held a press conference last month to announce 50% discounts on every second meal ordered, only to have McDonald's employees interrupt by parading with signs promoting \$2 lunch specials.

Even at cut-rate prices, there will still be fewer chickens to fry. At the Hsinchu Science and Industrial Park, home to many of Taiwan's flagship technology companies, more than three but of four workers are currently taking unpaid leave at least one day a week. Ryan Wu, chief operating officer of job-search website 1111 Job Bank, says that conditions at Hsinchu have never been so dire in the park's 29-year history. Wu says that two years ago, the companies that job hunters most often sought out using his service were microchip makers and electronics manufacturers; last year, the most-searched-for company was convenience-store chain 7-11. "I think there's extreme panic right now," Wu says.

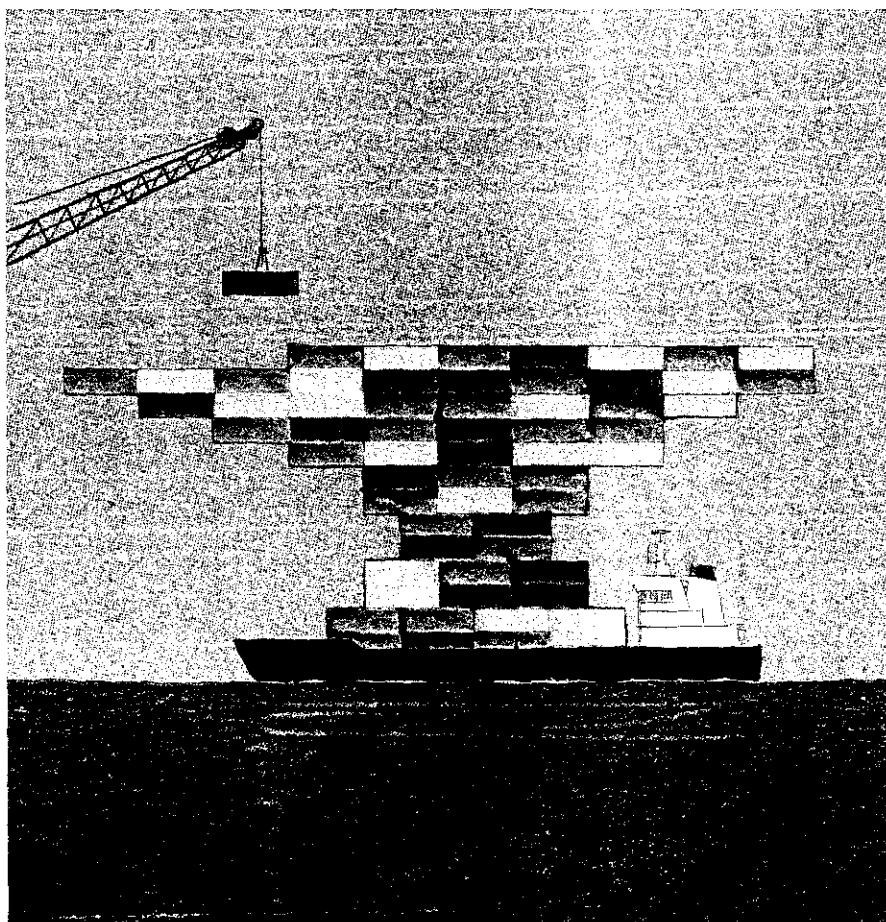
That panic is felt by politicians and policymakers, who have slashed interest rates and hiked fiscal spending in an attempt to stimulate growth. In January, Taiwan's government doled out \$2.6 billion in spending vouchers—or about \$100 a person—to encourage consumers

Asia's model resembles a vast Ponzi scheme, one that is precariously perched on the expectation that Americans will continue buying more and bigger TVs, computers and cars forever

to splash out. The administration of President Ma Ying-jeou is also pushing a \$14.7 billion program of infrastructure projects through the legislature, which includes funding for construction of better bridges and more subways. Singapore in January announced a \$13.4 billion "Resilience Package" that will increase the country's budget deficit to a record level. Yet there is a limit to what governments can do. Exports are simply too important to the tiger economies to be easily replaced. They represented 74% of Taiwan's GDP and 46% of South Korea's in 2007. "You can't change the [export] model," laments Song Seng Wun, an economist at CIMB-GK Research in Singapore. "You just have to make sure everyone can take the downturn."

