



Institute of Strategic and International Studies (ISIS) Malaysia

**CURRENT ECONOMIC SITUATION
(SELECTED ARTICLES FROM MAGAZINES)**
Amendment & updated version

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**INFORMATION SERVICES DIVISION
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CONTENTS

CURRENT ECONOMIC SITUATION

1. China's doubts about the dollar by Steve LeVine and Dexter Roberts. **Businessweek**, June 8, 2009, pp.-.
2. Can China topple the dollar by Daniel Drezner. **Businessweek**, June 8, 2009, pp. 8.
3. China rethinks the American way by Dexter Roberts. **Businessweek**, June 15, 2009, pp. 32.
4. Does the elephant dance? **The Economist**, June 6, 2009, pp. 31.
5. An (iron) fistful of help. **The Economist**, June 6, 2009, pp. 57.
6. In the blood. **The Economist**, June 6, 2009, pp. 72.
7. The biggest bill in history. **The Economist**, June 13, 2009, pp. 11.
8. **A special report on the euro.** Holding together. **The Economist**, June 13, 2009, pp. 3-5.
9. **A special report on the euro.** A tortuous path. **The Economist**, June 13, 2009, pp. 4.
10. **A special report on the euro.** One size fits none. **The Economist**, June 13, 2009, pp. 5-7.
11. **A special report on the euro.** No exit. **The Economist**, June 13, 2009, pp. 7-8.
12. **A special report on the euro.** The non-nuclear options. **The Economist**, June 13, 2009, pp. 8-10.
13. **A special report on the euro.** Fear of floating. **The Economist**, June 13, 2009, pp. 10-12.
14. **A special report on the euro.** Soft centre. **The Economist**, June 13, 2009, pp. 13-15.
15. **A special report on the euro.** Warmer inside. **The Economist**, June 13, 2009, pp. 15-16.
16. The big sweat. **The Economist**, June 13, 2009, pp. 70-72.
17. Promises, promises. **The Economist**, June 13, 2009, pp. 77.
18. Dismal science. **The Economist**, June 13, 2009, pp. 77.

19. Fatalism v fetishism. **The Economist**, June 13, 2009, pp. 78.
20. No exit. **The Economist**, June 20, 2009, pp. 16.
21. Not just straw men. **The Economist**, June 20, 2009, 2009, pp. 58-60.
22. The trail of disaster. **The Economist**, June 20, 2009, pp. 59.
23. Breaking free. **The Economist**, June 20, 2009, pp. 61-62.
24. Taming a wild beast. **The Economist**, June 20, 2009, pp. 68.
25. Reap what you sow. **The Economist**, June 20, 2009, pp. 69-70.
26. Not so fast. **The Economist**, June 20, 2009, 2009, pp. 70.
27. Burying Asia's savage past. **The Economist**, June 27, 2009, pp. 42.
28. A new (under) class of travelers. **The Economist**, June 27, 2009, pp. 67-68.
29. When the learning curve is long. **The Economist**, June 27, 2009, pp. 68.
30. Shopaholics wanted. **The Economist**, June 27, 2009, pp. 79-81.
31. Tied to the mast. **The Economist**, June 27, 2009, pp. 80.
32. Thirst-quenching. **The Economist**, June 27, 2009, pp. 81.
33. Sleep therapy. **The Economist**, June 27, 2009, pp. 81-82.
34. Duties call. **The Economist**, June 27, 2009, pp. 82-83.
35. Deliver us from competition. **The Economist**, June 27, 2009, pp. 84.
36. We owe what? by Shawn Tully. **Fortune**, June 22, 2009, pp. 36-40.
37. What Japan got right by Robert Alan Feldman. **Newsweek**, June 22, 2009, pp. 23.
38. The insurgents : the secret battle to save capitalism by Michael Hirsh. **Newsweek**, June 22, 2009, pp. 32-
39. Greed is good (to a point) by Fareed Zakaria. **Newsweek**, June 22, 2009, pp. 35-
40. The empire burden by Christopher Dickey. **Newsweek**, June 22, 2009, pp. 44-48.
41. The rebuilding the Middle Kingdom by Simon Elegant and Austin Ramzy. **Time**, June 1, 2009, pp. 26-31.
42. No sail by Stephen Roach. **Time**, June 8, 2009, pp. 44.

43. A developing vision by Bobby Ghosh. **Time**, June 8, 2009, pp. 22.
44. After the bubble by Bill Powell. **Time**, June 29-July 6, 2009, pp. -91.
45. The end of the affair by Justin Fox. **Time**, June 29-July 6, 2009, pp. 31.



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.

\$2 trillion

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

Data: BusinessWeek

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|

CAN CHINA TOPPLE THE DOLLAR?

BY DANIEL DREZNER

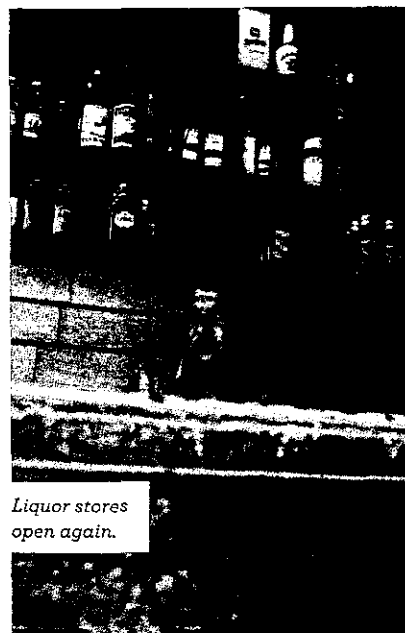
CURRENCY TO HEAR SOME TELL IT, China is campaigning to topple the dollar as the world's reserve currency, and just might get the job done soon. In March, China's central-bank governor, Zhou Xiaochuan, proposed the creation of "a super-sovereign reserve currency," and while he did not mention the dollar 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 curren-

cy 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.



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 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.



The dollar's reign won't end soon.

CHINA RETHINKS THE AMERICAN WAY

Mainlanders still relish U.S. products, but their view of U.S. management is increasingly negative

COMMENTARY



Geithner (right) is trying to reassure the Chinese their U.S. investments will be safe

By Dexter Roberts



BEIJING

As a journalist in China for nearly 15 years, I've had to play a second role as something of a guide to American culture. In the small talk that inevitably follows interviews with government or industry bigwigs, I'm sometimes asked: "How is this done in the States?" That's because China has often sought to emulate the American economic system. A planned stock exchange was pitched as a "Chinese Nasdaq." A central bank reform was modeled on the U.S. Federal Reserve system. And officials and executives alike boast that their staffers have spent time in the U.S., a badge of honor in China.

As Treasury Secretary Timothy Geithner motorcaded his way through Beijing this week, though, it became clear that mainlanders have far less respect for the American Way these days. While there's scant evidence that Chinese youth are avoiding McDonald's, KFC, or the myriad other beacons

of U.S. culture that dot the landscape, American management has fallen out of favor. "I used to think the U.S. was a very good country," says Li Mo, a 26-year-old wearing a red LeBron James T-shirt and sipping an iced mocha in a Beijing Starbucks. "But after the financial crisis, I began to think China is the best place in the world."

That's not to say people here are happy about Beijing's management of the economy. In fact, plenty of Chinese feel their country has too closely followed the lead of Washington—or Wall Street. China's sovereign wealth fund, the China Investment Corp., has been roundly criticized for losses (on paper, at least) of \$4 billion on investments in New York financial houses Blackstone Group and Morgan Stanley. And many

Critic Wang Xiaodong says the U.S. has focused too much on its financial sector while sending manufacturing offshore

fear Beijing may ultimately take a far bigger bath on the \$1.4 trillion-plus in U.S. securities it holds.

Much of the discontent is showing up on China's freewheeling Internet forums. On these Web sites, countless postings attack U.S. banks and politicians for reckless behavior. The U.S. economy "is like a dump truck just starting to tip," reads one comment on the Web site of broadcaster CCTV. On a hyper-patriotic online forum called Revival, another post declares that "anyone who sends money to the U.S. is betraying the Chinese people!"

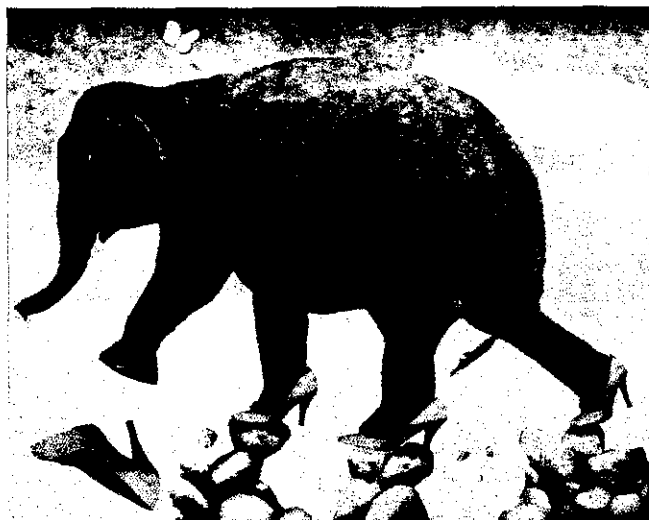
STOP TRYING TO PLEASE

Wang Xiaodong may be one of the most vociferous proponents of this view. I first met him more than a decade ago, when he was running *Strategy & Management*, a Chinese journal that advocated a turn away from Western values. He recently co-authored *China Is Not Happy*, a book that has sold more than half a million legal copies, with an untold number of pirated versions in circulation. In it, Wang criticizes the U.S., saying it has damaged itself by focusing too much on its financial sector while sending manufacturing offshore. China, he says, needs to adopt a more assertive economic, diplomatic, and military stance. "China's policies are always based on trying to please the West. We don't think this is necessary," Wang tells me as he sips a Coke, a beverage he allows is "pretty good."

The anger has found its way into official rhetoric. Premier Wen Jiabao on Mar. 13 urged Washington to "maintain its good credit, to honor its promises, and to guarantee the safety of China's assets." During his visit to Beijing, Geithner heard plenty of concern about such matters, with students at Peking University questioning him on the financial crisis and how Washington might put things right. And those worries about China's U.S. investment holdings? They're "very safe," he told the students. "We have the deepest, most liquid financial markets in the world." Good luck convincing the Chinese of that. |BW|

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. ■

► 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, D.C., 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.

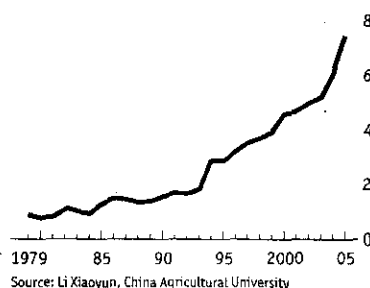
But its significance lies not just in its total value. Autocracies offer an alternative to western aid in several ways. In the past decade rich countries have tried to improve a dismal record of development spending by linking aid closely to the priorities of recipients (rather than financing a big project 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. ■

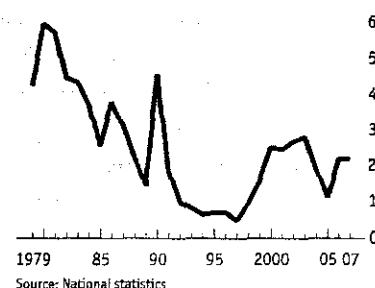
Some donors give more and more...

Foreign aid from China, yuan bn



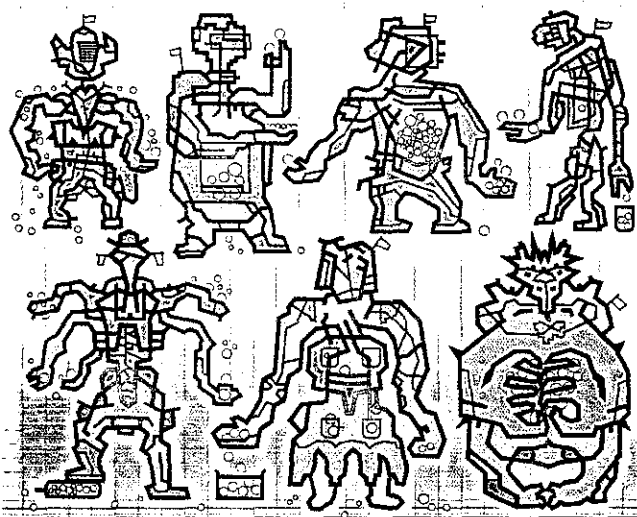
...and others are erratic

Foreign aid from Saudi Arabia, \$bn



Economics focus | In the blood

Attitudes towards redistribution have a strong cultural component



ARGUMENTS over economic policy are often heated. Debates about the extent to which tax and welfare policy should redistribute wealth from rich to poor tend to be particularly fractious. Understanding why people hold different opinions on the topic interests economists, not least because citizens' attitudes towards such matters are likely to influence the governments they elect. Some of the evidence from individual countries conforms to standard economic reasoning. Richer people, who have least to gain from redistribution, are usually less keen on it than their poorer compatriots. So are those who think they have a chance of being rich in the future, by moving up the economic ladder.

But opinions about redistribution also seem to vary from one country to another. And this has led economists to ask whether "culture" or "values" independently influence those opinions. Survey data about the political and economic attitudes of people in different countries show that the average American is far less favourably disposed towards redistribution than the typical European. Barack Obama got an unsolicited reminder of this on the campaign trail in 2008, when an off-the-cuff remark about the need to "spread the wealth around" provoked some shrill retorts. Such views, said Mr Obama's detractors, went against the grain of American values.

There is tremendous variation within Europe, too. People in former communist countries tend to favour more redistribution than those who live in Britain or the Netherlands. Is there something about Polish culture, say, which makes a person more favourably disposed towards redistribution than someone of similar income and education who happens to be British?

Apart from being little-charted terrain for economics, questions like this are also difficult to answer because culture, institutions, policies, economic outcomes and people's attitudes are all hopelessly intertwined. How, for example, can you separate the effects of a country's culture from those of its welfare system, which is both a part and product of that culture? Erzo Luttmer, and Monica Singhal of Harvard University argue in a new paper* that studying the attitudes of immigrants offers a possible way around this problem.

Immigrants have typically had their formative experiences in a country with different institutions, benefit systems and atti-

tudes from those of their adopted home. If culture matters, then their attitudes should be different from those of native citizens in similar economic circumstances and closer to those that prevail in their country of origin. Mr Luttmer and Ms Singhal analyse data from the European Social Survey, a biennial multi-country exercise, on the attitudes of over 6,000 immigrants who have moved from one of 32 countries in the survey to another and they find precisely this result.

Even after controlling for income, education and other relevant economic and social factors such as work history and age, views about redistribution in an immigrant's home country are a strong predictor of his own opinions. Indeed, this measure of "cultural background" explains as much as income levels, and three-fifths as much as income and education combined. These results hold even for immigrants who moved 20 years before they were surveyed; they cannot be attributed to people not having had time to adjust their views.

But what if immigrants are self-selecting, choosing to migrate to places where policies are to their liking? This may be true, but it would make the sort of effect that Mr Luttmer and Ms Singhal uncover less, not more, likely. They find, after all, that someone who grew up in a pro-redistribution society is significantly more in favour of redistribution than the natives of the country where he now lives. Selective emigration would imply the opposite, since people would presumably desert places where their attitudes were not the norm in favour of countries where their preferences were more typical.

People may also migrate because they know something about their own future prospects. For example, those who expect to be rich could emigrate from high-taxation places to places where there is less redistribution. It is impossible to control for such differences, since they are not observable. But such migration would also make it less likely that immigrants' preferences matched those of the country they left behind rather than those of the country they came to live in.

Bred to redistribute

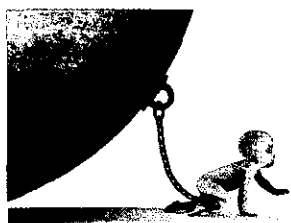
Even more convincing evidence of the impact of culture comes from second-generation immigrants. The opinions of children born in the host country about the desirability of redistribution are strongly influenced by the norms that prevail in the countries their parents came from. That denotes some transmission of values and attitudes between generations. But the effect of culture is only about two-thirds as large as it is for foreign-born immigrants. Although durable, it apparently fades with time.

Perhaps economists should not be too surprised by the persistent effects of culture on attitudes to economic policy. Ms Singhal attributes her initial interest in these questions to realising, during her graduate studies, that even Harvard economists with similar education, incomes and interests had views about the economic role of the state that seemed to vary by nationality. But the implications are potentially striking. Immigrants from pro-redistribution places, and their children too, are much more likely to vote for political parties that champion greater redistribution of wealth. That leads the authors to ask whether, over time, the composition of immigration into a country could end up having a meaningful impact on its tax policies. ■

* "Culture, Context, and the Taste for Redistribution" by Erzo Luttmer and Monica Singhal, May 2009: ksghome.harvard.edu/~msingha/CultureRedistribution.pdf

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 hovers 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



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 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- ➤

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

► 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

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 pre-

From Bretton Woods to euro

vent 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.

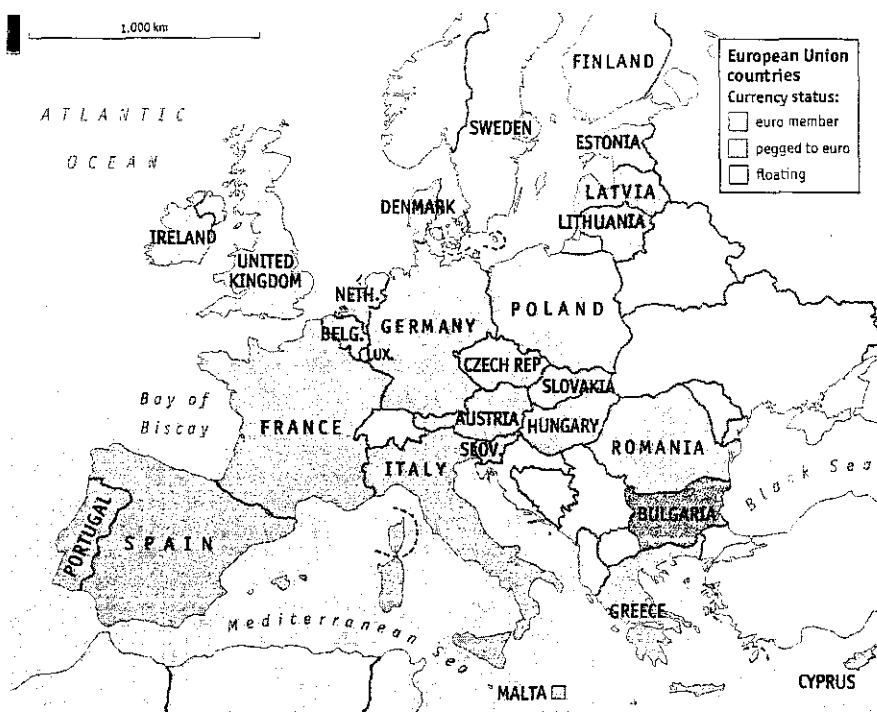
So far the euro has brought neither greater prosperity nor political union. Job-creation improved but productivity increases slowed, leaving the region's trend growth rate much the same as before EMU. In its early years the euro fell against the dollar, but it has since more than made up for its early 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 cur-

rent-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 dis-

parate 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 ac-

count 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 PIGS. 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 infla-

tion: 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.

