Institute of Strategic and International Studies (ISIS) Malaysia

CURRENT ECONOMIC SITUATION
(SELECTED ARTICLES FROM MAGAZINES)

June 1-15, 2009

INFORMATION SERVICES DIVISION
ISIS MALAYSIA

Central banker Zhou wants a new global currency to supplant the greenback

CHINA'S DOUBTS ABOUT THE DOLLAR

Behind its push to revamp the monetary system and promote the yuan are real worries about U.S. deficits

By Steve LeVine and Dexter Roberts

Beijing's quest to dethrone the dollar as the world's dominant currency is a natural strategy for hard-line Chinese leaders bent on undercutting U.S. influence in the world. Yet here's a twist: A key figure behind this policy drive, Chinese central banker Zhou Xiaochuan, is actually an economic reformer and internationally respected economist. And Zhou's criticism of America's runaway public finances and the dollar's postwar reign in global trade and finance isn't so easily dismissed.

Beijing is nudging trading partners to use its currency, the yuan, in trade transactions. Meanwhile Zhou, who has served as governor of the People's Bank of China since 2002, backs the creation of a "super-sovereign reserve currency" managed by the International Monetary Fund that would challenge the dollar's power. True, the greenback's exalted status isn't in immediate danger. However, an international campaign led by China to move away from a dollar-centric global economy is gathering momentum.

In recent days, worries about America's fraying public finances and dollar weakness have unnerved Treasury bond investors the world over, not to mention Zhou and Chinese Premier Wen Jiabao. Much of China's national wealth, about 70% of its $2 trillion in foreign reserves, is denominated in dollars.

Zhou earned his doctorate in economics from Beijing's prestigious Tsinghua University and knows that a bigger international role for the yuan is a fantasy unless China lets its currency trade freely and lifts capital controls on money going in and out of the mainland.

Instead, the Chinese economy is now somewhat hostage to economic policies set in Washington. The U.S. budget deficit has exploded, and the Federal Reserve is effectively printing money to buy Treasury bonds. That's a recipe for a weak dollar, a bond glut—and a nasty financial hit to Chinese holdings of U.S. Treasuries.

Well-informed Chinese now realize Beijing's strategy of keeping the yuan artificially low vs. the dollar to stoke exports—and then recycling export earnings back into the U.S. Treasury market—has backfired. Chinese blogs rant about "irresponsible investment policies of the Chinese government, which also happen to be subsidizing the U.S. economy," says Wenran Jiang, an associate political science professor at the University of Alberta.

LATIN CONNECTION

To reduce its exposure to U.S. economic policy, Beijing is forging currency swaps with Asian and Latin American nations, contracts that provide their central banks with yuan to use in trade with China. More ambitiously, Zhou thinks the IMF should create a new international currency that would be valued against a basket of existing currencies, such as the dollar, euro, and yuan. Instead of recycling unwanted dollars into U.S. Treasuries, a central bank would deposit them in an IMF account offering an interest rate. In theory, the new reserve currency would be more stable than the dollar because it would be "disconnected from economic conditions and sovereign interests of any single country," Zhou wrote in an essay published on China's central bank Web site in March.

Such a grand scheme, now backed by Russia and Brazil, is a long shot. Yet Zhou has tapped into resentment about the huge—and unique—funding advantages America enjoys. The U.S. can borrow and trade in its own currency, while other economies with dollar assets must worry about currency swings or U.S. policy shifts. That's why China's currency crusade may carry on long after the global recession subsides. |BW|

$2 trillion

Value of China's foreign currency reserves, 70% of which are estimated to be in dollar assets

Data: *BusinessWeek*

ILLUSTRATION BY SEAN MCCABE; PHOTOGRAPH OF ZHOU BY ZHANG PENG/IMAGINECHINA/ZUMA PRESS

SCOPE | InternationaList

CAN CHINA TOPPLE THE DOLLAR?

BY DANIEL DREZNER

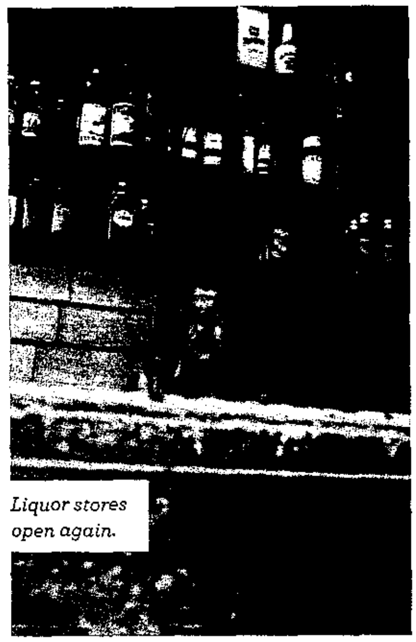
CURRENCY TO HEAR SOME TELL IT, China is campaigning to topple the dollar as the world's reserve currency, and just might get the job done soon. In March, China's central-bank governor, Zhou Xiaochuan, proposed the creation of "a super-sovereign reserve currency," and while he did not mention the dollar explicitly, the target was unmistakable. The dollar's role since the 1940s as the unit of account for most international trade and financial transactions has privileged American finances and American power. Losing that position would take America down a peg and open up the door to China, which followed up on its super-sovereign idea by initiating deals designed mainly to swap the yuan for the dollar in its trade with nations from Belarus to Brazil. And in a separate move that the *Financial Times* claimed was an effort to diversify away from the dollar, China has doubled its gold holdings over the past five years.

This flurry of activity has made some China watchers jittery: Nicholas Lardy, an expert on China's economy at the Peterson Institute for International Economics, soberly concluded that the United States has "no leverage." And economist Nouriel Roubini is warning that the Asian century, "dominated by a rising China and its currency," could begin in less than a decade if America doesn't get its "financial house in order."

But the dollar's reign is not about to end any time soon. Its role as a reserve currency rests on both the power of inertia and the powerful attraction of the American market. U.S. GDP is still more than twice China's, and its trade flows are 50 percent higher. No one knows exactly when (or if) China will catch up; some analysts say five years, some say 30. Regardless, its recent moves challenging the dollar are actually quite modest. Its series of bilateral currency swap deals with countries like Belarus, Argentina and Malaysia have attracted a lot of attention—the purpose of the swaps is to finance bilateral trade without dollars—but they amount to only about $95 billion in a globalized economy that saw $19.5 trillion in goods and services traded across borders last year. As for the doubling of China's gold reserves, it doesn't actually demonstrate diversification away from the dollar: while the total value of China's foreign-exchange reserves has increased tenfold during the same time period, the percentage of its total reserves in gold has fallen to 2 percent. Beijing has actually been diversifying away from gold.

Chinese officials acknowledge that the dollar will remain the reserve currency for some time (the head of the State Administration of Foreign Exchange recently talked about the yuan becoming convertible in 2020). For China, of course, the desire to change the status quo is mixed with the urge to preserve it. Keeping the dollar strong is the best way to protect its politically powerful export sector thriving.

The dollar's reign won't end soon.



Liquor stores open again.

DRINKING LIBERALLY IN BAGHDAD

BY LARRY KAPLOW

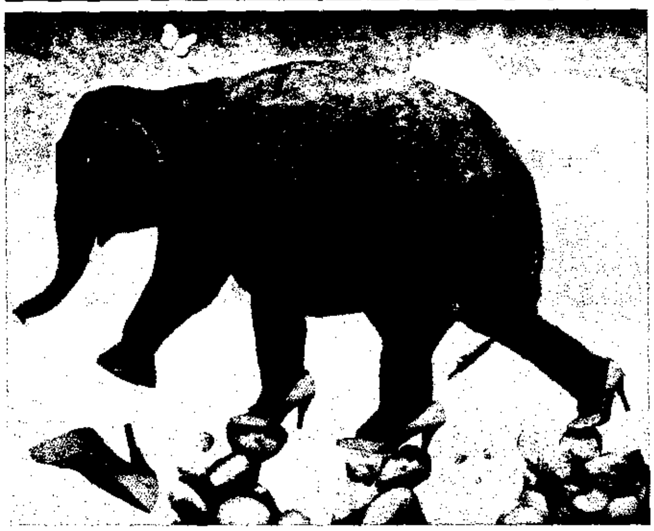
AFTER SADDAM HUSSEIN'S OVERTHROW, the dream of a secular Iraq faded as Iran's influence grew, headscarves for IRAQ women became a must, liquor stores closed and religious parties and militias grew in power. Now some observers are spotting a secular revival, as bars reopen, the militias retreat and Prime Minister Nuri al-Maliki's Islamic Dawa Party downplays religion. Dawa rejected calls to use the Imam Ali's holy sword on campaign materials for moderate districts like Baghdad in local elections in January. Secular underdogs did better than expected, and liberals are now hoping to top the 20 percent vote they've received in the past when parliamentary elections are held next year.

But the secular upswing may turn out to be a mirage. Maliki's recent gestures to moderates, like allowing more liquor sales and emphasizing Iraqi nationalism, may be genuine or may just be a rebranding effort to woo voters away from truly nonsectarian parties. Ayad Jamal Addin, a liberal aligned with former prime minister Ayad Allawi, admits, "Our funds are weak, our organization is weak, our media is weak." If Maliki's strategy succeeds, Iraq's secular minority will get weaker still.

FROM TOP: PHOTOGRAPH BY MOISES SAMAN—PANOS; NATALIE BEHRING—ONASIA

Banyan | Does the elephant dance?

Or, in its effort to cut a global dash, will India's feet always be hobbled by problems closer to home?



THE news in May that the Congress party had won India's elections by a big margin electrified the political establishment and sent shares soaring. Manmohan Singh, back as prime minister, still needs coalition partners, but no longer relies on Communists for his majority, and needs not pay so much heed to small, venal regional parties. At home, he pledges to forge ahead with liberal reforms. Abroad, too, says Shyam Saran, a special envoy for Mr Singh on climate change, his government "will enjoy greater room for manoeuvre than in its earlier incarnation".

If this freedom produces a robust, coherent foreign policy, it will be a post-cold-war first. "Does the elephant dance?" is the title of a forthcoming book on India's foreign policy, by a former Canadian envoy, David Malone. Until now the country has been a wallflower and it is about time it put on its pumps. India enjoys huge global respect as a successful democracy. In marked contrast to China's, its rise raises few hackles in the West. And its formidable intellectuals, entrepreneurs, Bollywood stars and diaspora give tremendous "soft" power. But in comparison with its stature, its influence remains pitiful, despite its recognition by America as a member of the nuclear club—the main (perhaps only) foreign-policy achievement of Mr Singh's first term.

Indian governments' main preoccupations are domestic—unsurprisingly, given a riotous Bartholomew Fair of a political system, and huge economic problems. India's immediate region has also frustrated its great-power ambitions, with Pakistan chiefly to blame. Much of Pakistan's elite continues to view India as a threat to their country's existence. This is misguided, and in the case of the army, self-serving. Pakistan's own jihadists remain a bigger danger. But Pakistan's morbid obsessions tie India down, too. In Mr Singh's second term, say his advisers, India will attempt to vault beyond concerns in its near-abroad. And, having appointed, in S.M. Krishna, a foreign minister expected to be grateful and ineffectual, he will be unfettered either by carping Communists or ambitious colleagues. He will be able to toe his own foreign-policy line. Top of his agenda will be trade, climate change and responding to China's rise.

Don't hold your breath on the first two. Mr Singh has liberal views on trade, and his cabinet shuffle notably got rid of the commerce minister, who was widely blamed for scuppering trade talks under the Doha round in Geneva last July. An early signing of a free-trade agreement between India and the ten-country Association of South-East Asian Nations (ASEAN) is expected. Yet such agreements offer more political than economic advantage. And the old domestic constraints remain. Mr Singh campaigned on what he calls "inclusive growth". This implies protection for farmers and more. Even if Mr Singh now favours the pursuit of freer trade, Sonia Gandhi, boss of the Congress family firm, with its roots in the countryside, may well overrule him.

As for climate change, Mr Saran points out that India, like other poor countries, will be among the worst-hit by a warming globe and has an overriding interest in a successful international regime emerging from the climate-change conference in Copenhagen in December. It is true that a first casualty of the melting of Himalayan glaciers would be the waters of the north-Indian plain. But Mr Saran also stresses that agreement cannot be reached at the expense of India's development. Many Indians feel that tackling climate change, like free trade, is something pushed on India by outsiders to bring it down. For the moment, India can hide behind America and China, which are barely inching towards a common approach.

That leaves China. To those paid to worry about such things the threat is clear and present. "He is coming over the passes from Sinkiang [Xinjiang]," says a senior Indian military man. "He is building the road to Burma [Myanmar]; he is seeking ports from all those around us; and he is selling arms to all and sundry." This, to Indian strategists, is the "string of pearls" strategy designed to encircle their country. Now China is trying to block the Asian Development Bank from financing a project in the north-eastern state of Arunachal Pradesh, territory claimed by China. Hawks say Indian politicians' judgment about China is clouded by economic ties. China is now India's biggest trading partner.

A whole lotta hedging going on

Yet China's trade with India, and others, counts for something besides commercial expedience. It helps explain China's push into India's backyard, with roads, ports and pipelines, chiefly via Myanmar and Pakistan. So does the perceived need to secure energy lines. China's oil use is doubling every 15 or so years. Nearly nine-tenths of its oil imports cross the Indian Ocean and pass through the Malacca Strait. India has almost identical energy concerns, though its potential chokepoint is not Malacca but the Strait of Hormuz. Its navy, like China's, has been rushing to secure friendly staging-posts around the Indian Ocean. As a hedge, it has also been forging links farther east with China's own maritime neighbours, including Vietnam, South Korea and Japan.

China's trade with India also counts by reaffirming a growing interdependence in a part of the world that still defends brittle notions of sovereignty. Properly handled, interdependence could smooth the rougher edges of rivalry. But that must depend in part on how much domestic populations have got at stake. Here, India scores poorly. This week a Unicef report warned that, despite several years of breakneck growth, India falls far short in protecting its own people from poverty. Some 230m Indians suffer from chronic hunger, a number that has grown thanks to the global downturn and sharp swings in the price of food and fuel. China's record, with malnourishment largely banished, is far better. Mr Singh's foreign policy begins at home. ■

Economist.com/blogs/banyan

America can afford to do without testing indefinitely (it stopped in 1992) as its own nuclear warheads age.

But some things have changed in ten years. At home, powerful computers for modelling test explosions have managed to solve problems that had once had even the testers stumped, and America's warheads have been shown to be more robust than first thought. The global system of monitoring stations being built to back up the CTBT was just a plan in 1999 but is now nearing completion (with some in America). North Korea's second nuclear test, in May, was also a test of the system's capabilities which it passed easily.

A concern has resurfaced that Russia, which has ratified, might be cheating by conducting very small nuclear tests, although America formally withdrew this complaint some years ago. Where such doubts arise (some also suspect China), there is provision for on-site inspection.

But as things stand, such inspections can be invoked only with the treaty in force. Several required ratifications are still outstanding. America's could prompt China, and a couple of others, to follow suit. But India will not even sign the CTBT, let alone ratify it. Pakistan will not if India does not. And North Korea clearly is not in the mood. ■

Development aid from authoritarian regimes

An (iron) fistful of help

China, Iran, Russia and Venezuela have been doling out largesse. Should Western democracies be worried?

CONGO and the International Monetary Fund are arguing about a bail-out. What's new, you might ask. Dog bites man. But the sticking point is, unexpectedly, not the country's economic policy, but how exactly to repay a $9 billion credit that Congo secured last year from China.

China's deal with Congo, and the disputes arising from it, are examples of a growing trend. Authoritarian governments are using their money to buy influence abroad. Sometimes the money comes as a commercial loan; sometimes, as a grant; frequently, as both. These flows are changing the business of aid, undermining attempts by Western countries to improve their programmes and encouraging recipients to play donors off against each other.

The use of aid to win friends and influence people is not new. America and the Soviet Union both used aid as a weapon in the cold war. Now a 21st-century equivalent is emerging. A study this week by a group of American institutions, Freedom House, Radio Liberty and Radio Free Asia, looks at the use by China, Iran, Russia and Venezuela of what it calls "authoritarian aid". The study, "Undermining Democracy", is the first attempt to estimate the global scale of such operations.

China's assistance programme is the most active. In 2007 its leaders said they would offer African countries $20 billion in new financing (they did not say on what terms or over what period). Hu Jintao, the president, repeated a promise to boost aid and cancel debts during a trip to Africa this February. The World Bank says China already gives Africa $2 billion a year (more than the bank itself does). China does not publish aid figures and a study in 2007 for the Centre for Global Development, a think tank in Washington, DC, put the figure lower, at $1.5 billion-$2 billion a year (with a third to a half for Africa). But all estimates agree that aid has been rising relentlessly (see chart 1) and that China, once a recipient, is now in the middle rank of donors, on a par with Australia or Spain, though with more commercial lending.

Over the past ten years, Venezuela's aid has been comparable to China's, though it is now falling behind. Gustavo Coronel, a critic of President Hugo Chávez, says Mr Chávez has made $43 billion worth of foreign "commitments" since 1999. Roughly $17 billion could be described as aid, including cheap oil to Cuba and cash transfers to Bolivia. The report estimates that Venezuela's cheap-oil programme alone is worth $1.7 billion a year, though its most flamboyant feature—cheap heating oil for poor Americans—was recently scrapped.

Russian and Iranian aid is more impenetrable than China's but flashes of information light up the murk. Iran offered $1 billion to Lebanon's Shias to help them rebuild their ruined houses after the 2006 Israeli war. This year, Russia offered Kyrgyzstan $2 billion, a gesture made, by amazing coincidence, just after Kyrgyzstan had thrown out American forces. Russia has long used energy prices and debt forgiveness to cajole or punish neighbours.

If you include another generous undemocratic donor, Saudi Arabia—whose aid, $2 billion in 2007, fluctuates as much as the oil price (see chart 2)—then total "authoritarian aid" comes to $10 billion a year and possibly more. That is a substantial, though not a game-changing sum. It is almost 10% of total aid from rich countries, and about what Britain or Japan gives.

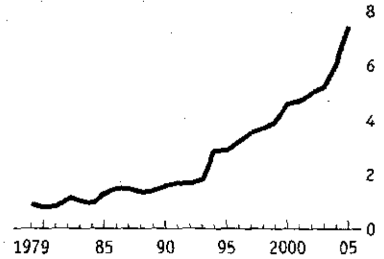
But its significance lies not just in its total value. Autocracies offer an alternative to western aid in several ways. In the past decade rich countries have tried to improve a dismal record of development spending by linking aid closely to the priorities of recipients (rather than financing a big project which the country does not need) and by demanding good governance. China and the rest do not.

Much of their aid is overtly political. Iran's offer of free electricity to Shia parts of Iraq is one example, Venezuela's bankrolling of Cuba another. Most is steered towards a few friendly regimes, or (in China's case) places with natural resources. China has pledged $600m to Cambodia, more than ten times as much as America. It has given Myanmar $400m in the past five years; American aid to the country is worth about $12m a year.

Naturally, help from harsh regimes is rarely encumbered with pesky demands for good governance. This makes it welcome to corrupt officials and even to those merely sick of being lectured by Westerners. Alas, it can encourage bad governance. China, the report says, is training 1,000 Central Asian policemen and judicial officials "most of whom could be classified as working in anti-democratic enterprises". The report concludes that authoritarian regimes are using aid to boost their soft power. If so, the spread of authoritarian aid is a challenge to more than just Western ideas of the right sort of giving. ■

Some donors give more and more...

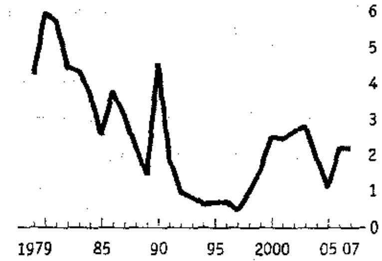
Foreign aid from China, yuan bn



Source: Li Xiaoyun, China Agricultural University

...and others are erratic

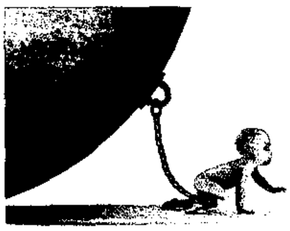
Foreign aid from Saudi Arabia, $bn



Source: National statistics

The biggest bill in history

The right and wrong ways to deal with the rich world's fiscal mess



THE worst global economic storm since the 1930s may be beginning to clear, but another cloud already looms on the financial horizon: massive public debt. Across the rich world governments are borrowing vast amounts as the recession reduces tax revenue and spending mounts—on bail-outs, unemployment benefits and stimulus plans. New figures from economists at the IMF suggest that the public debt of the ten leading rich countries will rise from 78% of GDP in 2007 to 114% by 2014. These governments will then owe around $50,000 for every one of their citizens (see pages 70-72).

Not since the second world war have so many governments borrowed so much so quickly or, collectively, been so heavily in hock. And today's debt surge, unlike the wartime one, will not be temporary. Even after the recession ends few rich countries will be running budgets tight enough to stop their debt from rising further. Worse, today's borrowing binge is taking place just before a slow-motion budget-bust caused by the pension and health-care costs of a greying population. By 2050 a third of the rich world's population will be over 60. The demographic bill is likely to be ten times bigger than the fiscal cost of the financial crisis.

Will they default, inflate or manage their way out?

This alarming trajectory puts policymakers in an increasingly tricky bind. In the short term government borrowing is an essential antidote to the slump. Without bank bail-outs the financial crash would have been even more of a catastrophe. Without stimulus the global recession would be deeper and longer—and it is a prolonged downturn that does the greatest damage to public finances. But in the long run today's fiscal laxity is unsustainable. Governments' thirst for funds will eventually crowd out private investment and reduce economic growth. More alarming, the scale of the coming indebtedness might ultimately induce governments to default or to cut the real cost of their debt through high inflation.

Investors have been fretting on both counts. Worries about default have been focused on weaker countries in the euro area, particularly Greece, Ireland, Italy, Portugal and Spain, where the single currency removes the option of unilateral inflation (see our special report). Ireland's debt was downgraded for a second time on June 8th. Fears of inflation have concentrated on America, where yields on ten-year Treasuries reached nearly 4% on June 10th; in December the figure was not much above 2%. Much of this rise stems from confidence about economic recovery rather than fiscal alarm. Yet eye-popping deficits and the uncharted nature of today's monetary policy, with the Federal Reserve (like the Bank of England) printing money to buy government bonds, are prompting concerns that America's debt might eventually be inflated away.

Justified or not, such worries will themselves wreak damage. The economic recovery could be stillborn if interest rates rise too far too fast. And today's policy remedies could become increasingly ineffective. Printing more money to buy government debt, for instance, might send long-term bond yields higher rather than lower.

What should policymakers do? A sudden fit of fiscal austerity would be a mistake. Even when economies stop shrinking, they will stay weak. Japan's experience in 1997, when a rise in consumption taxes pushed the economy back into recession, is a reminder that a rush to fiscal tightening is counterproductive, especially after a banking bust. Instead of slashing their deficits now, the rich world's governments need to promise, credibly, that they will do so once their economies are stronger.

Lord, make me prudent—but not yet

But how? Politicians' promises are not worth much by themselves. Any commitment to prudence must include clear principles on how deficits will be shrunk; new rules to stiffen politicians' spines; and quick action on politically difficult measures that would yield future savings without denting demand much today, such as raising the retirement age.

Broadly, governments should pledge to clean up their public finances by cutting future spending rather than raising taxes. Most European countries have scant room for higher taxes. In several, the government already hoovers up well over 40% of GDP. Tax reform will be necessary—particularly in places, such as Britain and Ireland, which relied far too much on revenues from frothy financial markets and housing bubbles. Even in the United States, where tax revenues add up to less than 30% of GDP, simply raising tax rates is not the best answer. There too, spending control should take priority, though there is certainly room for efficiency-enhancing tax reforms, such as eliminating the preferential tax treatment of housing and the deductibility of employer-provided health insurance.

The next step is to boost the credibility of these principles with rules and institutions to reinforce future politicians' resolve. Britain's Conservative Party cleverly wants to create an independent "Office for Budgetary Responsibility" to give an impartial assessment of the government's plans. Germany is poised to pass a constitutional amendment limiting its structural budget deficit to 0.35% of GDP from 2016. Barack Obama's team wants to resurrect deficit-control rules (see page 35). Such corsets need to be carefully designed—and Germany's may prove too rigid. But experience from Chile to Switzerland suggests that the right budgetary girdles can restrain profligacy.

Yet nothing sends a stronger signal than taking difficult decisions today. One priority is to raise the retirement age, which would boost tax revenues (as people work longer) and cut future pension costs. Many rich countries are already doing this, but they need to go further and faster. Another huge target is health care. America has the most wasteful system on the planet. Its fiscal future would be transformed if Congress passed reforms that emphasised control of costs as much as the expansion of coverage that Barack Obama rightly wants.

All this is a tall order. Politicians have failed to control the costs of ageing populations for years. Paradoxically, the financial bust, by adding so much debt, may boost the chances of a breakthrough. If not, another financial catastrophe looms. ■

Holding together

Also in this section

A tortuous path
From Bretton Woods to euro. Page 4

One size fits none
The euro did not cause all the euro area's troubles, but it will make them harder to put right. Page 5

No exit
Staying in the euro will be tough for some members, but leaving would be too awful to contemplate. Page 7

The non-nuclear options
In place of devaluation, troubled members could try reform. Page 8

Fear of floating
The financial crisis has made the euro look more alluring. Page 10

Soft centre
Can a currency survive without a state? Page 13

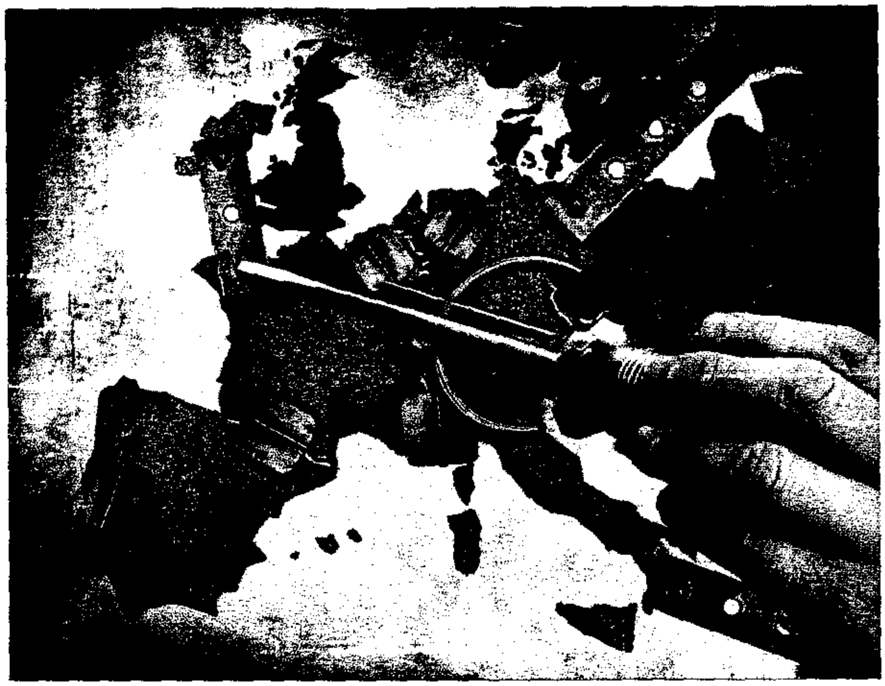
Warmer inside
The gains outweigh the losses. Page 15

Acknowledgments
In addition to those mentioned in the report, the author would like to thank: Marco Annunziata, Elsa Artadi, Katinka Barysch, Julian Callow, Andreas Galanakis, Luis Garicano, Stephen Jen, Philip Lane, Helen Louri, Spyros Papanicolaou, George Sfakianakis, Yannis Stournaras, Alan M. Taylor, Simon Tilford, Xavier Vives and Beatrice Weder di Mauro.

A list of sources is at
Economist.com/specialreports

An audio interview with the author is at
Economist.com/audiovideo

More articles about the euro are at
Economist.com/euro



The euro area, sorely tested by the financial crisis, has survived intact and is likely to expand further, says John O'Sullivan

IN THE mid-1980s *Rolling Stone* magazine published an essay by P.J. O'Rourke, a conservative American humorist, with the splendid title "Among the Euro-Weenies". In it the author poured scorn on Europe, an annoyingly fractured continent with its "dopey little countries", "pokey borders", "itty-bitty" languages and "Lilliputian" drinks measures. The mosaic of countries made the visitor feel claustrophobic: "You can't swing a cat without sending it through customs," he complained.

He will not have been aware, or cared much, that plans were already in train to give "Europe" the continental scale it so painfully lacked, as well as a currency that would rival the dollar. In 1986, the year of Mr O'Rourke's visit, the European Economic Community (as the European Union was then known) expanded from 10 to 12 countries, with the addition of Portugal and Spain. Its members had spent most of the 1970s erecting non-tariff barriers to internal trade, and the early 1980s battling over who should pay for its joint budget (a fight which, to be fair to the others, Britain started). With that settled, there was a fresh desire to make progress towards a genuinely open free-trade block.

The first fruit of that effort was the Single European Act, an agreement to dismantle the barriers to internal trade by the end of 1992. A rider to the act sketched out an ambition to complement the single market with a single currency. Few took that seriously, least of all British politicians, who had signed up to the act with enthusiasm because they were keen free-traders, but dismissed the grander kind of Community rhetoric as "euro-guff".

An idea whose time had come

Yet by the time a 1991 European summit was held in the Dutch city of Maastricht, a plan for economic and monetary union (EMU) was written into a new EU treaty, to be ratified by member states later. That the proposal had gained ground so swiftly was a surprise to many. The British government had thought that a committee of EU central-bank governors, charged in 1988 with studying if monetary union was feasible, would quash the idea. Instead the group, chaired by Jacques Delors, then president of the European Commission, the EU's executive branch, gave it qualified approval.

The Delors Report concluded that EMU could work if control of the single currency was kept from meddling politicians and left to independent technocrats at a European central bank, to be modelled on Germany's Bundesbank. The report gave warning, however, that to prevent large trade imbalances, reforms would be need- »

ed to make prices and wages more flexible and workers and capital more mobile.