This Time It's Different

ASIA HAS SUFFERED RECESSIONS BEFORE, of course, and bounced back strongly. But this downturn is different. Unlike during recessions in 1997-98 and 2001-02, Asia's favorite customer—the American consumer—appears to be making profound changes in his purchasing habits. In the long run, this may be a good thing. Roughly 25% of Asia's final exports end up in the U.S., and economists have been warning



for years that America's penchant for borrowing and spending, coupled with Asia's pattern of saving and selling, created massive trade imbalances that would ultimately prove to be economically destabilizing.

But in the short run, Asia is finding itself powerless to adjust quickly to the swift, steep decline in trade, which is not limited to U.S. exports. Trade among Asian countries is also plummeting, because much of this intraregional commerce is indirectly dependent upon Western consumption. A high proportion of Taiwan's trade with China, for example, has been made up of electronic components shipped to Chinese factories for assembly into finished products—which eventually wound up on the shelves of stores in the U.S. As a result, Taiwan's China trade is contracting twice as fast as the island's U.S. exports.

In short, Asia's growth model resembles a vast Ponzi scheme, one that is precariously perched on the expectation that Americans will continue buying more and bigger TVs, computers and cars forever—which in turn allows Asia to forever goose its growth by adding industrial capacity to feed the West.

This expectation has now been dashed, and the scheme is unraveling. Debt-ridden, house-poor and increasingly unemployed, U.S. shoppers are cutting back. Consumer spending in the U.S. dropped at an annual rate of more than 3% in both the third and fourth quarters of 2008—the steepest consecutive quarterly declines on record. As incomes shrink and America adopts a more frugal mind-set, some economists do not expect shoppers to return to free-spending ways for years—or perhaps generations. Economist Stephen Roach, chairman of Morgan Stanley Asia, says that “there is good reason to believe the capitulation of the American consumer has only just begun.” U.S. consumer spending as a percentage of GDP reached 72% in 2007, well above the pre-bubble norm of 67%. Using that as a gauge, Roach says that only 20% of the potential retrenchment of spending has taken place, even after the dramatic decline at the end of 2008. “The imbalance that contributed to the crisis—overconsumption and excessive savings—cannot continue,” says Ajay Chhibber, director of the Asia bureau at the United Nations Development Program in New York City. “The model where you stimulate and [then] go back to the old days is gone.”

Building a Better Tiger

ASIAN LEADERS FOR YEARS HAVE RECOGNIZED the need to reduce dependence upon exports to the developed world. But as long as the engine wasn't broke, they weren't

inclined to make extraordinary efforts to fix it. Now, it appears Asia's primary growth driver is, at the very least, badly bent. Meaningful reforms that diversify the sources of economic growth may be needed if the region is to avert a prolonged period of moribund economic activity.

The first layer of diversification must come in the makeup of the tigers' export markets by strengthening and extending trade links beyond the U.S. and Europe. Policymakers in Taiwan aim to do this by stimulating trade with other emerging

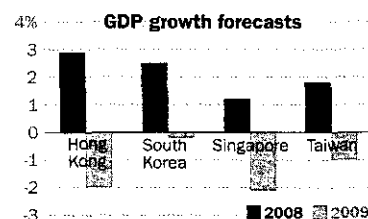
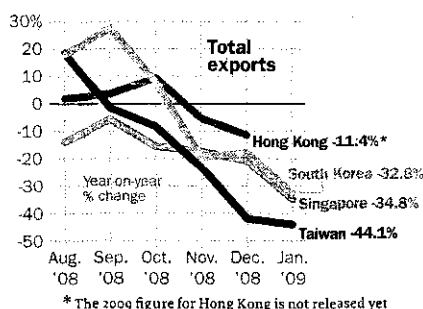
homes for the elderly, that would relieve some of the financial burdens on working-class families and encourage them to spend rather than save. “What tended to be taken care of in the household could become more marketized,” says Lim Won Hyuk, an economist at the Korea Development Institute in Seoul. “There is a lot of room for job creation.”

South Korea's service sector in general is still fettered by regulation that stifles its development as a source of growth and employment. A December report by the Organization for Economic Cooperation and Development found that service companies are burdened by higher taxes and energy costs than manufacturers, while excessive regulation creates barriers for start-ups. Hwang Doo Jin, an architect who operates his own small firm in Seoul, complains of endless, stressful hours untangling the confusing rules that govern his business. “It is easier to produce a masterpiece than run a viable business over time,” Hwang says.