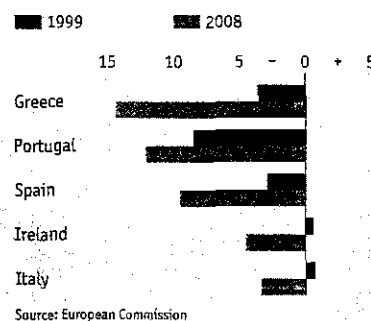
The ECB's one-size-fits-all monetary policy can never be perfectly tailored for any individual member country. In principle, higher inflation should act as a coolant to overheating economies by reducing real household incomes and by making firms less competitive, reducing the incentive to invest. In 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,

Taking the strain

Current-account balance, % of GDP



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.

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.

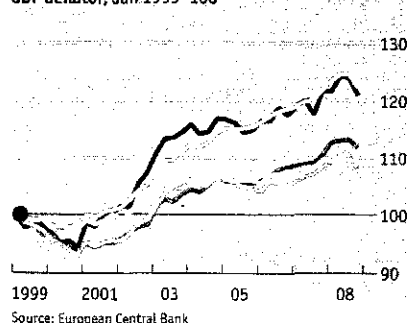
Ireland and Spain were ripe for housing booms too. Both countries have a high rate of owner-occupancy and space for fresh construction. The obsession with housing spilled over from Britain, a serial miscreant when it comes to house-price booms. When Spain and Ireland adopted the euro, they imported low 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

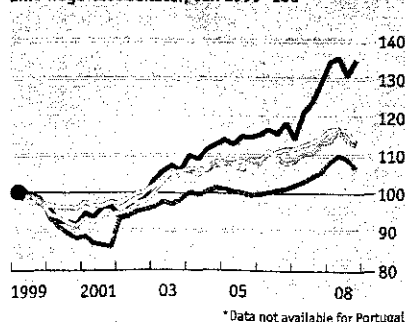
Losing effectiveness

Real effective exchange rates measured by:

GDP deflator, Jan 1999=100



unit-wage-cost deflator, Jan 1999=100*



► 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 compet-

itiveness 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 rocky 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. De-

valuation 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 UFF'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 Piñonero, 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 end-

ed 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).

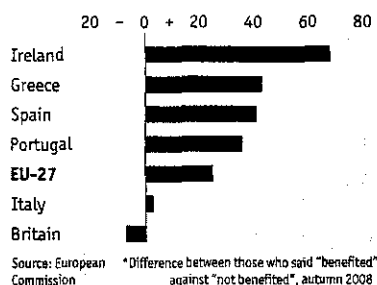
Most Greeks are in favour of the euro, and only 12% think EU membership is bad for their country. That is poor ground on which to build a case for quitting the euro. Greece's finance minister, Yannis Papathanassiou, thinks that the recent spike in

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

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



► 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 pro-

ducing 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 be-

cause 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.

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

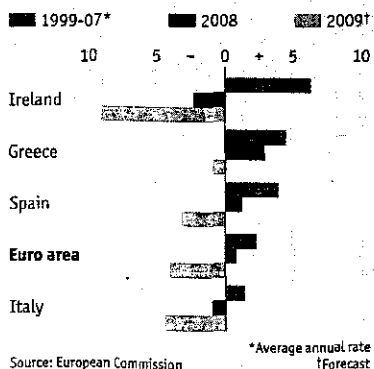
The spread of fixed-term employment contracts in Spain (from the mid-1980s) and Italy (in the mid-1990s) helped make hiring and firing more responsive to the business cycle. The innovation had an immediate pay-off: it created jobs. Firms were content to take on temporary workers, often immigrants, because 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 ►►

Where it hurts

GDP, % change on year earlier



► 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 suffi-

ciently 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 "impossi-

ble 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

	% 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.

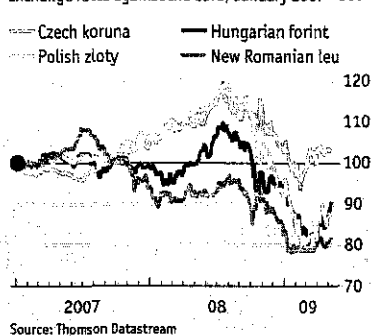
In purgatory

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 eas-

Oh for an anchor

Exchange rates against the euro, January 2007 = 100



ing 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.

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.

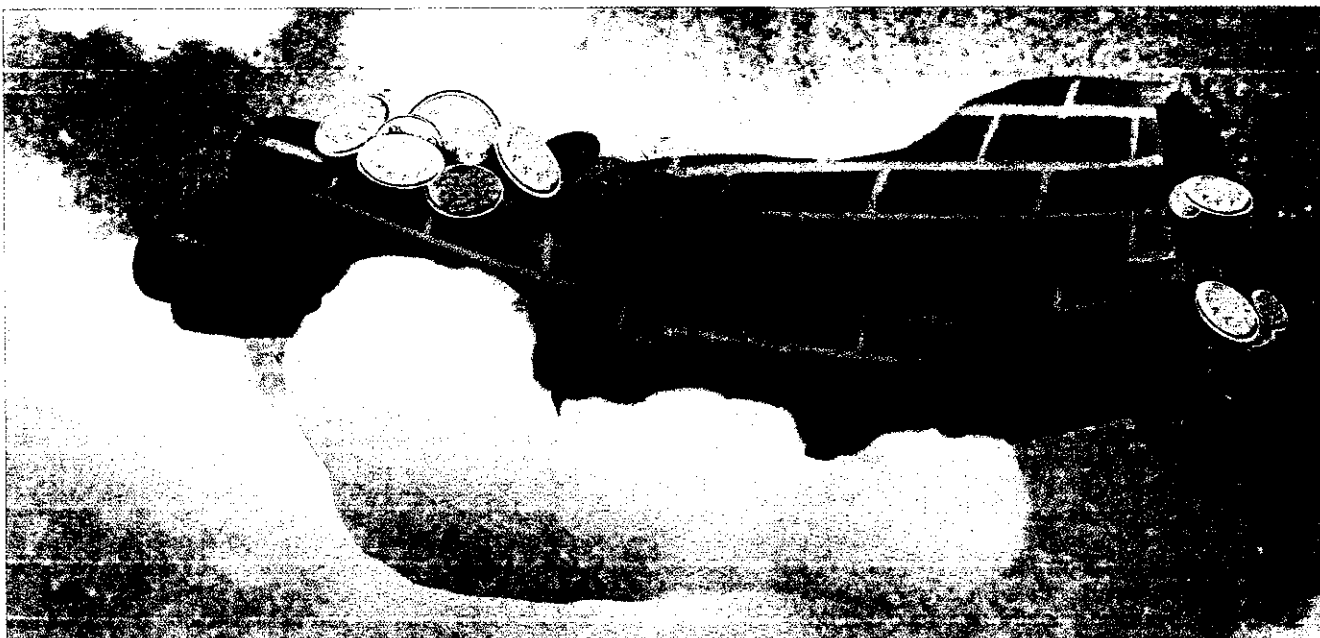
Poland may be able to guard against the

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 Ger-

man 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 capi-

tal 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 Otmár 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 be be-

come 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.

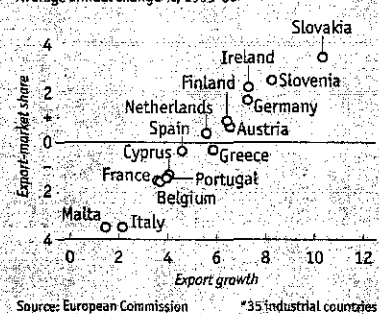
On standard gauges of competitiveness, such as real effective exchange rates, a number of euro-zone countries appear to have big problems. Yet things may look worse than they are. Measures based on relative unit wage costs across the whole economy are crude. In booming Spain and Greece, much of the heat 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

Great exportations

Export-market share* and growth
Average annual change %, 1999-08



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.

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 swift, 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 CEPR: "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. ■

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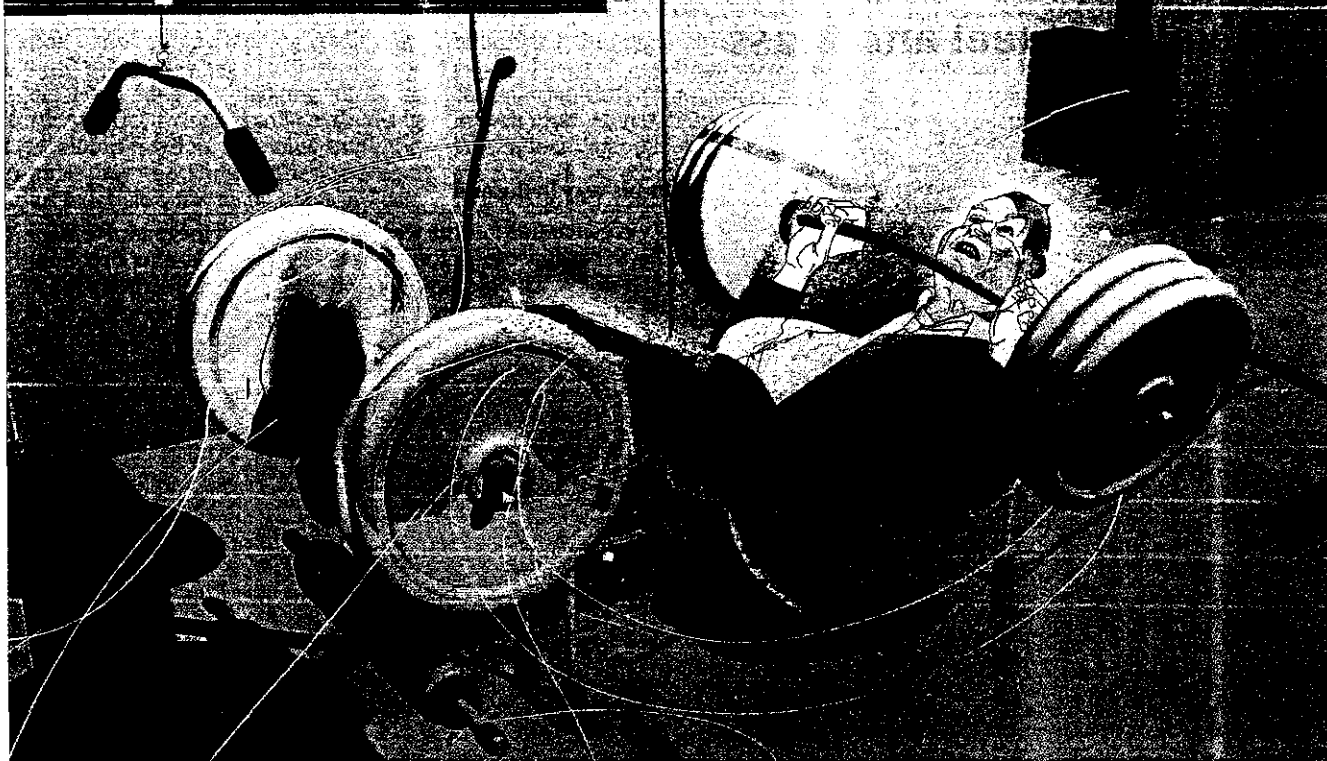
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The big sweat

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

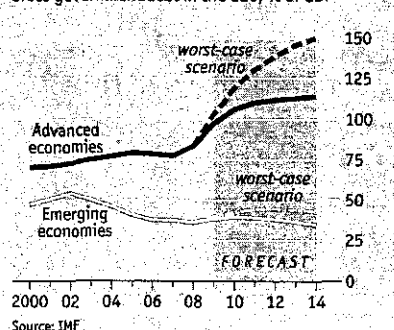
OVERINDULGENCE has a price. After years of scoffing food and swilling booze, the cost is physical. After a debt-fuelled financial bender, it is fiscal. Governments have been propping up the world economy with a borrowing spree of their own. The recession has drained tax revenues and policymakers have 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 govern-

Dire or higher?

Gross government debt in the G20, % of GDP



ments' solvency push interest rates up, the debt ratio could be 150% (see chart 1).

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.

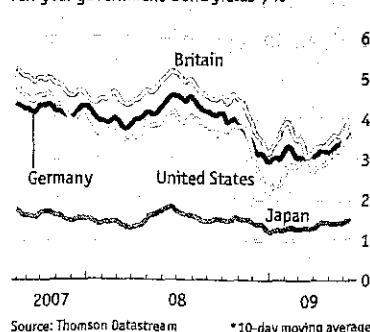
The rich world's build-up of debt may also cause changes in countries' relative creditworthiness. Investors have long viewed emerging economies as riskier sovereign borrowers than rich ones, because of their history of macroeconomic instability and more frequent defaults. But the biggest emerging economies 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

Ten-year government-bond yields*, %



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

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

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 au-



Redefining collateral damage

thorities 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.

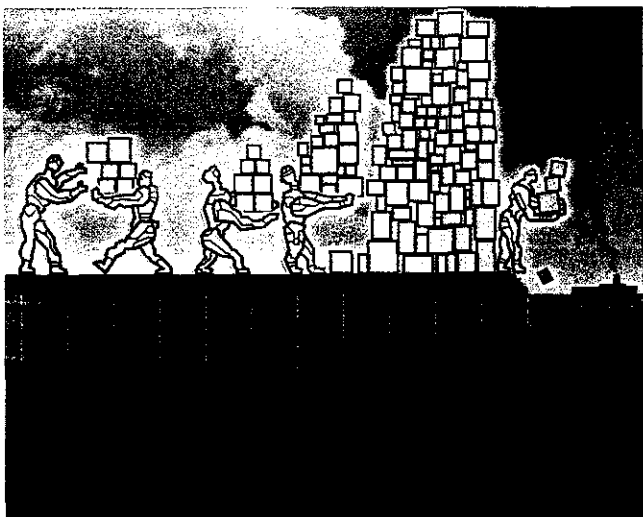
The excess borrowing that did for shadow banks threatens consumers, too. They are scrambling to save more as house prices plunge. Their mortgage debts loom larger because of vanishing inflation. This urge to shore up wealth is self-defeating in aggregate, as it curbs spending and incomes. It also renders 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 ex-

porting 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

► management fees have steadily risen, from 1.3% in 1994 to 1.6% last year. Retail fund-managers have fed themselves well, but their investors have been left with the scraps.

Even institutional investors such as pension funds and insurance companies, which ought to have the clout to force down fees, are paying more. A survey by Watson Wyatt, a consulting firm, found that the cost of running a pension scheme increased by around half between 2003 and 2008. That was because schemes allocated more of their portfolios to hedge funds and private-equity managers, which charge much high-

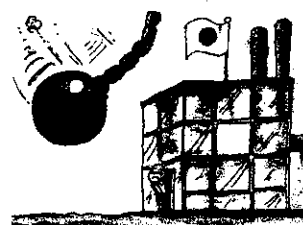
er fees. Chasing performance by paying higher fees might work for individual investors, but in aggregate it is doomed to fail. The return to the average investor is the market return minus costs; if costs rise, returns must fall.

Retail investors, in particular, would do well to learn that lesson, and take responsibility for their own finances. Just as they shop around to find the best estate agent, they can seek out low-charging vehicles such as exchange-traded funds. If enough investors focus on cost, not performance, the fund-management industry will have to give them a better deal. ■

Business in Japan

No exit

What Japan needs is more bankruptcies, not fewer



JAPAN has long practised a form of familial capitalism. In good times industrial collusion, overseen by bureaucrats, is practically official policy. The so-called "convoy system" lets corporate stragglers retain a small market share as bigger and better firms steam ahead. For decades this cosy form of capitalism ensured that competition was never too fierce and everyone prospered at least a bit. It certainly smoothed out the occasional ups and downs during the country's stunning post-war economic development, as it rapidly caught up with the West. So it is not surprising that many politicians and business leaders are advocating an even stronger dose of such medicine now. As Japan struggles with its deepest recession since the war, the government has established a mechanism to give financial help to poorly performing firms, companies are being encouraged to provide support to their weaker suppliers, and banks are being asked to do their bit, too.

There is nothing unusual about any of this, you might say. Governments around the world are racing to protect their cherished, if dented, national champions. Financial institutions and carmakers have been bailed out in both America and Europe. But in the West such assistance is the exception; in Japan it is central to the system. The problem is that keeping ailing companies on life-support holds back healthier firms and harms the economy overall. That is true everywhere, but Japan provides an extreme case that illustrates the dangers of coddling weak companies.

Japan's stronger firms have responded relatively quickly to the recession, in marked contrast to the dithering during the "lost decade" of the 1990s. It is still unclear whether they have done enough (see page 61). But it is certain that efforts to keep their struggling rivals afloat are hurting them.

Politicians, having been unwilling to push through painful structural reforms in relatively good times, are even more reluctant to put forward tough measures when times are bad. Banks are being pressured by the government to roll over existing loans and make new ones, and firms encouraged to extend credit and maintain business relations. The government's recent stimulus measures give failing firms taxpayers' money. A plan approved in May allocated ¥2 trillion (\$21 billion) to prop up (indirectly) troubled companies. Pioneer, an electronics

firm, Elipda, a chipmaker, and Japan Airlines are among the first to look for government support.

All of this does enormous harm. Weak firms need to exit the market, either by going bust or being sold to another firm, or the whole business environment gets stifled. Japan has far too much capacity in many businesses—eight mobile-phone makers, for instance, few of which make much money. This squeezes prices and margins, thus denying better-run firms the surplus capital they need to hire talented people, buy competitors or invest in research and development. It also locks up resources, both human and financial, that could be used more productively by stronger firms. Before the downturn, Japanese companies' return on equity averaged around 10%, about half the level of American firms.

Tellingly, the shut-down rate of companies in Japan is around half that in America and Britain. And the number of corporate insolvencies is expected to increase in Japan this year by only 15%, despite the depth of its recession, compared with more than 30% in western Europe and 40% in America. Normally a scarcity of corporate bankruptcies is a sign of economic vitality; in Japan, it is a sign of its economic weakness. Of course, keeping struggling firms alive protects jobs. But it also fossilises industry structures and hinders the development of a more flexible labour market and a business environment more supportive of new-company creation—two areas where Japan is also sadly deficient.

And the zombies march on

With a general election due to be called by September, in which a new political party may take the reins of government after more than half a century of almost uninterrupted rule by the Liberal Democratic Party, no one has said a word about reforming the economy to introduce more competition in more industries. But this should be on the agenda. During its post-war boom Japan built its reputation on the back of innovative products and fastidious quality; it has since become better known for zombie companies.

As governments around the world come under pressure to bail out everything from retailers to travel companies to automotive firms, Japan's experience—a downturn followed by years of stagnation—serves as a reminder of the importance of destruction in capitalism. Instead of continuing to prop up struggling companies, Japan and other countries need to let them go under, so that new, better ones can be created. ■



Also in this section

59 The poor and the global crisis

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

BRICs, emerging markets and the world economy

Not just straw men

The biggest emerging economies are rebounding, even without recovery in the West

THE inaugural summit of the BRICs—Brazil, Russia, India, China—came and went in Yekaterinburg this week with more rhetoric than substance. Although Russia's president, Dmitry Medvedev, called it "the epicentre of world politics", this disparate quartet signally failed to rival the Group of Eight industrial countries as a forum for economic discussion.

But that should be no surprise: to realise how disparate they are, consider that Russia and Brazil are big commodity exporters, whereas China is a big commodity importer; China is a proponent of the Doha trade round, India a sceptic; India and China vie for influence in the Indian Ocean, Russia and China compete in Central Asia.

Instead, the really striking thing is that four countries first lumped together as a group by the chief economist of Goldman Sachs chose to convene at all, and in such a high-profile way. And that when they met, they discussed topics such as reforming the IMF; their demand for more say in global policy-making; and, in the case of China, Brazil and Russia, a plan to switch some of their foreign-currency reserves out of dollars and into IMF bonds.