EMU's route from rhetoric to economic blueprint was a familiar one, if unusually swift. The push behind trade integration in Europe has been primarily political rather than economic. The EU itself was born of the catastrophe of two world wars, collisions of competing nation-states. It was designed to avoid a repeat of such conflicts by forging "ever closer union" in Europe. Economic ties were viewed as much as a means to co-operation as an end in themselves. The Delors Commission between 1985 and 1994 marked the zenith of this sort of integrationist zeal.

After many a flap (see box), EMU eventually metamorphosed into a bird of much grander plumage. On January 1st 1999 the currencies of 11 countries were fixed against a new currency, the euro, which became the unit of reckoning in wholesale financial markets. In 2002 euro notes and coins came in and the old paper currencies were phased out. Since the single currency's launch five more countries have joined the euro area. In a unique economic experiment, 16 countries with a combined population of 329m have handed over monetary sovereignty to an entity at arm's length from national politics: the European Central Bank (ECB).

So far the experiment has worked fairly well. The ECB has fulfilled its remit to maintain the purchasing power of the euro. Since the currency's creation the average inflation rate in the euro area has been just over 2%. Fears that the euro would be a "soft" currency have proved unfounded. It is unquestioningly accepted at home and widely used beyond the euro area's borders. (Several countries, includ-

A tortuous path

From Bretton Woods to euro

THE idea of a single money as a path to European political union goes back a long way. In the 1950s a French economist, Jacques Rueff, wrote that "Europe shall be made through the currency, or it shall not be made." But the euro had pragmatic roots too. After the breakdown of the Bretton Woods system of fixed exchange rates in 1973 the Deutschmark emerged as the benchmark currency in continental Europe. The instability of floating currencies was a barrier to harmonious trade, but schemes to peg exchange rates frequently had to be redrawn because few countries could consistently match the Bundesbank's anti-inflation zeal. The might of German manufacturing forced frequent devaluations on others to keep their industries competitive.

Changes to exchange-rate pegs often caused tensions. François Mitterrand, who as French president was one of the signatories of the Maastricht treaty, is said to have remarked that "devaluations are never small enough to avoid losing face and never large enough to make a real difference to exports." As soon as Maastricht had been signed (with a British opt-out from EMU), those tensions resurfaced. In June 1992 the Danes voted narrowly against ratification, raising a question mark over the assumption that the path to EMU would be smooth. The Irish, in the only other scheduled referendum, voted in favour shortly afterwards, but Mitterrand announced a referendum in France for the following September, a risky gambit because French public opinion was cooling on monetary union.

Currency markets were also stirring. At the time all 12 EU countries, bar Greece, were in the exchange-rate mechanism (ERM), a system that tied currencies to each other within narrow trading bounds. Germany was at the scheme's heart: currencies were officially pegged to each other in a complex grid of bilateral rates but all were, in effect, tied to the D-mark. That became a problem when economic conditions in Germany and the rest of Europe diverged. To head off inflationary pressures caused by Germany's post-unification boom, the Bundesbank in July 1992 raised interest rates to 8.75%, a 60-year high.

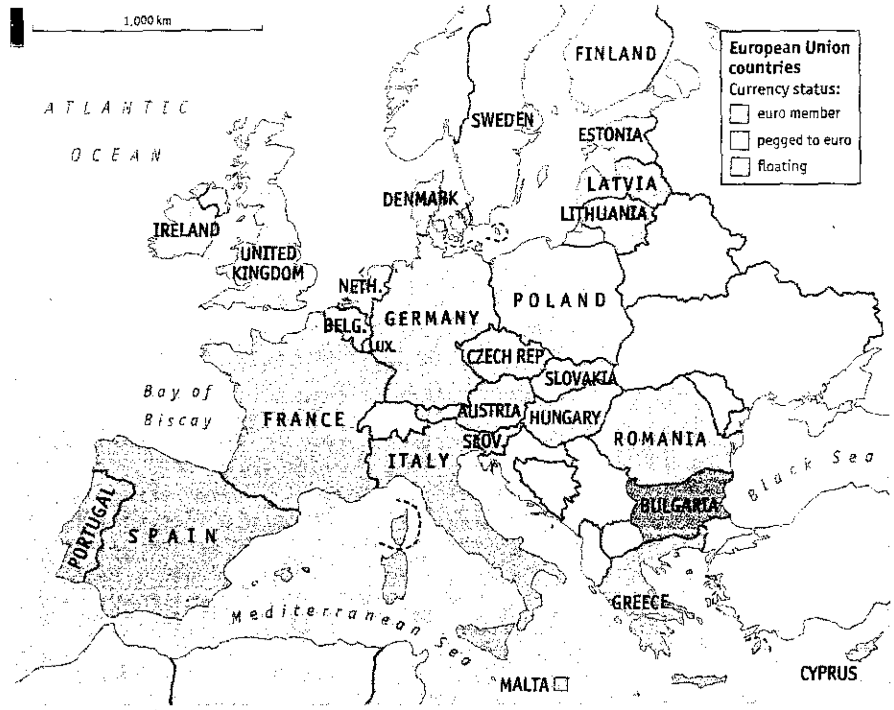
Those German rates caused strains in currency markets that worsened over the summer. In September first Italy and then Britain were forced to devalue, in Britain's case after spending billions of dollars trying to defend its ERM parity against speculators. In the following months Spain, Portugal and Ireland too had to let their currencies slide. France battled to hold to its parity and only just succeeded. Its referendum produced a narrow vote in favour of the Maastricht treaty.

Look at it this way

Different countries learnt different lessons from the crisis. Britain saw dangers in fixed exchange-rate schemes. Its economy started to pick up almost immediately after its ejection from the ERM. The French were confirmed in their belief that a monetary union was necessary both to prevent speculative attacks on currencies and to ensure that Europe's monetary policy was not made exclusively in Germany. Some German policymakers, previously sceptical of EMU, fretted that any repeat of the crisis would be a threat to the single market.

It was residual German scepticism that caused stiff tests to be set up for countries that wish to join the euro. The "convergence criteria" set out in the treaty called for would-be joiners to meet targets for inflation, bond yields, exchange-rate stability, budget deficits and public debt. The criteria were criticised as having little to do with a country's ability to cope once monetary policy was no longer tailored to national needs. Instead, they seemed designed to favour a core group of like-minded countries, centred around Germany, and to exclude others, particularly Italy, which it was feared would use EMU's low interest rates to relax fiscal discipline.

Things turned out differently. By 1997, the year in which the tests would be applied to a first wave of would-be entrants, Germany and others in the core group had trouble fitting into the Maastricht straitjacket themselves. The time scale for the fiscal targets had to be fudged, which let Italy and others slip through. France insisted that the "stability pact" proposed in the treaty be renamed "stability and growth pact". Germany demanded a cap on budget deficits of 3% of GDP. When both countries themselves later breached that limit, the rules had to be made somewhat more elastic.



ing Montenegro and Kosovo, use the euro as their currency without formally belonging to the euro zone.) The switch from old currency to new went remarkably smoothly, though consumers in many countries complained, perhaps predictably, that they were charged higher prices as merchants rounded up to new price-points in euros. But this caused barely a blip in the official inflation figures.

So far the euro has brought neither greater prosperity nor political union. Job-creation improved but productivity increases slowed, leaving the region's trend growth rate much the same as before EMU. In its early years the euro fell against the dollar, but it has since more than made up for its early losses. It has quickly established itself as a global currency without becoming a true rival to the greenback's status. For much of the euro zone's first decade Germany, its largest economy, was in the doldrums, but after a long period of wage restraint its export industries started to lift the economy. Spain, Greece and Ireland proved more dynamic, each enjoying a consumer boom.

All seemed well until the present financial crisis struck. This reawakened worries about the imbalances that have built up inside the euro zone. Germany's huge current-account surplus is matched by big deficits elsewhere, particularly in the Mediterranean countries that German policymakers had been so keen to exclude from joining. It remains an open question how these will be resolved.

The financial crisis is proving by far the biggest test to date for the euro zone. This special report will look at its effects on the euro area and consider whether such a disparate group of countries can continue to share the same monetary policy. It will ask whether the crisis will spur economic reform and whether it will attract more members to the club or, conversely, whether some of them might be thinking about leaving. Lastly, it will examine the idea that in the longer term a multinational currency area will require greater political union to function properly. ■

One size fits none

The euro did not cause all the euro area's troubles, but it will make them harder to put right

TALK of economic hardship seems out of place on a sunny April day in Barcelona, one of Spain's most prosperous cities. Yet for all the bustle along the Rambla de Catalunya, the city's main drag, the restaurants and cafés are not as full as you might expect at the start of the Easter break. Jordi Galí, an economist at the nearby Universitat Pompeu Fabra (UPF), gives a decidedly unsunny assessment of the task facing Spain.

The country is enduring a painful housing bust that has led to a collapse in the construction industry, doubling the unemployment rate to 18.1% in little more than a year. Recovery seems a distant prospect, not least because during Spain's long boom production costs rose far faster than they did across the euro area as a whole. If left unchecked, higher costs will make it hard for exporters to compete with firms from other euro-zone countries, which account for most of Spain's foreign trade.

Locked into the single currency, Spain can no longer regain its lost competitiveness by cutting its exchange rate. Mr Galí frets that this may condemn the country to a protracted slump. "The discipline of living without devaluation is tough," he says. "It's like enrolling your child in a demanding school. Results may improve, but there's also a risk the child will rebel and fail if you push too hard."

Defiance will be all the greater after a long period of relative ease. For most of the euro's first decade Spain was a star pupil. Its economy grew at an average annual rate of 3.9% between 1999 and 2007, almost twice the euro-zone average and much faster than in any of the currency area's other big countries, France, Germany and Italy. Unemployment fell from close to 20% in the mid-1990s to just 7.9% in 2007. Even that startling drop does not do justice to the pace of job creation. Employment rose at an average annual rate of 2.8% between 1997 and 2007. The boom in housebuilding lured in migrant workers, many from Africa. The proportion of women at work increased from 38.5% in 1999 to 54.7% in 2007.

Now the legacy of that long boom threatens to deliver a long slump. Of the 11 countries that adopted the euro in 1999, Spain has seen the fastest rise in output prices. Its real effective exchange rate, which measures the rise in domestic prices compared with those in 36 countries weighted by their trade with Spain, rose by around a fifth in the decade after the euro's launch (see chart 1 on the next page, left side). Competitiveness gauges such as these are notoriously sensitive to the price measure used, but on another indicator, based on relative unit wage costs, the erosion of Spain's cost edge is almost as marked (see chart 1, right side). ▸▸

Both gauges point up problems in the same handful of countries: Portugal, Ireland, Italy, Greece and Spain—a group given the ugly acronym PIIGS. All five have seen a sharp deterioration in their current-account balances since the start of EMU (see chart 2). Those shifts testify to unsustainable booms in domestic demand, but also signal that local firms have found it hard to compete with imports at home and to sell their wares abroad. Pay rises ran well ahead of efficiency gains in all these countries. In Ireland and Greece gains in output per worker were healthy but wage inflation was high. In Portugal and Spain inflation was a little lower but still well above the euro-area norm. The bigger issue was dismal productivity growth, which was Italy's main problem too.

Swines with flu

All these countries suffer not only from a lack of competitiveness but from other, perhaps more damaging, disorders too. Heavy public-debt burdens and chronic deficits were a feature in Greece and Italy long before the current crisis. Ireland and Spain enjoyed house-price and construction booms that have now turned to busts. In Ireland propping up ailing banks that had lent too freely to property developers and homebuyers, at home and abroad, has bumped up the fiscal cost of recession. (Luckily for Spain, its regulators forced commercial banks to behave more prudently in the boom.) A steady accumulation of current-account deficits has left Greece, Portugal and Spain with net foreign debts of 80-100% of their GDP. These frailties are a threat to the stability of the euro area as a whole.

How much of these imbalances are due to the euro itself? The ECB, a fledgling institution, has managed to keep a lid on inflation: in the euro's first decade consumer prices across the currency zone rose at an average of only 2.1% a year. But in such a large and diverse economy price pressures naturally vary. Capping inflation in fast-growing hotspots, such as Greece and Spain, would have needed a far tighter monetary policy than in the cooler northern climes. Interest rates that seemed right for the whole euro area were too high for sluggish Germany and too low for friskier Greece, Ireland and Spain.

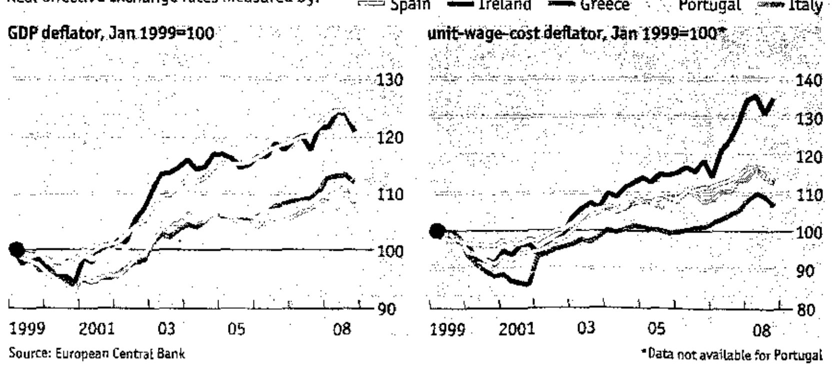
The ECB's one-size-fits-all monetary policy can never be perfectly tailored for any individual member country. In principle, higher inflation should act as a coolant to overheating economies by reducing real household incomes and by making firms less competitive, reducing the incentive to invest. In practice, strong real growth and high inflation are a draw to foreign capital, adding more fuel to the fire. For the same exchange-rate risk, a euro put to work in Spain might earn a better return than in slower-growing parts of the euro zone.

The main hazard for investors in high-inflation countries—that a steady loss of domestic purchasing power will drag the currency down—is eliminated in a fixed-exchange-rate zone. The removal of currency risk from within the euro area helps explain why some countries were able to run eye-watering current-account deficits. In 2007 both Spain and Portugal had deficits close to 10% of GDP. Greece's was 13%. In its absolute size, Spain's deficit was second only to America's.

Foreign capital kept booms going for longer, but that was true in many rich countries outside the euro zone as well. There were other factors at play. The euro was created at a point when the Great Moderation, a long period of stable growth and low inflation in rich countries, was in full train. Investors had come to believe that wild swings in the business cycle were a thing of the past, making them all too willing to take on risk, including loans to countries that already had large foreign debts. Exchange rates often provide useful warnings about emerging imbalances, but overconfidence and herd behaviour weakened the signal.

Losing effectiveness 1

Real effective exchange rates measured by:

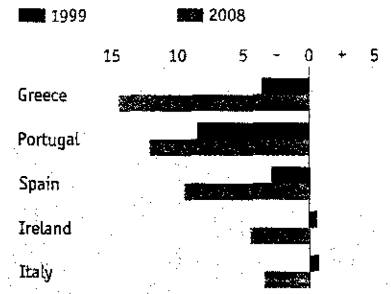


Source: European Central Bank

*Data not available for Portugal

Taking the strain 2

Current-account balance, % of GDP



Source: European Commission

Even if the first wave of currency union had excluded Spain and Greece, as some German policymakers had wanted, their economies might still have sucked in foreign capital. The eight eastern European countries that joined the EU from 2004 attracted huge sums of foreign capital even though for many of them euro membership was a distant prospect. This suggests that, even outside the euro, Spain and Greece would have had access to plenty of foreign credit with which to feed a domestic spending boom.

Ireland and Spain were ripe for housing booms too. Both countries have a high rate of owner-occupancy and space for fresh construction. The obsession with housing spilled over from Britain, a serial miscreant when it comes to house-price booms. When Spain and Ireland adopted the euro, they imported low interest rates from Germany: the ECB was the Bundesbank writ large. By then Britain had already adopted the German model of a central bank free from political influence and determined to fight inflation. The results, inside and outside the euro zone, were much the same: lower interest rates that sent house prices mad. Britain, at least, was able to tailor its interest rates to local conditions, but not by enough to prevent a housing bubble.

If euro membership is only partly responsible for the overheating in Ireland, Greece, Portugal and Spain (sluggish Italy can only dream of such excesses), it will make it harder for these countries to deal ▸▸

with the resulting loss of competitiveness. Spain's unemployment rate is already the highest in the euro area and likely to rise further. If Spain's jobless rate sticks at 20%, will voters blame the euro?

A handy scapegoat

"No one sold the euro as a solution to high unemployment," says Mr Galí. But, he adds, the economy used to benefit when market pressures forced down the local currency: "In 1992 and 1993 a series of devaluations got us out of trouble." Now Spain needs other adjustment mechanisms: lower wages to restore cost competitiveness to its firms and a flexible job market to speed the flow of workers from industries such as construction, which catered to a boom fired by domestic demand, to export firms that can generate the revenues to service Spain's debts.

That transition would be hard enough in the best of circumstances. Spain has one of the most rigid job markets in the developed world. Many jobs are heavily protected and wages are set centrally. That will make adjustment all the more difficult. The fear is that Spain will stagnate even as other economies start to revive. "My nightmare is that the world economy, including Europe, recovers and Spain does not manage to hook up to that," says Andreu Mas-Colell, another economist at UPF. "That would be a disaster. It would strain the link between Spain and the rest of the EU. We will also have to deal with tighter monetary policy if the rest of the euro area picks up, creating more pressure."

That fear of being left behind is widely shared in other countries too. Some economists believe that countries now stuck in a slump and unable to adjust their production costs may well start questioning the benefits of euro membership. But where is the exit sign? ■

No exit

Staying in the euro will be tough for some members, but leaving would be too awful to contemplate

IN THE weeks following the collapse of Lehman Brothers last September the number of euro banknotes in circulation suddenly increased. Fears about the rickety state of banks had made many people mistrustful of keeping money on deposit. Far safer to keep cash stuffed under a mattress. The more discriminating hoarders, it was said, were careful to squirrel away banknotes with serial numbers prefixed by the letter "X", indicating currency issued in Germany. Notes with "U" (French) or "P" (Dutch) prefix were also fine, but those with a "Y" or an "S", issued by Greece and Italy, were shunned.

The logic was that if you were preparing for financial apocalypse, you had better not rely on the euro area surviving intact. In fact, banknotes are a shared obligation of all euro-zone members, no matter where they are printed. If the issuing country were to leave the single currency, a five-euro note would still be worth five euros, whatever the serial number. However, interest-bearing debt denominated in euros is a different matter, and bond markets quickly started to sort the Xs from the Ys.

By early 2009 the yield on a ten-year Greek government bond was almost twice that on a comparable German Bund. The spread over Bunds for Italian, Spanish and Irish bonds also widened dramatically before narrowing again more recently. One explanation was that in skittish markets Bunds were prized for their extra liquidity. Another was that the bond-trading arms of bombed-out banks were less willing to make markets in the issues of small countries, such as Greece and Ireland, which left their prices unmoored.

But at least part of the rise in spreads reflected concern that countries might find it hard to pay back their borrowings. The government bonds of Greece, Ireland, Portugal and Spain were all downgraded a notch by credit-rating agencies. For some, bond spreads are a crude gauge of the risk that the euro will break up. If a euro-zone member were shut out of capital markets and had to default on its debt, it might be tempted to use the opportunity to recreate its own currency and devalue. In that event, creditors could be forced to convert their bonds into claims in a new currency at a discount linked to a new exchange rate against the euro. Default would be one way for countries to free themselves from the euro's shackles—or, to look at it from the opposite point of view, for the euro zone to rid itself of troublesome members.

A game of consequences

That kind of thinking, however, is found mostly among those who were doubtful that the euro would ever get off the ground in the first place. It is rare in countries seen as candidates for exit. As Eurocrats in Brussels are keen to stress, far from breaking up, the euro zone is growing. Since its launch it has taken on five new members, and more are queuing to join.

The costs of backing out of the euro are hard to calculate but would certainly be heavy. The mere whiff of devaluation would cause a bank run: people would scramble to deposit their euros with foreign banks to avoid forced conversion to the new, weaker currency. Bondholders would shun the debt of the departing country, and funding of budget deficits and maturing debt would be suspended.

Changing all contracts in euros—bonds, mortgages, bank deposits, wage deals and so on—to the new currency would be a logistical nightmare. The changeover to the euro was planned in detail and the exchange rate was fixed in advance, in co-operation with all the euro members. The reverse operation would be nothing like as orderly, not least because the exchange rate would be a moving target.

If businesses converted their debts to a weaker currency, that might constitute default and trigger legal challenges. If they stuck to their covenants, they would have to service their euro debts from earnings in a weaker currency. That would hurt firms which rely mostly on profits from their domestic market. The convulsions would be felt by other euro-area members too. The writedown of the departing country's government bonds might threaten the solvency of banks in the rest of the euro zone. Around half of Italian government bonds, for instance, are held outside Italy. Other euro-area members could suffer contagion as markets bet on further defaults.

If the act of leaving would be hard, the aftermath might be even harder. A country that forced bondholders to take a loss would be punished. Continued access to bond markets would come at a high price. Investors would ask for a huge premium to ▸▸

▸cover the risk of further default. On that count alone, borrowing costs would be far higher than they were within the safer confines of the euro area.

Investors would have to protect themselves from two further risks: exchange-rate volatility and inflation. A former euro member would have to reinvent its own monetary policy and would struggle to convince investors that it could keep a lid on inflation. One of the euro's big attractions was that it offered many countries a shortcut to a credible monetary set-up. Devaluation could itself trigger a wage-price spiral. For high-debt countries, such as Greece and Italy, the interest rates demanded by markets to insure themselves against such risks would be ruinous.

And even though the costs are likely to be heavy, the immediate benefits might prove only transitory. A devaluation is a proxy for a national pay cut: it helps exporters but makes consumers of imports poorer. Workforces would put up strong resistance to being paid in a weaker currency. In countries such as Greece and Ireland, whose exports contain a lot of imports, a devaluation would push up inflation. And where a large proportion of wage contracts is indexed to prices, as in Spain, higher inflation would rapidly work its way through to wages.

The wrong cure

An exit from the euro would not tackle weak productivity growth and inflexible wages, which are the root causes of low competitiveness. In time, further devaluations might be needed. Countries with high debts and a history of poor macroeconomic management would be most tempted to leave. But these are also the countries most likely to be hurt.

A more plausible, though still unlikely, scenario would involve a breakaway by a group of low-debt and cost-competitive countries, centred around Germany. Members of a new, "hard" European currency would leave behind a stock of depreciating euro debt and might be rewarded by lower borrowing costs on debt issues in the new currency. Yet a large part of the appeal to Germany of the single currency has been that it rules out revaluations and rewards its firms for being competitive. Germany, France and the rest have too much invested in the success of the EU and the euro to put it at risk. As Daniel Gros of the Centre for European Policy Studies, a Brussels think-tank, puts it: "The weak can't leave and the strong won't leave." ■

The non-nuclear options

In place of devaluation, troubled members could try reform

SPAIN may soon be faced with two options, says UPF's Mr Mas-Colell: a permanent slump or economic reform. "A third option, exit from the euro, is not a possibility. Spain won't leave because it is very pro-Europe. To leave would be seen as a national failure rather than a liberation." Euro membership is a symbol of Spain's progress as a democracy as well as its economic development. For some, it is an insurance against a return to dictatorship and autarky. "Our experience is that when we went for being more European, the results were positive," says Elena Pisonero, a former vice-minister for commerce, now at the Madrid office of KPMG, a consultancy. "In the past [during the dictatorship of Francisco Franco, which ended in 1975] we were closed off. Opening up our borders brought huge benefits."

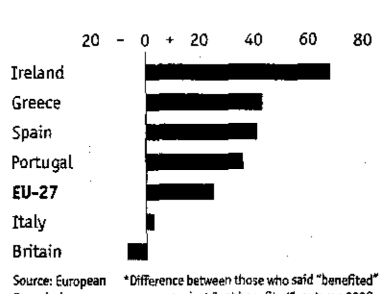
Ireland, like Spain, has been helped by EU funds for roads, farming and universities. According to the most recent Eurobarometer, a twice-yearly opinion poll, 79% of respondents in Ireland believe that overall their country has benefited from EU membership, and only 11% think it has not. The positive response in Greece, Spain and Portugal was above the average for all EU countries (see chart 3, next page).

Most Greeks are in favour of the euro, and only 12% think EU membership is bad for their country. That is poor ground on which to build a case for quitting the euro. Greece's finance minister, Yannis Papathanassiou, thinks that the recent spike in Greece's borrowing costs was driven by the mistaken belief that last December's violent street protests were due to a faltering economy. In fact the demonstrations were sparked by the killing of a 15-year-old boy in Athens by a policeman. Some people had taken rising bond spreads as an omen of default and euro break-up. That prospect, always distant, has now receded further. "Despite the high spreads, we have shown that we can refinance our debt," says Mr Papathanassiou.

Italy's economic travails have attracted less attention recently. Unlike Greece, Ireland and Spain, whose economies grew rapidly before crisis struck, Italy has seen its GDP growth drift consistently below the euro-zone average (see chart 4). Its cost- ▸▸

Appreciated 3

Balance* of people polled who believe membership of the European Union has benefited their country, %



Source: European Commission *Difference between those who said "benefited" against "not benefited", autumn 2008

competitiveness has declined and its public debt was already 106% of GDP last year and will now rise still further. Yet in March, when the strains in the euro area's public-debt markets were at their greatest, Italy's ten-year bond yields were around 1.5 percentage points above Germany's, compared with a gap of 2.8 percentage points for Greece.

Nor was Italy's public debt downgraded. "Perhaps the credit-rating agencies are being responsible," an Italian economist suggests by way of explanation. If Italy did get into funding trouble, that would have repercussions for the rest of the euro zone. Its public debt dwarfs that of countries the size of Ireland or Greece.

If the rating agencies have been careful not to sound the alarm, the same is true of Italy's politicians. In the past Silvio Berlusconi, the prime minister, and Giulio Tremonti, the finance minister, have been quick to blame the euro and the ECB for Italy's economic problems. Bashing the euro was a useful way of attacking Romano Prodi, a centre-left opponent, who in his first stint as prime minister, in the late 1990s, took Italy into the euro before becoming president of the European Commission. The rhetoric has noticeably softened. Earlier this year Mr Tremonti described the euro zone as "totally sustainable". The currency crises in Hungary and Iceland were salutary, says Roberto Perotti of Milan's Bocconi University. "No serious politician now says 'let's leave'."

Devaluation by proxy

Is there a way of achieving the effects of a fall in the real exchange rate without going to the extremes of ditching the euro? As long as it does not trigger a burst of wage inflation, a devaluation lowers wage costs relative to those of workers abroad, improving the competitiveness of firms producing things that can be traded across borders. A weaker currency also shifts the balance of demand by making imported consumer goods dearer and exports cheaper. That cools spending at home and tilts the scales towards firms that sell abroad, nudging workers and capital in their direction.

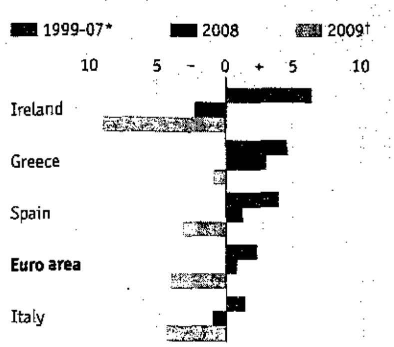
In a currency union, pay needs to adjust that much more quickly to changing market conditions to shift workers out of high-cost industries. But until quite recently pay has tended to be "sticky" on the way down: workers have generally been reluctant to take wage cuts, at least in nominal terms, which has made real-wage adjustment slow. On many reckonings, the rate at which Germany went into the euro in 1999 was too high. The traded value of the Deutschmark had not fallen to reflect the higher unit wage costs that were a legacy of the unification boom. It took many years of very low wage growth and rising productivity before Germany regained its edge on costs.

That route to redemption has become even harder for today's high-cost countries because there is little consumer-price inflation around to erode real wages and rebuild profit margins. Unemployment seems likely to rise steeply before wages start to adjust.

Ireland will make the adjustment more quickly than the others. Already there are signs that private-sector wages are falling in response to rapidly rising unemployment. The 7.5% cut in public-sector pay that came into force in May was mostly a response to the fiscal crisis, but was also sold as a remedy for lost competitiveness. Ireland is set to endure a deeper recession than other rich countries because of its "globalised" economic model. But because of that sensitivity to the world business cycle and its reliance on big multinational firms for investment, wages are unlikely to stay out of whack for too long.

Where it hurts 4

GDP, % change on year earlier



Source: European Commission *Average annual rate †Forecast

In the Mediterranean economies the pressure on wages is mostly in the wrong direction. In Spain most private-sector pay deals contain clauses that compensate employees if inflation is stronger than expected. The country also has a managed system of wage-setting that fails to make enough allowance for different productivity levels across the economy.

Wages in Italy are set centrally too (as they are in Greece), although compensation for inflation is no longer automatic. The infamous *scala mobile*, which maintained a rigid link between Italian wages and prices, was scrapped in 1992 after a long struggle.

Here today, gone tomorrow

The spread of fixed-term employment contracts in Spain (from the mid-1980s) and Italy (in the mid-1990s) helped make hiring and firing more responsive to the business cycle. The innovation had an immediate pay-off: it created jobs. Firms were content to take on temporary workers, often immigrants, because they knew they could easily lay them off again. Before the crisis hit, temporary jobs accounted for more than a third of Spain's total, the largest share in the EU. Tito Boeri of Bocconi University reckons that a fifth of Italy's workforce are on (short) fixed-term contracts. The rest enjoy a high level of job protection which politicians dare not dismantle. Both countries saw temporary contracts as the only way to free the jobs market.

Jobs that were created in good times are now being shed quickly. The downturn has highlighted the gross unfairness of the dual labour market. It puts the burden of adjustment on groups with no tenure (women, immigrants and the young). Protected workers, the bulk of the workforce, cling to their jobs. That tends to fossilise the structure of the economy. Old industries, where productivity is waning, are slow to die and new firms slow to start up.

The growth of temporary contracts hurts productivity in another way. Firms are obliged to lay off (typically young) contract workers at the end of a fixed period, so they have little incentive to train tomorrow's workforce. Instead they are stuck with older, tenured workers heading for retirement. The result in Italy, says Mr Boeri, is a "lost generation" of workers with limited skills. Admittedly the growth in temporary contracts has helped many people ▸▸

back into work and has lowered long-term unemployment. But the evidence from Spain suggests that such contracts are rarely a bridge to better things: less than 5% are converted into permanent jobs.