The tigers are already heading in the right direction. Shortly after South Korean President Lee Myung Bak took office last year, he launched a program to improve the services sector by increasing financial assistance to targeted businesses and by reducing red tape. Taiwan President Ma Ying-jeou is undertaking his own deregulation program, with a special focus on Taiwan's biggest trading partner, China. Ma believes that sectors of Taiwan's economy, such as tourism and finance, have been stunted by the island's political standoff with Beijing. (China considers Taiwan a renegade province.) Ma is pushing for an agreement with China that would allow for free flows of capital and services across the Taiwan Strait for the first time. He has already opened the island to mainland tourists and eased restrictions on Taiwan investment in China.

Yet if the tigers really want to thrive in the future, the answer might lie in rejecting another legacy of Park Chung Hee: the idea that governments alone can successfully engineer high economic performance. Jim Walker, an economist at independent research firm Asianomics in Hong Kong, argues that politicians still intervene too much in their economies instead of allowing market forces to work. “What governments need to do is start trusting their own people rather than hoping the West is going to get it right all of the time,” Walker says. For the tigers to keep roaring, they may need to find their future, for the first time, at home. —WITH REPORTING BY NEEL CHOWDHURY/SINGAPORE, NATALIE TSO/TAIPEI AND JENNIFER VEALE/SEOUL ■

Tumbling Trade. Plunging exports are killing growth rates

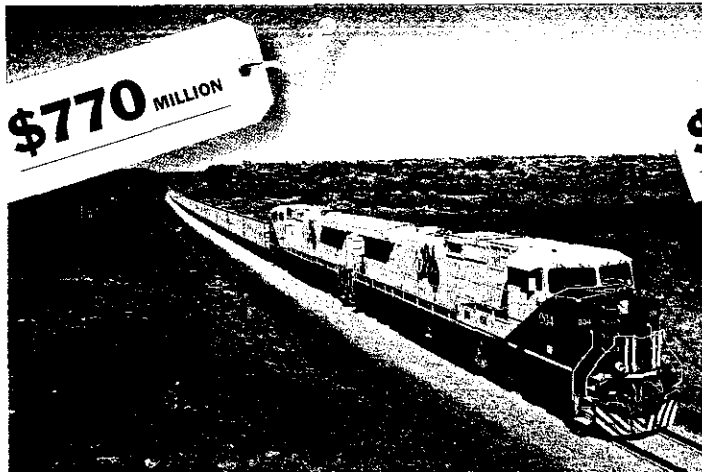


Sources: Goldman Sachs Global ECS Asia Research; Hong Kong Census and Statistics Department; Merrill Lynch

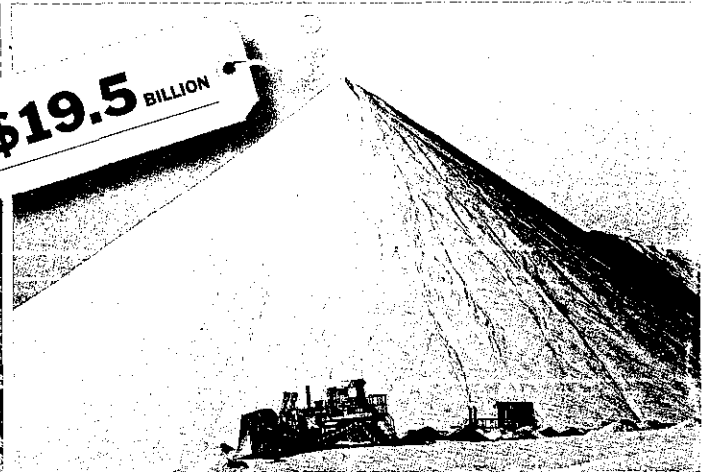
markets, such as Russia, Brazil, India and the Middle East. Commerce within the region also needs a boost. The tigers need to “open up trade among the markets here, and to develop local goods that are attractive to local markets,” says Joe Zveglic, assistant chief economist at the Asian Development Bank in Manila.