All this reflects growing self-confidence. The largest emerging markets are recovering fast and starting to think the recession may mark another milestone in a worldwide shift of economic power away from the West. Estimates for their national

incomes in the first quarter were better than expected. In the year to the end of March GDP rose by around 6% in China and India. The two accounted for no less than half the world's increase in wireless-technology subscriptions in that period. In Brazil GDP fell slightly in the first quarter but it is growing faster than the Latin American average and most economists think growth will return to its pre-crisis level as early as next year. In contrast, output in most large industrial economies is still falling. The exception in the BRICs is the host: dragged down by plunging oil prices last year, Russia's economy shrank by 9.5% in the first quarter, the worst performance in the G20 after Japan.

The fortunes of the others mark a sharp rebound since the turn of the year. Then, it seemed, the largest emerging markets faced being overwhelmed along with everyone else. Chinese exports in January were 18% lower than they had been a year earlier. Industrial growth fell by two-thirds in November and December. And around 20m migrant workers were wending their way back to their villages, jobless after the collapse of construction and export booms in coastal cities. The notion of "decoupling"—that emerging markets were no longer mere moons revolving around planet West—suffered a severe setback.

So what should one make of the turnaround? Might there be something to decou-

pling after all? Why are the BRICs recovering? And what are the implications for the rest of the world?

Decoupling means not simply that emerging markets tend to grow faster than rich industrial ones, although that is certainly true; it also implies that to some extent the two groups dance to different tunes, with emerging markets growing or shrinking autonomously, not just under the influence of rich ones. A study last year by Ayhan Kose of the IMF, Christopher Otrok of the University of Virginia and Eswar Prasad of Cornell University gave some support to this idea.

You would expect less decoupling as a result of globalisation. The cycles of output, consumption and investment should become more closely aligned in countries engaged in world trade. Yet when the authors looked at these indicators, they found something different. The cycles of output, consumption and investment did indeed become more closely aligned in rich countries. And the same thing happened in emerging markets. But when the authors compared the two groups, they found they were diverging. The business cycles of America and Europe converged. The business cycles of India and China converged. The business cycles of rich and emerging markets had decoupled.

When this study came out in mid-2008 the worldwide crash seemed to render it instantly obsolete. Yet the sheer size of the meltdown may temporarily have swamped deeper trends that are now reasserting themselves as the initial shock recedes. In 2000 developing countries accounted for 37% of world output (at purchasing power parities). Last year their share rose to 45%. The share of the BRICs leapt from 16% to 22%, a sharp rise in such a short period. Almost 60% of all the in- ➤

crease in world output that occurred in 2000-08 happened in developing countries; half of it took place in the BRICS alone (see chart on next page).

If this pattern of growth were resuming, it would be good news: nearly half the world economy would be bouncing back. And there are one or two signs that the benefits of growth in the BRICS are being felt farther afield. Anecdotal evidence suggests "south-south" trade and investment by richer emerging markets in poorer ones continued to rise even as global capital and trade flows fell. One example of this is the "land grab" in which China and Gulf countries are buying millions of acres of farmland in Africa and South-East Asia. China overtook America to become Brazil's largest export market in March and April; it is also now the largest exporter to India. China is using its \$2 trillion of foreign reserves to invest in other emerging markets: for example, putting \$10 billion into Petrobras, Brazil's state-run oil company.

China's appetite for raw materials to fuel resurgent growth probably explains the 36% rise in industrial raw-material prices since the start of this year, benefiting exporters of things like copper—though how long this will last is an open question. If it comes from the boom in Chinese investment spending, then the boom could continue. If China is merely filling its stores temporarily after a period of destocking, then prices could fall again.

But the resilience of China, India and Brazil cannot offset the dire state of the rest of the world economy. While the three giants recover, developing countries as a whole are mired in recession. The giants seem to be decoupling not only from the West but from many of their smaller emerging brethren, too.

A series of reports confirms how badly things are going there. A review of ten poor countries by the Overseas Development Institute, a think-tank in London, concludes that they were worse hit than anyone expected, with sharp declines in remittances, employment and revenues and widespread balance-of-payments problems. As the study's author, Dirk Willem te Velde, points out, the differences are often striking. In some countries—Indonesia, Kenya, Bangladesh—foreign direct investment has held up reasonably well; others—Ghana, Nigeria and Zambia—are facing sharp declines. Cambodian textile exports have been hit harder than Bangladeshi ones. But because import demand, capital flows and the need for foreign workers declined precipitously in the West, almost all developing countries are suffering.

In its most recent assessment, the United Nations says at least 60 poor and emerging markets will this year suffer falls in income per person. The UN's forecasts for eastern Europe and sub-Saharan Africa are especially dark. For eastern Europe,

The poor and the global crisis

The trail of disaster

The downturn is claiming victims that never appear on a balance sheet

NINE months after the collapse of Lehman Brothers, the world's economic crisis is still usually discussed as though it consisted of dire bank balance sheets, falling exports and bankruptcies or job losses in the West. But at the other end of the trail that starts with financial woes in rich countries are underweight children and anaemic expectant mothers in poor ones. New research by the United Nations' standing committee on nutrition (available on www.unscn.org) gives a first estimate of how the crisis has hurt the group of people most affected by the crash: the very poorest.

In 1990-2007, the number of hungry people rose by about 80m, though this was, by and large, a period of rising incomes in developing countries (and a huge increase in population). In 2008 alone, the number rose a further 40m, to 963m—half as much in one year as during the previous 17. In other words, lots more children and pregnant women are not getting the food they need. The report reckons that the number of underweight children will rise from 121m to 125m by 2010, assuming no change in the size of the world economy (in fact, it is expected to shrink 2% this year). The World Bank has already estimated that until 2015 the crisis will lead to between 200,000 and 400,000 more children dying every year.

The poorest face two crises: the world recession and the resumption of food-price rises. Food prices had been falling but even then, the global price fall did not translate into a comparable decline on local markets in most poor countries, so the poor did not benefit much. World prices bottomed out in December 2008 and have since risen 26%. In the poorest countries, a rise of 50% in the price of staples pushes up the family food budget

from 50% to 60% of household income.

Initially, people skimp on non-staple foods, cutting the quality and diversity of their intake; in the next stage, the quantity and safety of diets suffer. That in turn damages their health. Currently, around 50m, or 40%, of pregnant women in developing countries are anaemic. Anaemia in expectant mothers, which causes low birth weight and unhealthy babies, is likely to rise by a further 1.2m in Asia and 700,000 in Africa.

To make matters worse, this is happening at a time when the global slump is causing job losses or wage squeezes everywhere—worldwide unemployment rose to 6% in 2008—so in some poor countries, it now takes an extra ten hours a week or more to feed a family of five.

The resulting burden falls heavily on women. As the report says starkly: "Women are usually the last to benefit from increasing income [but] they are usually the first to make sacrifices when the financial situation deteriorates."



A long walk from the boardroom

Russia and its neighbours, the body predicts a fall in output of 5%. Arvind Subramanian, an economist at the Peterson Institute for International Economics, a think-tank in Washington, DC, argues that the recession in eastern Europe sounds the death knell for one of the two main growth strategies of the past 20 years—capital-account liberalisation (growth through exports is the other). The east European countries threw their financial sectors open to the world. In 11 of the region's countries, foreign banks account for over 60% of bank assets. The flood of foreign-currency borrowing destabilised their economies and left them vulnerable when Western

banks reduced lending.

In Africa, the UN predicts, output will now fall by 0.9%. That might not sound too bad but only two months ago the IMF was forecasting a rise of 1.7% and at the start of the year the UN had projected a 4.8% increase. To return to pre-crisis growth, says the African Development Bank (AFDB), would require the continent to attract \$50 billion of new money this year. Africa is nowhere near those levels because world capital flows are falling. The latest forecast by the Institute of International Finance says total net flows will collapse from \$890 billion in 2007 to just \$141 billion this year.

The AFDB fears that "a growth crisis" ►►

may be turning into a "development crisis", leading to sharp increases in poverty and malnutrition. By the end of 2009, says the UN, there will be between 105m and 143m more people in poverty than if growth had continued at its pre-crisis levels (see box on previous page). The main exception is in smaller East Asian countries, where industrial output is rebounding and GDP growth is likely to resume in the second quarter.

At the moment, then, recovery in the BRICS is coinciding with recession in the developing world as a whole. If this does not point to any change in global economic conditions, what does it reflect?

Partly, that the BRICS depend less on exports than do many emerging markets. In Brazil and India exports are less than 15% of GDP. China, too, exports less than many people think. Though exports were 34% of GDP in 2008, these included "processing exports"—goods imported into China, processed and exported without much value having been added. All three were thus less affected by the slowdown in world trade than most.

The BRICS were cautious in liberalising their financial systems, so have been less affected than, say, eastern Europe, by the West's financial heart attack. And their recoveries have been boosted by governments which have dramatically loosened monetary policy and increased government spending. But many other countries are relatively closed to trade and finance. Smaller ones like Chile and Taiwan have had a large fiscal stimulus. But few have done so well. Something more is needed to explain the recovery of the giants. A plausible explanation is size.

Size matters when world trade is falling because large economies have millions of domestic consumers to turn to when foreign markets fail. China is the best example. Small economies need trade to specialise, but the pressure of selling into a big domestic market helps companies in large economies remain competitive even without a lot of competition from imports. Big economies also tend to be diversified. India, for example, exports not just garments and cheap electronics—characteristic of many countries with similar levels of income per head—but ships, petrochemicals, steel and business services. Being diversified means little when markets all fail at once. But it is a big advantage when recovery begins since you are more likely to be in a business in which demand is rising.

Size and variety may also help the economic stimulus programmes of China, India and Brazil. In general, one of the commonest problems of government reflation is that the benefits leak out beyond your borders because the programme sucks in imports. Giant economies do not face this problem so acutely because even when trade has been liberalised, imports natu-

rally tend to be a lower share of GDP.

The other challenge is to ensure that government stimulus programmes are broadly based. This could be more difficult in small economies which specialise in relatively fewer sectors. A handful of big companies may be able to use political clout to grab the benefits of spending for themselves. In principle, giant countries such as India or China have more companies competing to manipulate the government for a share of the spoils. That is speculation, but the fact is that the stimulus programmes in the big emerging markets have been, mostly, large and effective.

China's stimulus package was the earliest and best-known example of fiscal shock and awe. But it is only part of the story. The government is using the state-owned banks to pump out loans at astonishing rates. According to Josh Felman, of the IMF's Asia research department, state banks and others issued 5.5 trillion yuan (\$800 billion) of new loans in the first quarter—more than in the whole of 2008. This is producing a spending splurge on steroids. Excluding SUVs, almost as many cars are being sold in China as in America. In 2006 Americans bought twice as many.

Brazil and India are following suit, albeit more modestly. Brazil reduced reserve requirements and gave banks and its deposit-insurance fund incentives to buy up the loan portfolios of smaller banks. These measures injected 135 billion reais (\$69 billion) into the domestic credit markets, according to Otaviano Canuto of the World Bank. Domestic credit rose sharply between September 2008 and January 2009 and consumer confidence is rebounding.

The source of India's resilience, argues Mr Subramanian, was "goldilocks globalisation": neither too dependent on foreign capital, like eastern Europe, nor too reliant on foreign customers, like parts of East Asia. Foreign capital dried up in the crisis, so India relied on domestic savings, which amounted to almost 38% of GDP in the year to March 2008. Companies thus turned for loans to India's unfashionable state banks, which hold almost 70% of bank assets, rather than borrowing over-

seas or raising money on the stockmarket.

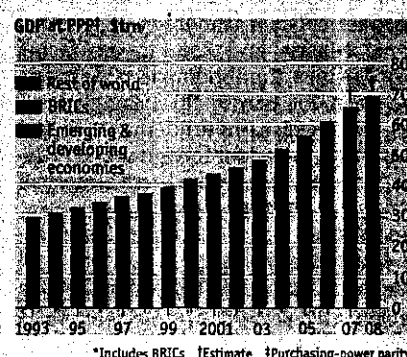
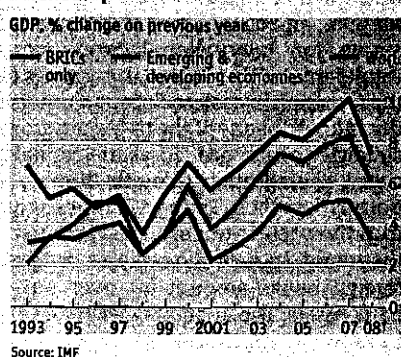
India's growth was also shored up by government outlays, such as a generous pay rise for state employees, the cancellation of small farmers' debts, and the expansion of its rural-workfare scheme. Announced before the crisis struck, this spending was fortuitous. It left the public finances deep in the red, even as it helped the government to a decisive election victory. So far, this political triumph has boosted confidence in India more than the budget deficit has dampened it.

State of triumph

The question is whether such splurges are efficient and how long can they last. Consider China's investment (see page 69). According to the IMF's Mr Felman, in early 2008 all the contribution of investment to growth came from non-state-owned enterprises, mostly the private sector; since December 2008, more than half has come from state-owned enterprises. Something similar is happening in Brazil. Between last September and this January credit from foreign-owned and domestic private banks rose by 3%; credit from public banks rose by 14%. The beneficiaries seem to be large firms, where loans are growing four times as quickly as at small ones.

It is not clear how far, in the long run, the BRICS will be affected by a big rise in the size of the government and large state-owned firms. But that rise is probably inevitable. China and, to a lesser extent, Brazil and India, benefited hugely from America's appetite for imports in 2000-08. That appetite has fallen and is likely to remain low for years, as American consumers adjust their spending and savings habits. The rise may also be difficult to reverse: the experience of the West has been that the public sector expands relentlessly until it reaches between 40% and 50% of GDP. But if the BRICS cannot export their way out of recession, the expansion of government is the main alternative to the slump being endured in those other big capital exporters, Germany and Japan. It is part of the price China and others are paying to clamber out of recession before everyone else. ■

Bricked up





Corporate restructuring in Japan

Breaking free

TOKYO

Japanese firms are responding quickly to the recession, but are they doing enough?

IN RECENT months Toyota has replaced its bosses, halted pet projects and temporarily cut production in Japan almost in half. Toshiba took control of affiliates and said it would shut down unprofitable businesses. Sony plans to halve the number of its suppliers to save ¥500 billion (\$5.2 billion) this year alone. All have cut back their part-time and temporary workers, who had only ever been promised a pay-cheque, not a job for life. The actions of these prominent Japanese companies have encouraged others to follow suit.

During the "lost decade" of 1991-2002 Japanese firms dithered rather than adopting the harsh measures that might have prevented a drawn-out stagnation. But this time around the response has been much faster and deeper. After all, if any country ought to know how to respond to a low- or no-growth environment it is Japan: it has had plenty of practice.

The press has done its part, continually reminding the public of the "once in a century" nature of the crisis and thus providing support for the lay-offs. And banks have played a more constructive role than they did in the 1990s, by refusing to extend credit to some needy firms that cannot meet their obligations—to the dismay of politicians and bureaucrats.

It helps that unlike during the bursting of the country's bubble economy in 1991, the crisis originated outside Japan and all unpleasant measures could be blamed on the American bankers whom many Japa-

nese held responsible for it. And the sudden collapse of export sales, which happened in tandem with a spike in commodity prices and an appreciation of the yen (which makes Japan's exports more expensive), meant that corporate Japan had no choice but to act.

All this is quite a turnaround. During the lost decade Japan regarded its problems as a private, domestic matter: it resented outside pressure to sort out errant banks, speculative property developers, overly ambitious conglomerates and so on. Corporate reforms were introduced, albeit slowly and imperfectly. Jobs, sacrosanct in Japan, were eventually shed. The reaction this time is notable because it capitalises on the changes introduced back then and provides an opportunity to push for even more restructuring.

It is sorely needed. The drop-off in demand from the West has clobbered Japan's export economy. Foreign trade is down one-third. Japan's economy is expected to contract by 6% this year, making it the worst-hit among rich countries. Industrial overcapacity is thought to be much higher than in America or Europe. Indeed, things are so bad that it is generally assumed that they cannot get any worse, and will instead improve over the next six months as the inventory cycle turns and firms restock. This has helped push the Nikkei 225 share index up by around 40% since March, when it hit a 26-year-low.

Many firms failed to restructure seri-

ously during the lost decade, especially after 2002 when record profits poured in from exports. Companies refused to pare their sprawling operations and spin off non-core units (it is common for firms to own their own hot-spring resorts, for instance). But the recession has strengthened the hand of reformers.

The most widespread form of restructuring is the easiest: cutting staff. Since the lost decade, Japan's labour force has become more flexible, as the post-war tradition of lifetime employment has waned. "Non-regular" workers, as temps and part-timers are known, have increased from one-fifth to one-third of the workforce. Labour represents around 70% of Japanese business costs: though hard on individuals who are sacked, the rise of non-regular workers has let firms cut costs fast.

It is still difficult and expensive to lay off "regular" workers. Firms typically provide the main pensions of staff they jettison, as well as lump-sum severance packages. This explains why companies such as Toshiba must raise huge sums to cover restructuring costs.

Another sign of change is corporate Japan's sudden zeal for mergers and acquisitions, despite the uncertain business environment and a scarcity of capital. Last year Japanese firms spent a record amount acquiring businesses abroad, and the buying has not abated. Firms such as Kirin, a beverage-maker, J-Power, an electricity wholesaler, and many others have bought foreign companies this year. Japan's stagnant domestic economy offers no prospects for growth, and the strong yen, low asset prices and a dearth of rival bidders make it a good time to pounce.

But most transactions were domestic, as companies spin off units or took direct control of affiliates. In recent months Hitachi, Toshiba and Fujitsu, among others, have shuffled their businesses in ways that ▶▶

Also in this section

- 62 Saving jobs in Europe
- 62 America's thriving gossip magazines
- 63 Airbus and Boeing resume their feud
- 64 The Saad and Algosaihi groups
- 64 General Motors sells Saab
- 65 Corporate hedging gets harder
- 66 Face Value: Adnan Yousif, an Islamic banker with global ambition

Business.view, our online column on business, appears on Economist.com on Tuesdays. Past and present columns can be viewed at

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► were unthinkable before the downturn. In the first quarter of this year dealmaking in Japan even exceeded that in China, with a total value of \$30 billion.

But is the restructuring going far enough? The emphasis has been on cost-cutting, rather than overhauling business models. And most of the big moves have been made by Japan's big export-focused firms, which were the first to be affected by the downturn. There has been much less

reform among Japan's huge swathe of inefficient, domestically oriented companies.

Moreover, even those firms that are trying to cut costs have tried to spread the pain among their suppliers, which may actually make things worse in the long run. The advantage of commercial camaraderie is that firms can count on at least a little business to keep them alive. But propping up ailing ones ultimately harms their healthier rivals, by depriving them of resources

they could more fruitfully deploy, including capital and qualified staff.

An executive at a medium-sized supplier to a big electronics firm explains how. The electronics firm continues to do business with weak suppliers offering inferior technology, depressing prices and profits for stronger ones. This has forced him to cut his research budget. "How can we keep up with the technology cycles if we lack the profits to invest?" he asks. ■

Saving jobs in Europe

Pain and pleasure

ROME

Work with no pay for some workers and pay with no work for others

NEXT month the shareholders of British Airways will enjoy the services of the firm's embattled boss and finance chief, free of charge, as the pair do their bit to cut costs by foregoing a month's wages. This week the firm urged other employees to volunteer to work without pay for a spell as well, since the airline is in a "fight for survival". To soften the blow, it has generously offered to spread out the loss of earnings over several months.