A group of economists led by Samuel Bentolila of CEMFI, a graduate school in Madrid, have set out a reform manifesto for Spain's jobs market. They suggest that wage-setting could be made more flexible if deals struck at the level of individual firms were allowed to prevail over regional or industry agreements. They also propose replacing fixed-term contracts for new hires with a permanent contract in which firing costs rise with seniority but not as high as at present.

Mr Boeri and his colleagues have called for a similar scheme in Italy, where workers build up employment rights over time. Abolishing job protection makes most workers worse off, so it tends to run into political obstacles. The next best thing is gradually to reduce average firing costs and giving firms better incentives to train their workers. If Italy wants to encourage workers to risk moving jobs, it also needs to beef up its skimpy unemployment benefits. "Italy should say to its partners: 'our fiscal stimulus is to introduce a welfare safety net to speed up the reallocation of jobs'," says Mr Boeri.

Never a good time for reforms

Such reforms would be desirable even if nobody had signed up to the euro. When the currency was created, the hope was that the loss of the safety valve of devaluation would help to boost productivity and make markets more flexible. For most of its first decade timid politicians were able to shelter behind the economic stability that the euro helped provide. Without a crisis it is hard to persuade voters of the need for radical change. Yet recession is the worst time to make changes that leave some groups poorer.

Italy's previous big recession, in 1992-93, prompted a wave of reforms: privatisations, changes to pension entitlements, the creation of a competition authority and the demise of the *scala mobile*. Greece is now inching ahead with some reforms along similar lines. The government has sold Olympic Airways, a subsidy-thirsty airline, and a competition law is going through parliament that will give antitrust authorities more power to challenge—and break up—big companies that can set prices. In Spain one relatively painless reform would be to change the rules for renting out property, which currently overprotect tenants. If owners felt more relaxed about letting out second homes, workers might find it easier to move in search of jobs. It might even lift house prices.

For now, policymakers are too worried about fragile demand to risk tackling the supply side of the economy. Today's economic crisis has little to do with differential wage costs within the euro. In terms of relative unit wage costs, Germany's competitiveness has improved by around 13% since the euro started. Yet this year the German economy is set to shrink by more than any other in the euro area bar Ireland because of its heavy reliance on exports. Greece is expected to hold up better because it is less exposed to the global economy ("a good thing for a bad reason," notes one policymaker). Its GDP is likely to fall by around 1%, making it one of the most resilient economies of the OECD's 30 members. Italy's economy will do far worse, but there is less of a sense of crisis because it has long been struggling anyway.

Root-and-branch structural reform will have to wait a while longer. Germany's travails are not a good advertisement for maximising competitiveness. Only in Ireland, where the economic model is based on openness to trade and foreign investment, is competitiveness a big part of the policy debate. Elsewhere politicians seem somewhat stuck. "At some point we'll have to accept that it's better to have people in work than to have high wages," says Mr Mas-Colell. "In Spain we are not ready for that. There is an illusion, a hope, that we will wake up tomorrow and things will be better."

Yet all the current troubles of the hardest-hit euro-zone countries do not seem to have put off a raft of applicants, mostly in eastern Europe, from trying to join the club. Indeed, if anything, the financial crisis has made many countries even keener to join. Do they know what they are doing? ■

Fear of floating

The financial crisis has made the euro look more alluring

IN 1999, the year the euro was launched, the Nobel prize for economics was awarded to Robert Mundell, a Canadian economist. That was good timing because his work was influential in shaping the euro zone. In a 1961 paper Mr Mundell had pioneered the theory of an "optimal currency area", a territory suited to adopting a common monetary policy. A main requirement, he concluded, was that workers throughout such an area would be sufficiently inclined to move jobs to even out regional booms and slumps. In later research others added strong trade links, wage flexibility and a central fiscal authority to the list of necessary features.

Equally important to the decision to join a monetary union was another of Mundell's insights, developed with Marcus Fleming at the International Monetary Fund, which entered the economics textbooks. This was the idea of the "impossible trinity": that a country could not simultaneously have a fixed exchange rate, be open to capital flows and operate an independent monetary policy. It could opt for any two of these features but not all three together. With free capital flows, monetary policy could be directed either at stabilising an exchange rate or controlling inflation, but not both. A country that targets domestic inflation and is open to foreign capital must have a flexible exchange rate. ▸▸

When Mr Mundell expounded his theory, in the early 1960s, most rich countries were tied to the Bretton Woods system of fixed exchange rates. Because capital flows were tightly controlled, countries could set their own interest-rate policies and still keep exchange rates more or less fixed against the American dollar.

Canada was different. Its long border, heavy trade and strong industry links with America made capital controls impractical. For Canada to have an independent monetary policy, it had to let its currency float. In later writings Mr Mundell expressed regret about Canada's choice, as well as enthusiasm for European monetary union. In principle, a currency adjusts to keep economies in balance, but in practice, argued Mr Mundell, exchange rates veer wildly from their ideal levels. Large and volatile capital flows mean that floating currencies can be a source of instability. They are also a poor substitute for fully flexible wages and prices.

In or out?

The merits of monetary flexibility versus exchange-rate stability have to be weighed up by the 11 EU countries that are not (yet) in the euro. The choice is straightforward for Britain, which has long been reluctant to give up its independent monetary policy and has an opt-out from the euro. Britain's policy brass tend to see a flexible exchange rate as a useful safety valve. Sweden, like Britain, does not seem to have much to gain from hitching itself to the ECB. It has built a credible monetary regime, with an independent central bank, along similar lines. Since a referendum in 2003 that came out against membership, Sweden has shown no interest in getting closer to the euro club.

Denmark's currency is pegged to the euro but the country remains outside the euro zone after twice failing to secure a popular vote in favour of joining. It has the worst of all worlds. The currency peg is open to speculative attack, so its exchange-rate stability is precarious; yet to preserve it, the country has had to sacrifice an independent monetary policy. The government has been mulling a third referendum but the new prime minister, Lars Lokke Rasmussen, said in April that it would not take place this year.

The other eight potential members are former planned economies in central and eastern Europe (CEE) that joined the EU on or after May 2004. All are keen to adopt the euro. Those that had been cool on membership, such as the Czech Republic, have warmed up since last autumn's financial turmoil. Most are small and very open economies whose exports account for a large share of GDP and whose trade ties to the euro area are strong. As emerging economies they are prone to sudden shifts in foreign-investor sentiment, which makes for volatile currencies, so exchange-rate stability holds considerable appeal for them. None of them has a long record of stable money, so loss of monetary independence would not be greatly mourned. For four of the eight the euro is already their monetary anchor. The three Baltic countries, Estonia, Latvia and Lithuania, have long pegged their currencies to the euro, and before that to the D-mark. Bulgaria also has a euro peg.

For small, open economies such as those of the Baltic states (and Iceland, which now plans to join the EU as a stepping stone to adopting the euro), it makes sense to tie currencies to a big and stable neighbour. Even Milton Friedman, a fervent advocate of floating exchange rates, thought so. In the Baltics, Latvia's euro ambitions are on hold. Following a bail-out led by the IMF in December, its economy and public finances are in intensive care. Estonia wants to join quickly and may do so as soon as 2011. A realistic target for Lithuania is 2012.

For a larger country, such as Britain, the benefits of membership are less obvious. A bigger portion of the goods and services it consumes is produced at home, so there is more scope to manage domestic prices through an independent monetary policy.

Poland could fit that bill too. It is the largest and one of the least open of the CEE8 (see table 5). Though not nearly as rich as Sweden in terms of income per head, it has many more people, so its economy is bigger. Its exports account for two-fifths of GDP. Because its exposure to world trade is smaller than that of many other EU countries, it has suffered far less from the global recession. The European Commission reckons its economy will shrink by 1.4% this year, which is not a lot by the dismal standards of the region.

The case for a quick dash

Despite the size and resilience of Poland's economy, its government wants to get into the euro as soon as possible. It hopes to join the ERM-2 (a pledge to keep the exchange rate within agreed bounds for two years) early next year in order to qualify for euro membership by 2012. As elsewhere in the region, part of the rush to qualify is to forestall a further drop in the zloty, which would make foreign-currency loans harder to pay off. Around 30% of private-sector debt is in foreign currency, far less than in Hungary but more than enough to hurt the economy if the zloty sinks. Hopes of entry in 2012 may be optimistic, and some economists question the wisdom of forcing the pace. As a fast-changing economy Poland might need the flexibility of a floating exchange rate for a little longer to keep it competitive and to smooth adjustments.

But can it rely on the right kind of help from currency markets? Recent experience suggests that there is no stable link between the economy's vital signs and shifts in its currency. For a while the exchange rate had been a balm. Between 2005 and 2007 the zloty's value increased in line with productivity (as a country becomes richer, its currency tends to rise in real ▸▸

The outsiders 5

	% of GDP 2009		GDP at market prices, €bn, 2008	Exports, % of GDP, 2007	Consumer prices*	10-year gov't bond yield, %†
	Budget balance	Public debt				
Euro area	-5.3	77.7	9,209	41.6	2.7	3.69
Britain	-11.5	68.4	1,812	26.4	3.7	4.11
Bulgaria	-0.5	16.0	34	63.4	10.1	7.04‡
Czech Republic	-4.3	33.7	149	80.2	4.7	4.65
Denmark	-1.5	32.5	233	52.3	3.2	4.10
Estonia	-3.0	6.8	16	74.4	8.6	na
Hungary	-3.4	80.8	105	80.3	5.0	9.40
Latvia	-11.1	34.1	23	42.2	13.4	7.90
Lithuania	-5.4	22.6	32	54.4	10.5	7.89§
Poland	-6.6	53.6	362	40.8	4.0	6.02
Romania	-5.1	18.2	137	29.5	7.6	8.95
Sweden	-2.6	44.0	328	52.6	3.1	3.49

Sources: European Commission; Thomson Datastream; Bloomberg

*% increase on a year earlier, latest 12-month average †Latest 12-month average ‡Latest 5-month average §8-year gov't bond

terms). That helped to keep inflation low without harming exports.

The benign period ended in the autumn of 2007. The zloty, and some other eastern European currencies, were driven up (see chart 6) as investors piled into emerging markets in the belief that they would soon "decouple" from troubled rich-world economies. A year later, following the collapse of Lehman Brothers, the markets made a U-turn. Capital flooded out of eastern Europe, starving the region of foreign currency and plunging it into a severe crisis.

When a floating exchange rate proves to be an irritant rather than an emollient, fixing it once and for all has greater appeal. Most of Poland's trade is with the euro area and much of that is intra-firm trade: between, say, a German firm and its Polish subsidiary. Adopting the euro should open Poland up to more of that sort of trade and the stable, long-term capital investment that goes with it. And once currency risk vanishes, government, firms and households will all be able to borrow more cheaply—and, as important, given the recent freeze-outs—more easily.

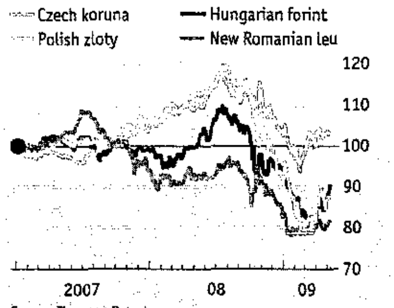
In purgatory

The financial crisis may have increased the allure of the euro zone, but it has also made it trickier to get in. To join, countries must first meet the "convergence criteria": targets for inflation and public finances, as well as market-based tests for low long-term interest rates and a stable exchange rate (ie, two years in ERM-2). Slovakia made the cut when the criteria were last assessed, in May 2008, and joined in January. Of the eight CEE countries still outside, all bar Poland and the Czech Republic missed the mark on inflation, which was supposed to be no more than 1.5 percentage points above the average of the three EU countries with the lowest rate. Poland, for its part, failed to qualify because of doubts that it could control its budget deficit and worries that it owed its low inflation to the rise in the zloty (which was not in ERM-2).

With economies facing a deep recession, inflation is set to drop sharply (though the benchmark for the test is falling too). The public-finance criteria will be far harder to meet. Euro aspirants must show that they can keep their budget deficits below 3% of GDP and cap their debt ratio at 60%. That is tough in a downturn: most countries inside the euro area are already in breach of these rules. But hopes that the rules might be relaxed have been dashed. Those inside the euro fear that easing up on potential entrants would undermine the single currency. There may be a feeling that "we had to suffer to get in; so should you." Some outside the ark are also against a free-for-all. The stronger aspirants, Poland and the Czech Republic, have distanced themselves from calls by troubled Hungary (like Latvia, an IMF supplicant) to shorten the qualifying period in ERM-2 from two years.

Oh for an anchor 6

Exchange rates against the euro, January 2007=100



Source: Thomson Datastream

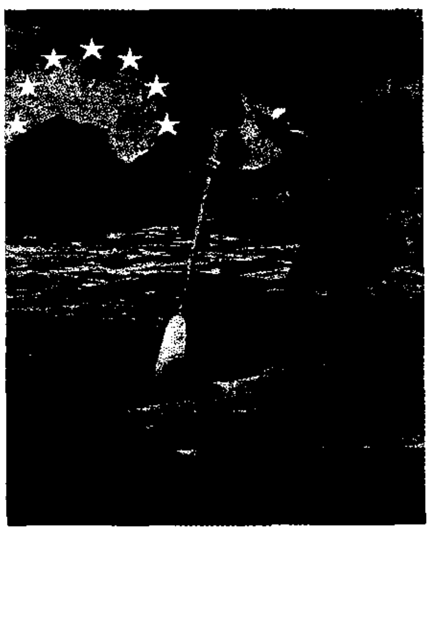
Would fast-track entry really harm the euro? The worry that euro-zone countries such as Spain may suffer prolonged slumps because they lost control of unit wage costs lends the inflation test some weight, though not much. Willem Buiter at the London School of Economics is not convinced. He thinks that inflation convergence is something to be expected after adopting the euro, not before. Getting rid of anything that may give rise to inflation is in the self-interest of new joiners. So is fiscal discipline. But insisting on them prior to entry amounts to "misplaced paternalism", according to Mr Buiter. "If you have time to get inflation down, fine. But floating exchange rates are dangerous. The main thing is to get in."

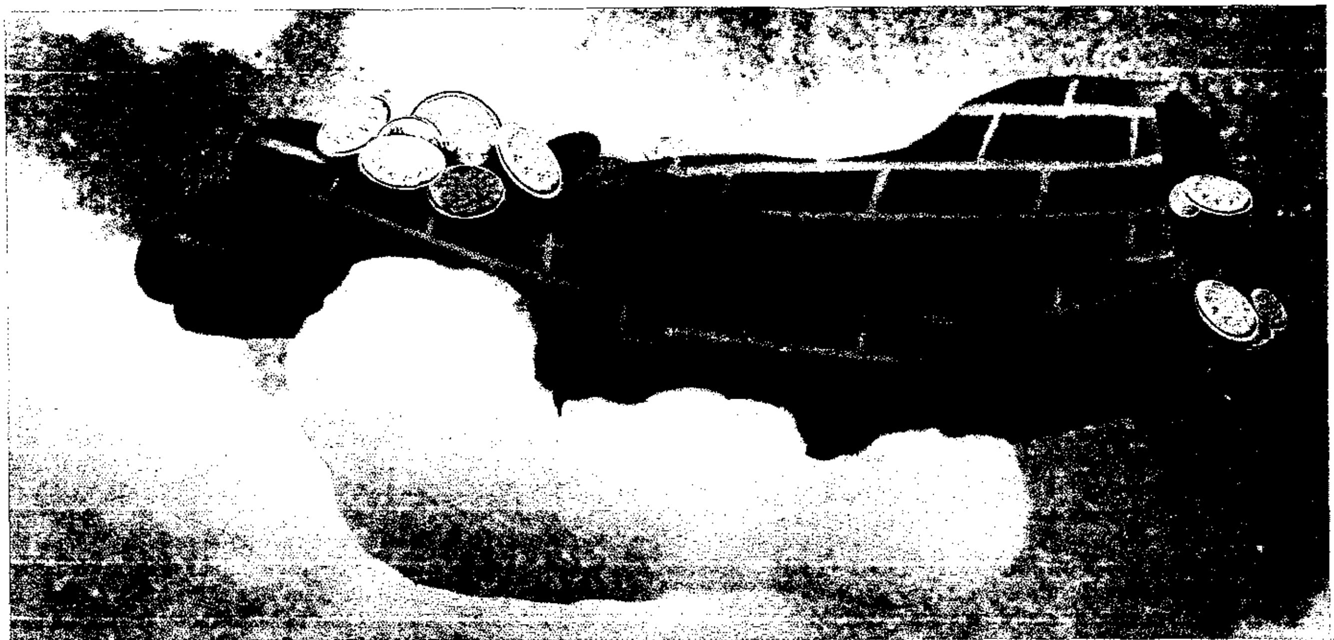
On one count, the would-be entrants are more flexible than the incumbents. Migrants from Poland and other eastern European countries have shown themselves willing to move in search of work. Lessons can also be learnt from the mistakes of others. Andrzej Slawinski, a member of the Polish central bank's monetary-policy council, believes there is less of a risk that the new member states will follow in the footsteps of Greece, Ireland, Portugal and Spain. They are still poor by EU standards, so can look forward to a period of fast productivity growth. Were unit wage costs to rise too far, they could recover competitiveness more quickly.

Poland may be able to guard against the risk of credit and housing booms because the climate now favours tighter bank regulation. "Banking supervisors must have the authority to react to the business cycle in a dynamic way," says Mr Slawinski. Governments must also be careful not to fuel housing booms with tax breaks. Instead property taxes could be used to cool overheated housing markets.

Once Poland and the smaller CEE countries adopt the euro, might Britain's attitude change? If Denmark were to join too, the euro area would cover almost all of the EU's member states, so Britain might once again look like the odd one out. Even so, it is likely to draw the same lesson from this crisis as it did from the ERM expulsion in 1992: that devaluation is a good thing. There is chagrin in some European capitals (especially in Dublin) that sterling has dropped so far and fast against the euro. A weaker pound, even with world trade in retreat, still cushions the profit margins of struggling exporters. It will only harden the belief in Britain that currency flexibility should not be lightly given up.

In any case, no British government could now consider signing up to the euro without first winning a referendum, and opinion polls have shown a fairly consistent two-to-one majority against joining the single currency. Even if Britons could be sold on the narrower issue of economic benefit, they are more likely than most Europeans to see national control over monetary policy as indivisible from other kinds of sovereignty. The euro's success so far has suggested that a currency can be stable without the backing of a unitary state. But the financial crisis has raised a fresh question mark over that idea. ■





Soft centre

Can a currency survive without a state?

LAST November the European Commission set out its proposals for a Europe-wide fiscal stimulus, worth a combined €200 billion, roughly 1.5% of the 27-nation block's combined GDP. The commission has a relatively small budget and no authority to compel member states to shell out extra cash or cut taxes (and, to its regret, little clout to stop them from running up budget deficits). So it had to content itself mainly with a co-ordinating role.

The commission, along with the European Investment Bank, found €30 billion of EU money to contribute towards the €200 billion target, mostly by speeding up spending programmes. Of this, €5 billion was unspent infrastructure money from the EU budget which would normally be returned to the rich member states that had provided it. Three months later governments were still arguing about where or indeed whether this money, a trifling sum in the scheme of things, should be spent. Brussels insiders see this episode as typical of the painfully slow process of putting plans into action. It also illustrated how reluctant governments are to cede control over their own revenues.

There had been hopes that they might become more co-operative. Helmut Kohl, who as German chancellor was one of the midwives of the Maastricht treaty, thought a single currency could not survive without political union; indeed its main appeal was that it would make such union more likely. In November 1991, a month before the Maastricht summit, he told the German parliament that it was a "fallacy" that monetary union could last without political union. By the time the euro was launched in 1999, many people thought that some form of fiscal counterweight to monetary union would soon follow. "You didn't have to be a federalist to believe then that the euro would prompt more political integration," says Jean Pisani-Ferry of Bruegel, a Brussels think-tank.

The belief seemed well founded on several counts. Money is a form of government debt, so a paper currency, it was thought, must need a state behind it. Historical examples of a currency block not backed by a unitary state are rare, and such few as there have been did not last long. According to the theory of optimal currency areas, a central fiscal policy is necessary because a single interest rate will not suit conditions in all parts of a currency zone. Just as welfare spending and revenue raising help to smooth out regional kinks in national business cycles, a "fiscal euro zone" would act as a stabilising force for a shared currency area.

Rules of the game

What institutional structures would be needed for political union was rarely made clear, only that there would soon be more of it. In the meantime a set of fiscal rules—the stability and growth pact, which put a cap on budget deficits and public debt—would take the place of a central system of revenue sharing. Each country would insure itself against a downward lurch in its economy by running a balanced budget or, in good times, a surplus.

These fiscal rules had another purpose, which was often given greater emphasis: to prevent imprudent countries from imposing costs on others. Big deficits in one country might make it harder for others to compete for funds from savers, driving up interest rates for all. If such deficits were to add materially to the average debt burden, investors might fret that governments will attempt either to inflate away their debts or to pass them on to other countries, so will demand higher rates from all borrowers as protection. The EU treaty contains two clauses to try to limit this transfer of costs. The first bars the ECB from creating money to finance deficits. The second forbids countries from assuming the debts of others (the "no bail-out" clause).

The pact did not work well. The emphasis on the costs to others of fiscal indiscipline meant that countries were careful to behave no worse than their peers, rather than trying to be prudent on their own behalf. In good times public finances tended to add to, not subtract from, demand pressures: fiscal policy often worked against the monetary sort rather than complementing it, as the pact intended. The costs of fiscal laxity were low. Before crisis struck, the slack attitude towards credit risk in bond markets meant that borrowing costs for high- and low-debt countries were similar. When in 2003 the European Commission threatened to impose penalties on France and Germany for excessive ▸▸

deficits, the pact was first suspended and then amended, with get-out clauses for "exceptional" events.

Ireland and Spain had complied with the pact in good times, but had relied too heavily on windfall revenues that evaporated along with their housing booms. Ministers had been able to insist that their fiscal policies were sound because they fitted in with the pact's narrow guidelines, says Mr Pisani-Ferry. Since fiscal soundness was central to "stability", they could claim that their overall economic policy was fine too.

Once the crisis had blown up last autumn, the lack of a fiscal centre to the euro zone became a live issue. Initially the euro rallied, but haphazard efforts to shore up banks, and later the economy, undid that early vote of confidence. Scared investors rushed into the safest dollar assets, lured by the liquidity of the vast market for US Treasuries, as the euro area was revealed as a mess of fragmented bond markets. Small euro-area countries with oversized banking industries, such as Ireland and Belgium, found that their bonds were shunned, driving up their borrowing costs relative to Germany's. Markets were becoming increasingly anxious that a euro-zone issuer might run into funding difficulties, since there was no system for countries to help each other out.

The clunky governance of the EU and euro area worked against a rapid response to the crisis. Political power within the EU is dispersed, residing in state capitals rather than in Brussels. There is no powerful executive to take and enforce quick decisions. National interests got in the way of fiscal-stimulus packages and efforts to co-ordinate bank guarantees and rescues. Germany has the deepest pockets, but its instinctive thrift (and the suspicion that the benefits would be felt mostly outside Germany) militated against swift and co-ordinated action. That made it harder for less affluent countries to loosen their purse strings, as they could not risk looking in worse fiscal shape than their peers.

Good old ECB

The one euro-zone institution that could—and did—act decisively was the ECB. But even its ability to tackle slumps is constrained. Were there just one sovereign issuer of euro-zone debt, rather than 16, the ECB could more easily engage in unorthodox policy measures, such as buying up government bonds to drive down long-term interest rates. It would also find it easier to negotiate an indemnity against capital losses on asset purchases.

Despite the crisis, there are few signs of progress towards better fiscal co-ordination. Earlier this year, as bond spreads continued to rise, policymakers dropped heavy hints that struggling sovereign borrowers would not go unaided. Peer Steinbrück, the German finance minister, said in February that if a euro-area country found itself in trouble, "we will show ourselves to be capable of acting." The following month Joaquín Almunia, head of the commission's economics directorate, said that a European "solution" was in place so that any cash-starved country would not have to go to the IMF for an emergency loan. Mr Almunia did not give any details. The German finance ministry later denied that it was working on bail-out scenarios.

The panic revealed another gap in the euro area's fiscal set-up: a process for dealing with a sovereign default, or the threat of one. The larger the number of countries that have adopted the single currency, the more likely it is that one will get into trouble. It would be sensible to have a contingency plan.

One idea is a dedicated bail-out fund for euro-zone members, along the lines of the IMF. This is proposed by Thomas Mayer, an economist at Deutsche Bank, who started his career at the fund in the 1980s. Like the IMF, a European Monetary Fund (EMF) would offer emergency loans for governments unable to finance their budget deficits or roll over maturing debts. In return for this insurance, each member would contribute capital to the fund in proportion to the size of its population or GDP. Loans would come with conditions. A supplicant would have to pledge to put its public finances in order and undertake other economic reforms to persuade bond markets to renew lending.

This sort of proposal attracts two main criticisms. First, it is wasteful to duplicate the efforts of the IMF. Until very recently the fund was struggling to define its role (and raise money) because it had so few lending opportunities. Now it is busy fighting fires again, many of them in eastern Europe, so there is far less talk of staff cuts. But an EMF could stand idle for even longer before it saw action. A second quibble is that a euro fund may find it difficult to impose tough conditions on rescue loans. Better to let the IMF play the role of bad cop, say some, than have protesters burning the EU flag in countries forced to slash public spending or hike taxes.

Mr Mayer retorts that even the IMF has learnt that its interventions work only if countries co-operate. The idea that a financial policeman has to be strict to be effective is dated. He sees a European fund as more than an emergency kitty for cash-starved euro members. It could act as a permanent monitor of economic policies, including government budgets, and issue a seal of approval for countries wishing to take part in a joint bond issue. Over time, the emergency fund could evolve into an institution that improves the euro area's fiscal co-ordination.

The beauty of a euro bond

The hurdle for membership of such a programme would need to be high to persuade countries with good credit, such as Germany, to sign up to it, and to convince credit-rating agencies and investors to rank its bonds highly. But a large collective bond issue could have benefits even for countries with low credit risk, as it would rival America's Treasuries market for liquidity. A single issuer would make euro-area bonds more attractive to managers of foreign-exchange reserves, who want safe stores of value that can be converted into cash quickly and cheaply in an emergency. A joint bond issue could thus enhance the euro's standing as a reserve currency, as well as lowering borrowing costs for all countries that took part in it.

The idea of a shared euro bond has been pushed by Italy's Mr Prodi, George Soros, a veteran investor, and others. That Italy is keen on the idea is hardly surprising: pooling its poor credit ratings with others of higher standing would lower its borrowing costs and reduce the risk, albeit small, that it might have its financing cut off. Germany is understandably cool on the idea. Mr Steinbrück has said that the extra cost to his taxpayers would make it hard to sell politically. Many in Germany feel that even temporary help for cash-strapped partners should be provided by the IMF only, and on strict terms. They resent the fact that Greece and Ireland enjoyed years of prosperity and still found themselves in fiscal trouble. Bail-outs, they feel, only encourage profligacy.

A rescue of one country by its partners could undermine popular support for the euro, says Otmar Issing, the ECB's chief economist for its first eight years, because it would imply a transfer of taxpayers' money without endorsement from the voters in countries that have to pay.

Mr Issing, who had previously sat on the Bundesbank's rate-setting council, once believed that the euro needed more political union to thrive, but has modified ▸▸

his views. Political union, he now thinks, may even work against monetary union if it is founded on a model that would make economies more rigid. EU policies, once in place, are hard to reverse even if they are clearly harmful, as decades of farm subsidies have shown. The euro has little bearing on ambitions for a common foreign or defence policy.

The euro's short history suggests that a successful monetary union does not necessarily need deeper political integration. True, by American standards the euro area's response to the crisis was slow and lacked co-ordination. But that is part of the price countries pay (and consider worth paying) for retaining full fiscal sovereignty. In any case, since welfare benefits are more generous and taxes heavier in Europe than in America, automatic fiscal stabilisers are more powerful in the old continent. A measure of co-ordination is already built into the euro area's fiscal policy.

The stability and growth pact is now too full of holes to be a binding constraint on fiscal policy. In an important sense it was always redundant. If monetary financing is banned and the "no bail-out" commitment is real, then fiscal discipline is largely an issue for individual countries. If they let finances slip, bond markets will exact a penalty in higher borrowing costs, as they have done in recent months.

There are nevertheless a few minimum requirements for a fiscal euro zone. The first is a set of clear rules for what would happen if a euro-zone member were frozen out of market funding. This will become more important as more countries join. Second is an agreement on how the ECB would be recapitalised in the unlikely event that bank failures were to leave it with big losses on its loan book, or that it were to make large outright purchases of securities that subsequently went bad. A third element of fiscal union is needed to bind not just the euro area but the EU's entire single market: a shared fund for cross-border bank bail-outs. Without an agreement on support for troubled multinational banks, an open EU market in financial services may be impossible to maintain. Ironically, such a scheme would have to include Britain and Sweden, two countries that are outside the euro zone but have lots of banking interests in other EU countries. ■

Warmer inside

The gains outweigh the losses

THIS crisis has tested many schemes and wheezes (some to destruction), from securitised mortgages to collateralised-debt obligations, from light-touch regulation to inflation targeting. How does the euro fare in this reckoning? According to one school of thought it is a fair-weather set-up, seemingly effective when economies are expanding but poorly equipped to deal with crises and manage the pressures and conflicts of a sinking economy. Conversely, many in Brussels and Frankfurt argue that being in the euro zone helped member countries emerge relatively unscathed from the worst financial crisis since the 1930s. Which view is right?

The extreme lurches in markets during the worst of the crunch last autumn made the certainties of fixed exchange rates look enticing. One lesson from the crisis is that asset prices can be unduly volatile and often veer wildly from their true values, in ways that undermine economic stability. That goes especially for housing but is also true of other asset prices, such as exchange rates. Another message is that interest-rate policy is not as powerful a stabilising force as had been thought. Other means of shaping demand are needed to complement it. Swapping an independent monetary policy for the stability of a fixed exchange rate now seems less of a sacrifice. That also closes off the escape route of letting the currency slip if wages move out of line with productivity. Yet deflation seems such a threat precisely because prices and wages are proving less "sticky" on the way down than macroeconomic textbooks had reckoned with.