The second layer of diversification requires reducing overall dependence on trade by promoting domestic consumption and expanding service sectors. Park Chung Hee's growth model discouraged investment in domestically focused sectors and consumer spending—both of which could provide a cushion to Asian economies in global downturns. Vestiges of his biases remain, to the detriment of the South Korean economy. For example, South Korea hasn't developed the kind of social services, such as day-care centers for the children of working parents and

TIME: MARCH 16, 2009



BUYER: Hunan Valin **SELLER:** Fortescue Metals *The Chinese steelmaker now owns 16.5% of the Australian iron-ore-mining company*



BUYER: Chinalco **SELLER:** Rio Tinto *Latest cash injection brings Chinalco's stake to 18%*

BUSINESS

Buying Binge. As commodities prices crash, China is snapping up stakes in mining and oil companies to lock in vital resources

BY BILL POWELL

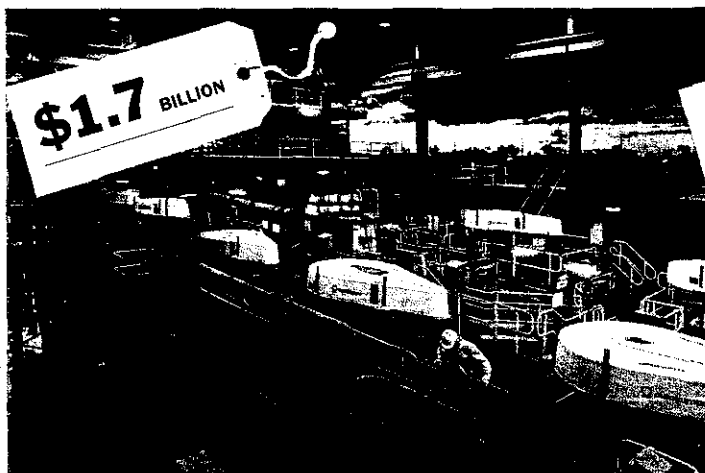
A FEW YEARS AGO, THE CHINESE called it their "Going Out" strategy. State-owned companies in key industries were being encouraged by the government to plant the flag of Chinese capitalism around the world by purchasing stakes in foreign companies. China was booming, flush with cash and full of optimism—naïve optimism, it turned out. In 2005, China National Offshore Oil Corp., China's oil and gas giant, tried to buy Unocal, the American oil company, and learned just how xenophobic Washington could be: the deal was called off

after strident objections from congressional leaders. Two years later, Beijing's fledgling sovereign wealth fund China Investment Corp. poured \$3 billion into Blackstone in return for a 10% stake in the New York City-based private-equity firm, just before the bottom fell out of U.S. debt and equity markets. That deal was followed by a \$5 billion purchase of a 9.9% stake in Morgan Stanley, then in the early throes of the credit crisis. Morgan Stanley's share price has since fallen by more than half.

These were expensive lessons, but make no mistake: Beijing has not decided

staying home is better than "Going Out." State companies are still sitting on mountains of cash, and although China's economy is slowing, officials see the global recession as a prime opportunity to cheaply acquire holdings of strategically important natural resources such as iron ore, copper, oil and gas—commodities China's leadership knows it will need much more of in the long run. In the past month, Chinese companies have bought assets abroad at an unprecedented pace. Aluminum Corp. of China (Chinalco), a major holding company focused on resources, has announced plans to invest \$19.5 billion in Rio Tinto, one of the world's largest mining companies. If completed the deal would be the biggest foreign purchase any Chinese company has ever made. China Minmetals, another state-owned firm, said it would pay \$1.7 billion in cash for Australia-based Oz Minerals, the world's second largest zinc miner. On Feb. 23, Hunan Valin Iron & Steel Group of China purchased a \$771 million stake in Australian iron-ore exporter Fortescue Metals Group.

It's not just minerals Beijing is now frantic to buy. On March 3, China National Petroleum Corp. agreed to buy Calgary-based Verence Energy, which has a 50% stake in a huge Libyan oilfield, for \$390 million. The China Development Bank and China Petroleum & Oil Corp. last month invested \$10 billion in Petrobras, Brazil's state-owned oil company and the prime operator in one of the most promising new offshore fields in the world. The deal gives Petrobras capital to further develop the fields. In return, China



BUYER: Minmetals SELLER: Oz Minerals *The deal effectively cleared the Australian company's entire existing debt*



LENDER: Chinese government BORROWER: Rosneft *The Russian oil company will pay off a \$15 billion loan by sending crude to China*

will get 100,000 to 160,000 barrels of oil a day over 20 years.