Marcegaglia, a big Italian steel firm, has been a little bit more imaginative in its bid to protect jobs. Since February, the 4,500 workers at its 27 Italian factories have been enjoying more time off than usual, since the firm does not have enough work to keep them busy. But they will not lose any pay. Luigi Dedei, a trade union official who helped negotiate this agreement, says that many are from farming families or have vegetable plots and have been using their new-found leisure time to tend their crops.

Production of metal products in Italy dropped by 11.9% in the fourth quarter of last year and by a further 31.7% in the first quarter of this year. Marcegaglia turns

steel coils into the tubes, strips, bars and plates needed in an enormous range of goods. Its production has fallen this year by between 25% and 30%, depending on the product. The scheme allows the firm to avoid laying off skilled workers who would be hard to replace when the economy recovers. It also avoids the pay cuts that workers would suffer if Marcegaglia entrusted them to a national fund that pays reduced wages to those who would otherwise be laid off.

Antonio Marcegaglia, the group's managing director, admits that not all firms can afford such schemes, especially if the downturn is protracted. But there is something in it for the owners: workers have promised to repay the firm for the holidays taken but not yet earned by working overtime when the economy picks up. (Overtime accounted for about 5% of hours worked before the recession hit.) Mr Marcegaglia is confident that the group's output will return to the record level of 2008 next year, so the scheme may be short-lived. Meanwhile, says Mr Dedei, workers whose night shifts have been eliminated are probably taking their time off in bed.

America's thriving gossip magazines

Rags to riches

NEW YORK

One corner of the print-news industry is relatively healthy

FOR seven of the past eight weeks the front cover of *Us Weekly* magazine has featured salacious stories about Jon and Kate Gosselin. The Gosselins, who have eight children including sextuplets, are the stars of an obscure American reality-TV programme that briefly became the most watched show on cable. Sensing a surge of interest, other celebrity magazines have piled in with reports of marital disharmony. Even in a recession, tittle-tattle sells.

Buoyed by recession-resistant food, pharmaceutical and shampoo advertisements, gossip magazines have lost fewer advertising pages in the past year than business or news magazines, according to a tally by *Mediaweek*. The two biggest, *People* and *Us Weekly*, each sold more copies last year than they did in 2001. In a world of fragmenting audiences they boast an enormous reach. Fully 43m Americans, about two-thirds of them women, flick through a copy of *People* each week.

This is odd, because the forces blamed for the decline of print news are no less potent in the celebrity sector. Celebrity news has its own online aggregators, several of them linked to web portals, such as omg!, the gossip arm of Yahoo!. The self-publicising Perez Hilton leads a legion of bloggers. Tweets, mobile-phone alerts and gossipy television shows (there are five, up from three in 2000) provide much more timely information about the lives of the beautiful than do magazines. There is more direct competition, too, with three big glossy magazines having launched since 2002.

It may be that the new entrants have simply mopped up excess interest in the doings of Paris Hilton and Lindsay Lohan. Larry Hackett, the editor of *People*, reckons that the public appetite for entertainment news was underserved until recently. Far from harming the established publications, the multimedia gossip barrage may be driving readers to check scurrilous rumours with them. ►



These days he's gardening

regulated state by state, the wait for an optional federal charter goes on. Nor were concrete proposals offered on money-market funds, runs on which intensified the trauma following Lehman's demise. Officials argue, with some justification, that these omissions are sound tactics: Congress can swallow only so much esoteric reform in one go.

Even without these measures, the white paper may get pulled apart. There is unease on Capitol Hill over an expanded role for the Fed and continued Balkanisation. Bank lobby groups will try to water down the consumer agency's powers and to persuade lawmakers that higher capital requirements will curb lending to hard-working Americans (and put the industry at a disadvantage to international rivals). The reforms must jostle with other initiatives, such as health care, for legislative time. Some doubt their chances of passing in any form until next year. The new foundation's plans may have been drawn up; its final shape and timing are uncertain. ■

TPG exits Shenzhen Development Bank

Money from another time

HONG KONG

A foreign banking expedition in China reaches a premature but successful end

BACK in 2004, when China was more convinced that the West had something to offer its financial system, TPG, an American private-equity firm, was permitted to bypass the country's restrictive regulations and buy a controlling 17% stake in a publicly traded basket case called Shenzhen Development Bank (SDB). The news, on June 12th, that TPG is to sell its stake to Ping An, a large Chinese insurer, draws another line under that era.

SDB was the first bank to list on Shenzhen's stock exchange, and in the craze that followed the shareholder list swelled to more than 600,000 individuals. But by the time of TPG's purchase, it was in a sorry state. Disclosed non-performing loans accounted for 14% of loans; the actual amount was undoubtedly much higher.

SDB did, however, have several assets that in the Chinese context were almost priceless: a national banking licence and more than 260 branches covering almost all of the country. The potential for a banking collapse was enough for the Chinese authorities to waive rules barring foreign control, foreign management and foreign purchases of domestic shares. The potential in China's embryonic banking market was enough for TPG to take a chance.

In the aftermath of the acquisition performance improved, as did SDB's share

Explaining the oil-price rally

Taming a wild beast

As oil prices surge, so do worries about speculation

THE oil market, born in Texas, is behaving like a bucking bronco again. Prices that careened from \$147 a barrel in mid-2008 to \$31 before the end of last year have jumped back to around \$70 in recent days. Mindful that high oil prices could thwart an economic recovery, politicians are again blaming speculators for this unruly behaviour. Positions held on NYMEX, the New York commodities exchange, by investors expecting prices to rise have indeed soared (see chart).

It is difficult to assemble a definitive explanation for the rally. There is hope that the world financial system has escaped collapse and that global growth may improve soon. A weak dollar helps oil prices. But evidence of improving supply and demand in the crude-oil market remains thin: a bit more production restraint by the Organisation of Petroleum Exporting Countries; some stock-building in China; and a levelling off of inventories in the rich world.

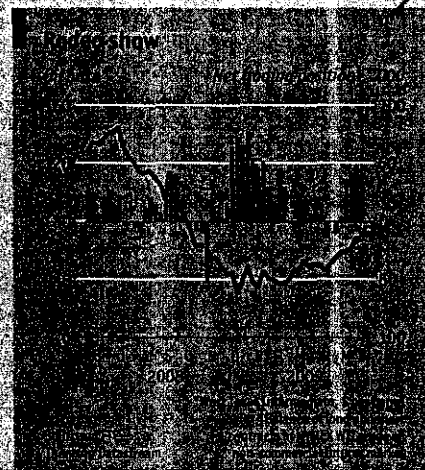
Proving that speculative investors are to blame for the volatility is also tricky. In 2008 America's Commodity Futures Trading Commission (CFTC), which regulates NYMEX, examined how the changing positions of hedge funds affect prices. It found correlation, not causation—speculators were clinging on for the ride, not making the beast buck.

But the CFTC's investigations were hampered by the fact that it could not examine intra-day trades. Nor could it monitor certain derivatives, such as those traded via London's InterContinental Exchange (ICE), in which Wall Street dealers are particularly prominent.

This lack of transparency alarms the regulators—and their political masters. In

a sign of things to come in the oil market, on June 12th the CFTC said it had launched an unprecedented public investigation to see whether the biggest natural-gas contract traded on ICE was moving prices around in the more regulated futures markets. If so, those trading it may become subject to the position limits that traders on NYMEX face.

The CFTC's new chairman, Gary Gensler, has come into office determined to broaden such initiatives to encompass the derivatives market as a whole. But his aim is to use transparency to create a more orderly market, not to set prices. That makes sense. Speculators do bring real information to prices—the bullish ones may, for example, be hoarding oil in the belief that prices will rise. But they will only make money in the long run if the fundamentals of supply and demand bear them out. If not, they will be tossed about just as badly as everyone else.



price. But there were limits on further progress. Writing off bad loans, building systems and extending more credit requires capital, but SDB's various efforts to raise funds could not get past China's regulators. This is unlikely to be a problem for Ping An, which is well-treated at home but found itself lost abroad after a calamitous recent investment in Fortis, a now-dismantled European bank. In theory Ping An has the resources to address SDB's capital needs, and could pair its domestic insurance franchise with SDB's national banking reach.

For TPG, being seen to have rehabilitated a bank and successfully passed it on could open doors for future deals that China's increasingly xenophobic regulators would be otherwise unlikely to approve.

After a disastrous investment in Washington Mutual, a failed American bank, TPG was also doubtless under pressure to show some gains for investors. Although the terms are complex and not fully public, TPG put less than \$300m into SDB (perhaps much less) and will take out more than \$1.6 billion (perhaps much more).

The size of TPG's returns has prompted reports that the deal may be blocked by officials. No private-equity firm likes having its exit strategy undermined but this would be no disaster. Barring another round of banking failures, no foreign firm will be granted a similar franchise in China for years to come. Even with strings attached, TPG would be hard-pressed to find a more interesting place for its money. ■

CDSs and bankruptcy

No empty threat

Credit-default swaps are pitting firms against their own creditors

SIX FLAGS, an American theme-park operator, filed for Chapter 11 bankruptcy protection on June 13th, bringing its long ride to reduce debt obligations to an abrupt halt. The surprise was that bondholders, not the tepid credit markets, stymied the restructuring effort. Bankruptcy codes assume that creditors always attempt to keep solvent firms out of bankruptcy. Six Flags and others are finding that financial innovation has undermined that premise.

Pragmatic lenders who hedged their economic exposure through credit-default swaps (CDSs), a type of insurance against default, can often make higher returns from CDS payouts than from out-of-court restructuring plans. In the case of Six Flags, fingers are pointing at a Fidelity mutual fund for turning down an offer that would have granted unsecured creditors an 85% equity stake. Mike Simonton, an analyst at Fitch, a ratings agency, calculates that uninsured bondholders will receive less than 10% of the equity now that Six Flags has filed for protection.

Some investors take an even more predatory approach. By purchasing a material amount of a firm's debt in conjunction with a disproportionately large number of CDS contracts, rapacious lenders (mostly hedge funds) can render bankruptcy more attractive than solvency.

Henry Hu of the University of Texas calls this phenomenon the "empty creditor" problem. About two years ago Mr Hu began noticing odd behaviour in bankruptcy proceedings—one bemused courtroom witness a junior creditor argue that the valuation placed on a firm was too high. With default rates climbing, he sees such perverse incentives as a looming threat to financial stability. Already the bankruptcies of AbitibiBowater, a paper manufacturer, and General Growth Properties, a property investor, in mid-April have been blamed on bondholders with unusual economic exposures. Some also suspect that CDS contracts played a role in General Motors' filing earlier this month.

Solutions to the problem are, so far, purely theoretical. One option would be regulation requiring disclosure by investors of all credit-linked positions. There is now almost no disclosure of who owns derivatives on a company's debt, leaving firms to guess how amenable creditors will be when approached with a restructuring plan. Longer-term solutions rest on an overhaul of the bankruptcy code and



Downhill from here

debt agreements to award votes and control based on net economic exposure, rather than the nominal amount of debt owned. Supporters of the market point to the value of CDSs in reducing the cost of capital and to plans for a central clearing house that will reduce redundancy and increase transparency. But the reform roller-coaster has not yet come to a halt. ■

Investment spending in China

Reap what you sow

HONG KONG

China's capital spending could soon be bigger than America's

DESPITE falling exports, China's economic growth has remained relatively strong this year thanks to a surge in investment sparked by the government's stimulus measures. Official data show that fixed-asset investment leapt by an astonishing 39% in the year to May, or by a record 49% in real terms. Sowing more today should yield a bigger harvest tomorrow, but how wisely is this capital being used?

Official figures almost certainly overstate the size of the spending boom: local bureaucrats may well be exaggerating investment in order to impress their masters in Beijing. More important, the government's figures misleadingly include land purchases and mergers and acquisitions. But even if measured on a national-accounts basis, like GDP, investment is probably growing at a still-impressive real annual rate of around 20%. This year China's domestic investment in dollar terms is like-

ly to exceed that in America (see chart).

There is widespread concern that this investment boom is adding to China's excess capacity. Investment amounted to 44% of GDP last year (compared with 18% in America), which many economists reckon was already too much. Worse still, as well as forcing state firms to invest, the government is directing state-owned banks to lend more, despite falling corporate profits. Many of those loans could turn sour. Like Japan in the 1980s, it is argued, an artificially low cost of capital causes chronic over-investment and falling returns. If so, it will end in tears. To assess that risk you need to ask two questions. How much excess capacity was there already? And where is the new investment going?

There is certainly excess capacity in a few sectors (steel and some export industries, such as textiles). But the best measure of spare capacity for the economy as a whole—the difference between actual and potential GDP, or "output gap"—is probably only about 2% of GDP, compared with an average of almost 7% in the rich world.

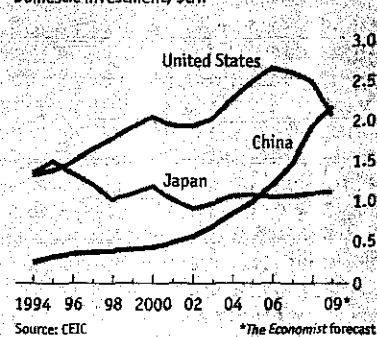
The large role played by state-owned banks is bound to have resulted in some misallocation of capital, but a recent study by Helen Qiao and Yu Song at Goldman Sachs argues that concerns about over-investment are exaggerated. A successful developing economy should have a high ratio of investment to GDP. And a rising rate does not mean that the efficiency of capital is falling; capital-output ratios are supposed to increase as economies develop. America's capital stock is much larger relative to its GDP than China's, with 20 times more capital per person than in China.

A better measure of capital efficiency is profitability. Profits have indeed slumped over the past year, but taking the past decade to adjust for the impact of the economic cycle, profit margins have not narrowed as one might expect if there were massive spare capacity. The argument that the average cost of capital is ludicrously low is also no longer true. China's real interest rate is now 7%, which is among the highest in the world.

Where is the new investment going? ►►

Who is number one?

Domestic investment, \$trn



There has been little new spending in industries with overcapacity, such as steel and computers. But the surge in state-directed investment has fuelled fears about its quality. In its latest *China Quarterly Update*, the World Bank calculates that government-influenced investment so far this year was 39% higher (on a national-accounts basis) than a year earlier, while "market-based" investment rose by a more modest 13%. This implies that government-influenced investment accounts for about three-fifths of the growth in investment this year, up from one-fifth last year.

The usual assumption is that govern-

ment investment is less efficient and will therefore harm long-term growth. But the fastest expansion in spending has been in railways (up by 111% this year). As a developing country, China still lacks decent infrastructure; railways, in particular, have long been an economic bottleneck. Investment in roads, the power grid and water should also yield high long-term returns by allowing China to sustain rapid growth.

And the government is focusing its infrastructure stimulus on less developed parts of the country where the benefits promise to be greatest. According to Paul Cavey at Macquarie Securities, fixed-asset

investment in western provinces was 46% higher in the first four months of this year than in the same period of 2008, almost double the rise in richer eastern provinces.

Some of the money being spent in China will inevitably be wasted, but it is wrong to denounce all government-directed investment as inefficient. In the short term it creates jobs, and better infrastructure will support future growth. It is certainly not a substitute for the structural reforms needed to lift consumer demand in the longer term, but it could help. After all, without running water and electricity, people will not buy a washing machine. ■

Buttonwood | Not so fast

Appetite for risk may have returned, but the crisis is not over

LOW interest rates are intended to ease the burden on debtors, discourage saving, encourage spending and thereby revive the economy. But they also have a distorting effect on asset markets. By reducing the cost of speculation, they encourage bubbles.

So although it is good news that some indicators (such as the cost of bank borrowing) have improved, risk appetites also need monitoring closely. The "search for yield" which marked the boom of 2005, 2006 and early 2007 seems to have started again. Retail investors, disappointed with measly returns on savings accounts, are piling into corporate-bond funds. One British manager is reportedly raking in £1 billion (\$1.6 billion) a month.

Those investors will have to hope that the managers choose their bonds wisely. Standard & Poor's, a credit-rating agency, reports that more companies have defaulted in 2009 than in the whole of last year, and expects the default rate, 7.29% in May, to hit 14.3% by next year. The agency's "weakest link" category contains 290 firms, with nearly \$370 billion of debt, that are deemed to be at risk of failure.

The banks are also rediscovering their willingness to take risks. In a review of the investment-banking sector on June 15th, JPMorgan said that rival banks, eager to rebuild market share, are offering to do deals at "irresponsible prices".

The silver lining to this cloud is that large companies have been able to take advantage of investor enthusiasm to raise money in both the bond and equity markets. J. Sainsbury, a British supermarket group, launched a £445m rights issue on June 17th to fund expansion plans. The very idea would have been unimaginable three months ago.

All this is encouraging the feeling that the worst of the crisis is over. Equity mar-



kets enjoyed an almost uninterrupted rebound between March and mid-June, according to Société Générale, the MSCI World index rose in 13 out of the 14 weeks to June 12th, the best sequence since December 1999. This, in turn, was linked to the feeling that the worst of the recession was seen in the first quarter, and that the global economy could be rebounding by the second half of this year.

There is a kind of positive feedback loop here, in which confidence about the economy boosts the stockmarket and a rising market helps restore economic sentiment (indeed, share prices are included in leading indicators). As strategists at Citigroup remark, the world seems to have moved from worrying about the Great Depression to talking about the Great Escape.

But how real is this shift? Not all the recent economic data have been positive. The June Empire State survey of manufacturing activity in New York showed a retreat. German export figures for April showed a 4.8% month-on-month fall. The latest figures for American and euro-zone industrial production showed similar dips. American raw domestic steel produc-

tion is down 47% year on year; railway traffic in May was almost a quarter below its level of a year earlier. Bankers say that chief executives seem a lot less confident about the existence of "green shoots" than markets are.

The danger is that policymakers have done more to revive the financial markets than they have to shore up the real economy. Tim Lee of PI Economics thinks the authorities are simply inflating another bubble. The carry trade (borrowing in low-yielding currencies to invest in higher-yielding ones) has returned, as shown by the strength of the Australian dollar.

This bubble may start to deflate. Investors are already rediscovering their appetite for government bonds: the yield on ten-year Treasuries had drifted back from a peak of 3.93% on June 10th to 3.67% a week later. Investors may be starting to realise that, even if the biggest falls in output have passed, the outlook for 2010 is still likely to be sluggish.

After all, the problems that existed at the start of this crisis have not gone away. Delinquencies on American mortgage loans are still rising; the seasonally adjusted rate in the first quarter was higher across all categories. European banks may still need to write down another \$283 billion of assets this year and next, according to the European Central Bank. Worst of all, Capital Economics says American consumer debt is more than 130% of disposable income, double its level in the 1980s. Reducing this ratio will require widespread defaults, rapid inflation or a prolonged period of higher savings rates. None of those would be particularly good news for the markets. The crisis took a long time to build up. It will not disappear as a result of one good quarter.