On standard gauges of competitiveness, such as real effective exchange rates, a number of euro-zone countries appear to have big problems. Yet things may look worse than they are. Measures based on relative unit wage costs across the whole economy are crude. In booming Spain and Greece, much of the heat in wages was in parts of the economy, such as construction, that serve domestic spending and are sheltered from foreign competition. Export industries may have a better chance of benefiting from a global recovery than the figures suggest at first glance.

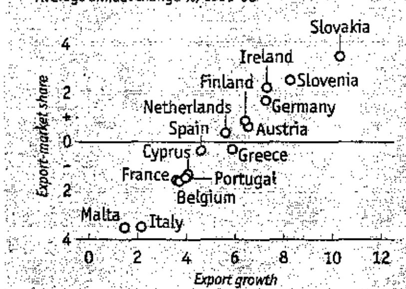
Spain, in particular, may not be quite as uncompetitive as it seems. José Luis Escrivá, an economist at BBVA, a Madrid-based bank, reckons that Spanish exporters have performed fairly well in retaining export market share against other countries, bar super-competitive Germany. "What Spain had mostly was an import boom," he says. Now imports are declining at a much faster rate than GDP, which will trim Spain's current-account deficit to a more manageable size.

A recent study by the European Commission lends some support to that view. The export-market shares of Spain and Greece fell only slightly between 1999 and 2008 (see chart 7). Export growth was stronger than in Belgium, France and Portugal, if not as vibrant as in Austria, Finland, Germany and the Netherlands. Ireland's export-market share increased over the period, even if the greatest strides were made in the euro's early years. Perhaps its exporters, many of them big American-owned firms, were wise enough to hold back on big wage and price increases in a country that could not devalue.

Great exportations 7

Export-market share* and growth

Average annual change %, 1999-08



Source: European Commission *35 industrial countries

Italian exports, however, were dismal. Firms in Italy lost market share faster than in any other big euro-zone country. Italy's undoing is to specialise in industries such as textiles and furniture where competi- ▸▸

tion from China and other emerging markets is particularly keen.

A devaluation might offer temporary respite for Italian exporters, but it would not be a lasting solution to being in the wrong businesses. Neither could it disguise the economy's real problems: legal protection for jobs that stops workers moving from dying industries to growing ones; a wage-bargaining system that has made for poor matches between pay and productivity; and an unimpressive record on innovation that has inhibited the emergence of new firms in high-value-added industries. This familiar Italian litany is the "never-ending story of things that need reform", sighs one economist.

However, there are signs of progress. Confindustria, Italy's biggest employers' body, recently signed an accord with two of the three largest trade-union confederations to overhaul the national wage system. CGIL, the largest union group, did not sign up to the deal, but the Italian government said it would go ahead anyway.

Deconstructed

Spain and Ireland have more to worry about than wage costs in export industries. Big construction busts are, as a rule, hard to recover from. At the peak of their housing booms, up to a fifth of their workers had jobs related to construction or property sales. Many of those jobs will not come back, and finding other things to do for such an army of redundant workers will take time. Ireland has a more flexible jobs market, so its recovery is likely to be swifter, if still far from painless. Its GDP is set to shrink by as much as 9% this year. Spain's economy is more hidebound, so it will take longer to revive.

It is hard to see how a devaluation would help much even if that option were available. "If Spain's main problem were competitiveness, I wouldn't worry," says Mr Gros of the CEPS: "The Phillips curve [which suggests an inverse relationship between wage inflation and unemployment] would take care of it."

The lack of a "fiscal euro zone", a central spending body financed by a shared pool of tax revenues, has hampered an effective response to the economic downturn. Yet without the euro things might have been a lot worse. Co-ordinating a European response amid a series of currency crises or exchange-rate rows would have been far trickier. Bond investors have become choosier about sovereign credit risk, so some euro-area borrowers have had to stump up higher coupons for their recent bond issues. But no one was frozen out of markets. Even when spreads were at their widest, Greece and Ireland, the euro-zone's high-yielders, were able to finance their borrowing needs at a reasonable cost. The security of access to financing has made the euro area even more attractive to the EU's eastern states, some of which have had to fall back on rescue loans or precautionary credit lines from the IMF.

The prospect that a euro-zone country might default on its loans, never mind leave the euro, is fairly remote. But the taboo around the subject leaves bond investors uncertain about how such a problem might be resolved if it did occur. That uncertainty should be dealt with. Policymakers have dropped hints that should one country's financing troubles spread to another, a bail-out plan is in place. Yet the risk of contagion is overblown. An orderly debt restructuring for a country within the euro zone would not be the end of the world, or indeed of the single currency. A bail-out by fellow members might do greater harm by damaging popular support for the single currency.

There is a central irony about the euro. Many of its architects saw it as a means of advancing political union in Europe and were barely interested in a monetary union as an economic venture. Their hopes have been dashed, but as a technical exercise the euro has been a huge success. The currency is accepted in vast swathes of the rich world and quite a bit of the poor world too. The value of euro banknotes in circulation and the market for euro-denominated securities already rival the dollar, a long-established currency backed by a single nation-state.

For economists such as Robert Mundell and others, who saw huge benefits in shared currencies but had despaired of politicians giving up monetary control, the euro is an exciting experiment. By contrast, the politicians that made the leap have been disappointed by the euro's failure, so far, to spur deeper political integration.

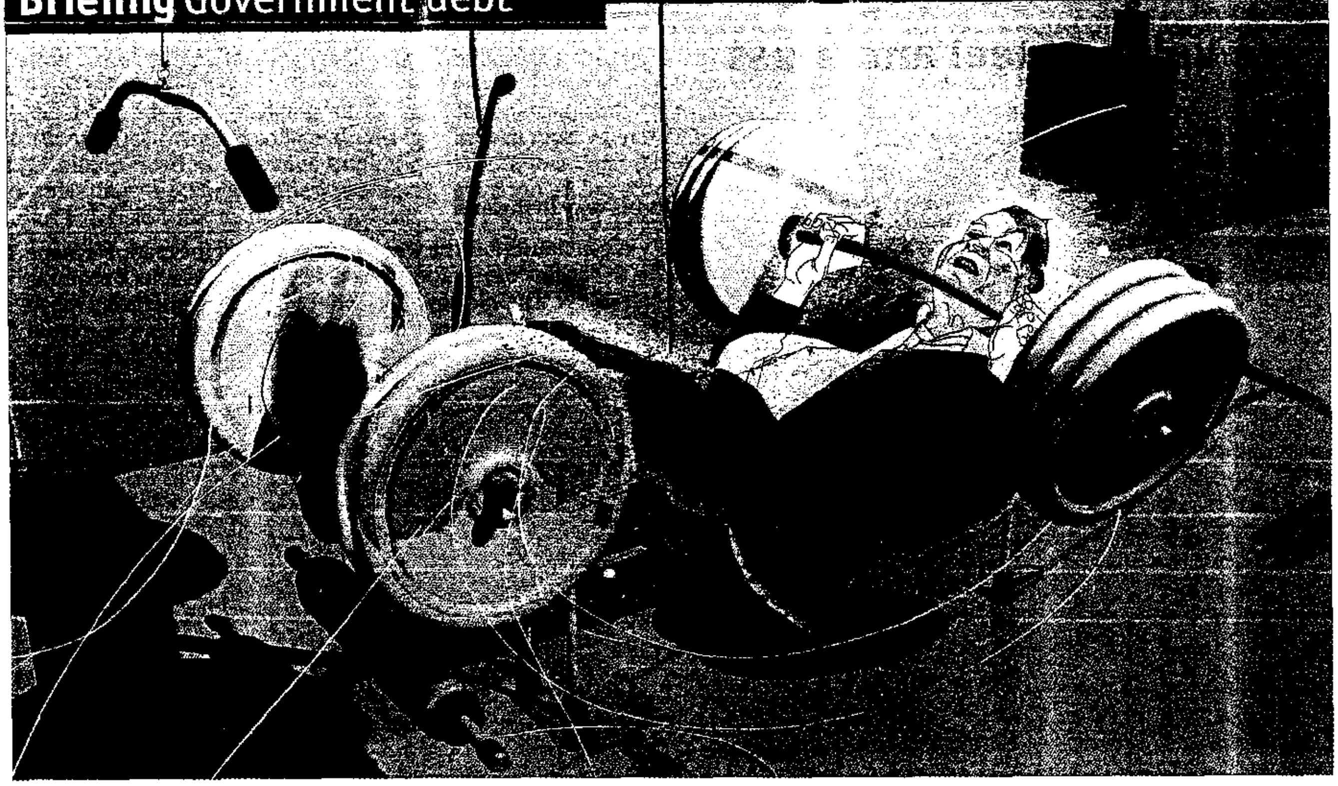
For all its shortcomings, the euro zone is far more likely to expand than shrink over the next decade. Most EU countries that remain outside, bar Britain and Sweden, are eager to join. The harm done by housing and construction booms in Ireland and Spain should be a caution to would-be members who, once inside, may get carried away by low borrowing costs. Against that, a big lesson from the crisis is not to rely too much on short-term interest rates to rein in credit and home-loan booms. The rush to join the euro zone is surely a vote of confidence. It must be doing something right. ■

Future special reports
Countries and regions
Texas July 11th
The Arab world July 25th
Indonesia September 12th

Business, finance, economics and ideas
Global greying June 27th
Telecoms September 26th
The world economy October 3rd

Previous special reports and a list of forthcoming ones can be found online

Economist.com/specialreports



The big sweat

WASHINGTON, DC

Banking catastrophes and recession have led to vast increases in rich countries' public debts. Getting their finances back into shape will be painful

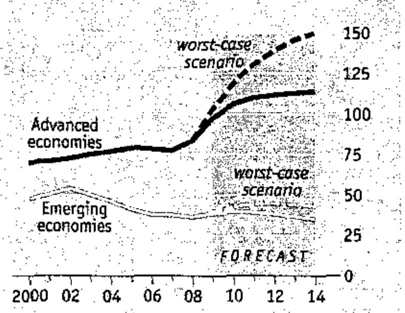
OVERINDULGENCE has a price. After years of scoffing food and swilling booze, the cost is physical. After a debt-fuelled financial bender, it is fiscal. Governments have been propping up the world economy with a borrowing spree of their own. The recession has drained tax revenues and policymakers have been spending unprecedented sums to get their economies going and support their banks. Sovereign debt is piling up.

According to a study by economists at the IMF, published on June 9th, by next year the gross public debt of the ten richest countries attending the summits of the G20 club of big economies will reach 106% of GDP, up from 78% in 2007. That translates into more than $9 trillion of extra debt in three years.

There is more to come. Because economic growth is likely to be weak for several years after the recession ends, especially in countries such as America and Britain where over-indebted consumers must rebuild their savings, budget deficits will remain big. The IMF economists' baseline is that the government debt of the rich ten will hit 114% of GDP by 2014. Under a darker scenario in which economies languish for longer while fears about governments' solvency push interest rates up, the debt ratio could be 150% (see chart 1).

Dire or higher? 1

Gross government debt in the G20, % of GDP



Source: IMF

Governments have never borrowed so much in peacetime. Their huge debts will shape the world economy for a decade. In the short term the extra borrowing is prudent: governments must expand their balance-sheets to counter the savage pace at which firms and households are cutting back. Were governments not stepping in, the private shift to thrift would be causing an even deeper recession. Tax revenues would fall by more, banks would be even wobblier and public borrowing might end up even higher.

So far, the flight from risk that has made government intervention necessary has also minimised its cost. Investors have flocked to the safety of government bonds, allowing sovereign borrowers to raise money cheaply. Although yields have risen this year, governments in most big economies are still paying less than they were when the crisis began in 2007 (see chart 2 on the next page).

The real questions concern the medium term. How much damage will greater indebtedness do to economic growth and governments' creditworthiness? Borrowing on today's scale is plainly unsustainable, but will the rich world's governments be able to contain their debt burdens through budgetary discipline alone, or will they be tempted to turn to inflation or even forced to default? An assessment of these risks requires a look at the crises of the past, the financial markets of the present and the timeless arithmetic of debt.

History suggests that a big build-up of public debt is all but inevitable given the magnitude of the recent crash. A study of 14 severe banking crises in the 20th century by Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard University shows that public debt rises by an average of 86% in real terms in the years after big financial busts, as economies flag and governments are forced into serial attempts to revitalise them.

Default or high inflation are common. In the 1930s even America and Britain changed the terms of their government ▸▸

debt. America abrogated the "gold clause" (which fixed the payment of interest and principal in terms of the metal) after leaving the gold standard. Britain restructured the terms of some war bonds. The debt burdens of Germany after the first world war and Japan after the second were slashed by hyperinflation.

Since the 1940s no advanced economy has defaulted on its bonds (though numerous emerging ones have). And many rich-world governments have been able to lighten their debt burdens without resorting to high inflation. Britain's public-debt ratio soared to 250% of GDP as a result of the second world war and America's exceeded 100%. Both fell sharply in later decades, thanks largely to fast growth.

In the past 20 years several smaller rich economies, including Canada, Denmark and Ireland, slimmed their public debt by 40% of GDP or more as economic growth accelerated and budgets were kept tight. Ireland was conspicuously successful: in 1987 its gross debt was 109% of GDP; by 2007 it was down to 25%. Another smallish country, Sweden, proved that public finances can bounce back quickly from a banking bust. In the early 1990s its government-debt burden went up from 40% of GDP to more than 70%, but fell to below 50% by 2000.

Alas, there are plenty of reasons why a quick rebound will be harder today. The number of countries involved makes it less likely that any of them can count on exports to boost their economic recovery, as Sweden did. Because households will need to save much more and growth may be sluggish for several years, Japan may be a more relevant precedent. Years of stagnation after its property bubble burst have almost tripled Japan's public-debt ratio, from 65% of GDP in 1990 to more than 170% now.

Governments can no longer rely on some forces that aided a return to fiscal fitness in the past. During the second world war capital could not flee, and governments controlled prices and could appeal to patriotism. Now they must make their case in global capital markets. More recently Ireland and others were helped by steep falls in interest rates. With rates already low, that bonus will not recur.

Nor is the financial crisis the only cause of budgetary strain. In America, for instance, Barack Obama's administration has ambitious plans for broader health-care coverage, though it promises to pay for it. Worse, the biggest peacetime jump in the rich world's public debt is taking place just before a slow, secular collapse in most countries' public finances as workers age and the costs of health care rise. According to the IMF's calculations, the present value of the fiscal cost of an ageing population is, on average, ten times that of the financial crisis. Left unchecked, demographic pressures will send the combined public debt of the big rich economies towards 200% of GDP by 2030.

The sheer scale of their fiscal burdens may tempt governments to lighten their loads by inflation or even outright default. Inflation seems increasingly plausible because many central banks are already printing money to buy government bonds. To fiscal pessimists this is but a small step from printing money simply to pay the government's bills. Adding to their worries, many economists argue that a bout of modest inflation would be the least painful way to ease the financial hangover.

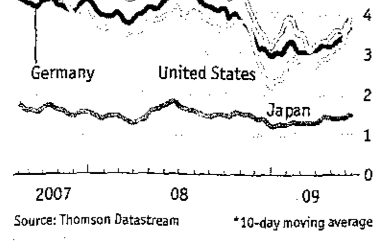
The rich world's build-up of debt may also cause changes in countries' relative creditworthiness. Investors have long viewed emerging economies as riskier sovereign borrowers than rich ones, because of their history of macroeconomic instability and more frequent defaults. But the biggest emerging economies are now by and large in better fiscal shape than their richer fellows, and that discrepancy is set to widen. The emerging members of the G20 had a ratio of public debt to GDP of 38% in 2007. By 2014, says the IMF study, this is likely to fall to 35%, less than a third of the rich world's average. As a result the gap between the yields investors demand from rich and emerging economies' bonds is likely to narrow.

Measuring market pressure

Uncertainty about all this has been evident in bond markets (and, somewhat erratically, in the prices of sovereign credit-default swaps: see page 75). Although yields are broadly low, prices have been volatile. Earlier this year the markets' fears were focused on weaker members of the euro area, notably Greece, Ireland, Portugal and Spain. In mid-March yields on long-term Greek and Irish government bonds hit 6%, almost twice that on German bonds. Without their own currencies these countries cannot unilaterally inflate away their debt, so the worry lies in the increased risk of default. All four have had their debt downgraded by the big credit-rating agencies. Ireland was marked down again by Standard & Poor's on June 8th.

Still cheap, for now 2

Ten-year government-bond yields*, %



Source: Thomson Datastream

*10-day moving average

Lately markets have also been paying attention to America and Britain. Standard & Poor's put a negative outlook on Britain's AAA rating last month. Yields on American Treasury bonds have risen sharply. On June 10th the yield on ten-year bonds came within a whisker of 4%; late last year it was not far above 2%. Ben Bernanke, head of the Federal Reserve, has attributed some of this increase to concerns about America's fiscal future. But much of it, he believes, is due to an ebbing of the panic that sent investors rushing to buy government debt last year. Because rising sovereign yields have been accompanied by narrower spreads on riskier debt, such as lower-grade corporate bonds, this is plausible.

Investors' uncertainty is not surprising. To gauge governments' ability and willingness to carry debt burdens, they must apply both the laws of arithmetic and less precise political and economic calculations. Arithmetically, a government's debt burden is sustainable if it can pay the interest without borrowing more. Otherwise the government will eventually fall into a debt trap, borrowing ever more just to service earlier debt. In practice merely stabilising debt ratios at a higher level may not be enough, because extra public debt crowds out private investment and drags down long-term growth. A better goal is to work off big increases in debt. How difficult that is depends on the size of the debt, the pace at which the economy grows and the interest rate the government must pay.

Suppose a country's gross public debt is 100% of its GDP. If the economy grows by 4% in nominal terms and long-term interest rates are 5%, the government will need a primary budget surplus—ie, before interest payments—of 1% of GDP to keep its debt ratio unchanged. To work off a rise of ten percentage points in the debt ratio over ten years requires an additional percentage point on the primary surplus.

This arithmetic suggests that the projected 36-point rise in indebtedness between 2007 and 2014 should not in itself be a calamity. It also implies that countries which entered the financial crisis with modest burdens have more room for manoeuvre than those already deeply in debt. Some of the hardest-hit countries, such as Ireland and Spain, began with low debt ratios, making default extremely unlikely, at least in the short term. Italy and Japan were hemmed in from the start. America met the crash with a gross debt ratio of just above 60% of GDP. Germany's ratio was similar and Britain's a bit lower (see table 3 on the next page).

Gross debt is a good measure of the public sector's demands from financial markets, since it includes all outstanding government paper. It is the measure used in the IMF study. But it does not give a full picture. Some countries include internal government IOUs in their figures: Ameri-

The good, the bad and the ugly 3

Government debt, % of GDP

	Gross debt 2007	Net debt 2007	Gross debt 2014*	Fiscal adjustment required†
Australia	15.4	-6.0	16.6	1.2
Britain	46.9	30.2	87.8	5.7
Canada	64.1	23.4	66.2	1.0
France	70.1	34.4	89.7	4.5
Germany	65.5	44.5	91.0	1.8
Italy	113.2	87.6	129.4	4.8
Japan	170.6	85.9	234.2	14.3
South Korea	28.9	-37.7	51.8	-0.7
Spain	42.7	19.1	69.2	3.1
United States	62.9	43.0	106.7	3.5

*Forecast †Difference between forecast primary budget balance in 2014 and primary balance needed for debt sustainability as calculated by the IMF

Sources: IMF; OECD; *The Economist*

ca, for instance, counts the bonds held in its government pension plan. Because other countries do not, that overstates America's relative gross debt burden. Washington policymakers prefer to look at "debt held by the public", which excludes those internal IOUs. At 37% of GDP in 2007, it puts America in a better light.

Although gross debt is the best guide to governments' financial obligations, net debt, which subtracts the value of their assets, is a better indicator of their creditworthiness. The difference can be huge. Norway's gross debt was close to 60% of GDP in 2007, but thanks to its oil-based sovereign-wealth fund it had a net surplus of almost 150% of GDP. Since Japan's government controls vast assets, notably the Japan Post bank, its net debt, at 86% of GDP, is far lower than its gross debt. After financial crises, the gap can widen a lot. When governments take over failed banks their gross debt soars, but because the accompanying assets have value net debt goes up by much less. Comparing net debt across countries is harder than comparing gross debt, because estimating the value of government assets is hard. Even so, the ranking of big rich economies' burdens, and of the likely increases in them, is much the same on both measures.

Furthermore, calculations about the sustainability of debt must take into account more than just its size relative to GDP. As a rule, countries that issue debt in their own currency to their own citizens are less vulnerable than those that must sell bonds in foreign currencies or that depend heavily on foreign lenders. Emerging economies, which have usually borrowed from abroad, have often faced crises with debt burdens of less than 60% of GDP. Japan, with a large pool of private domestic savings, funds a debt burden almost three times as big as that easily—and cheaply. Persistent economic weakness has pressed yields on Japanese government bonds down from 7% in 1990 to below 2%.

This gives some comfort to rich countries with rising debt burdens—especially America, because the dollar is the world's reserve currency. The rise in private saving after the financial crisis should also hold down the cost of borrowing. That said, America, like Britain and many other countries but unlike Japan, relies on foreign investors, who may prove less willing to fund a much larger debt burden. In the past a bigger burden in America has led to slightly higher long-term interest rates. One often-cited study suggests that a rise of ten percentage points in the ratio of debt to GDP increases long-term bond yields by a third of a percentage point. If America's debt burden gets a lot bigger, however, this could change. Studies from continental Europe suggest that the extra interest-rate cost rises with indebtedness.

The budget balance, which indicates the prudence of fiscal policy from year to year, also helps in determining a government's vulnerability. On that measure the economies of the euro zone fare relatively well. Germany, for instance, entered the crisis with a primary surplus. Both Britain and America had deficits.

From prudence to profligacy

Unfortunately, some countries that seemed to be in decent shape, such as Ireland and Spain, turn out to have relied too much on revenues from soaring property prices and have seen their tax bases collapse. The IMF's economists reckon that by 2014 Ireland's gross public debt is likely to exceed 120% of GDP, undoing all the gains from the past two decades, while its primary deficit will still be 6.7% of GDP. In Britain, which counted on taxes from financial assets and property, the primary deficit is still likely to be above 3% of GDP in 2014, one of the highest among the world's big rich economies.

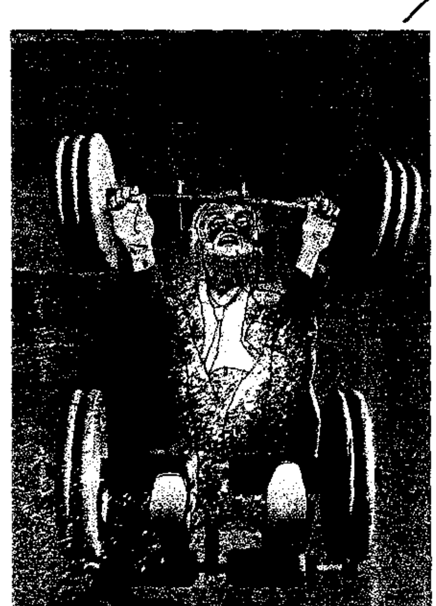
All this is daunting enough. But for a full sense of the task facing governments, demographic pressures have to be added to the crisis-related damage. On this score all the world's big rich economies are in trouble, but some are worse placed than others—which implies that they will have to run bigger primary budget surpluses. The present value of the increase in America's future age-related budget obligations is about five times its GDP. For Britain, the figure is about three times.

To estimate just how much pain lies ahead, the IMF's economists put all these elements together, assume that long-term interest rates exceed economic growth rates by a percentage point (the long-term pre-crisis average) and then calculate by how much primary budget balances would have to improve in order to bring gross debt ratios to a sustainable level. The economists define this level as 60% or, for Japan, half of today's figure (ie, 85%). Their results suggest that Ireland and Japan have most to do. Both would need to boost their primary balances by more than 12% of GDP, compared with what is forecast for 2014. Britain would need an improvement of close to 6%. The gap in America is 3.5% and in Germany just under 2%.

All told the outlook is bleak. In a few countries, the financial crisis has badly damaged the public finances. Elsewhere it has accelerated a chronic age-related deterioration. Everywhere the short-term fiscal pain is much smaller than the long-term mess that lies ahead. Unless belts are tightened by several notches, real interest rates are sure to rise, as will the risk premiums on many governments' debt. Economic growth will suffer and sovereign-debt crises will become more likely.

Somehow, governments have to avoid such a catastrophe without killing the recovery by tightening policy too soon. Japan made that mistake when concerns about its growing public debt led its government to increase the consumption tax in 1997, which helped to send the economy back into recession. Yet doing nothing could have much the same effect, because investors' fears about fiscal sustainability will push up bond yields, which also could stifle the recovery.

The best way out is to tackle the costs of ageing head-on by, for instance, raising retirement ages further. That would brighten the medium-term fiscal outlook without damaging demand now. Broadly, spending cuts should be preferred to tax increases. And rather than raise tax rates, governments would do better to improve their tax codes, broadening the base and eliminating distortive loopholes (such as preferential treatment of housing). Other priorities will vary from one country to the next. But after today's borrowing binge, doing nothing is no longer an option. ■



The IMF's search for funds

Promises, promises

Redefining collateral damage

Politics influences fulfilment of the G20's funding pledges

MUCH has changed for the IMF as a result of the financial crisis. The G20 summit in London in April promised a tripling of its lending capacity. Long known for championing fiscal stringency, the fund has recommended that Tanzania and Mozambique consider countercyclical fiscal expansions. Mexico, Colombia and Poland have been enticed to sign up for its new precautionary lines of credit. Another first is now well on the way, as the IMF prepares to issue its own bonds.

The bonds have aroused a flurry of interest from emerging markets. The fund announced on June 9th that the Chinese authorities had signalled their intention to invest up to $50 billion in its notes. On June 10th Brazil's finance minister said the country was interested in bonds worth $10 billion. Russia had previously said that it was eyeing a similar amount. According to the fund, the bonds will give emerging economies access to "a safe investment instrument with reasonable return".

As big an attraction, argues Eswar Prasad, a Cornell University professor who once headed the fund's China desk, is that the bonds would count as foreign reserves, allowing emerging economies to exchange one reserve asset for another with no budgetary impact. IMF notes denominated in Special Drawing Rights, the fund's quasi-currency, would provide their buyers with a new way to diversify the composition of a small part of their reserves away from the American dollar. Russia's central bank confirmed on June 10th that it may shift some of its reserves from Treasuries into IMF bonds.

Politics, inevitably, also plays its part. Contributing to the fund gives countries a louder voice in its decision-making. But by choosing to buy bonds, rather than making a more conventional longer-term loan to the IMF, these countries may also be signalling that they want faster progress on a planned overhaul of emerging economies' voting rights within the institution.

Concerns over governance also complicate the picture in the rich world. In America, voting in the House of Representatives on a bill that appended the country's promised $108 billion contribution to the IMF to funding for the country's war efforts in Iraq and Afghanistan has had to be postponed, in spite of strong backing from the White House and the Treasury.

Opposition to the bill comes partly from anti-war Democrats. But Republicans dislike the idea of money being set aside for the IMF to spend on other countries when America has so many economic woes of its own. The idea that IMF funds could end up helping western European banks exposed to eastern Europe is another gripe. The administration is working hard to win over the naysayers on its own side. And bumps in the road are not that surprising. Despite the united front at the G20 bash, multilateralism remains a hard sell when the time comes to stump up. ■

Paul Krugman's London lectures

Dismal science

The Nobel laureate speaks on the crisis in the economy and in economics

THE London School of Economics was once so popular among young American scholars that British students used to joke that LSE stood for "Let's See Europe". A distinguished sightseer, Paul Krugman, returned to the LSE on June 8th to give the annual Lionel Robbins memorial lectures. Mr Krugman, who gave the Robbins lectures 21 years ago, tried to answer two big questions in the course of his three talks. Why did economists not foresee calamity? And how will the world economy climb out of recession?

The immediate cause of the crisis, "the mother of all global housing bubbles", was spotted by many economists. That house prices had risen too far was obvious, even if policymakers had seemed less sure. The surprise was that the bursting of the bubble would be so damaging. "I had no idea it would end so badly," said Mr Krugman.

One big blind spot was the financial system. The mistake was to think "a bank had to look like something Jimmy Stewart could run", with rows of tellers taking deposits in a marble-fronted building. In fact a bank is anything that uses short-term borrowing to finance long-term assets that are hard to sell at a push. The shadow banking system was as important to the economy as the ordinary kind, but was far more vulnerable. Its collapse was the modern re-run of the bank failures of the 1930s, said Mr Krugman.

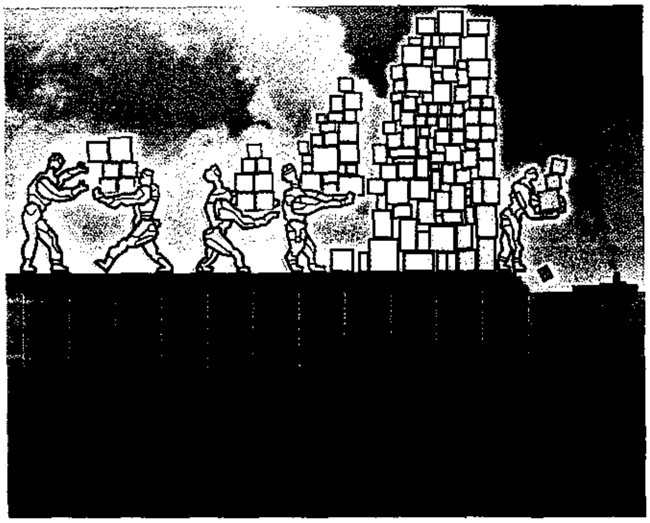
The excess borrowing that did for shadow banks threatens consumers, too. They are scrambling to save more as house prices plunge. Their mortgage debts loom larger because of vanishing inflation. This urge to shore up wealth is self-defeating in aggregate, as it curbs spending and incomes. It also renders conventional monetary policy impotent, as the interest rate that prevents too much saving is below zero.

That creates a role for fiscal policy. If zero interest rates cannot get consumers to spend, then governments must spend instead. That remedy comes from economics so the discipline is not without merit. The trouble is, "the analysis we're using is decades old". It dates back to Keynes, one of the few economists whose reputation has been burnished by the crisis. (Another is Hyman Minsky, whose main insight was that stability leads to too much debt, and then to collapse.) Most work in macroeconomics in the past 30 years has been useless at best and harmful at worst, said Mr Krugman.