Two days before the Brazilian deal, China secured what may be the most strategically significant agreement of all: Beijing agreed to lend \$15 billion to cash-strapped Rosneft, Russia's oil major, and another \$10 billion to Transneft, Russia's biggest pipeline company. The loans will be paid off not in cash, but in crude—300,000 barrels a day from the huge east Siberian oil field. That's about 4% of China's current total demand for crude, secured on very favorable terms. Over the 20-year life of the deal, Beijing will effectively be paying about \$20 per barrel. Crude prices, which last summer peaked at more than \$140 per barrel, now sit just above \$40.

There is a lot more oil and gas where that came from, if Beijing can bring itself to depend on Moscow as a supplier. That isn't as easy as proximity might suggest. The two countries have never trusted each other. But economics now dictates that historical enmity be put aside. With the collapse of oil prices and the credit crisis, Russia needs cash. China needs fossil fuels; it needs them from a variety of suppliers far into the future—and it has the money to pay for them. Half of the country's massive national savings of \$2 trillion is in corporate coffers. "These [Chinese] companies know this slump, while deep, will not last forever," says Xu Minle, a Shanghai-based analyst at BOC International. "China is now making strategic investments overseas at a comparatively lower cost."

There's no question that it's a buyer's market for raw materials, and that many

resource companies are struggling to find willing partners and financiers. China's Rosneft injection will allow the Russian company to pay off \$8.5 billion in debt—60% of it owed to foreign banks—that matures this year. Beijing looks like the last, best hope of miners and drillers.

But the deals are not without controversy, particularly in Australia, where some are worried that control of vital resources is being handed over to the Chinese. Chinalco is a huge consumer of iron ore, and mining companies fear that the investment in Rio Tinto could give China more influence over the price of iron in global commodities markets. Every year, steel and aluminum producers worldwide dicker with the big raw-material producers over new contracts. During the boom years, when Chinese companies' appetite for virtually every metal was voracious, they got stuck with stiff price increases. But the deal could give Chinalco, which already owns 9.3% of Rio, additional stakes in the mining

'It's up to Rio to convince us that [the Chinalco deal] does not transfer key pricing power over a key commodity to a key customer.'

—AN INSTITUTIONAL INVESTOR IN RIO TINTO

company's choicest deposits of copper, iron ore and bauxite. The secretary general of China's Iron and Steel Association, Shan Shanghua, has already hinted that Chinese buyers could have some additional clout at the bargaining table.

This rankles some of Rio's shareholders. One institutional investor told *TIME* that it's "up to Rio to convince us that this does not transfer key pricing power over a key commodity to a big customer. They need to make that case, or I'm not inclined to vote for the deal" when it comes up for approval in May or June. The investment also must be cleared by the Australian Foreign Investment Review Board.

At a March 2 news briefing in Sydney, Chinalco President Xiong Weiping tried to allay fears. "The transaction will in no way lead to any control of the natural resources of Australia," he said, adding that Rio's corporate strategies and management practices would also remain unchanged. For now at least, blatant anti-Chinese sentiment in Australia appears to be bottled up, and the investment is expected to go through.

Considering how far mineral prices have fallen, some analysts believe Chinalco might actually be paying a premium for Rio Tinto assets. But BOC International's Xu says "the price is much, much lower for the assets—particularly iron ore and copper—than it would have been just six months ago. This seems like a pretty good deal." As long as commodity prices are depressed, Chinese companies—having learned the pitfalls of "Going Out"—are likely to be ravenous buyers. ■



The Great Bond Bailout

Investors who own financial institutions' debt are getting bailed out. Is that the right policy?

Extra Money

To read Justin Fox's daily take on business and the economy, go to time.com/curiouscapitalist

AMERICANS ARE TICKED OFF ABOUT the bank bailouts. Furious. They think somebody—other than the taxpayers—needs to pay. Let's try to work out who that somebody ought to be.

The banks' shareholders don't make a promising target. The stock prices of Citigroup and Bank of America, to name two especially dramatic examples, are down more than 90% from their 2007 peaks. There are arguments, relating to incentives for executives and future shareholders, for wiping out current shareholders at the most troubled banks. But that won't pay for anything—the shareholders simply don't have much more value to cough up. Same goes for those who work in the business. Many have lost their job and life savings, and most have seen their salary cut. Yes, there have been egregious bonuses and golden parachutes—and they ought to be clawed back—but that won't pay for a trillion-dollar (or more) bailout. Which leaves ... the folks who loaned the banks money. The banks' creditors have been the clearest beneficiaries of the bailouts—leaving them with the most wherewithal to contribute.