Banyan | Burying Asia's savage past

Balancing reconciliation with justice may be impossible. A tiny bit of either would be nice



FOR several weeks a neat former schoolteacher has sat in a Phnom Penh dock, detailing before the tribunal how meticulously he used to carry out the orders of his bosses. As a child, he said by way of clarification, he had always been "a well-disciplined boy, who respected the teachers and did good deeds". This is Kaing Guek Eav, alias Duch, former commandant of Tuol Sleng, a Khmer Rouge torture-centre and prison, which 14,000 men, women and children entered but only a dozen survived. Duch has admitted blame for the horrors at Tuol Sleng. According to the *New York Times*, he couldn't bear to hear the late Pol Pot claim that Tuol Sleng was a fabrication of his enemies. He thus seems certain to be the first person convicted for playing a part in Khmer Rouge atrocities from 1975-79 that killed up to 2m Cambodians.

This is not unqualified good news. Justice comes years too late. The United Nations and Cambodia haggled for a decade just over the details of the court, eventually set up in 2007. The costs have been gargantuan, though, according to its outgoing chief foreign prosecutor this week, it is still "underfunded and under-resourced". Political meddling is high, and corruption apparently abounds. Some of the senior Khmer Rouge leaders who gave Duch his orders await trial, but they are frail and may not live long. Besides, Cambodia's strongman leader, Hun Sen, is a former Khmer Rouge himself and may be unwilling to see too much dug up. Duch may be the first to be tried, but also the last.

Asia has plenty of killing grounds, and their story is similar. In Timor-Leste two truth-seeking commissions have looked respectively into the death of 200,000 people during Indonesia's scorched-earth occupation after 1975, and into an orgy of arson and killing by the Indonesian army and its vigilante henchmen after East Timorese voted for independence in 1999. By coming up with a record, and by even eliciting an admission of blame by Indonesia, the reports exceeded expectation. Yet many Timorese want a proper reckoning. Reconciliation can get in the way. The reports have gathered dust. Timor-Leste's present leaders argue that, with aid scarce, filling bellies trumps paying for tribunals.

Above all, they do not want to open old wounds. Timor-Leste's first president, Xanana Gusmão, who like Nelson Mandela was a former prisoner of the old regime, also followed Mr Mandela in calling for forgiveness. His successor, José Ramos-

Horta, has since pardoned the very few men to have been imprisoned for the 1999 violence. A culture of amnesty prevails. There is little evidence that it has helped stability. On the contrary, Timor-Leste has seen gang warfare, a mutiny by part of the army and an assassination attempt on Mr Ramos-Horta.

Political leaders' wish to sweep the past under the rug is such an Asian habit that suspicions are aroused when a government seems too keen to try the opposite. Take Bangladesh. The Awami League under Sheikh Hasina wants to try 50 Bangladeshis for atrocities in the 1971 war of secession, in which perhaps 3m died. The suspects include nearly the entire current leadership of Jamaat-e-Islami, the biggest Islamic party and a former coalition partner of Sheikh Hasina's nemesis, Khaleda Zia. Jamaat-e-Islami's youth wing, in league with the West Pakistani army, specialised in killing intellectuals. Still, Sheikh Hasina's nakedly political motives would undermine a tribunal's credibility abroad.

In the end the international response makes, or more usually breaks, the search for justice, which almost always needs foreign support. Who, for instance, pays for reparations? In Cambodia it will not be the doddering former Khmer leaders. In Timor-Leste it was suggested that those who sold arms to the Indonesian army should stump up a share. And pigs may fly. As tribunal costs (and failures) mount, the United Nations and rich-world donors tend to slough off responsibility.

More than that, the process of justice and reconciliation is usually hostage to hard-nosed geopolitics. In private, diplomats from China, staunch ally of the Khmer Rouge and still Cambodia's chief patron today, put down the tribunal's aims. It is easy to forget how the United States also backed the Khmers Rouges as victims of Vietnamese expansionism. Support for the Indonesian army during the cold war meant that America overlooked atrocities in East Timor. That had changed by 1999. But after September 11th Indonesia, the scourge of East Timor, became a chief ally in the war against terror. A newly democratic Indonesia is hardly to blame for its army's past. Besides, many Indonesians were themselves victims of state-backed violence during the Suharto era.

Might is right

Similarly, hard-nosed geopolitics bodes ill for any accounting in Sri Lanka, now that the Sri Lankan army has defeated the Liberation Tigers of Tamil Eelam, with both sides accused of war crimes. For the process to start now is out of the question. Domestic critics of the army's conduct fear for their lives as "traitors". But the response of the UN Security Council was dismal during this year's military endgame, in which tens of thousands of civilians were trapped. Though the UN agrees that "timely and decisive" action should be taken when governments fail to protect their own people, lobbying for pressure on Sri Lanka by the West was mild, and cynical opposition to council action by China and Russia, two chief sellers of arms to Sri Lanka, was vigorous.

As for China itself, Banyan lived a decade ago in a Beijing compound whose backdoor guard, a soft-spoken bourgeois type, had not exchanged a word with the frontdoor guard, his tormentor during the Cultural Revolution, since the last ghastly struggle session in 1969. The era remains nearly off-limits for public debate, and the only reckoning was the show-trial of the Gang of Four in 1981. In that light, any attempt at a first draft of historical honesty, as in Cambodia or East Timor, looks far better than nothing. ■



Migration and climate change

A new (under) class of travellers

ADDIS ABABA AND LOKICHOGGIO

Victims of a warming world may be caught in a bureaucratic limbo unless things are done to ease—and better still, pre-empt—their travails

THE airstrip at Lokichoggio, in the scorched wastes of north Kenya, was once ground zero for food aid. During Sudan's civil war, flights from here kept millions of people alive. The warehouses are quieter now, but NGOs keep a toehold, in case war restarts—and to deal with what pundits call the "permanent emergency" of "environmentally induced" migration.

Take the local Turkana people. Their numbers have surged in recent decades, and will double again before 2040. But as the area gets hotter and drier, it has less water, grazing and firewood. The drought cycle in northern Kenya has gone from once every eight years to every three years and may contract further. That means no recovery time for the Turkana and their livestock; the result is an increasingly frantic drift from one dry place to another.

A local crisis with local causes? Only partly. Scientists think it is part of a global phenomenon: people across the world on the move as a result of environmental degradation. Just how many are moving, or about to move, is maddeningly unclear.

The International Organisation for Migration thinks there will be 200m climate-change migrants by 2050, when the world's population is set to peak at 9 billion. Others put the total at 700m.

These startling numbers may conjure up a picture of huge, desperate masses,

trekking long distances and if necessary overrunning border defences because their homelands have dried up or been submerged. But at least initially, the situation in Kenya and other parts of east Africa is likely to be more typical: an already poor population whose perpetual search for adequate pasture and shelter grows harder and harder. In such conditions, local disputes—even relatively petty ones between clans and extended families—can easily worsen, and become embroiled in broader religious or political fights. And that in turn makes it harder for everybody in the area to survive, and more desperate to find new places to live, even if they are not far away.

A new report—"In Search of Shelter"—by the United Nations University, the charity CARE and Columbia University in New York lists the eco-migration "hot spots": dry bits of Africa; river systems in Asia; the interior and coast of Mexico and the Caribbean; and low islands in the Indian and Pacific Oceans.

A one-metre rise in sea levels could displace 24m people along the Ganges, Brahmaputra, Irrawaddy, Salween, Mekong, Yangtze and Yellow rivers—which together support a quarter of humanity. A two-metre rise could uproot 14m people on the Mekong alone and swamp much of its farmland. Meanwhile, the melting of the Himalayan glacier will cause floods and

erosion upstream, boosting the price of rice and other staples. And many regional conflicts could be exacerbated.

The scale of the likely population shift raises big questions. Will climate-change migrants be recognised? The classic definition of refugees—tossed between states by war or tyranny—is outdated. Eco-migrants will be paperless paupers, whose multiple woes are hard to disentangle.

Poverty campaigners want a revised legal regime to protect the new migrants. However, this looks tricky. America resists calling them "environmental refugees": the word "refugee" implies guarantees that cannot realistically be given to the coming torrent of migrants. As American diplomats quietly admit, their rich country is still reeling from Hurricane Katrina in 2005, which killed 1,800 people and displaced hundreds of thousands.

Can the United Nations High Commissioner for Refugees (UNHCR) expand to cope with eco-migrants? It has already struggled to widen its remit to include the internally displaced (26m at the end of 2008) as well as strictly-defined refugees (10m, excluding the Palestinians who come under another agency). A tenfold surge in the numbers within its orbit would push the agency out of control, says James Milner, a professor at Ottawa's Carleton University. Meanwhile some aid workers see signs of a competition between institutions to take ownership of the eco-migration issue, perhaps by oversimplifying it.

Charles Ehrhart of CARE thinks UNHCR will remain central, but wonders how it or anybody can now distinguish between "forced" and "voluntary" migration. He says climate change may cut agricultural output by half in lowland Africa by 2020. "In such a context, does migration ►►

Also in this section

68 The World Bank and the environment

Greenview, our online column on the environment, appears on Economist.com on Mondays. The columns can be viewed at Economist.com/greenview

► constitute a choice or a necessity?"

Migrants' rights may be easy to assert for islanders whose homes are drowned—but hard in the case of big, messy movements across Africa and Asia. Most of the displaced will drift to the next-most-liveable place, as the poor do anyway.

"Many states are already overwhelmed by internally displaced populations," says Mr Ehrhart. "Will they be able to support even more people on the move? If not, whose duty is it to make up the difference?". At the least, the gap between carbon usage and climate change's effects portends angry North-South rows.

Meles Zenawi, who as Ethiopia's prime minister will speak for Africa at several global gatherings this year, predicts that some parts of the continent will become uninhabitable and "those who did the damage will have to pay." At the December summit on climate change in Copenhagen, he hopes that Africa will "aggressively" demand compensation for environmental damage as well as help with migrants and the mitigation of climate change: in his view a demand of \$40 billion would be reasonable.

Many agree that more research is needed to pinpoint the reasons why migrants pick up sticks. People concur that climate change fuels conflict in Darfur, but nobody knows how big a factor it is. Drought helped jihadist fighters seize bits of south Somalia, but was it the main reason?

Gloom abounds. James Lovelock, an environmental guru, posits a collapse in human population, in part related to migration, with a few "lifeboat" regions surviving. Then there is the pace of social change. The number of "megacities"—with populations in the tens of millions—may grow to several hundred by the middle of the 21st century. Most are poorly planned.

Would a migrant from a collapsed city receive aid? "We've not experienced anything of this kind, where whole regions, whole countries, may well become unviable," says Jeffrey Sachs, head of Columbia University's Earth Institute.

No wonder strategists see vast new security risks, and a big expansion in the world's "ungoverned spaces". But much can be done before the exodus turns biblical. In West Africa subsistence farming is badly irrigated. Improve that, throw in some seeds and fertiliser, scrap tariffs, build warehouses and roads, and the region may beat the worst of climate change.

Geographers at UN Habitat, a city-planning agency, say conurbations must adapt to the needs of climate-change migrants. "You can't just stockpile people," says Alex de Sherbiri of Columbia University. The pressure is tangible in Addis Ababa, which already has teeming slums. The price of teff, a staple, has surged after a famine that is still pushing people to the city. Mr Meles is not alone in his wrath. ■

The World Bank and the environment

When the learning curve is long

After an abrupt about-face, an agency frets about its footprint

IF ANYONE suggested the World Bank did not take global warming seriously, its bosses would bristle: only last October, they would point out, the institution issued a "strategic framework" laying out its thinking on development and climate change. This promised more emphasis on noble things like energy efficiency and renewable power; and more bank support for "sustainable forest management, including reduced deforestation."

Those words intrigued green campaigners, who were up in arms over a \$90m loan by the bank's private-sector arm, the International Finance Corporation (IFC), to the Bertin group, Brazil's leading beef exporter. As the greens observed, cattle farming is widely seen as the biggest threat to the Amazon's trees.

Doubts about the loan were not confined to angry tree-huggers. In a paper that was initially confidential but leaked on the internet, the bank's own Independent Evaluation Group (IEG)—which is supposed to watch the secondary effects of the agency's work—had argued that the credit posed "a grave risk to the environment".

The IFC overruled this advice, saying in January 2008 that its loan to Bertin would help the firm "in establishing sustainable operations throughout its supply chain, especially with its cattle suppliers in the Amazon region." But on June 12th there was a change of heart. The bank said it was pulling out of the Bertin project: it was no longer satisfied that its concerns over sustain-

ability were being met.

There were yelps of glee from greens—along with harder questions about how possible it really is for the world's leading development agency to promote growth, satisfy its member governments and protect the planet all at the same time.

Defenders of the bank say that its concerns over climate change are more than verbiage: of the \$7.5 billion it lent for energy projects in 2008, a respectable \$2.7 billion went to efforts aimed at saving energy or boosting renewable power. This was twice as much as it had lent for such projects in 2007. Admittedly, the bank does also fund coal-fired projects, but it insists that wherever possible, it will opt for greener forms of power.

Earlier this year, a (public) report by the IEG said the bank could congratulate itself on promoting energy efficiency. But as it recognised, this success did not mean everyone's heart had turned green: rising fuel prices had made energy saving an easy sell in many countries. And this benign atmosphere may not last. There are poor countries that see environmentalism as a luxury that hurts their immediate growth prospects. On June 22nd Ethiopia blamed power cuts on the World Bank's refusal to fund a 60MW diesel generator.

David Wheeler, a former World Bank economist who is now at the Centre for Global Development, a think-tank, says such tensions are bound to persist. The bank's regional units are under pressure to meet lending targets and get money out to governments. In that culture, the bank's bureaucrats won't work too hard on goals that hold little appeal for client countries.

Still, when countries want to act over climate change, the bank can do a lot to assist. Mexico, for example, has sought help with cutting energy use in city transport and producing cleaner power. The bank is lending it \$500m in low-interest credits out of a \$5.2 billion Clean Technology Fund to finance new bus networks, replacing the gas-guzzlers that clog Mexico's roads.

Vinod Thomas, the IEG's director-general, sums up the dilemma: "Climate change threatens to derail development, while business-as-usual development threatens to destabilise the climate."

Managing this tension will involve a lot more reflection about the trade-off between growth, the mitigation of climate change and adaptation to its effects. At the bank, some thinking does seem to be going on: that is the topic of its next World Development Report—an annual assessment of the fight against poverty.

Whatever the report says, it will be hard to convince poor countries that action over climate change is a necessity, not a luxury, and that it will not impede growth. The Bertin shambles may go down as a warning for everybody involved in a giant exercise in on-the-job learning. ■



Brazil's burning desire for pasture



Consumer spending in Asia

Shopaholics wanted

HONG KONG

Can Asians replace Americans as a driver of global growth?

ASIA'S emerging economies are bouncing back much more strongly than any others. While America's industrial production continued to slide in May, output in emerging Asia has regained its pre-crisis level (see chart 1). This is largely due to China; but although production in the region's smaller economies is still well down on a year ago, it is rebounding in those countries too. Taiwan's industrial output rose by an annualised 80% in the three months to May compared with the previous three months. JPMorgan estimates that emerging Asia's GDP has grown by an annualised 7% in the second quarter.

Asia's ability to decouple from America reflects the fact that the region's downturn was caused only partly by the slump in

American activity. In most Asian economies falling domestic demand was more important than the drop in net exports in explaining the collapse in GDP growth. The surge in food and energy prices in the first half of 2008 squeezed profits and spending power. Tighter monetary policy aimed at curbing inflation then further choked domestic demand.

The recent recovery in industrial production reflects the end of destocking by manufacturers as well as the large fiscal stimulus by most governments. But the boost from both of these factors will fade. Meanwhile, export markets in developed economies are likely to remain weak. So the recovery in Asian economies will stumble unless domestic spending, notably consumption, perks up.

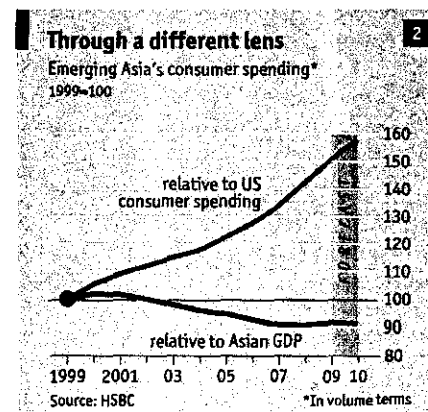
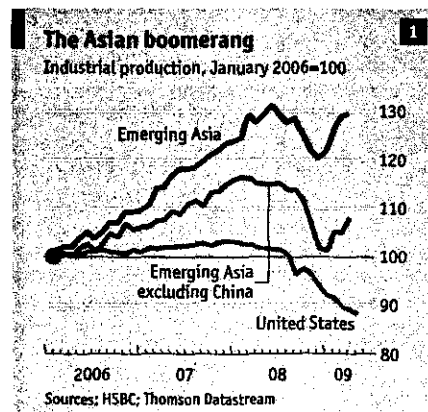
Consumers' appetite to spend varies hugely across the region. In China, India and Indonesia spending has increased by annual rates of more than 5% during the global downturn. China's retail sales have soared by 15% over the past year. This overstates the true growth rate because it includes government purchases, but official household surveys suggest that real spending is growing at a still-impressive rate of 9%. In the year to May, sales of household electronics were up by 12%, clothing by 22% and cars by a stunning 47%.

Elsewhere in the region, spending has stumbled, squeezed by higher unemployment and lower wages. In Hong Kong, Sin-

gapore and South Korea real consumer spending was 4-5% lower in the first quarter than a year earlier, a much bigger drop than in America. But Frederic Neumann, an economist at HSBC, sees tentative signs that spending is picking up. Taiwan's retail sales rose in May for the third consecutive month. Department-store sales in South Korea rose by 5% in the year to May.

It is often argued that emerging Asian economies have large current-account surpluses—and are thus not pulling their fair weight in the world—because consumers like to save rather than spend. Yet this does not really fit the facts. During the past five years consumer spending in emerging Asia has grown by an annual average of 6.5%, much faster than in any other part of the world. It is true that consumption has fallen as a share of GDP, but that is because investment and exports have grown even faster, not because spending has been weak. Relative to American consumer spending, Asian consumption has soared (see chart 2).

In most Asian economies, private consumption is 50-60% of GDP, which is not out of line with rates in countries at similar



► levels of income elsewhere. China, however, is an exception. Private consumption there fell from 46% of GDP in 2000 to only 35% last year—half that in America. In dollar terms, spending is only one-sixth of that in America. (Singapore's consumption is also low, at just under 40% of GDP.)

This explains why China's government has recently taken bolder action than others to boost consumption. Over the past six months the government in Beijing has introduced a host of incentives to encourage households to open their wallets. Rural residents get subsidies for buying vehicles and other goods such as televisions, refrigerators, computers and mobile phones; urban residents get a subsidy if they trade in cars and home appliances for new goods; tax rates on low-emission cars have also been cut. There is huge potential for higher consumption in the countryside as incomes rise: only 30% of rural households have a refrigerator, for example, compared with virtually all urban households.

The government has also introduced several measures this year to improve the social safety net, such as spending more on health care, pensions and payments to low-income households. On June 19th it ordered all state-owned firms that had listed on the stockmarket since 2005 to transfer 10% of their shares to the National Social Security Fund to shore up its assets. The short-term impact is likely to be modest but if such measures ease households' worries about future pensions and health care, it could in the long term encourage them to save less and spend more.

Another way to boost consumption is to make it easier to borrow. In most Asian economies household debt is less than 50% of GDP, compared with around 100% in many developed economies; in China and India it is less than 15%. South Korea is the big exception: households have as

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Buttonwood | Tied to the mast

Coping with the politics of austerity

TAXES are unpopular, and so are public-spending cuts. Democracies may thus have an innate tendency to run up budget deficits. How to control the politicians' urge to splurge? In Greek mythology the song of the Sirens was so seductive that enraptured sailors let their ships run on to the rocks. Odysseus stopped his sailors' ears with wax and had himself tied to his ship's mast so he could hear the song without endangering his vessel.