As for the economy, the road back to health will be long and painful. The big lesson from past bubbles is that recovery is export-led, which is not helpful "unless we can find another planet to export to". Otherwise, recovery will have to wait for savings to be rebuilt, and that will not happen quickly. Higher inflation than before the crisis might help, he said.

Economics focus | Fatalism v fetishism

How will developing countries grow after the financial crisis?



FORTY years ago Singapore, now home to the world's busiest port, was a forlorn outpost still garrisoned by the British. In 1961 South Korea was less industrialised than the communist north and dependent on American aid. In 1978 China's exports amounted to less than 5% of its GDP. These countries, and many of their neighbours, have since traded their way out of poverty. Given their success, it is easy to forget that some development economists were once prey to "export fatalism". Poor countries, they believed, had little to gain from venturing into the world market. If they tried to expand their exports, they would thwart each other, driving down the price of their commodities.

The financial crisis of the past nine months is stirring a new export fatalism in the minds of some economists. Even after the global economy recovers, developing countries may find it harder to pursue a policy of "export-led growth", which served countries like South Korea so well. Under this strategy, sometimes called "export fetishism", countries spur sales abroad, often by keeping their currencies cheap. Some save the proceeds in foreign-currency reserves, rather than spending them on imports. This strategy is one reason why the developing world's current-account surplus exceeded $700 billion in 2008, as measured by the IMF. In the past, these surpluses were offset by American deficits. But America may now rethink the bargain. This imbalance, whereby foreigners sell their goods to America in exchange for its assets, was one potential cause of the country's financial crisis.

If this global bargain does come unstuck, how should developing countries respond? In a new paper*, Dani Rodrik of Harvard University offers a novel suggestion. He argues that developing countries should continue to promote exportables, but no longer promote exports. What's the difference? An exportable is a good that could be traded across borders, but need not be. Mr Rodrik's recommended policies would help countries make more of these exportables, without selling quite so many abroad.

Countries grow by shifting labour and investment from traditional activities, where productivity is stagnant, to new industries, which abound in economies of scale or opportunities to assimilate better techniques. These new industries usually make exportable goods, such as cotton textiles or toys. But whatever the fetishists believe, there is nothing special about the act of exporting per se, Mr Rodrik argues. For example, companies do not need to venture abroad to feel the bracing sting of international competition. If their products can be traded across borders, then foreign rivals can compete with them at home.

As countries industrialise and diversify, their exports grow, which sometimes results in a trade surplus. These three things tend to go together. But in a statistical "horse race" between the three—industrialisation, exports and exports minus imports—Mr Rodrik finds that it is the growth of tradable, industrial goods, as a share of GDP, that does most of the work.

How do you promote exportables without promoting exports? Cheap currencies will not do the trick. They serve as a subsidy to exports, but also act like a tax on imports. They encourage the production of tradable goods, but discourage their consumption—which is why producers look for buyers abroad.

Policymakers need a different set of tools, Mr Rodrik argues. They should set aside their exchange-rate policies in favour of industrial policy, subsidising promising new industries directly. These sops would expand the production of tradable goods above what the market would dictate. But the subsidy would not discourage their consumption. Indeed, policymakers should allow the country's exchange rate to strengthen naturally, eliminating any trade surplus. The stronger currency would cost favoured industries some foreign customers. But these firms would still do better overall than under a policy of laissez-faire.

Return of the cargo cult

Mr Rodrik offers a solution to an awkward problem: how policymakers can restore the growth strategies of the pre-crisis era without reviving the trade imbalances that accompanied them. But is his solution as neat as it sounds? Start with the theory. Mr Rodrik claims there is nothing special about exporting. He is probably right. But his statistical test is unlikely to be the last word on the matter, given the difficulties of disentangling variables that move together. Mr Rodrik's model also assumes a single tradable good. Under his policies, countries sell the same kind of stuff at home that they formerly sold to foreigners. In a more elaborate model, foreign and local tastes would differ. China, for example, made most of the world's third-generation mobile phones long before 3G telephony was available at home. Firms in poor countries can learn a lot from serving richer customers abroad.

What about the practice? Subsidies are notoriously prone to error and abuse. Even before the crisis, Mr Rodrik was keen to rehabilitate industrial policy in the eyes of many economists, who doubt governments' ability to pick winners but have every faith in their aptitude for favouring corporate friends. In these circles, a cheap currency is often seen as the least disreputable form of industrial policy, because it benefits exporters in general, without favouring any particular industry or firm.

This ingenious economist may also be preparing for a future that is further off than you might think. American policymakers are certainly worried about their country's trade deficit. But they are far more concerned about unemployment. Most of their efforts to revive demand will tend to widen the trade gap, at least in the short run. The American government is also more anxious than ever to sell its paper, and whatever they say in public, the central banks of China and other big emerging economies still seem happy to buy. Export fetishism seems fated to endure. ■

* "Growth after the Crisis" by Dani Rodrik, May 2009

WE OWE WHAT?

THE NEXT CRISIS: AMERICA'S DEBT

At this rate, your share of the load will be $155,000 in a decade. How chronic deficits are putting the country on a path to fiscal collapse.

/// BY SHAWN TULLY ///

NORMALLY PAUL KRUGMAN, the liberal pundit and Nobel laureate in economics, and Paul Ryan, a conservative Republican congressman from Wisconsin, share little in common except their first names and a scorching passion for views they champion from opposite political poles. So when the two combatants agree on a fundamental threat to the U.S. economy, Americans should heed this alarm as the real thing. What's worrying both Krugman and Ryan is the rapid increase in the federal debt—not so much the stimulus-driven rise to mountainous levels in the next few years, but the huge structural deficits that, under all projections, keep building the burden far into the future to unsustainable, ruinous heights. "The long-term outlook remains worrying," warned Krugman in his *New York Times* column. Krugman strongly supports President Obama's spending plans but bemoans the shortfall in taxes to pay for them.

Ryan flays the administration for piling new spending on top of already enormous deficits. "This isn't a temporary stimulus but a ramp-up in debt followed by a greater explosion in spending and debt," he told *Fortune*, predicting a day when America's creditors will start viewing the U.S. Treasury as a risky bet. "The bond markets will come after us with a vengeance. We're playing with fire." Krugman favors far higher taxes, while Ryan wants to curb spending, but for now what's so big and so dangerous that it distresses such diverse types as Krugman and Ryan—and should scare all Americans—is the Great Debt Threat.

The bill is far too big for only the rich to pick up. There aren't enough of them. America will have to lean on citizens far below the $250,000 income threshold: nurses, electricians, secretaries, and factory workers. Within a decade the average household that pays income tax will owe the equivalent of $155,000 in federal debt, about $90,000 more than last year. What the Obama administration isn't telling Americans is that the only practical solution is a giant tax increase aimed squarely at the middle class. The alternative, big cuts in spending, aren't part of the President's agenda. To keep the debt from wrecking the economy, the U.S. would need to raise annual federal income taxes an average of $11,000 in 2019 for all families that pay them, an increase of about 55%. "The revenues needed are far too big to raise from high earners," says Alan Auerbach, an economist at the University of California at Berkeley. "The government will have to go where the money is, to the middle class." The most likely levy: a European-style value-added tax (VAT) that would substantially raise the price of everything from autos to restaurant meals.

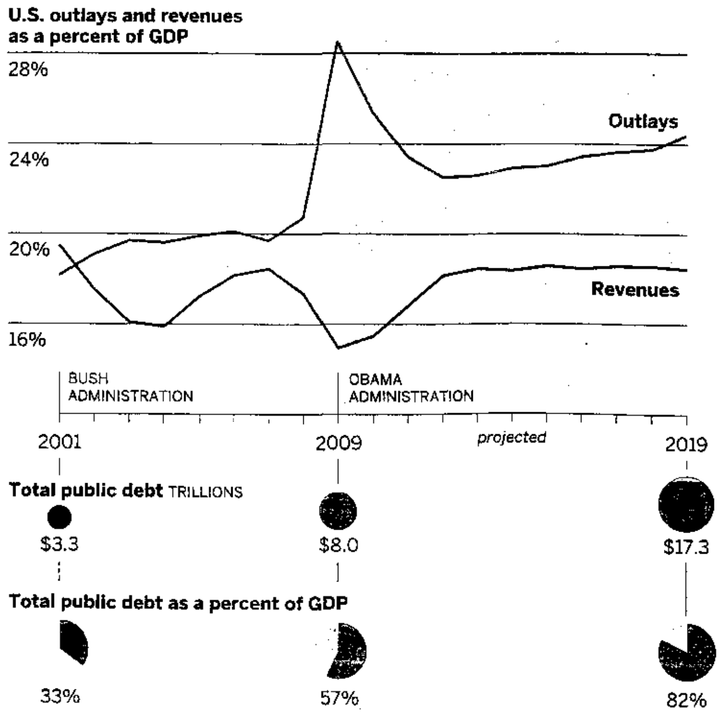
The growing debt will burden Americans not just with heavier taxes but also with higher interest rates and slower economic growth. On June 3, Fed chairman Ben Bernanke warned Congress that heavy borrowing is one of the factors driving up rates. The trend is just beginning, according to Allan Meltzer, the distinguished monetarist at Carnegie Mellon. "Rates can only stay low if foreign investors keep buying our debt," he warns. "I predict far higher rates over the next few years." The risk that the U.S. will follow Britain, which was warned recently that it could lose its triple-A bond rating, has risen from virtually nil to a real possibility, judging by the sevenfold jump in the cost of insuring Treasury debt in the past year. The big borrowing is already spooking the bond markets. This year rates on 10-year Treasuries have jumped from 2.2% to 3.7%. A further increase in rates would aggravate the situation, raising the interest costs on the debt and increasing its size even more.

As Krugman and Ryan point out, the problem isn't so much the big budget gaps for this year and next, though their scale is shocking. It's the policies that will allow the trend to become far worse in the future. After the stimulus spending winds down and the economy recovers, our spending will still far exceed our revenues. In 2009 the U.S. will post a deficit of $1.8 trillion, or 13.1% of GDP, according to the nonpartisan Congressional Budget Office, twice the post–World War II record of 6% in 1983 under Ronald Reagan. Now let's look forward to 2019, the final year for the budget projections for the administration and the CBO. Even in a scenario that assumes healthy economic growth, the CBO puts the 2019 deficit at $1.2 trillion, or 5.7% of GDP. "That wouldn't be a huge number for an economic downturn, but it's extremely high in a full-employment period," says William Gale, an economist at the centrist Brookings Institution. It gets worse from there. Around 2020 the cost of the big entitlements, Social Security and Medicare, soar as the peak wave of baby boomers retire.

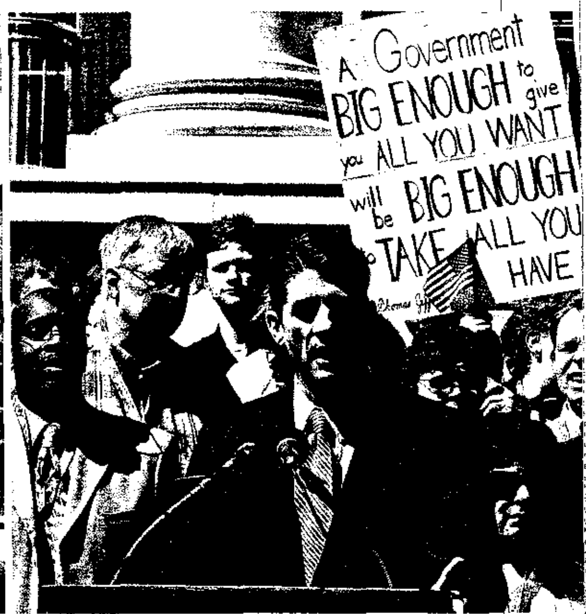
It can't go on forever, and it won't. What will shock America into action is the prospect of fiscal collapse,

THE GAP THAT NEVER CLOSES

The stimulus-driven bulge in federal deficits eventually narrows but keeps going, leading to a crushing burden of debt.



PREVIOUS SPREAD: GETTY IMAGES (2); SOURCE: CONGRESSIONAL BUDGET OFFICE



IS A VAT TAX COMING? THE PRESIDENT'S BUDGET DIRECTOR, PETER ORSZAG (ABOVE, WITH OBAMA), SAYS NO WAY. BUT GOP REP. PAUL RYAN (RIGHT) CONTENDS THAT IT'S "DEFINITELY THE TRAJECTORY OBAMA IS PUTTING US ON."

which will grow more vivid each year. In 2008 federal borrowing accounted for 41% of GDP, about the postwar average. By 2019 the burden will double to 82% by the CBO's reckoning, reaching $17.3 trillion, nearly triple last year's level. By that point $1 of every six the U.S. spends will go to interest, compared with one in 12 last year. The U.S. trajectory points to the area that medieval maps labeled "Here Lie Dragons." After 2019 the debt rises with no ceiling in sight, according to all major forecasts, driven by the growth of interest and entitlements. The Government Accountability Office estimates that if current policies continue, interest will absorb 30% of all revenues by 2040 and entitlements will consume the rest, leaving nothing for defense, education, or veterans' benefits.

TO UNDERSTAND WHY a massive tax increase, probably a VAT, is the mostly likely outcome, it's crucial to look at what's driving the long-term, widening gap between revenues and spending. Put simply, spending is following a steep upward curve, while revenues are basically fixed as a portion of GDP. Why? Because future spending is driven mostly by entitlements, which are programmed to rise far faster than national income, while revenues depend heavily on the personal income tax, which yields receipts that typically rise or fall with GDP. Under George W. Bush, the U.S. experienced a prelude to the crisis before us: Spending rose rapidly, while revenues remained reasonably flat. Bush created an expensive new entitlement, the Medicare drug benefit (cost this year: $63 billion), and let spending on domestic programs from education to veterans' benefits run wild. Over seven years the wars in Afghanistan and Iraq added a total of some $900 billion to the budget. All told, Bush raised spending from 18.5% to 21% of GDP, setting in motion a chronic budget gap by piling on new spending without paying for it.

Under Obama the Bush trend keeps going, but this time on steroids. It's important to see the Obama budget projections as two phases, the crisis period of astronomical spending in 2009 and 2010, and the normal phase, from 2011 to 2019. Most of his stimulus and other big programs are designed to give the economy a jolt in 2009 and 2010 and then largely disappear or be offset by tax increases—at least that's the plan. Then the surge in outlays comes from two forces that would wreak budget havoc for any President: the relentless rise in entitlements and the surge in debt interest.

Making the challenge far greater: Obama's budget is packed with a wish list of expensive new programs, led by a giant health-care-reform plan. He promises to pay for them mainly with higher taxes. But if extra revenues don't materialize—and most that he's proposed now look unlikely—will he abandon many of his cherished priorities or push them through without full funding, substantially deepening the debt crisis? The answer could determine how fast America reaches the hour of reckoning that could usher in a VAT.

Let's divide Obama's budget projections into the plausible,

WHAT OBAMA ISN'T TELLING AMERICANS IS THAT THE ONLY PRACTICAL SOLUTION IS A GIANT TAX INCREASE.

LEFT TO RIGHT: RON EDMONDS—AP; MORRY GASH—AP

PREVIOUS SPREAD: GETTY IMAGES (2); SOURCE: CONGRESSIONAL BUDGET OFFICE

BY THE NUMBERS

$17 TRILLION

The projected national debt by 2019, which would be equivalent to 82% of GDP, double last year's level.

the impossible, and the questionable. First, the plausible: It's optimistic but highly possible that spending on Fannie Mae, Freddie Mac, and the Troubled Assets Relief Program (TARP) will fall from more than $500 billion this year to around $20 billion in 2010, and keep declining from there. It's also plausible that the costs of the wars in Afghanistan and Iraq will fall to around $50 billion a year.

Now the practically impossible: Obama is using a timeworn gimmick by pledging that nonmilitary discretionary spending, outlays that require annual approval, will rise just 2.1% a year from 2012 to 2019. It won't happen. Obama is raising spending in this category, which includes education, health research, and homeland security, a generous 9% in 2009 and 10% in 2010, excluding the stimulus outlays. "It's far more likely the category will match its historical growth rate of around 6.5% a year," says Brian Riedl, an economist with the conservative Heritage Foundation. The GAO says it will rise with GDP, at well over 5%.

Let's examine one of the questionables. Obama's prize initiative—and by far his biggest—is his health-care plan. In his 2010 budget request the President proposes a $635 billion "down payment" or "reserve fund" toward universal health coverage over ten years. As the administration acknowledges, the $635 billion doesn't come close to covering the full expense of the program. Leonard Burman, chief of the nonpartisan Tax Policy Center, estimates the total cost at $1.5 trillion. Obama plans to offset the down payment from two sources: from limiting deductions for high earners—still another hit to the over-$250,000 crowd—and from squeezing the balance from Medicare through curbing unnecessary hospital stays and ending a plan offering HMO services. Once again, Obama will most likely lose a big part of the revenue he counted on. The limitation on deductions is encountering what looks like fatal opposition in Congress. Obama and his budget director, Peter Orszag, swear that the health-care plan will not worsen the deficit. "We are committed to making sure that health-care reform is deficit neutral," Orszag told *Fortune*.

CLOSING THE GAP BY TAXING ONLY PEOPLE EARNING OVER $250,000 WOULD REQUIRE RAISING THEIR TOP RATES TO 60%.

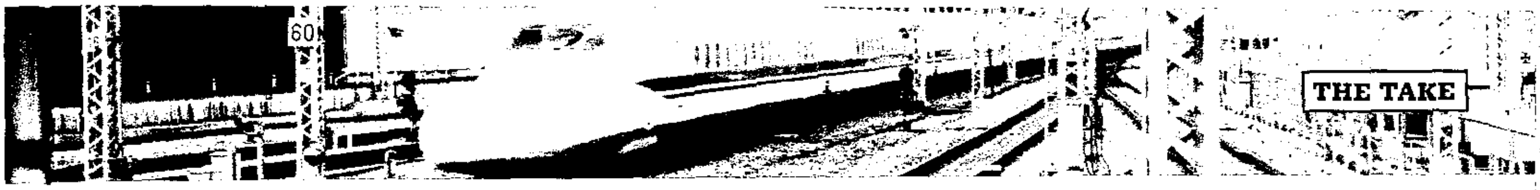
The administration's attachment to reform goes far beyond the campaign to provide universal care. Orszag adds, correctly, that unbridled health-care costs, chiefly for Medicare, "are the most important driver of our long-term entitlement problem." Obama is also counting on massive investment in infrastructure to reduce medical costs by spreading electronic record keeping, promoting prevention and wellness, and conducting research to determine the most effective therapies. It's impossible to predict how much money those initiatives would actually save. The administration isn't making a forecast.

Although a VAT seems inevitable, the administration isn't ready to get behind it. "While we are open to ideas to finance health-care reform in a deficit-neutral way," says Orszag, "the VAT is an idea popular with academics, but not one seriously considered by policymakers." The problem, however, is that the income tax simply won't do the job. Closing the budget deficit in 2019 by taxing only people earning more than $250,000 would require lifting their federal marginal tax rates to around 60%. The budget already calls for them to pay, on average, $30,000 more a year than in 2008, with the biggest hit falling on households with income above $500,000. Raising income taxes on all the Americans who pay them wouldn't work either. It would require a 55% increase per household, a political impossibility. The one other major new revenue raiser on the table is a tax on employer-provided health care, but that would merely help pay for a new program to cover the uninsured, rather than closing the deficit.

A VAT, on the other hand, would tax such a giant pool of purchases that a relatively low rate of 10% to 15% could generate the revenues needed to pay for Obama's agenda and balance the budget. The VAT, which would be imposed like a federal sales tax, is paid along the chain of production by wholesalers and retailers. The cost is passed to consumers in the form of higher prices. For the Democrats, the problem with the VAT is that it falls heavily on the middle class and low earners, who use a far higher portion of their incomes to buy things than the rich do. Some of the sting can be removed by exempting food and clothing from the VAT or sending rebates to lower-income households. But the middle class would be a big target in any event. "A lot more people will pay," says Gale. "We cannot get there from here without a VAT."

That brings us back to Krugman and Ryan. Wonder of wonders, they agree again—this time that a VAT is coming. Krugman likes the idea, though he says the middle class will pay more. "There's probably a value-added tax in our future," he writes. Ryan despises the VAT as the beginning of the end of the American empire. "The VAT is definitely the trajectory Obama is putting us on," he laments. Ryan believes that the big growth in government in Europe came from the easy money it provided. He makes a good point. It's not a destiny to be desired. And when the two Pauls agree, you can bet it's where things are headed. ■

FEEDBACK *stully@fortunemail.com*



What Japan Got Right

The economic news isn't all bad.

BY ROBERT ALAN FELDMAN

CORBIS

INTEREST IN JAPAN among global investors and policymakers is abysmal. Indeed, in many discussions, Japan is regarded as a museum piece or even a "failed economic state." High national debt, low returns on capital, high vulnerability to energy and agricultural shocks, a growing class of the permanently poor ... the list of reasons to ignore Japan is well known. This attitude is dangerous. The lessons from Japan's failures are clear. However, there are also things that Japan has done right economically—things that other nations would do well to emulate. Below are three important ones.

First, Japan has had huge success in inventory management. The country invented the idea of just-in-time production and delivery, but it has now taken the concept to another new level. The benefits of this are helping Japan avoid what might have been an even steeper downturn. Until the 1990s, any sharp drop in production would result in a sharp growth of inventories, which would in turn make it more difficult for factories to start producing again quickly when the economy improved. Now firms can adjust production very quickly, so that inventories do not pile up.

For example, as global demand collapsed last year, production in Japan was cut by 33 percent between September 2008 and February 2009, but inventories rose by only 3 percent by December, and subsequently fell. Had such a downturn in demand happened prior to better inventory control, the country would have faced many years of excess product in warehouses. The strict control of inventories will help Japan going forward. Low global demand may well hold production down, but inventory adjustment will not prolong the pain. Indeed, once begun, the pace of recovery in Japan may exceed expectations—at least until inventories are back to normal.

Second, Japanese firms tend to have strong balance sheets. At one time, these firms were notorious for holding too much cash. However, in light of the recent global disturbances, the benefits of having cash on the balance sheet are clearer—especially when financial contagion reduces the reliability of both banks and capital markets as sources of cash. Darwin's metaphor is apt: even though long necks seem like a waste in normal times, giraffes have an advantage in a drought; they can eat the leaves on the tops of trees that are out of reach for other animals. In an economic downturn, firms with high cash have an advantage, even though high cash seems like a waste in normal times. With low leverage and high cash, Japanese firms are more likely to weather the bad times than many foreign competitors.

> With low debts and a lot of cash, Japanese firms could weather bad times better than many foreign competitors.

Finally, it's important to note Japan's success in energy policy, which has been outstanding. In 1973, the nation imported about 5 million barrels of oil per day. Today, with GDP 2.3 times larger, Japan imports less than 4.2 million barrels per day.

This stunning improvement came through several routes. Japan was early to diversify away from oil to other fossil fuels, such as coal and liquid natural gas. Second, Japan increased its use of nuclear energy from 1 percent of total supply in the 1970s to about 14 percent today—not as much as France (43 percent), but significant nevertheless, and higher than the 9 percent in the U.S. Third, and most important, Japan was an honor student in conservation. Indeed, the amount of energy (not just oil) used per unit of GDP has fallen by about 1 percent per year, every year, since the mid-1970s. As an added benefit to the environment, CO_2 per unit of GDP is half the level of that in the United States.

How did they do it? In the industrial sector, the incentive to conserve was backed both by high energy prices, which derived from the regulatory regime, and by targeted conservation incentives for industry, such as tax breaks for fuel-efficient equipment. Additionally, social infrastructure and urban planning were oriented to conserve energy. For example, according to the Japan Business Federation, about 30.1 percent of surface passenger traffic in Japan goes by rail. In the U.S., the comparable figure is 0.2 percent. Japanese rail technology shows why rail is so popular: on Japan's fastest bullet train, it takes 2 hours and 36 minutes to go from Tokyo to Osaka, a distance of 557 kilometers (346 miles). The fastest train from Boston to New York takes about 3 hours and 30 minutes, over a distance of only 372 kilometers (231 miles).

None of these successes frees Japan from the need to address its many other problems, whether demographic, financial or economic. But the successes are still major achievements—and lessons for other nations in tough times. If we ask the economic mirror on our wall who has the best policies, we may not get the answer that we expect.

FELDMAN *is a managing director of Morgan Stanley Japan Securities Co., Ltd.*

June 22, 2009

PHOTOGRAPH BY CHARLES OMMANNEY—GETTY IMAGES

THE INSURGENTS

THE SECRET BATTLE TO SAVE CAPITALISM.

BY MICHAEL HIRSH

MARIA CANTWELL SAT AGHAST IN FRONT of the TV in her Senate office last fall, watching Wall Street crash. Not long after her arrival in D.C. in 2001, Enron imploded. Energy speculators wielding complex derivatives had gouged her constituents in Washington state out of $1 billion. The federal government, she thought, had done little since then to prevent fraud and manipulation. So last September, after Fannie Mae and Freddie Mac nearly failed, Lehman Brothers went under and the stock market plummeted, she decided she'd had enough. "I have seen this movie, and I know how it turns out," Cantwell said.

Cantwell knew something about business—she had made millions as an executive at RealNetworks during the dot-com boom. And she was concerned that the administration, filled with men who had supported financial deregulation during the Clinton administration, didn't have the stomach to impose the kind of tough reform she thought Wall Street required. So, along with a small group of insurgent Democrats in the Senate, she began pushing for a meeting with President Obama to make her case.

Finally in late March, Cantwell and her confederates—Carl Levin of Michigan, Byron Dorgan of North Dakota, Dianne Feinstein of California, Jim Webb of Virginia and Vermont's Bernard Sanders—met with Obama and members of his economic team in the White House. "I told the president I was concerned that the administration had people in charge who had missed all this before," she says. It was an awkward moment: two of the officials that Cantwell and her allies came to complain about—Obama's chief economic adviser, Larry Summers, and Treasury Secretary Tim Geithner—were sitting right there.

Yet one by one, the other senators echoed Cantwell's concerns. Obama's appointed officials and nominees were products of the system that had brought us this economic grief; they would tinker but in the end leave Wall Street mostly intact. "Some of the people around the president needed to be given a push," says Levin.

For their part, administration officials reject this view. "Nobody has been more aggressive than Tim Geithner and Larry

Summers on this issue," says Michael Barr, an assistant Treasury secretary working on regulatory issues. "From the start, they've been firm about the need for fundamental reform in the system." Summers acknowledges his views on regulation have evolved since the '90s, and he says the back and forth is helpful. "The president always wants access to the best thinking and widest range of views on any subject," Summers told NEWSWEEK.

The internecine war of wills between the insurgents and the White House economic team has occurred mostly out of sight. But it is part of a larger battle for the future of the financial system—and in some ways capitalism itself. At issue is whether the financial landscape—the size of Wall Street firms, who regulates them and the kinds of things they will be allowed to trade—will look much different once the crisis passes. These senators fear it won't unless they are vigilant.

The insurgents have their own agendas. Dorgan warned in 1999 that "massive taxpayer bailouts" would result from the repeal of the Glass-Steagall Act, a move that allowed investment and commercial banks to merge. Both Dorgan and Cantwell are worried about loopholes that will permit firms to keep trillions of dollars of derivative trades in the shadows, escaping regulation. Levin, for his part, wants to rescind many of the Clinton-era laws that led to deregulation, including the 2000 Commodity Futures Modernization Act, which exempted credit default swaps from regulation. Unless giant financial firms like Citigroup and AIG are broken up, Sanders says, they'll have to be bailed out again someday. Yet the six senators have united to play old-fashioned power politics: Cantwell and Sanders placed a hold on the nomination of Gary Gensler, the president's pick to chair the Commodity Futures Trading Commission. This was the key regulatory body that in 1998 had fought unsuccessfully under Brooksley Born to rein in derivatives trading. Born's efforts were beaten back by the Democratic administration under Bill Clinton, including Gensler, who as Treasury undersecretary had opposed regulation of credit default swaps. Those are the financial instruments that later brought AIG—and much of the financial system—to the brink of meltdown.

The Senate pressure seems to have paid off. In the last several weeks, Summers has engaged Cantwell in a series of phone calls about derivatives regulation. Cantwell and her supporters say that Summers listened to her eagerly and that the regulatory framework for derivatives laid out by Geithner a week after the calls bore her stamp. She was given assurances, for instance, that the administration would keep big firms from speculating by placing "aggregate," or total, limits on the derivative positions they could take.

CANTWELL IS SKEPTICAL THAT THE OBAMA TEAM WILL STAND UP TO WALL STREET.

Administration officials say they were already working on the changes, though Cantwell's advice was a valuable part of the process. This week, Geithner is expected to unveil his broadest proposals yet aimed at preventing interconnected financial firms from growing too big.

Even Gensler seems newly sympathetic to Cantwell and the insurgents. He says he is not opposed to tighter regulation. Gensler, a former Goldman Sachs executive, now concedes that he should have fought harder for aggressive regulation in the '90s. He also agrees that the dispute over his nomination probably pushed the administration to focus on regulation. Gensler described the senators who held up his nomination in diplomatic terms—Cantwell and Sanders finally let his confirmation vote go forward in May—as "allies in trying to bring reform to the over-the-counter derivatives marketplace."

Typically, Obama has also shown himself open to other views, and Levin and his allies say they believe the president is pushing his own economic team to crack down harder on Wall Street. "I think the president was always where we were on this issue," Levin says. (White House spokeswoman Jennifer Psaki says Obama gave a speech almost two years ago calling for major regulatory reform, and since he took office has "asked his economic team to seek input from all sides.") In late April, Obama gathered some of his chief outside economic critics—including two of the most vociferous, Nobelists Joseph Stiglitz and Paul Krugman—for a cozy dinner in the old family dining room of the White House. At one point during the two-hour meal, Stiglitz and Summers began arguing whether hedge funds might amass a windfall profit by purchasing the long-term bonds of bailed-out banks. Obama impatiently moved the discussion forward, saying the numbers weren't the point, solutions were, according to two participants who would relate the president's comments only on condition of anonymity.

Much remains unaddressed, say Cantwell and other critics. Now that the financial markets are beginning to stabilize and the big Wall Street players pledge to pay back their bailout billions, they are digging in against fundamental change. Recently, a group of big banks including Citigroup, JPMorgan and Goldman Sachs formed a new lobby to fight controls on over-the-counter derivatives. Cantwell is skeptical that the Obama team will hold the line against the Wall Street lobby. "Do I think they've become true believers? No, I don't." She says Gensler is already "whining" about how hard it is going to be to get new regulation past Wall Street. Gensler insists he and the Obama administration are determined to rein in the financial industry once and for all. "We need to regulate all derivatives, standard or customized, by regulating the dealers," he said. Gensler is clearly under a lot of pressure. The question is, who is he more worried about: Wall Street or fellow Democrats like Maria Cantwell?