Who are these creditors? The biggest group, with outstanding loans of about \$9 trillion, is ordinary depositors. When money is deposited, it's being lent to the bank. Those deposits were explicitly insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000 before the crisis, and the banks paid for that insurance (though not in full, given that FDIC coverage has been raised to \$250,000 and seems effectively without limit at bigger banks) and passed the cost

on in the form of lower interest rates than on, say, an uninsured money-market account. That, plus the fear that panicked depositors could start a devastating run on the banking system, explains why the protection will continue.

But banks also borrow on wholesale markets, mainly by issuing bonds. About

misjudgments. Plus, a few concessions from creditors could ease the burden on taxpayers dramatically. If Citi's \$486 billion in wholesale debt were converted into common shares—admittedly a pretty extreme solution—the company's balance-sheet woes would evaporate.

Which is why these arguments have been gaining in popularity. "I think it's very important that the creditors in this crisis take a hit," said New York University finance professor Matthew Richardson at an NYU conference in March. "We need to try to transfer some of the risk from taxpayers to the financial system."

Sounds awfully logical. So why haven't we stuck it to these guys? Because we're afraid they'll panic. "Unfortunately, we've built a system where if you hammer those guys hard, you're going to have a global credit collapse," said Simon Johnson, a former chief economist of the International Monetary Fund who teaches at the Massachusetts Institute of Technology and whose blog, *Baseline Scenario*, has become essential reading for crisis buffs. The Federal Reserve and Treasury left creditors at Lehman Brothers adrift in September, and the repercussions

were so dire that regulators resolved not to let such a thing happen again.

The FDIC can wind down banks in a more orderly fashion than occurred at Lehman. But FDIC chairwoman Sheila Bair and Fed Chairman Ben Bernanke have both said they don't have the authority to wind down global financial conglomerates like Citi. The upshot: "If you want to have no more Lehmans, then inevitably you wind up guaranteeing the banks' debts," said John Hempton, a money manager and former Australian treasury official whose *Bronte Capital* blog has become another crisis must-read. That is, an orderly reorganization of the financial system in which creditors make sacrifices would be great. But it's not really an option. So we keep bailing them out. ■



\$2.6 trillion of bank funding in the U.S., 20% of the total, comes from such debt securities, according to the FDIC. At the most troubled of the big banks, Citigroup, the figure is 27%. (Citi's domestic depositors account for just 16%—its main deposit base is overseas.) These bank bonds are mostly in the hands of large, sophisticated institutional investors—pension funds, insurance companies, mutual funds. It may be too much to ask small depositors to monitor the risks at the banks where they put their money and pay for getting it wrong. But these bond buyers are pros. If there is to be any market discipline of risk-taking by banks, bond investors ought to be the ones who enforce it by withholding their cash from the bad apples—and paying the price for

It may be too much to ask small depositors to monitor the risks at the banks where they put their money and pay for getting it wrong. But bond buyers are pros

Newsweek

POWER UP

By RANA FOROOHAR

AS CHINESE PREMIER WEN Jiabao informed the world recently, he's a "little bit worried." Not about China, mind you, but about the United States. "We have loaned huge amounts of money to the U.S., so of course we have to be concerned," said Wen earlier this month, warning America to "honor its word" and "ensure the safety of Chinese assets." Translation: Those guys on Wall Street really screwed up. We think the dollar might tank and erase the value of our \$2 trillion in T-bills. Get your act together.

LIGHTS ON: *The Chinese consumer outlook grows brighter*



It's a stunning turnabout from even a year ago, when such warnings were almost always issued by rich nations, like the U.S., to poorer ones. But a lot has changed in recent years and recent days. Emerging giants like China are stronger, more economically competent and vastly richer. Their confidence has only increased amid a calamity that is widely described as the worst "global" recession in 70 years, but is in fact not truly global. It is shrinking the richest economies, but only slowing the emerging giants. This year GDP is expected to contract by 3 percent in the U.S. and Europe, and by close to 6 percent in Japan, while continuing to expand in China and India by 7 and 5 percent, respectively.