Various attempts through history have been made to tie politicians to the mast and prevent them from ruining the public finances. The gold standard was one. By anchoring the value of money, the rights of creditors were protected. Spendthrift governments were forced to cut back.

But the gold standard and its successor, the Bretton Woods system, eventually fell apart. In their place came the "bond-market vigilantes". The idea was that investors would boycott the debt issues of offending countries and force governments to bring fiscal policy back into line. That discipline was undermined by the investment policies of Asian and Middle Eastern central banks, which recycled their surpluses into government bonds and kept countries' cost of borrowing down.

Now German politicians are attempting to impose their own discipline. In May they voted to restrict the ability of the federal government to run deficits of more than 0.35% of GDP from 2016. Compare that with a forecast deficit of 6% (including the Länder) next year. Even though the rule distinguishes between structural and cyclical deficits, it could still require Germany to raise taxes and slash spending in a recession—the mistake governments made in the early 1930s.

Perhaps the proposal will not stick. After all, the Gramm-Rudman-Hollings Act of 1985, designed to balance the Amer-



ican budget, was eventually overridden. And just look at California to see how well-meaning measures can lead to fiscal disaster. A two-thirds majority in the state legislature is needed to change taxes, and voters have used their referendum powers to block reforms. The result is that the state is drifting towards bankruptcy. Moody's warned on June 19th that it may downgrade California's credit rating by several notches, which could turn America's most populous state into a junk-bond issuer.

The California example is a sharp rejoinder to the superior attitude taken by Americans and Europeans during the Latin American and Asian crises of the 1980s and 1990s. Developing countries, it was assumed, were simply too immature to take control of their finances. But developed-country voters may be equally unwilling to swallow the medicine of austerity.

The politicians best placed to tackle their deficits may be those that are relatively free of legal restraint. In Britain, which has been described as an "elective dictatorship", the next government, likely to be the Conservative party, will inherit a fiscal mess. But it will be able to slash spending

and raise taxes without hindrance, albeit at the cost of staggering unpopularity.

To switch from Greek myth to Roman history, this might be called the Cincinnatus approach, after the Roman general who was summoned from his farm to deal with enemy attack and returned to the plough once his duty was done. The Conservatives can do the right thing, at the cost of being a one-term government. The temptation, of course, will be to fudge the choice: announce a plan to cut waste in public spending, raise a few stealth taxes and hope that the economy recovers sufficiently to solve the problem.

But this crisis may be different. First, tax revenues seem to have become very volatile. This may be due to economies' dependence on the financial sector and the taxes on traders' bonuses, investment-bank profits, capital gains on rising stockmarkets and all the rest. The shrinking of the financial sector may have caused a permanent dent in the public finances. Second, the long-term fiscal problems of ageing populations (health care, pension costs) will start to make themselves felt over the next decade.

It is true that governments have recovered from enormous deficits in the past, notably after large wars. But post-war economies have a natural tendency to rebound, as soldiers return to more productive work, factories switch from making tanks to building cars, and so forth. No such automatic boosters will kick in this time. The kind of patriotic spirit that encourages consumers to put up with austerity is not yet in evidence either. There could instead be a long decade of political turbulence as voters find that the champagne has run out, and all they have left to drink is castor oil.

much debt relative to their income as Americans and their saving rate has fallen over the past decade from 18% of disposable income to only 4%. In many other Asian economies financing for consumer durables is virtually nonexistent. Promisingly, the Chinese bank regulator announced draft rules in May to allow domestic and foreign institutions to set up consumer-finance firms to offer personal loans for consumer-goods purchases.

These measures are a modest step in the right direction. But a bigger test of Asian governments' resolve to shift the balance of growth from exports towards domestic spending is whether they will allow their exchange rates to rise. A revaluation would lift consumers' real purchasing power and give firms reason to shift resources towards producing for the domestic market. But so far, policymakers have been reluctant to let currencies rise too fast.

Asian spending is already an important engine of global growth. Even before the crisis, emerging Asia's consumer spending contributed slightly more (in absolute dollar terms) to the growth in global demand than did America's. But it could be even bigger if Asians enjoyed the full fruits of their hard labour, rather than subsidising Western consumers through undervalued currencies. It is time for an even greater shift in spending power from the West to the East. ■

Chinese IPOs resume

Thirst-quenching

HONG KONG

After a long period of inactivity, China's equity market reopens

IT IS like a downpour after a drought. In 2007 and early 2008, hundreds of Chinese companies worked feverishly with accountants and bankers to prepare for initial public offerings. Their work came to nothing. Collapsing share prices, a contracting economy, unrealistic expectations on the part of sellers and, finally, restrictions from regulators crushed the IPO market. Now the companies and bankers that have managed to survive a brutal year are once again seeking capital, through listings on bourses in the mainland and beyond.

The first raindrop in China has been Guilin Sanjin, a manufacturer of Chinese medicine, which is expected to issue shares on June 29th on the Shenzhen Stock Exchange, the market for the country's smaller companies. The size of the offering is likely to be a bit under \$100m—a mere rounding error compared to the mega-deals of two or three years ago, but a sign, nonetheless, that business has resumed.



He's in

Another 30 companies have reportedly received regulatory approval to list and have begun final preparation and marketing; 400 more sit in a queue waiting to be approved. Several state enterprises that went public on offshore markets, including China Mobile and CNOOC, an oil firm, are also expected to list at some point in Shanghai. So too may a handful of non-Chinese companies, with interest already expressed by HSBC, in deference to its Shanghai roots, and the New York Stock Exchange (NYSE).

In Hong Kong, a few companies did manage to float in the past few months but the going was tough, with price estimates cut repeatedly prior to the offering, buyers corralled from friends, families and affiliates, and a lacklustre aftermarket. Conditions have turned. Many of these deals are now up significantly. Three small companies have gone public since June 16th, with shares in each case rising by at least 20%.

Bawang, a Chinese toiletries company, is in the final stages of a roadshow and appears likely to price at the top of its pre-marketing estimate. More sizeable deals are expected by the year's end, including a listing of the Asian life-insurance operations of AIG, and dual China-Hong Kong listings for Agricultural Bank of China and two Chinese electrical-distribution firms.

America's capital markets are benefiting too. Two Chinese companies, one producing specialty chemicals (Chemspec) and another water-treatment equipment (Duoyuan Global), made splashy debuts on the NYSE on June 23rd. In every case, regardless of where the listing venue might be, the underlying appeal is the same. Says Jonathan Penkin of Goldman Sachs in Hong Kong: "People are looking for growth. You can find it here." ■

Money-market funds under scrutiny

Sleep therapy

NEW YORK

New rules designed to make money funds safer do not go far enough

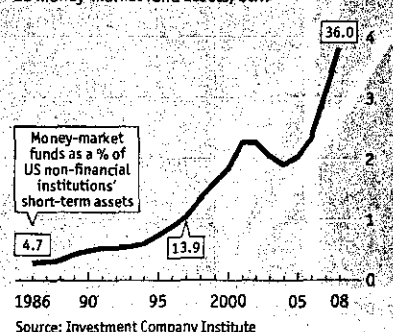
BRUCE BENT, a money-market-fund pioneer, liked to say the industry should aim to bore you into a sound night's sleep. That was before it turned terrifyingly exciting, thanks largely to Mr Bent's own Reserve Primary Fund, which in September became the first money fund since 1994 to "break the buck", or fall below the \$1 net-asset value per share that all funds seek to maintain. That triggered a run on money funds and traumatised the short-term debt markets they help to oil, forcing the American government to guarantee the industry's almost \$4 trillion of assets—and confirming fears that it had become a big source of systemic risk (see chart).

With the guarantees due to expire in mid-September, pressure is on to tighten regulation. On June 24th the Securities and Exchange Commission (SEC) proposed a number of rule changes that are likely to go into effect after a brief comment period. Funds would be required to hold up to 10% of their assets in cash or bonds that can be sold within a day so they can more easily meet redemptions; to cut the maximum average maturity of their portfolios from 90 to 60 days to reduce interest-rate risk; and to buy only top-notch securities (up to 5% can currently be invested a grade below). Funds will also be allowed to suspend withdrawals if they break the buck, to allow for more orderly liquidation.

Welcome though these measures are, they fall short of the dramatic action needed to tame the systemic threat. The SEC deferred a decision (again) on whether to reduce overall reliance on credit ratings. It also postponed judgment on whether to eliminate the stable net-asset value, which would make money funds more like standard mutual funds, the prices of which ▶▶

Too big to fail

US money-market fund assets, \$trn



fluctuate. Instead, this will be considered in a multi-agency report due in September.

Industry giants, such as Vanguard and BlackRock, have lobbied against moving to a floating asset value. It could prove counter-productive, sending investors scurrying to less regulated offshore vehicles that still offered a fixed price, argues Paul Schott Stevens, head of the Investment Company Institute, a trade group. The big question is whether money funds should be allowed to offer investors what amounts to a promise of capital preservation without having to succumb to bank-style supervision, capital requirements and insurance. Not for nothing are they called "shadow banks". A stable net-asset value may not be legally guaranteed, but shareholders

treat it that way. As with banks, there is a mismatch (albeit a smaller one) between the term of funds' liabilities and their assets. And they will enjoy implicit government backing, in aggregate if not individually, once the temporary insurance ends.

Policymakers seem to have little stomach for treating money funds as banks, however, despite support for the idea from Paul Volcker, an adviser to Barack Obama. This suggests that they have been too quick to accept the industry's prediction that radical surgery would cause chaos; tellingly, Mr Stevens talks of a "meeting of the minds" with officials. As long as money funds are able to keep bank-like features without bank-like scrutiny, they should keep everyone wide awake. ■

Friction in world trade

Duties call

A row with China points to fraying tempers

DESPITE the periodic sighting of green shoots elsewhere in the economy, the landscape of global trade remains resolutely bare. The World Bank said on June 22nd that world-trade volumes, reeling from a drastic collapse in global demand (see chart), will shrink by nearly 10% this year. That would be the sharpest fall since the Depression, and the first decline in trade since a small dip in 1982.

Unsurprisingly, tempers are fraying as governments struggle to find ways to protect their own. The latest salvo was fired on June 23rd by America and the European Union, which complained to the World Trade Organisation (WTO) about China's restrictions on the exports of nine minerals, including bauxite, coke, magnesium and manganese. These are important raw materials for the steel industry, among others, and China restricts their exports on the grounds that they are exhaustible resources. But America and the EU argue that by hindering their export, China is unfairly favouring domestic industries.

John Veroneau, a former American deputy trade representative, believes the case against China is a strong one. He also argues that this week's move can be seen as an effort to foster more trade (as there surely would be if China were to ease its export restrictions) at a time when trade is in a great deal of trouble. In practice, it is unlikely to have that effect. If the case proceeds to the stage where a formal WTO panel is formed to decide on its merits, it could drag on for several years, by which time trade will, with luck, have recovered from its current moribund state. ►►

Hedge-fund philanthropy

Alternative social investments

LONDON AND NEW YORK

Hedge-fund giving is proving surprisingly resilient

THIS has been the worst year or so in history for the hedge-fund industry, with many funds suffering deep losses and record numbers of them going out of business. Yet some leading hedge-funders remain firmly committed to giving away a chunk of their fortunes.

As *The Economist* went to press the Children's Investment Fund Foundation, a charity based in London, was due to announce that it had received a whopping £495m (\$822m) in the 2008 fiscal year from ROR, a hedge fund, under covenants built into the fund when it was founded by Christopher Cooper-Hohn in 2003. The gift took the value of the endowment to just over £1.5 billion, all of which Mr Cooper-Hohn and his wife, Jamie, who oversees the day-to-day running of the foundation, will use to help children in the developing world.

Yet the crisis has taken its toll on London's hedge-fund philanthropists. In two instances, the Cooper-Hohns have filled (at least temporarily) a funding gap caused by partners suffering such deep losses that they could no longer fulfil their pledges to fund projects. On June 5th an annual gala and auction organised by Arpad Busson, a starry hedge-fund boss, for Absolute Return for Kids (ARK), another charity, raised £5.6m, well down from £25.5m in 2008.

That made the annual transatlantic hedge-fund give-off between ARK and the organisation that inspired it even less of a contest than usual. At its gala auction in New York in May the Robin Hood Foundation, which tackles poverty in the city, raised a record \$72.6m, up from \$56.5m in 2008 and topping by just over \$m the previous high in boom-era 2007. The achievement owed much to George Soros, the original hedge-fund philanthropist, who pledged to give up to \$50m over two years if it was matched by a similar sum from Robin Hood's board members. That created a pool of up to \$100m to be used to match other pledges.

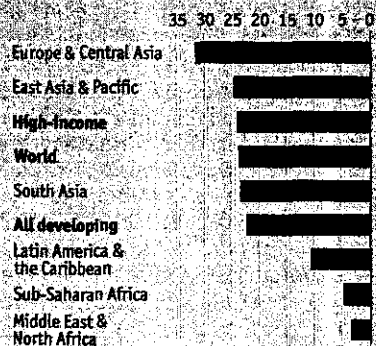
In keeping with the times, both galas were lower-key affairs than usual. ARK cut the cost of the evening by two-thirds, and for entertainment attendees had to make do with a speech from Boris Johnson, the mayor of London. And Robin Hood's traditional auction of items such as dinner with Mikhail Gorbachev or a day on the set of the next James Bond movie, which has been criticised as a platform for rich show-offs, was replaced with a fund-raising session using wireless technology that allowed donors to give anonymously.



Frugal Busson and bill-killer

Less for everyone

Export volumes
Latest, % decrease on a year earlier



Source: World Bank

Jeffrey Schott, a trade expert at the Peterson Institute for International Economics, a think-tank, says that the case against China may also help the cause of open trade in other ways. If Ron Kirk, America's new trade representative, demonstrates that he is actively enforcing the agreements already in place, he may get "the authority to negotiate Doha and other accords".

That may be too sanguine. True, America and the EU are not resorting to imposing fresh barriers of their own in this dispute; for that matter, China's export restrictions are not new either. But trade experts warn that protectionism remains a serious worry. Of particular concern are the so-called "Buy China" requirements added to China's stimulus package this month. These require recipients of money from China's mammoth fiscal expansion to choose domestic suppliers "unless products or services cannot be obtained in reasonable commercial conditions in China". This sounds like out-and-out protectionism. But America, which included similar "Buy America" provisions in its own stimulus bill, may find it hard to raise a stink. ■

The craze for clearing houses

Counter insurgency

Central counterparties may not be all they are cracked up to be

CENTRAL counterparties (CCPs) have been part of the financial plumbing in exchange-traded markets since at least 1925, when the Board of Trade Clearing Corporation in Chicago took responsibility for settling grain futures. But they have never been so popular as now.

The idea is a good one. CCPs act as the buyer to every seller in a market, and the seller to every buyer. They collect margins on every trade; members put money into a reserve fund as well. Traders only have to worry about the creditworthiness of one entity, with which they can net off their trades. If a big trader goes under the financial system is less likely to go with it.

CCPs are the norm in exchange-based markets but they have been scarce among surging over-the-counter (OTC) derivatives, notably the gigantic market for credit-default swaps (see chart). OTC traders like to deal directly with each other, and their products are often too specialised to fit on an exchange. Reform is coming. America's Treasury called in May for all "standardised" OTC derivatives to be cleared through CCPs. The world's big banks have promised to clear more derivatives. On June 22nd a convention to standardise credit-default-swap (CDS) con-

Mortgage defaults in America

Can pay, won't pay

It is easier to dump a home loan if a friend has done so too

HOUSE prices in America have fallen so far that as many as one in five households have mortgage debt greater than the value of their homes. In a few states, borrowers are not liable for the shortfall between an unpaid loan and the resale value of the home it is secured upon. Even where borrowers are on the hook, lenders often find it too costly to pursue unpaid debts. So some homeowners may be tempted to default and escape the burden of negative equity.

How widespread is this practice? New research* based on a survey of 1,000 homeowners suggests that one in four mortgage defaults are "strategic"—by people who could meet their payments but who choose not to. The main drivers of strategic default are the scale of negative equity, and moral and social considerations. Few would opt to renege on their mortgage if the equity gap were below 10% of their home's value, the authors find, partly because of the costs of moving. But one in six would bail out if loans were underwater by a half.

Four-fifths think strategic default is wrong. Those in the unethical minority are four times more likely to renege on loans (allowing for other influences)

when their negative equity reaches \$50,000. But morality has its price. When the equity gap reaches \$100,000, "immoral" homeowners are only twice as keen to walk away from their debts as "moral" ones. People under 35 or over 65 are less likely to believe that default is wrong. So are the well-educated.

Anger about bail-outs of banks or carmakers does not weaken the moral barrier to default. But people who live in neighbourhoods where home repossessions are frequent are more likely to welsh on loans. Homeowners who know someone who has defaulted strategically are 82% more likely to say they would do so, too. The likelihood of strategic default rises more quickly once the rate of local home foreclosures reaches a critical level. That hints at a vicious cycle of foreclosures that both depress home prices and weaken the social and economic barriers to further defaults. To break the cycle, policymakers need to address the problem of negative equity, not just unaffordable interest payments.

* "Moral and Social Constraints to Strategic Default on Mortgages" by Luigi Guiso, Paola Sapienza and Luigi Zingales, University of Chicago Working Paper

tracts for clearing took effect in Europe. New CCPs are sprouting everywhere.

Not everyone is happy about this trend. Craig Pirrong of the University of Houston worries that CCPs dull the incentive to trade prudently. Traders are more likely to take on risky positions because some of the losses they may generate are ultimately borne by others—the CCP and its other members. As for a CCP itself, however well intentioned it may be, it cannot monitor traders' complex derivative positions as well as they themselves can. And it is prob-

ably less motivated to try.

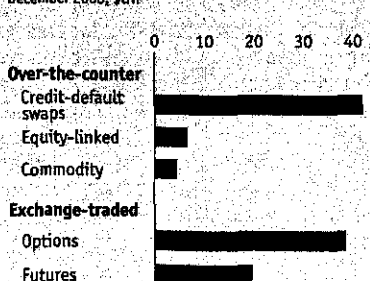
There is also a risk of creating too many CCPs. The scope for netting across all types of derivatives is reduced when CCPs are created to clear only one type of product; that could leave OTC traders with greater overall exposures than before. Even the benefit of netting within a single class of derivatives is impaired when more than one CCP starts up in the same market, which is precisely where things are heading. Three have been approved to clear CDSs in the past six months alone.

And while regulators fret that some banks are "too big to fail", they may be creating another set of institutions of equal systemic importance. "With their myriad clients the big trading banks in effect function as CCPs already," says Darrell Duffie of the Stanford Graduate School of Business. "Why double their number?"