NEXT ▶
THE CAPITALIST MANIFESTO
Why the system still works.
BY FAREED ZAKARIA

ECONOMY | PROSPERITY | ETHICS

THE CAPITALIST MANIFESTO

GREED IS GOOD (TO A POINT)

BY FAREED ZAKARIA

ARTWORK BY MARK WAGNER

A SPECTER IS HAUNTING THE WORLD—the return of capitalism. Over the past six months, politicians, businessmen and pundits have been convinced that we are in the midst of a crisis of capitalism that will require a massive transformation and years of pain to fix. Nothing will ever be the same again. "Another ideological god has failed," the dean of financial commentators, Martin Wolf, wrote in the *Financial Times*. Companies will "fundamentally reset" the way they work, said the CEO of General Electric, Jeffrey Immelt. "Capitalism will be different," said Treasury Secretary Timothy Geithner.

No economic system ever remains unchanged, of course, and certainly not after a deep financial collapse and a broad global recession. But over the past few months, even though we've had an imperfect stimulus package, nationalized no banks and undergone no grand reinvention of capitalism, the sense of panic seems to be easing. Perhaps this is a mirage—or perhaps the measures taken by states around the world, chiefly the U.S. government, have restored normalcy. Every expert has a critique of specific policies, but over time we might see that faced with the decision to underreact or overreact, most governments chose the latter. That choice might produce new problems in due course—a topic for another essay—but it appears to have averted a systemic breakdown.

There is still a long road ahead. There will be many more bankruptcies. Banks will have to slowly earn their way out of their problems or die. Consumers will save more before they start spending again. Mountains of debt will have to be reduced. American capitalism is being rebalanced, reregulated and thus restored. In doing so it will have to face up to long-neglected problems, if this is to lead to a true recovery, not just a brief reprieve.

Many experts are convinced that the situation cannot improve yet because their own sweeping solutions to the problem have not been implemented. Most of us want to see more punishment inflicted, particularly on America's bankers. Deep down we all have a Puritan belief that unless they suffer a good dose of pain, they will not truly repent. In fact, there has been much pain, especially in the financial industry, where tens of thousands of jobs, at all levels, have been lost. But fundamentally, markets are not about morality. They are large, complex systems, and if things get stable enough, they move on.

Consider our track record over the past 20 years, starting with the stock-market crash of 1987, when on Oct. 19 the Dow Jones lost 23 percent, the largest one-day loss in its history. The legendary economist John Kenneth Galbraith wrote that he just hoped that the coming recession wouldn't prove as painful as the Great Depression. It turned out to be a blip on the way to an even bigger, longer boom. Then there was the 1997 East Asian crisis, during the depths of which Paul Krugman wrote in a *Fortune* cover essay, "Never in the course of economic events—not even in the early years of the Depression—has so large a part of the world economy experienced so devastating a fall from grace." He went on to argue that if Asian countries did not adopt his radical strategy—currency controls—"we could be looking at ... the kind of slump that 60 years ago devastated societies, destabilized governments, and eventually led to war." Only one Asian country instituted currency controls, and partial ones at that. All rebounded within two years.

Each crisis convinced observers that it signaled the end of some new, dangerous feature of the economic landscape. But often that novelty accelerated in the years that followed. The 1987 crash was said to be the product of computer trading, which has, of course, expanded dramatically since then. The East Asian crisis was meant to end the happy talk about "emerging markets," which are now at the center of world growth. The collapse of Long-Term Capital Management in 1998—which then-Treasury secretary Robert Rubin described as "the worst financial crisis in 50 years"—was meant to be the end of hedge funds, which then massively expanded. The technology bubble's bursting in 2000 was supposed to put an end to the dreams of oddball Internet start-ups. Goodbye, Pets.com; hello, Twitter. Now we hear that this crisis is the end of derivatives. Let's see. Robert Shiller, one of the few who predicted this crash almost exactly—and the dotcom bust as well—argues that in fact we need *more* derivatives to make markets more stable.

A few years from now, strange as it may sound, we might all find that we are hungry for more capitalism, not less. An economic crisis slows growth, and when countries need growth, they turn to markets. After the Mexican and East Asian currency crises—which were far more painful in those countries than the current downturn has been in America—we saw the pace of market-oriented reform speed up. If, in the years ahead, the American consumer remains reluctant to spend, if federal and state governments groan under their debt loads, if government-owned companies remain expensive burdens, then private-sector activity will become the only path to create jobs. The simple truth is that with all its flaws, capitalism remains the most productive economic engine we have yet invented. Like Churchill's line about democracy, it is the worst of all economic systems, except for the others. Its chief vindication today has come halfway across the world, in countries like China and India, which have been able to grow and pull hundreds of millions of people

CRIE

PANICS, CRASHES AND FULL-BLOWN DEPRESSIONS DATE ALMOST AS FAR BACK AS THE BIRTH OF THE MODERN FINANCIAL SYSTEM IN THE NETHERLANDS AROUND 1620. A FEW OF THE MOST MEMORABLE SETBACKS:

1637 — **TULIP MANIA:** Speculators in the Netherlands bid up tulip bulbs to dizzying heights before the inevitable crash.

1719 — **LOUISIANA OR BUST:** Unwary investors are swept away by tales of outsize profits in France's Louisiana Territory.

1720 — **SOUTH SEAS FANTASY:** London's South Sea Co. goes deep into debt to support its claims of fabulous Pacific finds.

out of poverty by supporting markets and free trade. Last month India held elections during the worst of this crisis. Its powerful left-wing parties campaigned against liberalization and got their worst drubbing at the polls in 40 years.

Capitalism means growth, but also instability. The system is dynamic and inherently prone to crashes that cause great damage along the way. For about 90 years, we have been trying to regulate the system to stabilize it while still preserving its energy. We are at the start of another set of these efforts. In undertaking them, it is important to keep in mind what exactly went wrong. What we are experiencing is not a crisis of capitalism. It is a crisis of finance, of democracy, of globalization and ultimately of ethics.

"Capitalism messed up," the British tycoon Martin Sorrell wrote recently, "or, to be more precise, capitalists did." Actually, that's not true. Finance screwed up, or to be more precise, financiers did. In June 2007, when the financial crisis began, Coca-Cola, PepsiCo, IBM, Nike, Wal-Mart and Microsoft were all running their companies with strong balance sheets and sensible business models. Major American corporations were highly profitable, and they were spending prudently, holding on to cash to build a cushion for a downturn. For that reason, many of them have been able to weather the storm remarkably well. Finance and anything finance-related—like real estate—is another story.

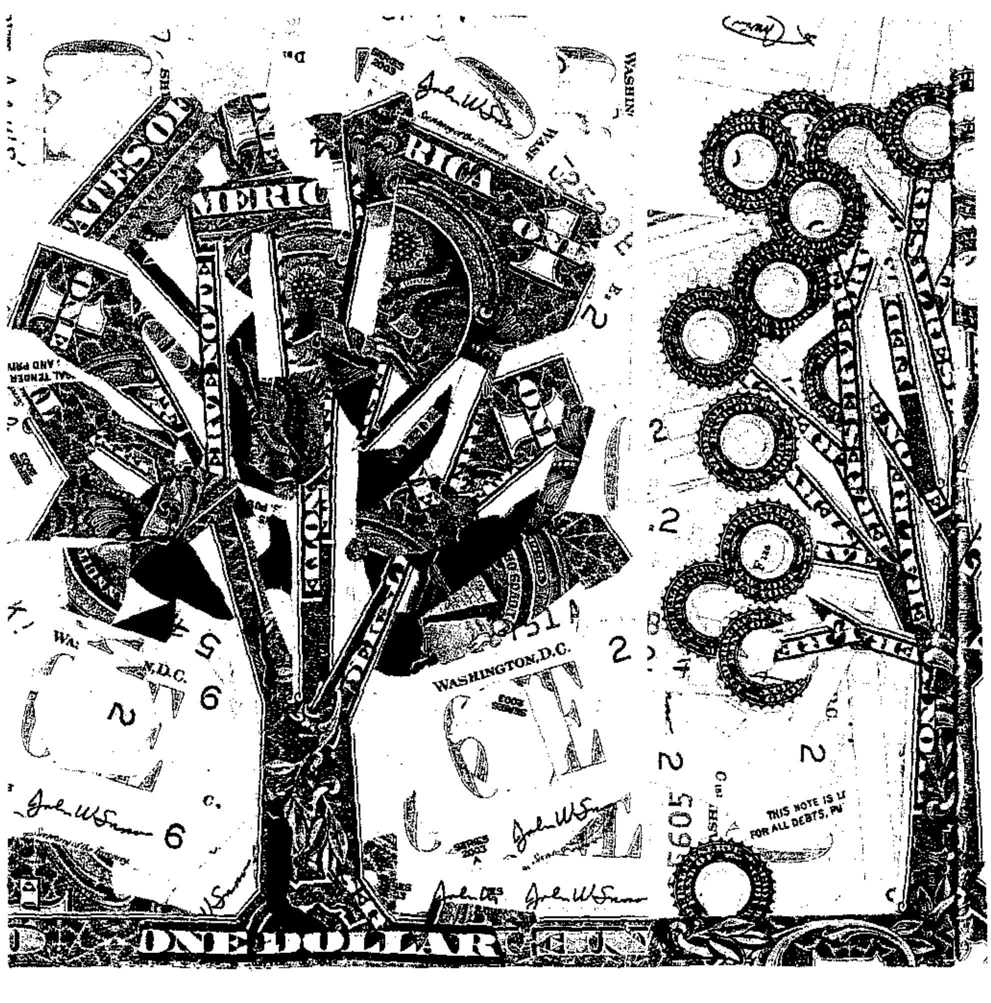
Finance has a history of messing up, from the Dutch tulip bubble in 1637 to now. The proximate causes of these busts have been varied, but follow a strikingly similar path. In calm times, political stability, economic growth and technological innovation all encourage an atmosphere of easy money and new forms of credit. Cheap credit causes greed, miscalculation and eventually ruin. President Martin Van Buren described the economic crisis of 1837 in Britain and America thusly: "Two nations, the most commercial in the world, enjoying but recently the highest degree of apparent prosperity and maintaining with each other the closest relations, are suddenly ... plunged into a state of embarrassment and distress. In both countries we have witnessed the same [expansion] of paper money and other facilities of credit; the same spirit of speculation ... the same overwhelming catastrophe." Obama could put that on his teleprompter today.

> WHAT WE ARE EXPERIENCING IS NOT A CRISIS OF CAPITALISM. IT IS A CRISIS OF FINANCE, OF DEMOCRACY, OF GLOBALIZATION AND ULTIMATELY OF ETHICS.

Many of the regulatory reforms that people in government are talking about now seem sensible and smart. Banks that are too large to fail should also be too large be leveraged at 30 to 1. The incentives for executives within banks are skewed toward reckless risk-taking with other people's money. ("Heads they win, tails they break even," is how Barney Frank describes the current setup.) Derivatives need to be better controlled. To call banks casinos, as is often done, is actually unfair to casinos, which are required to hold certain levels of capital because they must be able to cash in a customer's chips. Banks have not been required to do that for their key derivatives contract, credit default swaps.

Yet at the same time, we should proceed cautiously on massive new regulations. Many rules put in place in the 1930s still look smart; the problem is that over the past 15 years they were dismantled, or conscious decisions were made not to update them. Keep in mind that the one advanced industrial country where the banking system has weathered the storm superbly is Canada, which just kept the old rules in place, requiring banks to hold higher amounts of capital to offset their liabilities and to maintain lower levels of leverage. A few simple safeguards, and the whole system survived a massive storm.

The simplest safeguard American regu-



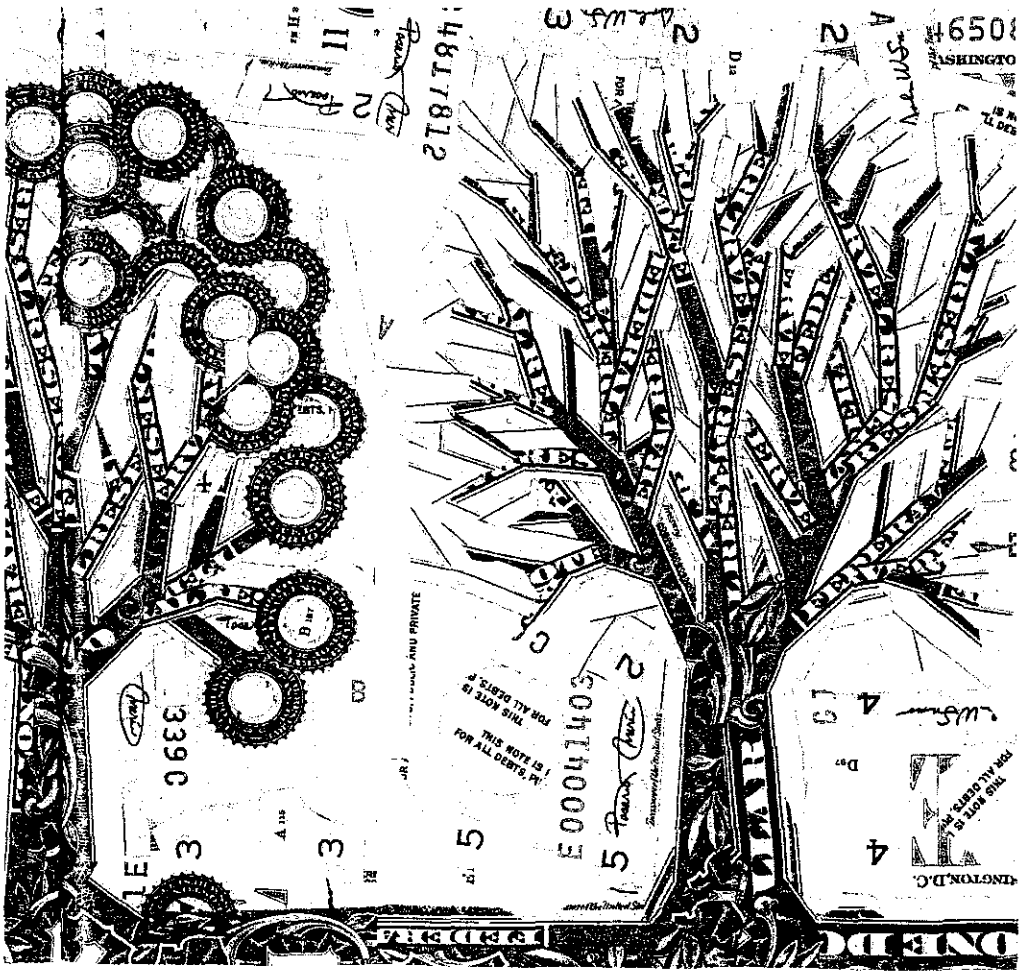
1792	1820s	1837	1840s	1893
U.S. BANK RUN: The ink is hardly dry on the Constitution before bank speculators and tight credit start the Panic of 1792.	**LATIN AMERICA LOSSES:** South American bond markets go wild, luring British bankers who soon regret their folly.	**DEPRESSION HITS U.S.:** Bank deregulation and frenzied land speculation provoke hysteria. Years of unemployment ensue.	**MAJOR TRAIN WRECK:** Some 150 years before the dotcom crash, British railways suffer a similar speculative bubble.	**END OF THE GILDED AGE:** A cascade of U.S. bank and railroad failures and a run on gold cause the Panic of 1893.

lators have had, of course, is the interest rate on credit. In responding to almost every crisis in the past 15 years, former Fed chairman Alan Greenspan always had the same solution: cut rates and ease up on money. In 1998, when Long-Term Capital Management collapsed, he suddenly and dramatically slashed rates, even though the economy was roaring along at 6 percent growth. In late 1999, buying into fears about Y2K, he swamped the markets with liquidity. (One effect: between November 1998 and February 2000, when rates finally rose, the NASDAQ jumped almost 250 percent, increasing in value by more than $3 trillion.) And finally, when the technology bubble burst and 9/11 hit, Greenspan again lowered rates and kept them low, this time inflating a massive housing bubble.

Greenspan behaved like most American political leaders over the past two decades—he chose the easy way out of a hard situation. William McChesney Martin, the great Fed chairman of the 1950s and 1960s, once said that his job was to take the punch bowl away just as the party had begun. No one wants to do that in America anymore—not the Fed chairman, not the regulators, not Congress and not the president.

Government actions should be "countercyclical"—that is, they should work to slow down growth. So, in boom times, the Fed would raise rates and require banks to have higher capital and lower leverage. Fannie Mae and Freddie Mac would start worrying about too much easy credit, raise standards for loans and disqualify buyers unlikely to be able to afford houses. Banks would be urged to slow down the supply of credit cards and other credit instruments. In fact, this is exactly how the governments of China and India behaved in 2007, when their economies were booming. At the peak, consumption in India actually declined as a percentage of GDP.

In the United States, the opposite happened: consumption surged from 67 percent to 73 percent of GDP. Presidents and congressmen extolled the virtues of homeownership for everyone. Congress pushed Fannie Mae and Freddie Mac to extend more loans. Regulators eased up on banks, and the Fed kept rates low. And the public cheered this pandering at every step.



Since Ronald Reagan's presidency, Americans have consumed more than we produced and have made up the difference by borrowing. This is true of individuals but, far more dangerously, of governments at every level. Government debt in America, especially when entitlements and state pension commitments are included, is terrifying. And yet no one has tried seriously to close the gap, which can be done only by (1) raising taxes or (2) cutting expenditures. Any sensible proposal will have to feature both prominently.

This is the disease of modern democracy: the system cannot impose any short-term pain for long-term gain. For 20 years, most serious structural problems—Social Security, health care, immigration—have been kicked down the road. And while the problem is acute in America, Europe and Japan face many of the same difficulties. Right now, the U.S. government's boldness is laudable, but it is being bold in spending money. In a few years, when the bills come due, and Congress must enact major spending cuts as well as raise taxes (and not just on the rich), that's when we will see if things have changed.

In reality, the problem goes well beyond Washington. It also goes beyond bad bankers, lax regulators and pandering politicians. The global financial system has been crashing more frequently over the past 30 years than in any comparable period in history. On the face of it, this suggests that we're screwing up, when in fact what is happening is more complex. The problems that have developed over the past decades are not simply the products of failures. They could as easily be described as the products of success.

Here's why we got to where we are. Since the late 1980s, the world has been moving toward a extraordinary degree of political stability. The end of the Cold War has ushered in a period with no major military competition among the world's great powers—something virtually unprecedented in modern history. It has meant the winding down of most of the proxy and civil wars, insurgencies and guerrilla actions that dotted the Cold War landscape. Even given the bloodshed in places like Iraq, Afghanistan and Somalia,

1907 **THE PANIC OF 1907:** John D. Rockefeller and J. P. Morgan narrowly avert total collapse after a trader's ill-judged bet.

1920s **FIRST FLORIDA LAND RUSH:** Rabid developers, easy credit and palmy dreams make a fine bubble—until it pops in 1925.

1929 **THE GREAT DEPRESSION:** The roaring '20s screech to a halt. Nearly half of the 25,000 U.S. banks fail before it's over.

1973-74 **THE 'NIFTY 50':** In the 1960s, Wall Street swears by these 50 large-cap stocks. By the mid-'70s it swears at them.

1986-90 **JAPAN SINKS:** The bursting of a monster real-estate bubble plunges the once booming country into a deep recession.

the number of people dying as a result of political violence of any kind has dropped steeply over the past three decades.

Then there is the end of inflation. In the 1970s, dozens of countries suffered hyperinflation, which destroyed the middle class, destabilized societies and led to political upheaval. Since then, central banks have become very good at taming the monster, and by 2007 the number of countries with high inflation had dwindled to a handful. Only one, Zimbabwe, had hyperinflation.

OVER THE PAST QUARTER CENTURY, MORE THAN 400 MILLION PEOPLE ACROSS ASIA HAVE BEEN LIFTED OUT OF POVERTY.

Add to this the information and Internet revolutions, and you have a series of historical changes that have produced a single global system, far more integrated and faster-moving than ever before. The results speak for themselves. Over the past quarter century, the global economy has doubled every 10 years, going from $31 trillion in 1999 to $62 trillion in 2008. Recessions have become tamer than ever before, averaging eight months rather than two years. More than 400 million people across Asia have been lifted out of poverty. Between 2003 and 2007, average income worldwide grew at a faster rate (3.1 percent) than in any previous period in recorded human history. In 2006 and 2007—the peak years of the boom—124 countries around the world grew at 4 percent a year or more, about four times as many as 25 years earlier.

Many of these countries had more cash than they knew what to do with. China sits on a war chest of more than $2 trillion, while eight other emerging-market nations have reserves of more than $100 billion. They've all looked to the safest investment they could imagine—U.S. government debt. In buying so much debt, they drove down the interest rate Washington had to offer, which in turn made credit in America cheap. So the effect of all this money sloshing around the world was to subsidize Americans in their favorite activity: shopping. But it affected other Western countries as well, from Spain to Ireland, where consumers and governments loaded themselves up with debt.

Good times always make people complacent. As the cost of capital sank over the past few years, people became increasingly foolish. The world economy had become the equivalent of a race car—faster and more complex than any vehicle anyone had ever seen. But it turned out that no one had driven a car like this before, and no one really knew how. So it crashed.

The real problem is that we're still driving this car. The global economy remains highly complex, interconnected and imbalanced. The Chinese still pile up surpluses and need to put them somewhere. Washington and Beijing will have to work hard to slowly stabilize their mutual dependence so that the system is not being set up for another crash.

More broadly, the fundamental crisis we face is of globalization itself. We have globalized the economies of nations. Trade, travel and tourism are bringing people together. Technology has created worldwide supply chains, companies and customers. But our politics remains resolutely national. This tension is at the heart of the many crashes of this era—a mismatch between interconnected economies that are producing global problems but no matching political process that can effect global solutions. Without better international coordination, there will be more crashes, and eventually there may be a retreat from globalization toward the safety—and slow growth—of protected national economies.

Throughout this essay, I have avoided treating this economic crisis as a grand morality play—a war between good and evil in which demon bankers destroyed all that is good and true about our societies. Complex historical events can rarely be reduced to something so simple. But we are suffering from a moral crisis, too, one that may lie at the heart of our problems.

Most of what happened over the past decade across the world was legal. Bankers did what they were allowed to do under the law. Politicians did what they thought the system asked of them. Bureaucrats were not exchanging cash for favors. But very few people acted responsibly, honorably or nobly (the very word sounds odd today). This might sound like a small point, but it is not. No system—capitalism, socialism, whatever—can work without a sense of ethics and values at its core. No matter what reforms we put in place, without common sense, judgment and an ethical standard, they will prove inadequate. We will never know where the next bubble will form, what the next innovations will look like and where excesses will build up. But we can ask that people steer themselves and their institutions with a greater reliance on a moral compass.

One of the great shifts taking place in American society has been away from the old guild system of self-regulation. Once upon a time, law, medicine and accounting viewed themselves as private-sector participants with public responsibilities. Lawyers are still called "officers of the court." And historically they acted with that sense of stewardship in mind, thinking of what was appropriate for the whole system and not simply for their firm. That meant advising their clients against time-consuming litigation or mindless mergers. Elihu Root, a leader of the New York bar in the late 19th century, once said, "About half the practice of a decent lawyer consists in telling would-be clients that they are damned fools and should stop."

It's not just the law that has changed; so have all the professions. Ever since the 1930s, accountants have been given a unique trust. "Who audits you?" asked Sen. Alben Barkley during a 1933 committee hearing. "Our conscience," replied Arthur Carter, the head of a large accounting firm. But by 2002 *The Wall Street Journal* was describing a different world, in which accountants had gone from "watchdogs to lapdogs," telling clients whatever they wanted to hear. Bankers similarly once saw themselves as being stewards of capital, responsible to their many constituents and embodying trust. But over the past few decades, they too became obsessed with profits and the short term, uncertain about their own future and that of their company. The

1997	1998	2000	2008	2009
THE 'ASIAN CONTAGION': A flood of foreign cash makes local bankers careless. Then the currency traders swarm in.	**TOO BIG TO FAIL:** LTCM, the "Rolls-Royce of hedge funds," hemorrhages money, but no one dares to refuse it a bailout.	**THE 'DOT BOMB':** Driven by Internet fever, the NASDAQ peaks at 5048 on March 10. From there it's all downhill	**THE DERIVATIVES DEBACLE:** Sci-fi financial inventions turn a U.S. housing-market correction into a worldwide meltdown	**IN SEARCH OF RECOVERY:** Maybe the Dow has stabilized. Maybe other indicators have slowed their fall. Maybe.

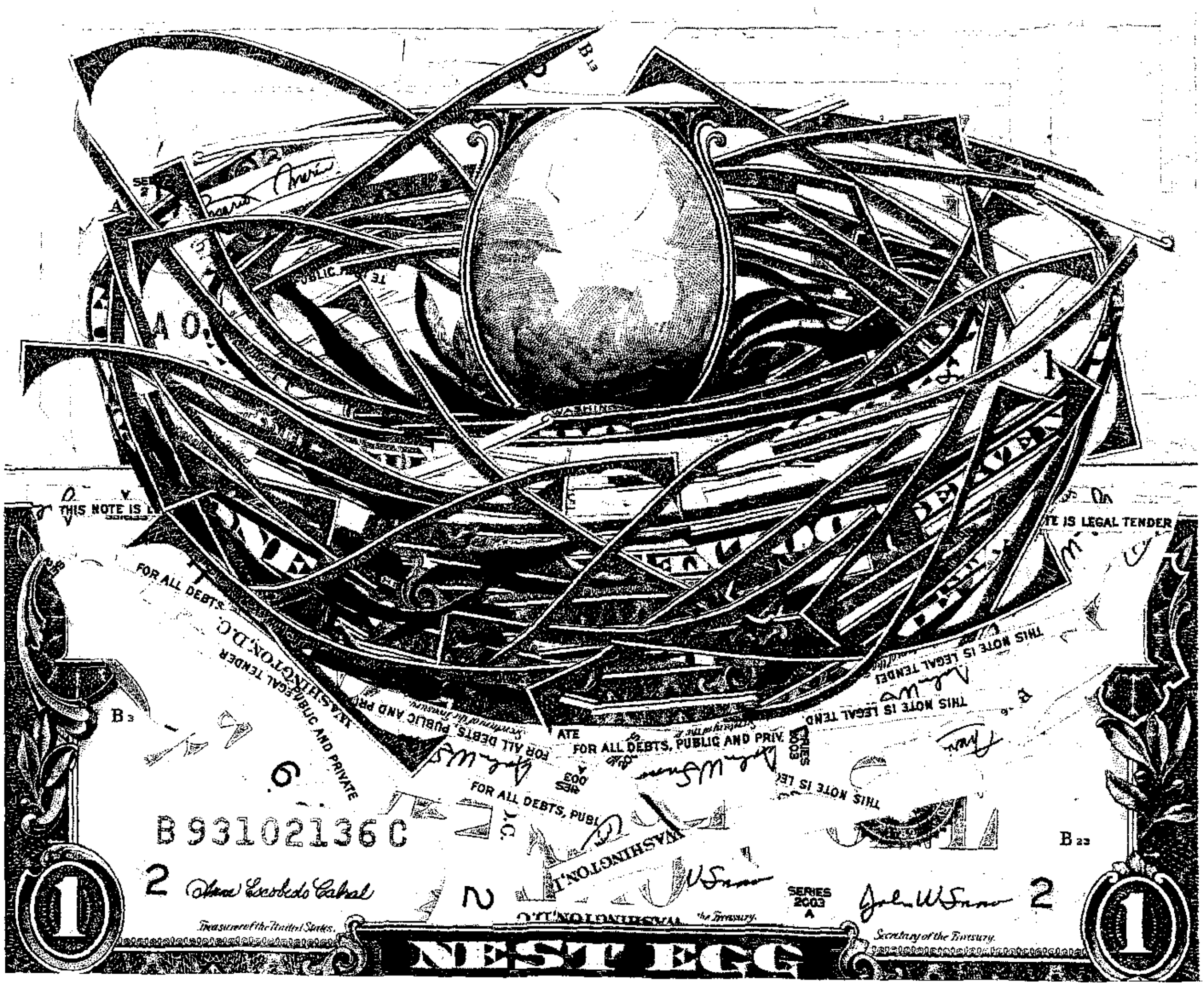
most recent example of this phenomenon has been at the rating agencies, which were generating fees that were too lucrative to be exacting in their judgments about their clients' products.

None of this has happened because businesspeople have suddenly become more immoral. It is part of the opening up and growing competitiveness of the business world. Many of the old banks and law firms operated as monopolies or cartels. They could afford to take the long view. They were also run by a WASP elite secure in its privilege. The members of today's meritocratic elite are more anxious and insecure. They know that they are being judged quarter by quarter.

The failure of self-regulation over the past 20 years—in investment banking, accounting, rating agencies—has led inevitably to the rise of greater government regulation. This marks an important change in the Anglo-American world, away from informal rules often enforced by private actors toward the more formal bureaucratic system common in continental Europe. Perhaps the state should not set the pay of the private sector. But surely CEOs should exercise some judgment about their own compensation and tie it far more closely to the long-term health of the company. It will still be possible to get very rich—Warren Buffett, after all, draws a salary of only $100,000.

There's a need for greater self-regulation not simply on Wall Street but also on Pennsylvania Avenue. We get exercised about the immorality of politicians when they're caught in sex scandals. Meanwhile they triple the national debt, enrich their lobbyist friends and write tax loopholes for specific corporations—all perfectly legal—and we regard this as normal. The revolving door between Washington government offices and lobbying firms is so lucrative and so established that anyone pointing out that it is—at base—institutionalized corruption is seen as baying at the moon. Not everything is written down, and not everything that is legally permissible is ethical. Who was the last ex-president to refuse to take a vast donation for his library from a foreign government that he had helped when in office?

We are in the midst of a vast crisis, and there is enough blame to go around and many fixes to make, from the international system to national governments to private firms. But at heart, there needs to be a deeper fix within all of us, a simple gut check. If it doesn't feel right, we shouldn't be doing it. That's not going to restore growth or mend globalization or save capitalism, but it might be a small start to sanity.