That growth gap is destined to reshape the economic future of the world. Goldman Sachs chief economist Jim O'Neill now predicts that the major emerging markets—Brazil, Russia, India and China, a.k.a. the BRICs—could overtake the combined GDP of the G7 nations by 2027, nearly a decade sooner than the forecast in a landmark study a few years back. The ascent of the formerly poor giants is accelerating, and their confidence is evident not only in the utterances of Wen Jiabao. Manmohan Singh of India has blamed the "massive failure" on authorities in "developed societies," but his peers all name America by name. Vladimir Putin of Russia scorns "the irresponsibility of the system that claims leadership." Luiz Inácio Lula da Silva of Brazil, in an interview with *NEWSWEEK* (following story), says the U.S. bears the brunt of responsibility for the crisis, and for fixing it at the upcoming G20 summit in London.

Power is not only shifting toward the BRICs, but among them as well. For all their outspokenness, Brazil and Russia have been hit much harder by the crisis than India and China. Dependent on sales of commodities that are shrinking rapidly in price, Russia's economy has fallen off a cliff, and could shrink 3 percent this year. Brazil will likely stagnate. Their recoveries could be slow and painful, too. Goldman Sachs projections for the period from 2011 to 2050 show Russia growing at just 2.8 percent, Brazil at 4.3 percent, China at 5.2 and India at 6.3. If those figures turn out to be correct, three of the top four economies in the world—China, the U.S., India and Japan, in that order—would be Asian within the next two decades. The Asian Century is almost here.

The markets seem to know it. While the S&P 500, down about 45 percent last year, has plummeted another 15 percent since the start of 2009, the Shanghai Composite In-

dex is up by 20 percent, continuing a rally that began in November.

The grim consumer outlook, unemployment paranoia and general siege mentality that's taken hold in the West is also largely absent in Asia. In China and India, sales of cars, white goods and many other types of consumer products are still rising, in large part because of the strong and swift stimulus measures taken by these nations, which have clearly learned a lot about macroeconomic policymaking since the 1990s. Capital goods and machinery are showing double-digit growth in India, and cement sales in China have suddenly risen, now that it's getting warm enough to build. Russia once again is the outlier: consumer spending there is still down sharply.

Americans are ceding the role of world's most resilient shoppers to the Chinese and Indians. Chinese bank lending this past December was up 1,000 percent over the same period last year, as the government lowered interest rates, reigniting the real-estate market. "That's opening up a whole new, broader base of local people

marketing campaigns of multinationals.

The BRICs are better positioned to recover than their richer peers. Broadly speaking, better control of inflation, lower deficits, increasing productivity, richer social programs and greater political stability have given the emerging giants greater room for error at a time when the macroeconomic environment in rich countries has been deteriorating. Even Brazil and hard-hit Russia have used raw-materials windfalls (oil and gas for Russia, soybeans and iron ore for Brazil) to build a buffer for the downturn—Russia has spent more than \$300 billion defending the ruble, and still has that much in reserve. Brazil's \$208 billion reserve remains almost untouched.

What's more, the BRICs have learned from our follies. Strong regulatory oversight allowed the Indian and Chinese financial sectors to emerge relatively unscathed from the credit crisis. Through the first half of 2008 (the most recent available data), Chinese banks were acquiring foreign rivals and increasing their share of global financial markets. If that continues,

What's called a 'global' recession is in fact shrinking economies mainly in the West, not the East.

in China who can now afford apartments—and believe me, the demand is there," says Michael Klibaner, head of China research for the real-estate market-research firm Jones Lang LaSalle.

The big question for China has been whether it can forge an economy that depends not on exports to the West, but on consumption. Klibaner says it's happening, because the strongest real-estate growth now is not in big cities that cater to exporters but in smaller ones geared toward the domestic market. That follows the trend in Brazil, where the middle class is the largest segment of the population, and also in India. "Consumer spending is 60 percent of GDP in India," says Global Insight chief economist Nariman Behravesh. "That's a key reason why the economy hasn't been hit harder in this downturn."

None of this means that BRIC consumers will save a world in financial crisis. Their purchasing power is still far too weak compared with rich nations like the U.S. and Japan. Yet as their economies grow, so will the power of their wallets. Sooner rather than later, consumers in the BRIC nations will dictate the R&D investments of major corporations, the travel routes of airlines and the

a Deutsche Bank report released last week predicts, China will become one of the dominant financial markets in the world by 2018, alongside the U.S. and the EU, with a 13 percent share in global bond markets, 40 percent of equity markets and 18 percent of global banking.