CCP clearing may also impose greater demands on cash for businesses that currently use OTC derivatives. Whereas banks could tailor collateral requirements to the nature of their customers, CCPs will impose uniform margin requirements on everyone. If the benefits of CCPs in OTC markets are so overwhelming, why did they not emerge on their own? ■

Getting the all clear

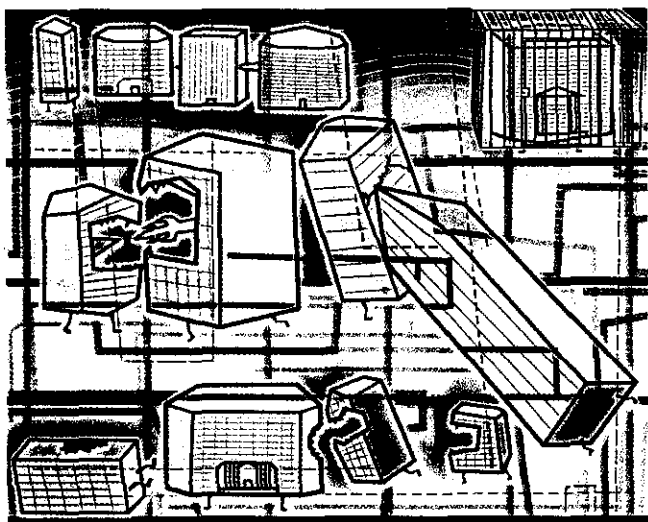
Global derivatives, notional amounts outstanding December 2008, \$trn



Source: Bank for International Settlements

Economics focus | Deliver us from competition

If competition in banking leads to too much risk-taking, the right remedy is better supervision



RICKY GERVAIS, a comedian, tells a story about an anxious flight. When informed that the airline no longer offered newspapers to passengers, in order to cut costs, he found it all too easy to imagine a maintenance worker inspecting the plane's undercarriage and asking: "Do we really need all these rivets?"

That firms which strive hard to sustain profits may act incautiously is a concern in many industries. The severity of today's financial crisis is blamed by some on the pressure of competition on banks. There is a bulky academic literature that links liberalisation of markets with an increase in bank failures. It argues that the lifting of restraints, such as interest-rate caps on deposits or rules that prevent banks from operating in certain markets, leads to more intense competition. That is good for borrowers, but it also hurts banks' profit margins by reducing the "franchise value" that comes from expected earnings.

A diminished franchise is not only bad for shareholders. By reducing the stake that banks have in their own long-term survival it may make bank failures more likely. A bank that could look forward to a stream of fat profits in a sheltered market would be careful to lend prudently to avoid a bankruptcy that would destroy the franchise. But a bank earning only lean and uncertain margins on garden-variety loans may have little to lose by gambling on riskier ventures. If these paid off, the bank would benefit. If they did not, depositors or government would pick up the bill.

This theory is backed by some empirical work. Research published in the *American Economic Review* in 1990 found that a measure of franchise values fell after restrictions were lifted on where banks could operate. Banks that lost market power as a consequence also held less capital as a buffer against bankruptcy. A more recent study by Vicente Salas, of the University of Zaragoza, and Jesus Saurina, director of the Bank of Spain's financial-stability wing, found the same pattern in Spanish banking. Fewer restrictions spurred competition, squeezed profit margins and led to more risk-taking by banks. (Not all the evidence points this way: though these studies of individual markets indicate that competition can lead to fragility, international comparisons suggest the opposite, according to a survey last year for the World Bank by Thorsten Beck, now of Tilburg University.)

There is clearly some tension between financial-stability

goals and the tenets of competition policy, which hold that oligopolies are inefficient and serve consumers badly. Nevertheless, many policymakers seem to think that some curbs on competition may be a price worth paying to improve stability. Australia's banking system has come through the crisis intact, for example, and the former head of the country's central bank, Ian Macfarlane, has said that one reason for this is that the biggest four banks were banned from merging. Freed from the fear of a takeover, bank executives did not have to chase profits as aggressively as their brethren in America or Britain. This may explain why the big four banks have not needed a government bail-out and have retained high credit ratings. Another case where an unchanging market structure has gone hand in hand with financial stability is Canada. It still has the same five big banks it had two decades ago and none has needed to draw on state support.

Efficiency versus stability

The antitrust response is to say the problem is not too much competition but too little regulation. Trustbusters are rightly wary of special pleading on behalf of banking or other industries. A bank bankruptcy may be troublesome if it triggers other failures and damages the whole payments and credit system. Yet there can be "systemic" problems in other competitive industries too. A food scare in one factory may prompt consumers to steer clear of similar products made by other firms, for example. But the remedy for worries about food safety is not to reduce competition but to regulate and enforce standards. So it should be in banking. Competition among airlines could in principle compromise passenger safety. That it does not is because of regulation. Setting Mr Gervais's worries aside, it is rarely suggested that food firms or airlines are less safe because of too much competition.

There is another reason not to treat banking as a special case. One route to market power is size. Consumers find it costly, or are often reluctant, to switch between banks so an industry dominated by a handful of firms is unlikely to be competitive. If the franchise-value argument is correct that ought, at least, to yield stability. What's more, bigger banks can diversify their earnings, which should further militate against failure. But a bank with sufficient market power would also be considered too big to fail, and would be rescued in the event of bankruptcy. Such knowledge can lead to excessive risk-taking and is one reason why Switzerland's central bank has said the country's two mega-banks may have to be cut down to size. Another idea in regulatory circles is to force big banks to hold a larger capital buffer than smaller ones.

For finance to be stable, banks have to bear the costs of their risk-taking. A bank's franchise value is one form of capital. It is lost forever if the bank fails and so is a guard against reckless gambling with deposits. The idea of bribing people to behave well (in this case, by letting banks enjoy market power) may be objectionable but is at least familiar. The theory of "efficiency wages" says that firms which cannot monitor workers' efforts well should instead pay high wages to make it costlier for them to risk being sacked. But it would be far better to keep a closer eye on banks and force them to match their tangible capital with their risk-taking appetite. By making banks build reserves in good times and reducing their room to get around capital regimes, Spain's regulators drew the right lesson. Where competition leads to more risk-taking, the correct response is to monitor banks more closely. ■

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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 plays 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.

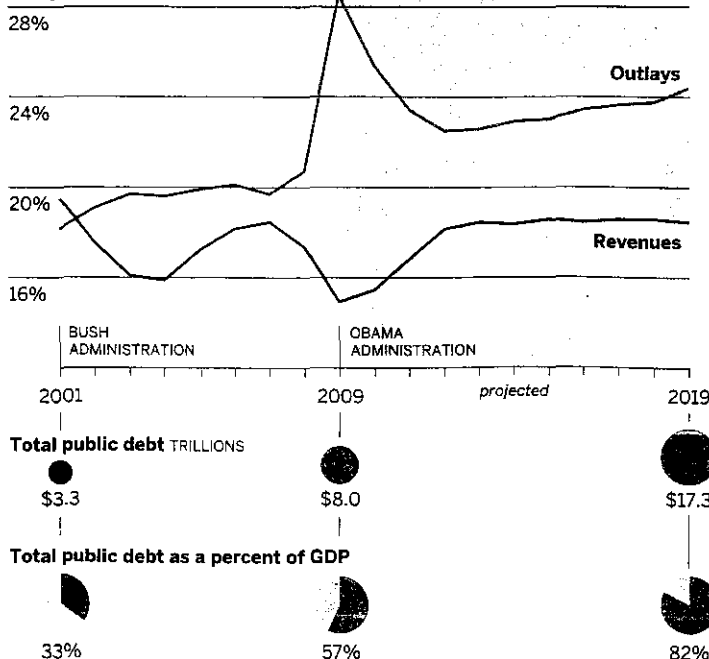
As Krugman and Ryan point out, the problem isn't so much the big budget gaps for this year and next, though their scale is shocking. It's the policies that will allow the trend to become far worse in the future. After the stimulus spending winds down and the economy recovers, our spending will still 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.

U.S. outlays and revenues as a percent of GDP





which will grow more vivid each year. In 2008 federal borrowing accounted for 41% of GDP, about the post-war 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,

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."

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

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*.

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. ■

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



What Japan Got Right

The economic news isn't all bad.

BY ROBERT ALAN FELDMAN



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.

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, CO₂ 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.

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

CORBIS



THE INSURGENTS

THE SECRET BATTLE TO SAVE CAPITALISM.

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

BY MICHAEL HIRSH

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

PHOTOGRAPH BY CHARLES OMMANNEY—GETTY IMAGES

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

THE CAPITALIST MANIFESTO

GREED IS GOOD (TO A POINT)

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

BY FAREED ZAKARIA

ARTWORK BY MARK WAGNER

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 startups. 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

CRISIS

1637

1719

1720

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:

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

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

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

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.

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-

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

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

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 to be leveraged at 30 to 1. The incentives for executives within banks are skewed toward reckless risk-taking



1792

U.S. BANK RUN: The ink is hardly dry on the Constitution before bank speculators and tight credit start the Panic of 1792.

1820s

LATIN AMERICA LOSSES: South American bond markets go wild, luring British bankers who soon regret their folly.

1837

DEPRESSION HITS U.S.: Bank deregulation and frenzied land speculation provoke hysteria. Years of unemployment ensue.

1840s

MAJOR TRAIN WRECK: Some 150 years before the dotcom crash, British railways suffer a similar speculative bubble.

1893

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,

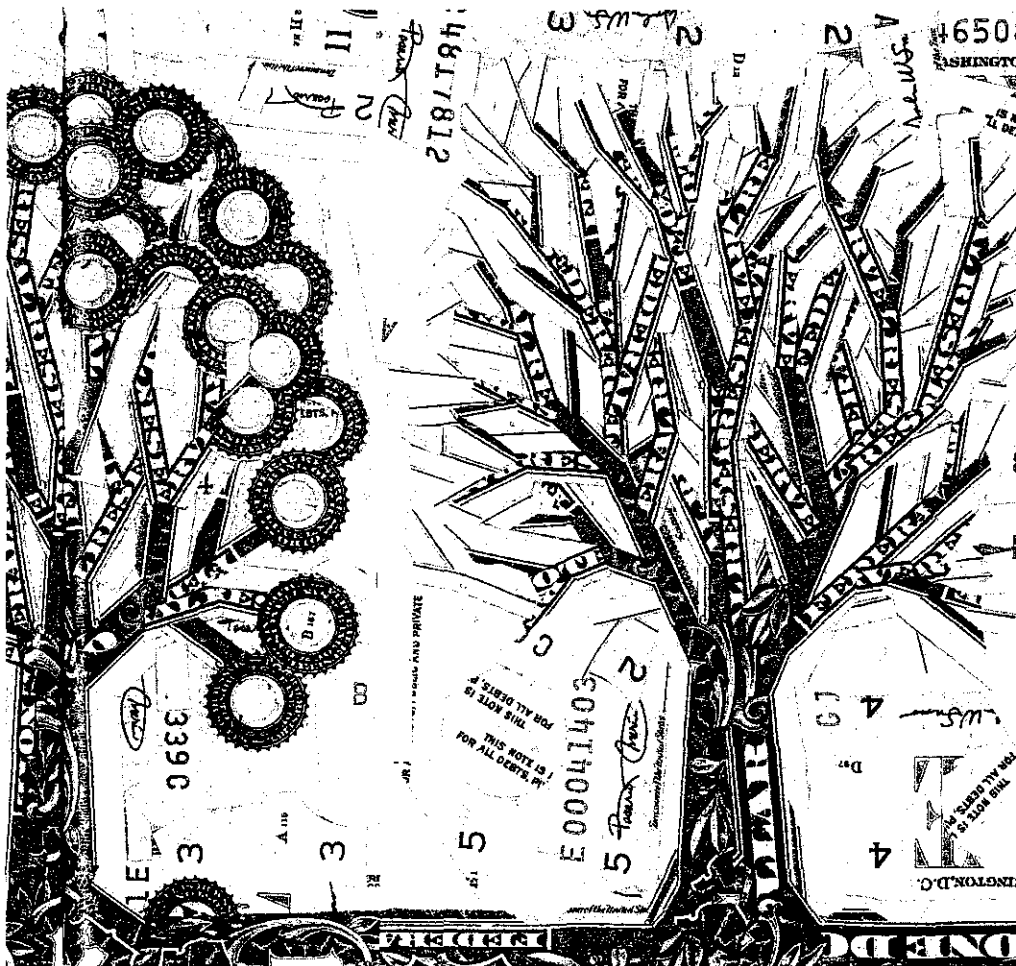
and the Fed kept rates low. And the public cheered this pandering at every step.

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 an 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



**OVER THE PAST
QUARTER CENTURY, MORE
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countries with high inflation had dwindled to a handful. Only one, Zimbabwe, had hyperinflation.

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. Bank-

ers 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

THE 'ASIAN CONTAGION': A flood of foreign cash makes local bankers careless. Then the currency traders swarm in.

1998

TOO BIG TO FAIL: LTCM, the "Rolls-Royce of hedge funds," hemorrhages money, but no one dares to refuse it a bailout.

2000

THE 'DOT BOMB': Driven by Internet fever, the NASDAQ peaks at 5048 on March 10. From there it's all downhill.

2000

THE DERIVATIVES DEBACLE: Self-financial inventions turn a U.S. housing-market correction into a worldwide meltdown.

2009

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.

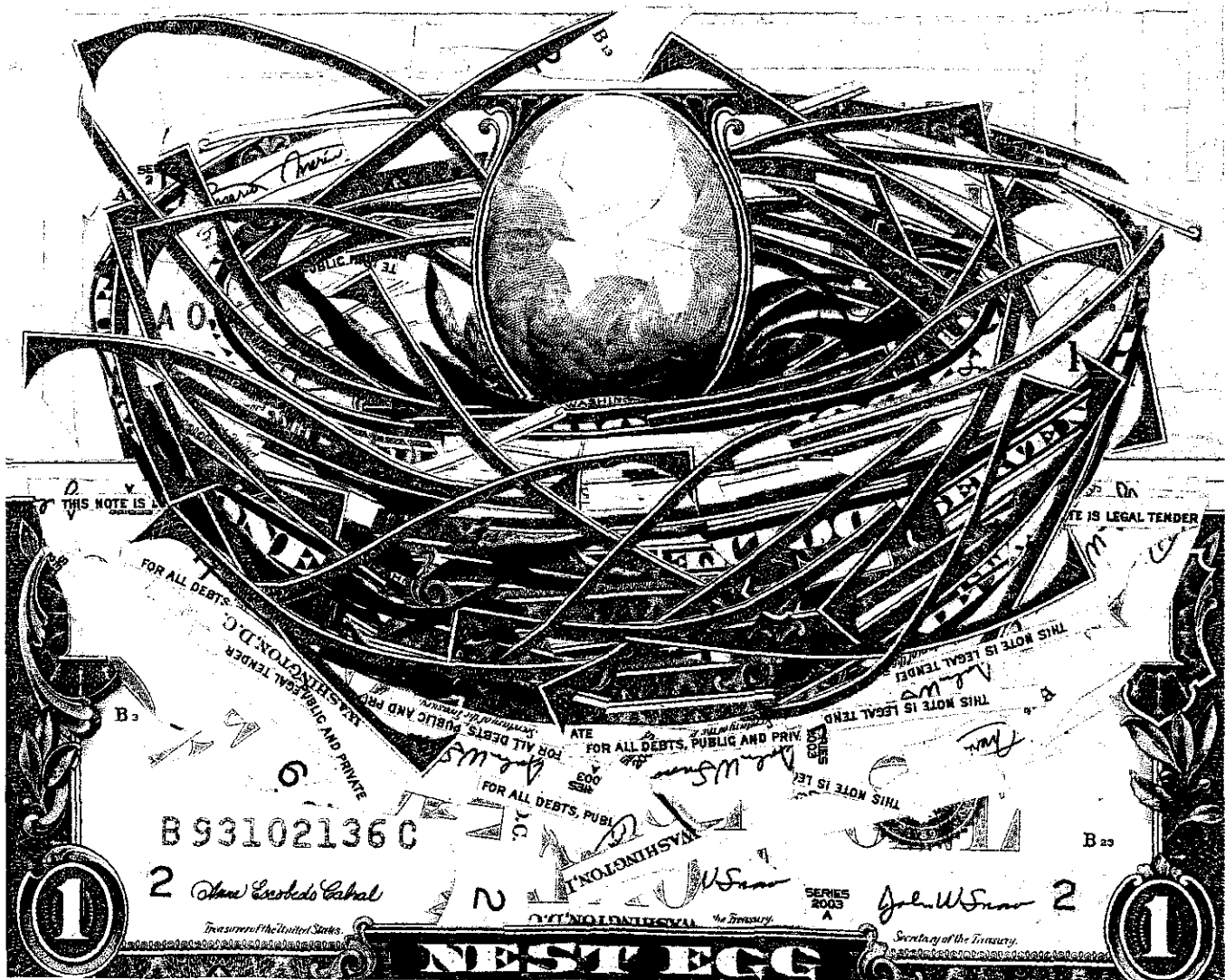
The failure of self-regulation over the past 20 years—in investment banking, accounting, rating agencies—has led inevitably to the rise of greater government regulation. This marks an impor-

tant 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

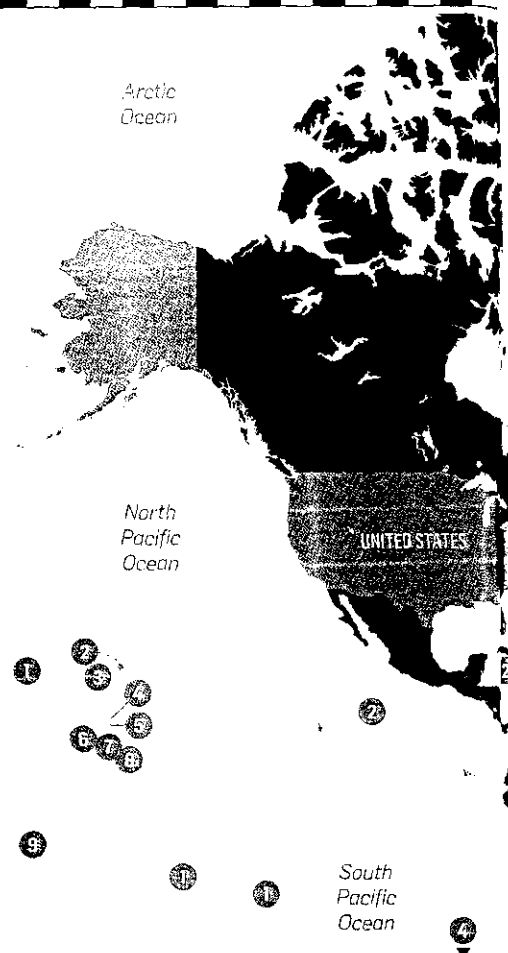
Bush administration envisioned for Iraq.

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.