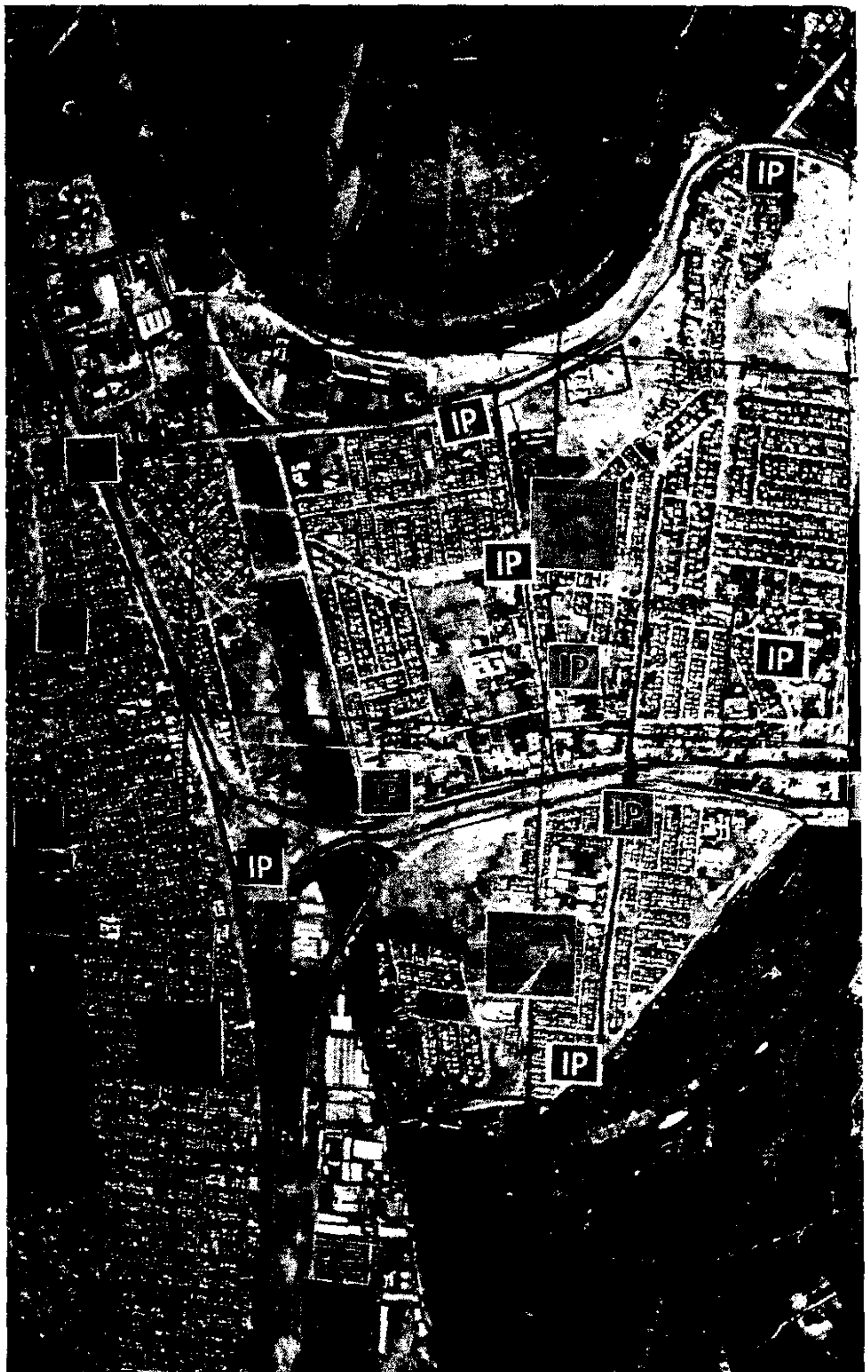


The Empire Burden

BY CHRISTOPHER DICKEY

WHEN GEORGE ORWELL WAS A YOUNG man in the 1920s, he served as a British policeman in the colony of Burma. On duty there he saw, as he put it, "the dirty work of empire at close quarters." He deplored the "white man's" oppression of the "native people" in "the East." But what Orwell found most disconcerting was the trap his own country had fallen into. "When the white man turns tyrant, it is his own freedom that he destroys," Orwell wrote a few years later in his essay "Shooting an Elephant." "In every crisis he has got to do what the 'natives' expect of him. He wears a mask, and his face grows to fit it."

We may have moved beyond the paternalistic rhetoric of the early Orwell, but more recent jargon like "mission creep," coined during the Somalia debacle of the early 1990s, covers similar ground. In fact, the history of the past century should have proved conclusively that empires are traps, draining enormous resources and eventually enormous prestige from those who



NO WAY OUT
A SATELLITE MAP OF THE IRAQI CITY OF BAQUBAH.

build them. Whether past imperialists saw their missions as conquerors and occupiers or liberators, peacekeepers and nation-builders, or all of the above, those Western countries that have claimed "a foothold in a foreign land," as the 19th-century naval strategist A. T. Mahan put it, have often found themselves serving interests that were no longer clearly their own.

The Obama administration is learning that lesson. It came to office a little more than four months ago committed to withdrawing from Iraq, and to stabilizing Afghanistan so it could get out of there, too. But we heard recently from U.S. Army Chief of Staff Gen. George Casey that plans have been drawn up in case American fighting forces have to remain in Iraq for another decade—and this despite a written agreement with Baghdad to pull all troops out by the end of 2011. Why? Not least because the Iraqis that the Americans helped put in power think they may need those forces to stay. Iraqi Vice President Adil Abdul-Mahdi recently told a small group of reporters that he is "very concerned" about what will happen if the Americans leave. So, he suggested, the United States might well be asked to remain.

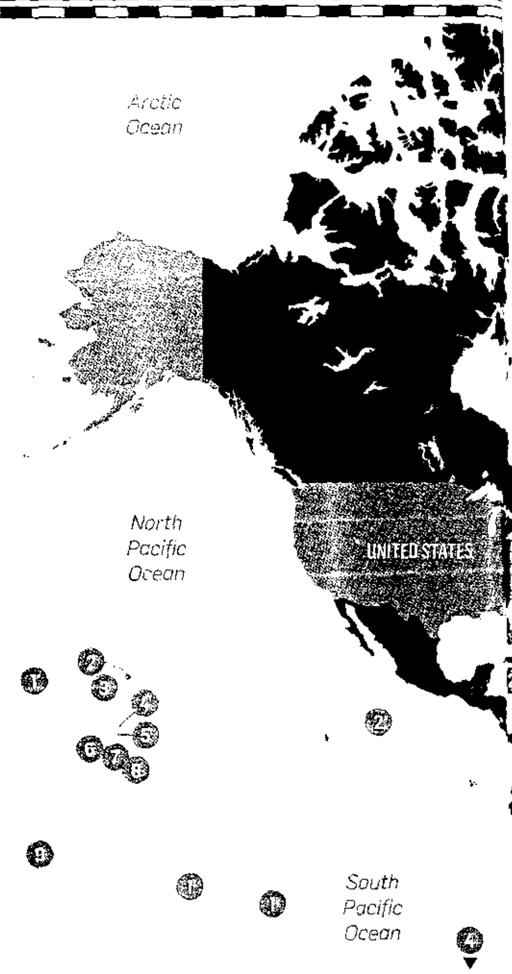
It's rare, in fact, that imperial powers decide on their own to give up any fragment of their foreign territories or influence. The British, for instance, "regarded long-term occupation as an inherent part of their 'civilizing mission'," the Harvard historian Niall Ferguson wrote in 2003. A self-described neo-imperialist, Ferguson supported the invasion of Iraq then taking place, but worried that the Americans wanted to get out too fast. "When the British intervened in a country like Iraq, they simply didn't have an exit strategy," Ferguson wrote. Their job would be done only when the country in question met their standards of civilization, the rule of law and free markets. "The only issue was whether to rule directly—installing a British governor—or indirectly, with a British 'secretary' offering 'advice' to a local puppet," Ferguson noted. Presumably it was this latter case that some in the Bush administration envisioned for Iraq.

The question Orwell posed was about who really pulled the strings: the empire or its subjects. And there may come a time when neither side really knows. People in the colonies, territories and countries under tutelage reach a point where they cannot imagine how they would survive without the help of a faraway power—even if they resent its interference. And the erstwhile imperialists, once they've been forced out of their largest possessions, cannot imagine giving up even a small fraction more of territory or influence, no matter how much it costs them militarily, economically or politically.

As a result, vestiges of past empires can be found all over the globe. Back in 1982 British Prime Minister Margaret Thatcher launched a full-scale war to hold on to the windswept Falkland Islands, even though they are almost 13,000 kilometers away from England and only about 160 kilometers from the shores of Argentina. The little enclaves of Ceuta and Melilla on the Moroccan coast remain parts of Spain and therefore of the European Union. So, would-be immigrants from deep in Africa regularly trek hundreds and even thousands of kilometers across the desert to try to storm the fences in hopes of asylum. Meanwhile, the United States itself continues to administer remnants of the imperial possessions it took in the Spanish-American War of 1898, including Guam, Puerto Rico and, yes, Cuba's Guantánamo Bay.

But it's the French who offer the most complicated and potentially the most instructive case study in past atrophy and future ambitions. The sun never sets on what Paris calls "the confetti of empire": from French Polynesia, New Caledonia and Wallis and Futuna in the South Pacific to Saint-Pierre and Miquelon off the coast of Newfoundland. Indeed, France's longest land border is not with Germany or Spain, but, thanks to French Guiana, with Brazil. "It is all about extending our influence," a senior official at the French Foreign Ministry says bluntly, if privately.

But is it? Equitable treaties clearly make



FRANCE

POSSESSIONS	POPULATION	POSSESSIONS	POPULATION
1 French Polynesia	287,000	11 Juan de Nova*	70 to 130 research scientists
2 Clipperton Island	0	12 Bassas da India*	
3 St-Pierre and Miquelon	7,000	13 Europa*	
4 St-Martin	30,000	14 Glorieuses*	
5 St-Barthélemy	7,400	15 Tromelin*	
6 Guadeloupe	434,000	16 Crozet*	
7 Martinique	410,000	17 Kerguelen*	
8 French Guiana	195,000	18 Amsterdam*	
9 Mayotte	186,000	19 St-Paul*	
10 Réunion	780,000	20 New Caledonia	227,400
		21 Wallis and Futuna	15,300

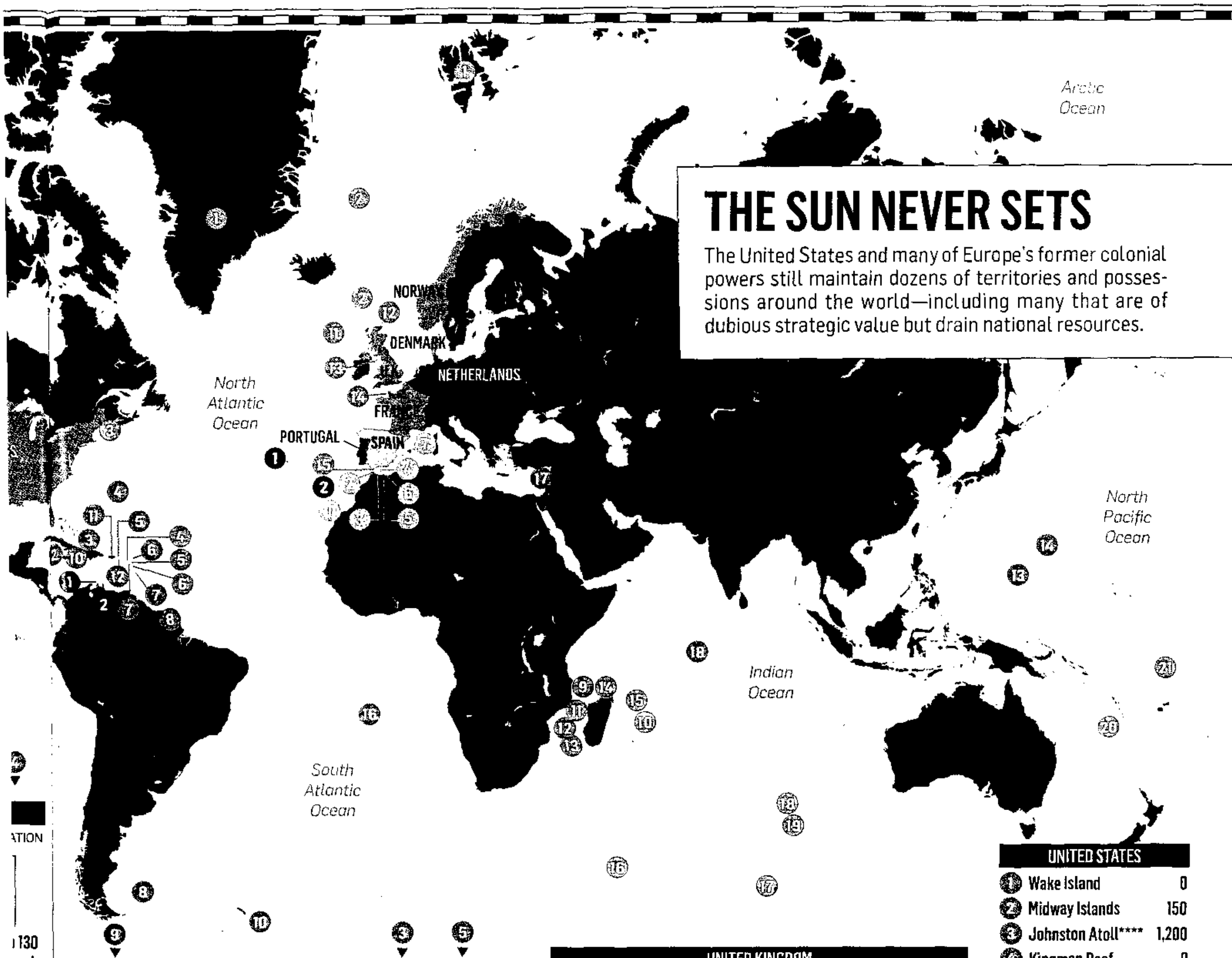
DENMARK

1 Greenland	57,600
2 Faeroe Islands	48,900

PORTUGAL

1 Azores	242,600
2 Madeira	260,000

more sense if you can get them. In May French President Nicolas Sarkozy inaugurated a new French military base in Abu Dhabi. Similar in purpose if not in scale to American installations in Qatar and Bahrain, farther up the coast, it is touted as a demonstration of France's changing approach to force projection. Camp Peace, as it is called (in a touch Orwell himself might have appreciated), is meant to dem-



THE SUN NEVER SETS

The United States and many of Europe's former colonial powers still maintain dozens of territories and possessions around the world—including many that are of dubious strategic value but drain national resources.

SPAIN	
1 Canary Islands	2,026,000
2 Ceuta	76,100
3 Peñón de Vélez de la Gomera†	60
4 Peñón de Alhucemas†	60
5 Melilla	69,400
6 Chafarinas Islands	190†
7 Balearic Islands	1,030,700

NETHERLANDS	
1 Aruba	103,000
2 Neth. Antilles	227,000

NORWAY	
1 Svalbard	2,100
2 Jan Mayen Island**	18
3 Bouvet Island	0
4 Peter I Island	0
5 Queen Maud Land	0

UNITED KINGDOM	
1 Pitcairn Islands††	66
2 Cayman Islands	49,000
3 Turks and Caicos Isl.	22,900
4 Bermuda	66,500
5 British Virgin Islands	24,500
6 Anguilla	14,100
7 Montserrat	5,100
8 Falkland Islands	3,100
9 British Antarctic Territory***	400/50
10 South Georgia and the South Sandwich Islands	0
11 Rockall	0
12 Shetland Islands	22,000
13 Isle of Man	76,500
14 Channel Islands	150,000
15 Gibraltar	28,000
16 St. Helena†††	7,600
17 Akrotiri and Dhekelia	15,700
18 Brit. Indian Ocean Terr.	4,000

UNITED STATES	
1 Wake Island	0
2 Midway Islands	150
3 Johnston Atoll****	1,200
4 Kingman Reef	0
5 Palmyra Atoll	0
6 Howland Island	0
7 Baker Island	0
8 Jarvis Island	0
9 American Samoa	65,600
10 Navassa	0
11 Puerto Rico	3,971,000
12 Virgin Islands	109,800
13 Guam	178,400
14 N. Marianas Isl.	88,600

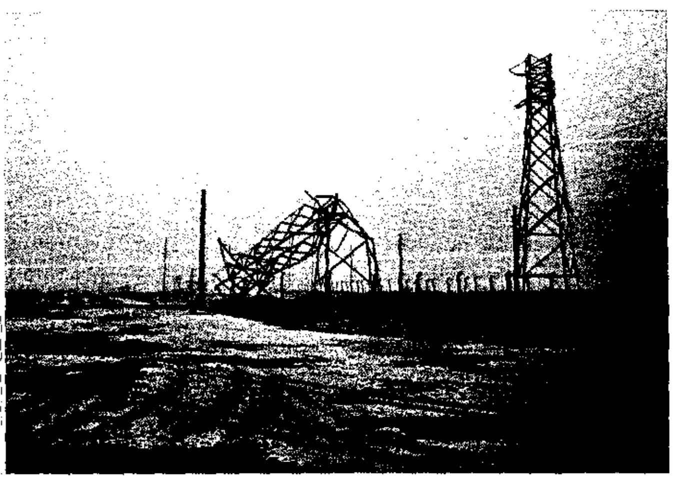
onstrate that France is willing to defend Abu Dhabi and to send that signal to Iran, less than 300 kilometers away. But more than a show of force, it's a show window for big-ticket French weapons systems that Paris would like to sell in the region. Unlike other French bases overseas, there is no history of French claims to sovereignty. Abu Dhabi wants to diversify its reliance on foreign defense forces. And—what is certainly the biggest break with the past—Abu Dhabi is footing the bill.

Guadeloupe and Martinique in the Caribbean are more typical. They are considered part of France's national territory, like the states of the United States. Yet despite massive subsidies funded by French taxpayers, they have been the scene of so much unrest over the past few months that Sarkozy has postponed a planned visit several times. The islanders are not fighting for independence, mind you, just for better deals from Paris to compensate for the higher cost of living in these tiny markets that have grown dependent on imports from a distant mainland.

Altogether, France's overseas possessions add about 2.6 million people to its population and 120,000 square kilometers of land to its territory, and give France the third

*COLLECTIVELY KNOWN AS FRENCH SOUTHERN AND ANTARCTIC LANDS. †SOLDIERS. **METEOROLOGISTS. ††PITCAIRN, HENDERSON, DUCIE AND OENO ISLANDS. ***SUMMER/WINTER POPULATION OF SCIENTISTS. †††INCLUDES ASCENSION AND TRISTAN DA CUNHA ISLANDS. ****STATIONED WORKERS (INCLUDES ABOUT 960 CIVILIAN AND 250 MILITARY PERSONNEL). GRAPHIC BY STANFORD KAY—NEWSWEEK

HIGH COSTS IN KHARMA, IRAQ (LEFT); A SANDSTORM IN SADR CITY.



largest area of exclusive maritime rights in the world. They produce nickel ore and codfish, they provided testing areas for atomic weapons in the past and are the site of launching pads for space exploration to this day. Yet whatever the benefits, the responsibilities and costs are greater. "Through the 1980s and even into the 1990s, some of these arguments carried real weight," says Robert Aldrich, author of *Greater France: A History of French Overseas Expansion*. Now, however, they are mainly a drain on the French budget, costing an estimated €16.7 billion per year. "In some ways," says Aldrich, "they are like old family jewels, perhaps not so valuable in monetary terms, though with a certain sentimental value."

Sentimental indeed. In the latter half of the 1980s, New Caledonia was on the verge of full-scale insurrection. Earlier this year the contagion of unrest spread quickly from Guadeloupe halfway around the world to the French island of Réunion in the Indian Ocean. Undeterred, Paris pushed ahead this spring to make Mayotte, a tiny island between Madagascar and Mozambique, the 101st *département* of the French Republic. The residents will be taxed, and receive welfare benefits—mainly the latter—just like on the mainland. They will be fully represented in the French Parliament and will be able to vote in all elections, including the European ones, because they will be considered Europeans, too. And eventually they will have to observe all of France's and Europe's laws and regulations.

The ostensible reason Paris took this decision is because that's what the people of Mayotte want. When the whole of the Comoros archipelago voted on its future in 1974, the other islands went for independence. Mayotte went for ... dependence. And in the referendum this March, the people voted overwhelmingly for even closer ties. In a wondrous bit of rhetorical excess, French Interior Minister Michèle Alliot-Marie said the whole show was "reaffirming the values that forge, today as yesterday, the unity of our Republic and our everlasting democracy."

Clearly the old "mission to civilize" endures, however culturally anomalous the results might be. Of the roughly 180,000 Mahorais, almost all are Muslims, and polygamy is widespread. But polygamy will now be against the law on Mayotte as it is in France. The problem of illegal immigration from the other Comoros islands to Mayotte, meanwhile, is enormous. Roughly a third of the population is considered, as the French say, *clandestin*. Many are pregnant women who risk their lives so their children will be born "in France" and be eligible for citizenship. The overall birthrate is such that in the next 15 years the population could reach 300,000. Already the maternity ward of the main hospital in Mayotte is France's busiest, with 20 babies born a day. Employment prospects for the kids as they grow up are slim. Of the 4,000 who enter the job market each year, only 1,000 find work. And then there's the position of the Islamic Republic of Comoros, which rules the other islands. It may be one of the most unstable governments in the world, but it claims that Mayotte is still part of its territory, and so does the United Nations.

Indeed, attempts by the French to explain why France wants Mayotte verge on the surreal. Left-wing critics charge, with no apparent sense of irony, that the French mainland wants to exploit Mayotte for its vanilla beans and the aromatic oil of the ylang-ylang tree. If the real motive to hold on were its strategic naval value at the head of the crowded Mozambique Channel, then it's surprising a French base planned for Mayotte in the 1970s has never been built.

In fact, what made global strategic sense for Admiral Mahan in the 19th century, when he advised grabbing footholds in foreign lands, is not so logical today. In a world of missiles, nukes and Internet-inspired terrorists with box cutters, the projection of political influence is at least as important as the projection of force. The idea of empire is no longer plausible, the reality of it no longer credible. The problem is not just that old imperialists had no exit strategy, it's that in some places, there's no exit to be found.

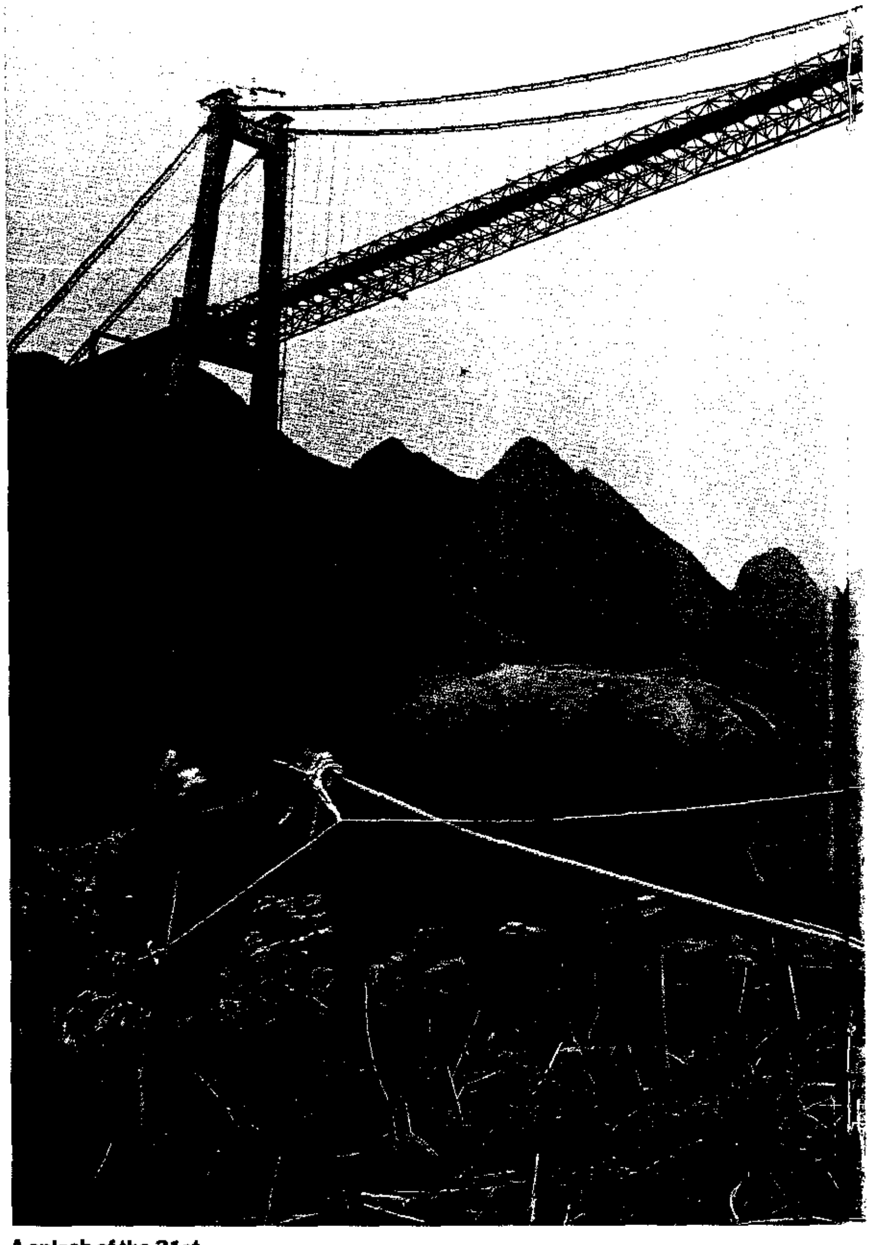
With TRACY MCNICOLL *in Paris*

TIME: JUNE 1, 2009

WORLD

Rebuilding The Middle Kingdom. To cushion itself against recession, China is investing in one of the most ambitious public-works programs ever seen

BY SIMON ELEGANT/BEIJING AND AUSTIN RAMZY/GUANLING



A splash of the 21st century *Farmer Wei Xinyuan plows his field in the shadow of the Baling River Bridge in Guizhou province*

GUIZHOU PROVINCE, IN SOUTHwestern China, is a place of striking natural beauty: jagged peaks surrounded by fields of bright green rape, ridges slashed with limestone outcrops and plunging waterfalls. But these days the region's grandest sight is man-made: the Baling River Bridge. Due to be completed early next year, this 1.4-mile (2.25 km) marvel of engineering is a jarringly conspicuous splash of 21st century technology amid Guizhou's farms and rice fields, which haven't changed much in thousands of years. It's as if the Golden Gate Bridge had been dropped into some bucolic Middle-earth mountainscape.

Out of place as it may appear, this is no bridge to nowhere. Soaring a quarter-mile (400 m) above the Baling River, the $216 million span will reduce travel time considerably for the stream of trucks and cars traversing a highway that connects the provincial capital, Guiyang, with the

 Photographs for TIME by Ariana Lindquist nearest big city, Kunming, the capital of neighboring Yunnan province. Far from resenting the bridge as a white elephant, the residents of nearby Guanling, a one-stoplight town where the average income is less than $150 a year, view it as crucial to economic development and improvement in their lives. "I really cannot wait for the bridge to be completed," says Yuan Bo, 25, a graphic designer who takes a two-hour bus ride every week from his home in Anshun to help in his family's Guanling restaurant.

What's good for Yuan Bo and Guanling is good for China. While the recession-racked West debates the wisdom of borrowing billions of dollars and spending it on economic stimulus, China is reaching into its vast financial reserves to launch one of the most ambitious and expensive public-works programs ever undertaken. The Baling River Bridge is only one of hundreds of infrastructure projects—ports, airports, bridges, schools, hospitals, highways, railroads—on which China plans to spend about $450 billion over the next several years. Announced in November, this pumped-up New Deal is aimed at more than cushioning China's economic fall as the global recession bites deeply into the country's manufacturing and export sectors. The new projects will make it much easier for commerce and people to move around China, hence stimulating domestic demand and reducing China's economic reliance on exports, vital as rich world consumers rebuild their balance sheets and international trade contracts.

China's leaders are using the financial crisis as an opportunity to consolidate gains already made in the country's global competitiveness while laying a foundation for even greater progress in the future—and for the international power that economic prowess can bring. Nationalist voices in the media are already framing the crisis as a transformational moment in China's rise and the decline of the U.S. "They've criticized the dollar and asked for a new global reserve currency. They've criticized the U.S. role in the International Monetary Fund," says Beijing-based China scholar Russell Leigh Moses. Premier Wen Jiabao recently pleaded with Washington to safeguard China's investment in U.S. bonds, which will decline in value if the dollar weakens on foreign-exchange markets. That too, says Moses, was a reminder to the U.S. that "you aren't in the driver's seat anymore and maybe you should move over."