Sooner than that, the Chinese will likely see an uptick in exports. Purchasing-order surveys in China have been up for three months now, notes CLSA economist Andy Rothman, as factory owners in places like the Yangtze River Delta struggle to fill rush jobs for Western clothing chains that panicked and reduced orders too much. Rothman calls it the "Wal-Mart effect," and expects the interest of increasingly thrifty Western consumers in all things cheap to help Chinese exporters rebound. Many others say the "cheap is cool" phenomenon will ultimately buoy all kinds of emerging-market products and services, from Mexican cement makers to Indian telecom providers, that still tend to offer the best prices. When consumers around the world do start buying again, it seems they'll be doing it in the BRIC countries.

With MAC MARGOLIS in Rio and JASON OVERDORF in New Delhi

N Read six expert opinions on carbon cap-and-trade at xtra.newsweek.com

CORPORATE CONSCIENCE

Charity Crunch Time. As the recession bites, companies struggle to get more out of their philanthropic spending

BY VIVIANNE WALT

LIKE MOST MULTINATIONAL CORPORATIONS, Unilever, the Anglo-Dutch household-products giant, is feeling the sting of the global recession. But at least one part of Unilever's empire is doing fine. Several years ago, the company launched a corporate-social-responsibility (CSR) program, in which it hired thousands of Indian women to sell the company's soaps, detergents and other items in their home villages, most of them too small and remote to rate a visit from a Unilever sales representative. The program, called Shakti (Energy), was meant to aid some of the company's poorest customers, but it has accomplished more than that. The 40,000 or so women working for Shakti's network have proven to be reliable representatives—and their clients reliable consumers—even in a downturn. "Because of the financial crisis this project has become even more important for us," says Hemant

Bakshi, Unilever executive director for customer development in Mumbai. "If we want to continue to grow during difficult times, we will have to leverage this."

Programs like Shakti, which successfully mix philanthropy with the bottom line, may show the way forward for companies trying to preserve their CSR programs in the rocky economic climate. Although companies are loath to admit that they are cutting their spending on social programs, nonprofit organizations tell *TIME* that since the recession hit, several have canceled commitments to help fund projects. "We have had three or four partners pull out since October or November, after we had every expectation of the money," says the head of a small organization in London that runs youth programs in eight countries, mostly in Africa. (He did not want to be named for fear of angering donors.) Says Hildy Simmons, who runs a Wall Street philanthropic-advisory service: "There is no new money going

into corporate programs, plus whatever monies there were are diminishing."

Indeed, the recession is hastening changes already under way in corporate philanthropy. In the past, many CSR departments were run by public relations officials and were geared primarily to polish the company's image. "The p.r. people wanted to know, How prominent will our names be on this?" says Salvatore LaSpada, chief executive of the Institute of Philanthropy in New York. Now, however, partly due to pressure from shareholders and board members demanding tangible results, businesses are favoring programs like Unilever's Shakti that aim to improve the world while boosting

Businesses are favoring programs that aim to improve the world while boosting profits—or at least aren't perceived to be wasting money

profits—or at least aren't perceived to be wasting money. During the recession, "a lot of activities will be linked to how companies can do business differently rather than just philanthropic giving," says Penny Fowler, who heads Oxfam's private-sector-advocacy team. "And that could be a good thing."

That kind of change has been good for Marks & Spencer. In 2007 the British food and clothing chain launched an in-house environmental campaign called Plan A—"because there is no Plan B for the planet," explains Mark Barry, the company's sustainable-development manager. Scrapping traditional charitable donations, Marks & Spencer budgeted \$215 million for a five-year program that included cutting the company's fuel and electricity use, charging customers for plastic bags and sourcing merchandise from green factories and farms. Barry says Plan A is so far paying for itself because it has lowered the company's energy spending and other costs.

In a more frugal world, it's all about getting more bang for the buck. Consider Puaramita Acharji, a West Bengali woman who joined Unilever's Shakti program several years ago and now earns about \$14 a month selling items in her village door-to-door. Small as that sum might be, Acharji says it has changed her life. Instead of being dependent on her husband, Acharji says, she now commands respect in the village. "It is enough to stand on my own two feet," she says. Increasingly, CSR programs will have to do the same. ■



ILLUSTRATION FOR TIME BY JON BRAUSE