For an economy like China's, which is the world's third largest but is still

16%

Percentage, coming to $586 billion, that will be spent under the stimulus package

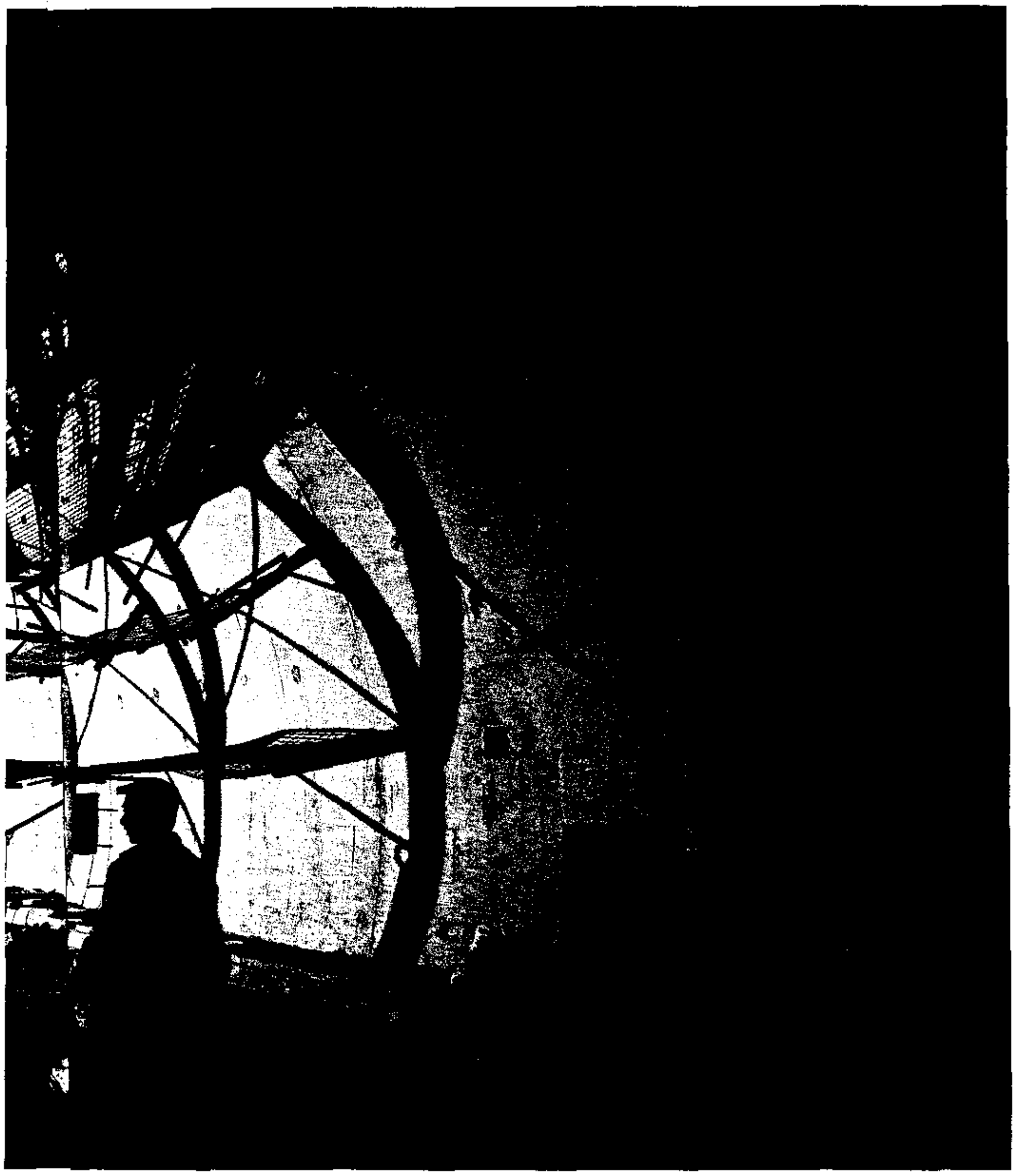
75%

Percentage of the total spending that will be devoted to infrastructure projects—ports, airports, schools, highways, railroads, hospitals—which will create thousands of jobs

Bringing development to the provinces *A construction worker walks through a tunnel leading to the Baling River Bridge*

just a third the size of the U.S.'s, the scale of the package is staggering. Total new spending is pegged at $586 billion, about 16% of GDP. In contrast, the $787 billion stimulus package approved by the U.S. Congress in February is just 6% of GDP. While upwards of 75% of Chinese spending will go toward infrastructure, just 10% of U.S. spending will. The difference to an extent reflects the fact that the nations are at different stages of economic development: America's railroad networks were built in the 19th century (and show it), and its interstate-highway system was mainly constructed in the 1950s and '60s. But it also speaks to the sheer scale of China's ambition to modernize itself.

Inevitably, some critics complain that Beijing has released few details of where the money will go and that some of the funding is not new: the package, for example, includes $147 billion for reconstruction in areas of Sichuan province that were devastated by a 2008 earthquake, money that would have been spent in any event. But wherever you go in China now, you come across projects that boggle the mind. In late March, for example, the government began soliciting bids for the Hong Kong–Zhuhai–Macau highway, a bridge-and-tunnel complex 16.5 miles (26.6 km) long that will allow connections among 35 ports in the Pearl River Delta, the cradle of China's economic boom. When completed in 2015, the $10 billion project will cut driving time from Hong Kong to the



industrial area of Zhuhai from about four hours to just 30 minutes.

Looking to the West

ARE SUCH HUGE PROJECTS REALLY NECESSARY? China, with its gleaming coastal cities and modern transport hubs, is already the envy of developing countries like India. And from Alaska to Japan, there are plenty of examples around the world of infrastructure projects that owed more to local politicking than to real economic need. Most of China's stimulus spending, critics note, will be supervised by local governments. This will undoubtedly mean that some money will end up lining the pockets of corrupt bureaucrats.

Yet there are early signs that the massive influx of government spending is already accomplishing its main goal: easing China's economic slowdown, which has been headlined by double-digit declines in exports, thousands of factory closures and the layoff of about 20 million workers. Economic statistics for the first quarter of 2009 were surprisingly positive, leading some economists to conclude that the rate of contraction was slowing and that China might be on the road to recovery. Power-generation and transportation statistics, key indicators of the economy's direction, registered modest increases in March after months of decline. Banks lent money at record levels, investment showed signs of recovery, and auto sales grew nearly 3.9% in the first quarter compared with the same period last year, thanks to subsidies for new-car buyers and lower sales taxes. The results led Wen to conclude that "Chinese government policy has been timely, correct and decisive."

'They've criticized the dollar and asked for a new global reserve currency. They've criticized the U.S. role in the IMF.'

—RUSSELL LEIGH MOSES, BEIJING-BASED CHINA SCHOLAR, ON THE LEADERSHIP'S NEW ASSERTIVENESS

China, of course, has certain advantages when it comes to managing shifting economic winds. There's no peskily powerful Congress to worry about, for one thing; what the Chinese government wants in the way of policy, it gets. Christopher Wood, chief Asia strategist for the brokerage and investment firm CLSA, says the fact that China's economy is a hybrid of capitalism and a socialist command economy has given the government much greater flexibility to intervene. Beijing more or less ordered Chinese banks to increase lending in response to the global financial meltdown. Wood, a former journalist well known for predicting the bursting of Japan's bubble 20 years ago, says he expects the beneficial effects of China's stimulus spending to continue for three to six months. While other Asian economies are expected to suffer sharp contractions in 2009, CLSA is predicting that China will hit its government-set GDP growth target of 8% this year, following a drop in the first quarter to 6.1%, the slowest annual growth rate since at least 1992.

But for any recovery to last beyond the end of the year, China's crucial manufacturing and export sector must revive. Otherwise, Wood says, stimulus spending could result in a "skewed outcome": billions of dollars in loans made to artificially boost growth could start to go bad, dragging down China's banks; at the same time, the country would remain saddled with a glut of factories producing a vast surplus of goods no one wants to buy.

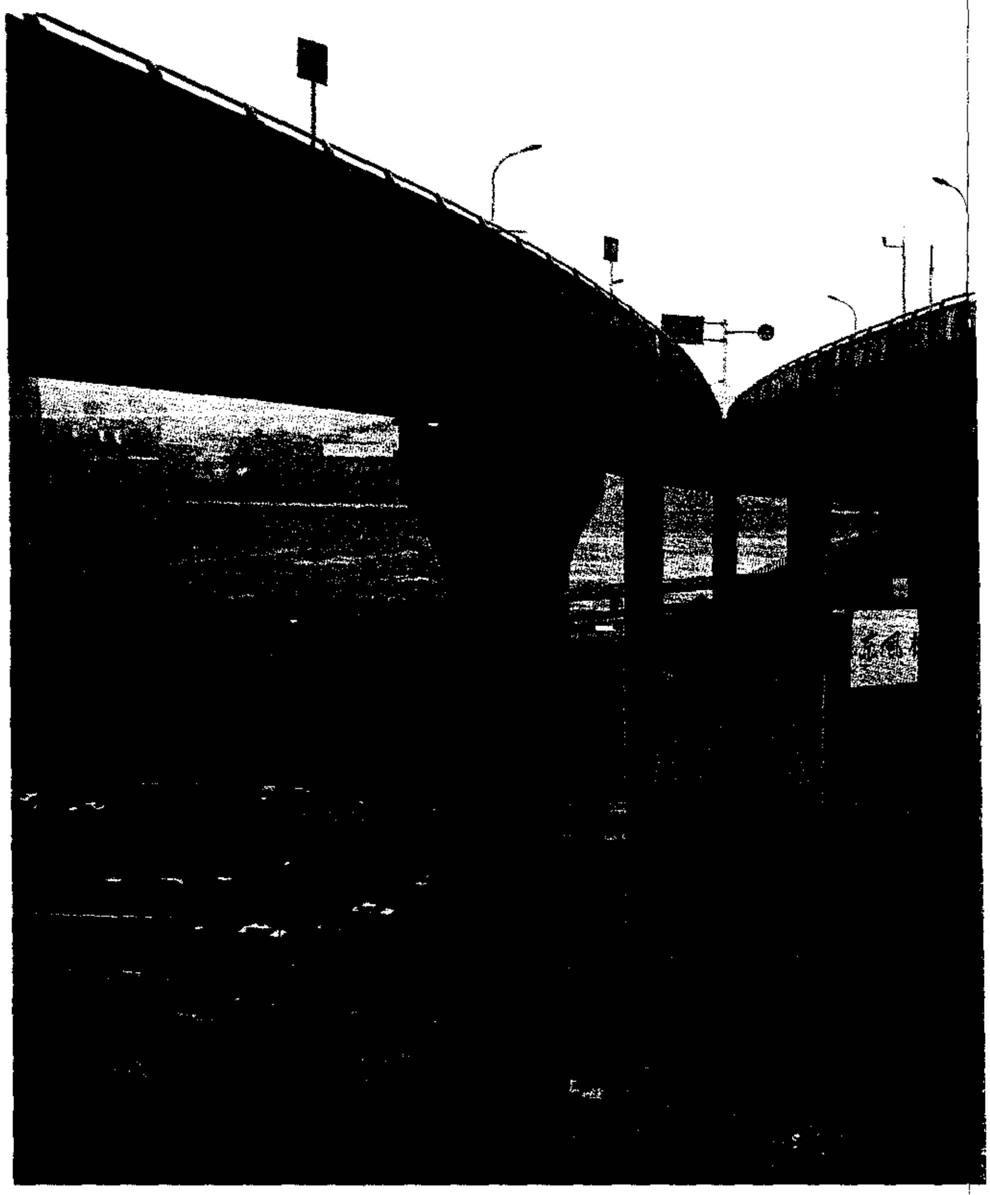
While the stimulus package has risks, it also affords China a chance to rebalance the country's growing wealth. One by-product of China's prolonged expansion is that coastal regions—marked by boomtowns such as Shanghai, Guangzhou, Xiamen and Tianjin as well as their hinterlands—have grown much faster than the country's interior provinces, which have always been poorer. For years the central government has tried various policies to lift western China, without much result. The infrastructure push gives Beijing another chance to address divisive and potentially explosive wealth gaps that have grown between east and west, rich and poor.

City on a Hill

THESE DIVISIONS, AND THE GOVERNMENT'S push to reduce them, are evident in the southwestern megalopolis of Chongqing. Built on the hilly banks of the Yangtze River, this ancient trading center was the effective capital of China during World War II and today is one of the world's largest municipalities, with a population of 31 million. The brightly lit buildings along the Chongqing riverfront display a cosmopolitan sophistication. But that impression quickly fades as you leave the city for the corrugated hills outside. "In Chongqing, the transportation system and so on are quite developed," says Shen Xiaozhong, deputy director of the city's office of the National Reform and Development Commission. "But go out 30 km from the city—not that far—and the conditions are still pretty poor." Truth to tell, they're bad enough in parts of the city itself, where legions of "stick stick" men line the sidewalks hoping to earn a few dollars carrying goods up the town's steep hillsides, reminding all who see them of China's lingering poverty.

Shen says government infrastructure projects have already created 20,000 jobs in Chongqing this year, mostly in construction. He outlines development plans that could pass for a battle strategy, with lines of attack—in this case, faster rail lines—spreading from Chongqing across the country. In response to the economic crisis, Beijing accelerated its schedule for improving the country's rail networks by five years. As a result, travel time for a train journey from Chongqing to Beijing is expected to fall from 25 hours to seven by 2015. That's just the start. Another runway will be added to Chongqing's airport, the electrical grid will be upgraded, $5.8 billion will be spent on improving public water supplies, and wastewater treatment will be expanded to cover 90% of urban sewage, up from about 70% now.

In Chongqing, signs of public-works programs are everywhere. A walk through the extensive stairways and underground markets that make up the city's downtown is interrupted by detours and periodic detonations, the result of work on

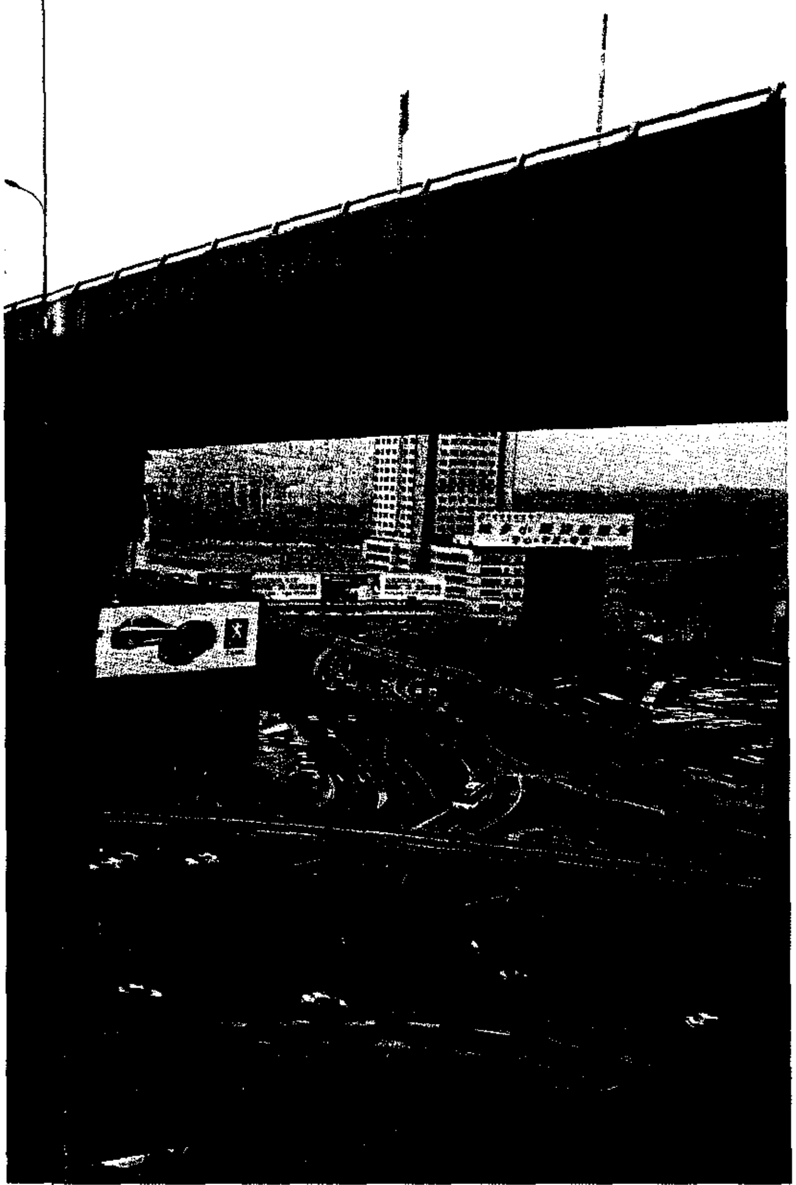


'We still need at least 20 years to develop infrastructure to catch up with developed countries.'

—SHEN XIAOZHONG, DEPUTY DIRECTOR, CHONGQING OFFICE OF THE NATIONAL REFORM AND DEVELOPMENT COMMISSION

a new light-rail system scheduled to be completed by 2011. "We still need at least 20 years to develop infrastructure to catch up with developed countries," says Shen. "For China, the infrastructure projects are not only temporary measures to get the country out of the downturn but an opportunity to prepare for the economy to take off in the future."

China is using the stimulus package to play catch-up on another front: the environment. Three decades of rapid, unchecked economic growth has turned many of the country's rivers into cesspools and lands into wastelands and much of its air into grimy soup. Some $30.9 billion has been officially allocated under the stimulus plan for "environmental projects" to help clean up the mess and put the country on



8%

China's GDP growth target for '09

3%

Congressional Budget Office's projection of U.S. GDP contraction for '09

Pouring the concrete *Chongqing, China's effective capital during World War II, is being rebuilt*

a path to more sustainable development. The government of Jiangsu province, for example, recently announced a $16 billion plan to clean up Lake Tai, once famed for its beauty and abundant fish but now better known for the choking algae blooms caused by industrial runoff that has made the water undrinkable for the millions who depend on it. "We are not taking environmental protection as a second priority," Jiangsu Governor Luo Zhijun recently told local reporters. "For us, it is just as important as economic development."

Mountain High, Emperor Far Away

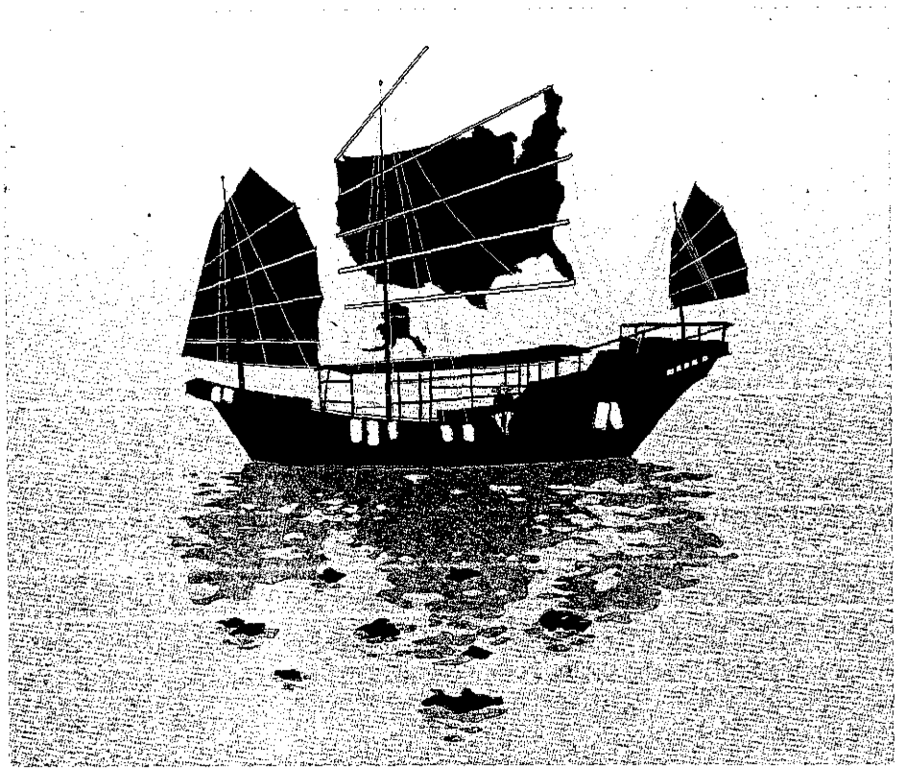
NO MATTER HOW WELL INTENTIONED, China's stimulus package may provide little more than a short-lived growth blip if officials are unable to control the perennial bugbear of Chinese economic development: pervasive corruption in local and provincial governments, which make their own way far from the brilliant technocrats in Beijing.

Take the case of a project already under construction in Yan'an, the end point of the Long March, a place steeped in symbolism for Chinese people. A few steps from a memorial to Zhang Side—a soldier who, after being killed while hauling charcoal in 1944, was picked by Mao Zedong to serve as an example of selfless communism—is the entry to a tunnel. Someday it will be part of a highway that leads west from Yan'an. The key word is *someday*. The Shazuimao tunnel, which faces a mountain that bears giant characters in Mao's calligraphy reading SERVE THE PEOPLE, has been delayed four times by workers protesting over unpaid wages. The city's transportation department and the local Communist Party discipline office are investigating allegations that the company originally hired to dig the tunnel subcontracted the work to an unqualified firm while pocketing a portion of the funding. "There's always money and corruption involved," grumbles a farmer named Wang who lives nearby. Authorities haven't completed their investigations, but there's no denying the delays. A banner at the mouth of the tunnel announces a completion date of October 2008. "This project has been a disaster for us," says Wang. "We would be lucky to have it done by this October."

Graft was rife in construction projects long before the current downturn. "Public spending is already subject to considerable siphoning off and, perhaps even more critically, waste," says Andrew Wedeman, a political scientist and Chinese-corruption expert at the University of Nebraska. During the boom years, such waste mattered less because growth was so robust. But if China's GDP expands only 6% to 8% this year, as some predict, corruption could dampen recovery. "What really matters is not if funds will be siphoned off or how much will be siphoned off," Wedeman says, "but rather whether the siphoning will have a clear and negative impact on the central government's efforts to restimulate the economy."

But notwithstanding the amounts that will disappear into bank accounts in Hong Kong, casinos in Macau and the gaudy houses that stud the outskirts of every Chinese city, China stands to gain more than it loses through its building campaign. The scale of its needs remains immense: the country's leaders are, after all, attempting to move more people out of dire poverty and into something like comfort in a shorter time than has ever been seen before in human history.

And so the work goes on. At the base of a $527 million bridge being built across the Yangtze River in Chongqing, dozens of dump trucks and backhoes rumble amid boulders and mud to prepare an access road to the span, scheduled to be completed this month. "It's good not having to worry about finding work and getting paid," says a laborer named Yang, who is helping construct the Chongqing Grand Theater, a magnificent music and opera house being built on a river headland within sight of the Chaotianmen bridge. "There are so many public projects going on, there will always be a place for me." —WITH REPORTING BY LIN YANG/GUANLING ■



GLOBAL INVESTING

No Sail. Why rising hopes for an Asia-led recovery are bound to founder

BY STEPHEN ROACH

THE SPIN GAME IS ON AS THE WORLD TRIES to talk itself out of the worst recession since the end of World War II. The good news is that there is a slowing in the rate of deterioration in the global economy. The tougher news is that this is hardly surprising. In the aftermath of unprecedented annualized plunges in real global GDP on the order of 6% to 7% in the fourth quarter of 2008 and the first quarter of 2009, the pace of deterioration almost had to moderate.

With history books replete with tales of *V*-shaped recoveries following steep downturns, financial markets have become giddy, hoping that signs of bottoming beget the long-awaited rebound. Nowhere is that more evident than in Asia, an increasingly China-centric region convinced it will lead the world out of its long nightmare.

If it were only that easy. Contrary to the lore of the "Asia century," the region continues to suffer from a lack of internal support from its 3.5 billion consumers. The private-consumption share of developing Asia's overall GDP fell to a record low of 47% in 2008—down from 55% as recently as 2001. In other words, Asia remains an export machine. Developing Asia's export share rose from 36% of pan-regional GDP during the financial crisis of 1997-98 to a record 47% in 2007. And recent research by the International Monetary Fund shows that Asian exports continue to be underpinned by demand from consumers in the industrial world—especially from the U.S. Despite a surge of trade within Asia, the bulk of these intraregional flows have been concentrated in parts and components that go into finished goods eventually consumed by developed economies.

Little wonder that in the aftermath of a record contraction in U.S. consumer spending in late 2008—4% average annualized declines in the final two quarters of the year in real terms—every major economy in Asia either slowed sharply or tumbled into deep recession. More than ever, the region's fate remains made in America.

If export-led China doesn't get a kick from the American consumer, a relapse for China-dependent Asia is a distinct possibility next year

This is where hopes of an Asia-led rebound are most tenuous. After a dozen years of excess, the overextended American consumer is tapped out. The "green shoots" crowd—those believing global recovery is nigh—drew special encouragement from a 2.2% rebound in real U.S. consumer expenditure in the first quarter of 2009. That encouragement is about to be dashed. Outright contractions in retail sales in March and April point to a renewed decline of at least 1% in real consumption in the current quarter.

Hit by the triple whammy of collapsing property values, equity-wealth destruction and ongoing unemployment shock, the American consumer is unlikely to spring back overnight. In fact, with asset-dependent U.S. households remaining income-short, overly indebted and savings-deficient, subdued consumption growth is likely for years. This is because the U.S. consumption share of real GDP, which hit a record 72.4% in the first quarter of 2009, needs, at a minimum, to return to its pre-bubble norm of 67%. That spells a sharp downshift in real consumption growth from the nearly 4% average pace of 1995 to 2007 to around 1.5% over the next three to five years. There will be years when the consumer falls short of that pace. The contraction of more than 1.5% over the past four quarters is a case in point. And there will be years when consumption appears stronger. But the die is cast for a protracted weakening of the world's biggest spender.

Therein lies a critical challenge for Asia. Unless it comes up with a new source of demand to support its export-led growth model, Asia will face stiff and enduring headwinds. Nowhere is this more evident than in China, where the mood has turned particularly upbeat. While I no longer doubt that China's performance will be better than expected in 2009, there is good reason to be wary of extrapolation. China's incipient rebound relies on a timeworn stimulus formula: upping the ante on infrastructure spending to support growth in anticipation of a return of global demand for Chinese-made goods. It's the latter presumption that remains iffy as the U.S. opts for prudence over profligacy.

If export-led China doesn't get a kick from the American consumer, a relapse for China-dependent Asia is a distinct possibility next year. Don't be fooled by catchphrases such as "green shoots" and the "Asia century." In the aftermath of the modern world's worst financial crisis and recession, an Asian-led global healing remains a real stretch. ■

Stephen Roach is chairman of Morgan Stanley Asia and was the firm's chief economist

ILLUSTRATION FOR TIME BY SHOUT

PROFILE

A Developing Vision

Egyptian Finance Minister Youssef Boutros-Ghali is bringing fresh thinking to the International Monetary Fund's powerful policymaking committee

BY BOBBY GHOSH

HIS STORIED SURNAME SITS LIGHTLY ON Youssef Boutros-Ghali's shoulders. "People recognize it, and my family is used to that because we've been in politics and government since the 1800s," says Egypt's urbane Finance Minister. The family name acquired international renown in 1991, when his uncle was elected Secretary-General of the United Nations. Then came ignominy. Denounced as divisive and incompetent by the U.S. and other Western nations, Boutros Boutros-Ghali became the first Secretary-General not to be re-elected for a second term.

Last October, some of those same Western nations helped elect Youssef chairman of the International Monetary Fund's policymaking committee, giving him a powerful voice in determining the IMF's role in the global economic crisis. It's the first time a non-Westerner has held the job, and Boutros-Ghali knows he carries the developing world's expectations. His main task, he says, is to get the IMF to better understand its borrowers. "[I've] experienced the pointy end of IMF policies," he says. "I bring a view different from a G-7 Finance Minister. I am sensitive to different things—I can help to change the optics."

'[I've] experienced the pointy end of IMF policies. I am sensitive to different things—I can help to change the optics.'

—YOUSSEF BOUTROS-GHALI, CHAIR, IMF POLICYMAKING COMMITTEE

To get the rich nations to see things differently will require diplomatic skills that often eluded his uncle, a dour and sometimes acerbic figure who clashed publicly with the U.S. over the Balkan wars, the genocide in Rwanda and Washington's unpaid U.N. dues. "My uncle tends to more public display, he tends to be more blunt," Boutros-Ghali says. "[At the IMF] different things are at stake. I will pound my fists in a closed room; there's nothing to be gained from doing it in public."

That prudence was one of several qualities that won Boutros-Ghali the IMF job. His track record as Egypt's Finance Minister was another: under him, the notoriously sclerotic Arab nation has grown at an annual rate of 7%. "He's seen as a facilitator, somebody who can generate progress," says Eswar Prasad, professor of trade policy at Cornell University and former head of the IMF's China division. "In Egypt, he's been able to operate under significant institutional and political constraints—that's valuable experience when you're dealing with the IMF."

For all his tact, however, Boutros-Ghali is not averse to holding up a mirror to the rich nations every once in a while. On the eve of April's G-20 summit in London, he warned that giant stimulus plans like those announced by the U.S. and the U.K. could lead to a humanitarian catastrophe in the developing world, because borrowing by rich countries would divert funds from the poor. "People are going to die, babies are not going to get the proper nourishment," Boutros-Ghali said. "Poverty is at the doorstep, something needs to be done."

The warnings, echoed by prominent economists, were heeded. At the London summit, the rich nations, wrangled by U.S. Treasury Secretary Tim Geithner, decided to triple the IMF's resources to $750 billion. After nearly a decade on the sidelines, it was suddenly a player again. "The IMF is back," crowed IMF managing director Dominique Strauss-Kahn. Boutros-Ghali is more cautious: "Now we need to make sure the money shows up, that it wasn't just pious words."

In the current crisis, the IMF faces a familiar dilemma: Should borrowers be required to undertake wholesale reforms in order to win loans? In the past the IMF has imposed tough conditions on borrowers, requiring them to prioritize economic and financial reforms ahead of political and social considerations. It's an issue that must be addressed anew, says Boutros-Ghali. "You want a minimum set of policies to make sure things don't get worse," he says. "[But] do we tell them to adjust right now, when it's most difficult? Or do we just give them the money?"

The policymaking committee's other critical task is to reform the IMF itself. Its 24-member executive board is dominated by Western nations, and doesn't take into account the rise of new powers like Brazil, Russia, India and China—the BRIC nations. Under a complex system of voting rights, Italy has greater clout than Russia or India. "Belgium and the Netherlands have one seat each, the same as Brazil, which is totally absurd," says Cornell's Prasad.

Geithner has said he'd like to see the board reduced to 20 seats, with more say for the BRIC bloc. Although that makes economic sense, it will be very hard to achieve, warns Prasad: "It's a zero-sum game: for someone to gain a bigger role, someone else has to lose theirs."

Egypt is not a BRIC nation, which may make Boutros-Ghali the ideal man for the position, says Desmond Lachman, an expert on multilateral lending institutions at the American Enterprise Institute: "If the Chinese wanted [the chair of the policy committee], there would have been friction with other emerging economies, like India. Boutros-Ghali, coming from a smaller country, can be even-handed."

Boutros-Ghali will also need to keep a close eye on his country's own economy: the global downturn has hit Egypt's growth. "The big problem is that it will slow job creation, and we can't afford that," Boutros-Ghali says. But, he adds, there's no reason to panic just yet: "We have a comfortable balance of payments and reserves." With a little luck, Egypt may escape the "pointy end" of the IMF's policies this time. ■

Photograph for TIME by Andrew Cutraro