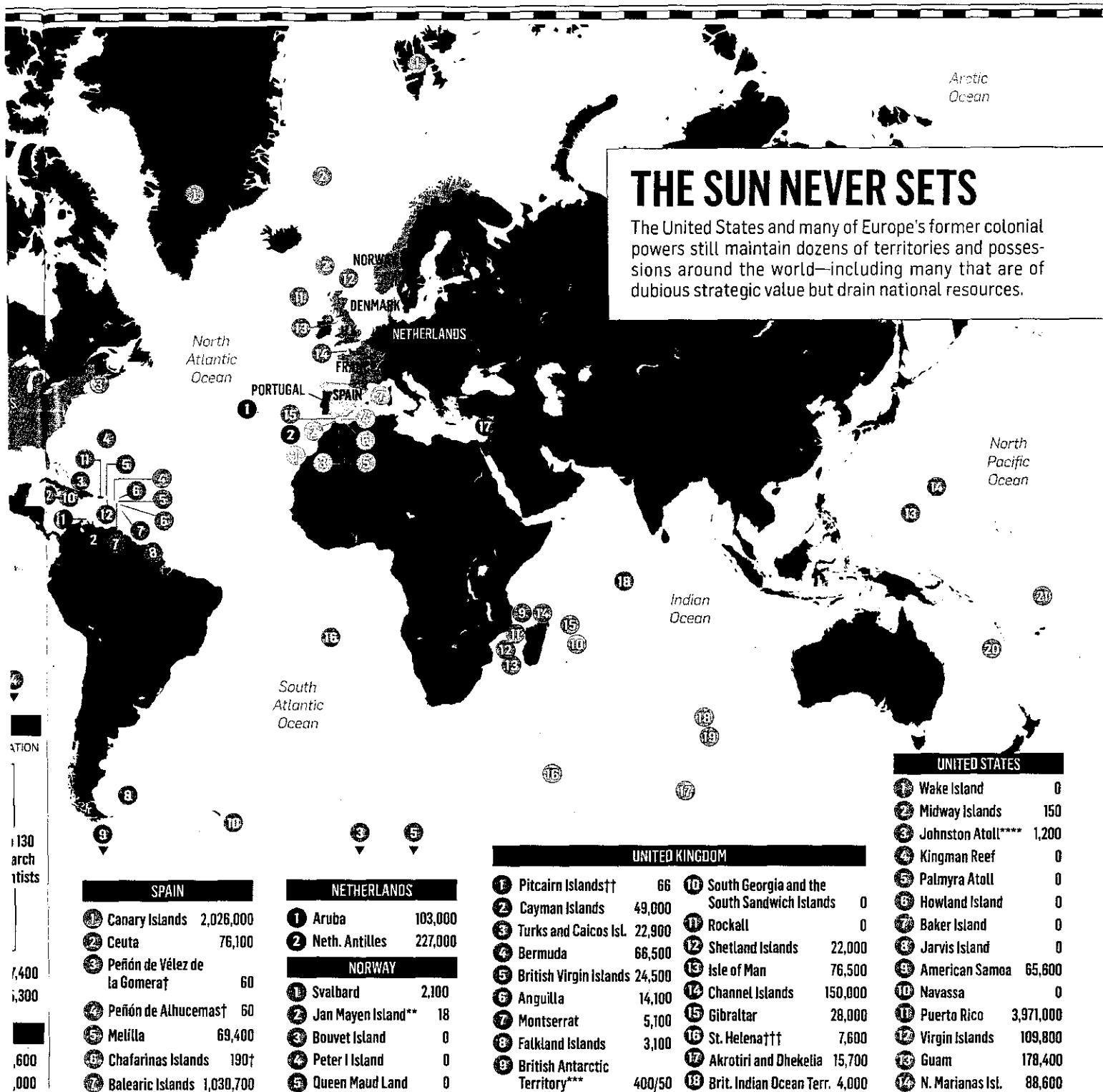
But is it? Equitable treaties clearly make



FRANCE			
POSSESSIONS	POPULATION	POSSESSIONS	POPULATION
1 French Polynesia	287,000	11 Juan de Nova*	
2 Clipperton Island	0	12 Bassas da India*	
3 St-Pierre and Miquelon	7,000	13 Europa*	
4 St-Martin	30,000	14 Glorieuses*	70 to 130 research scientists
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		PORTUGAL	
1 Greenland	57,600	1 Azores	242,600
2 Faeroe Islands	48,900	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.

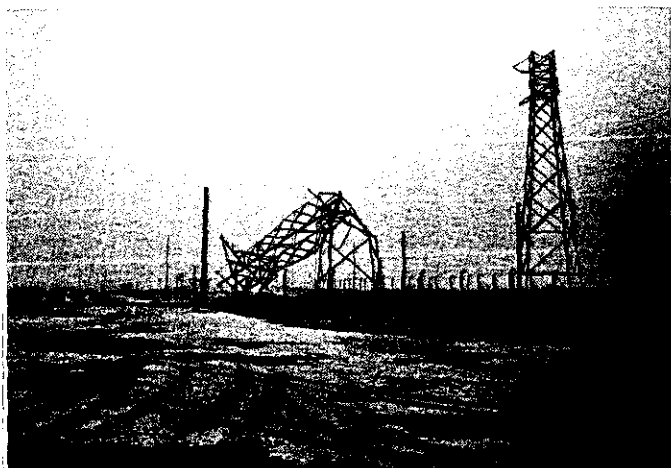
Guadeloupe and Martinique in the Caribbean are more typical. They are considered part of France's national territory, like the states of the United States. Yet despite massive subsidies funded by French taxpayers, they have been the scene of so much unrest over the past few months that Sarkozy has postponed 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. Employ-

ment 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

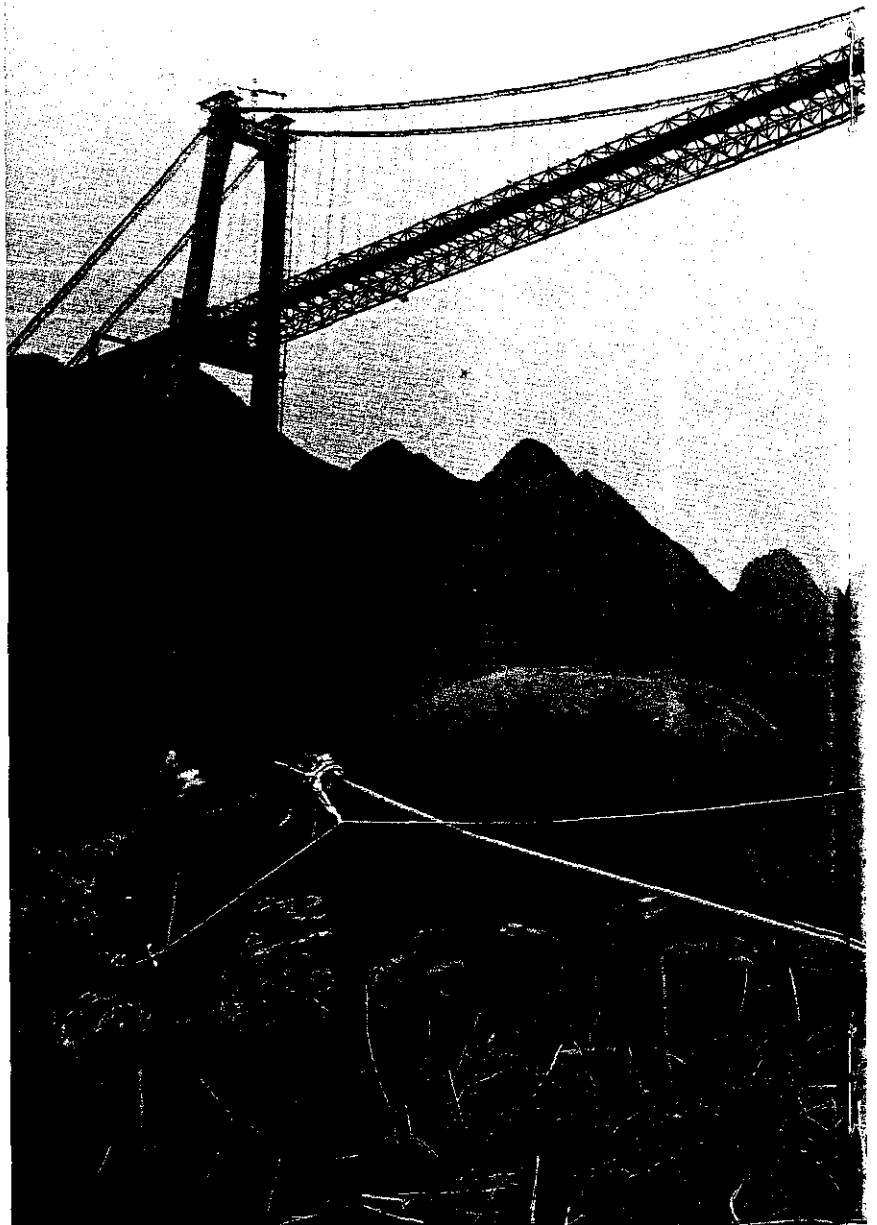
WORLD

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

GUIZHOU PROVINCE, IN SOUTH-western 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



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



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

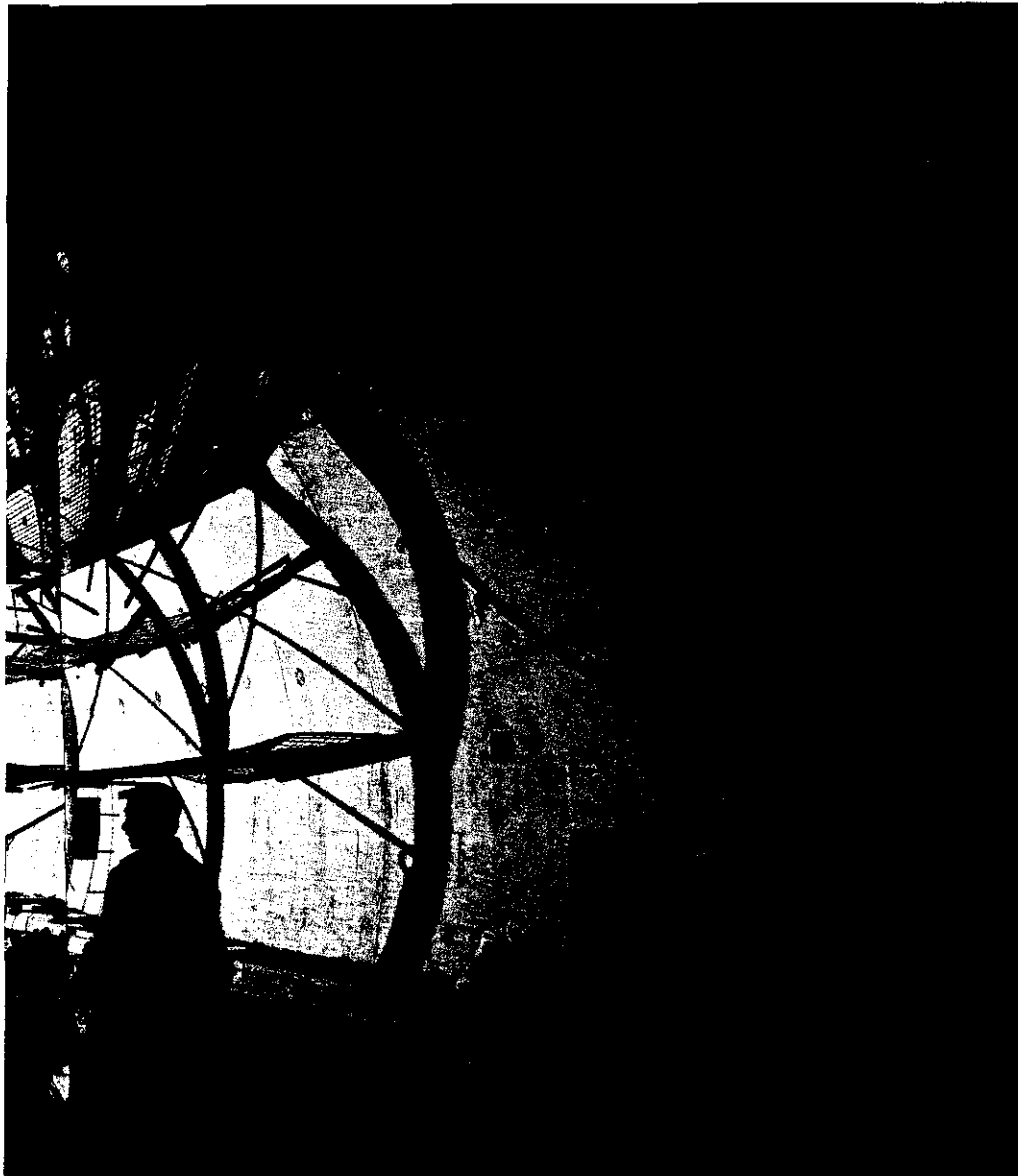
Bringing development to the provinces A construction worker walks through a tunnel leading to the Baling River Bridge



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 al-

'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

ready 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."

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

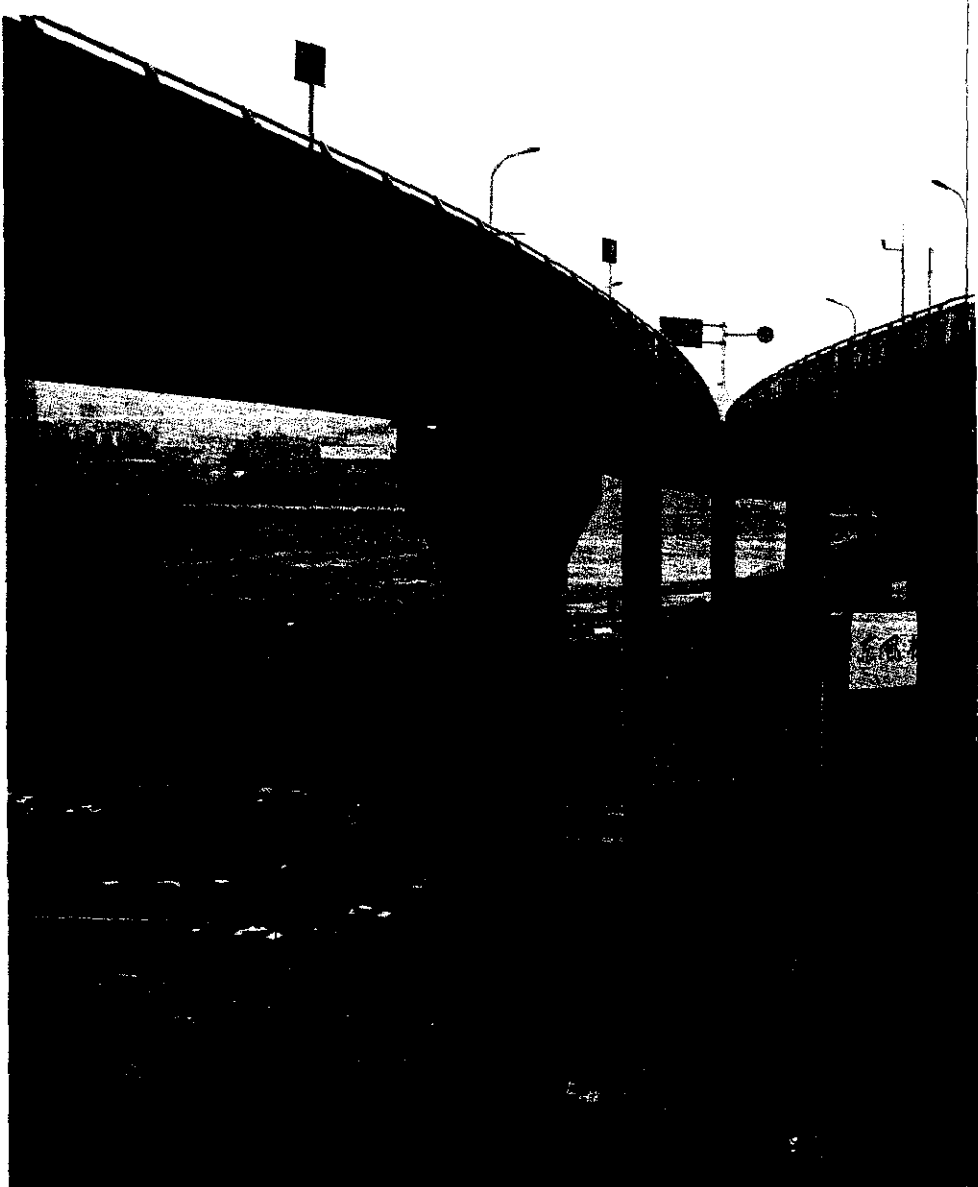
and Tianjin as well as their hinterlands—have grown much faster than the country's interior provinces, which have always been poorer. For years the central government has tried various policies to lift western China, without much result. The infrastructure push gives Beijing another chance to address 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

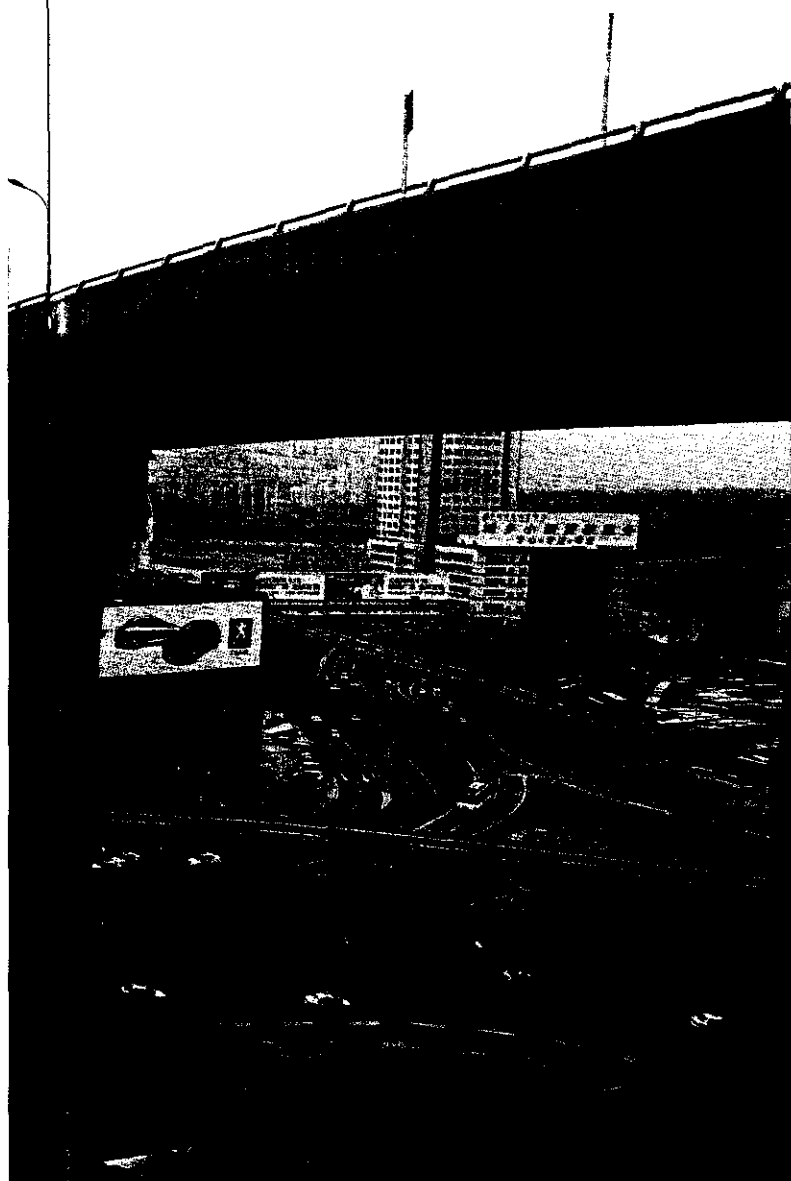


'We still need at least 20 years to develop infrastructure to catch up with developed countries.'

—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

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 ■

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



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

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

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. ■

'[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

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."

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

'89

DECEMBER 29, TOKYO, JAPAN

After The Bubble

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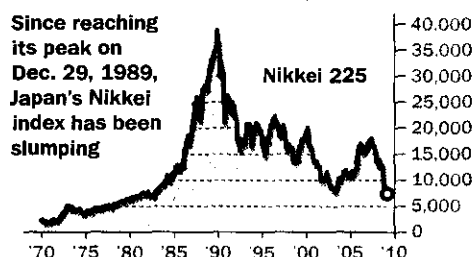
By Bill Powell/Tokyo



A tired mood *The scene today at
Tokyo's Chiyoda commercial district*



Peak, and Troughs



Source: Yahoo! Finance

IN THE AUTUMN OF 1989, JIN MATSUSHITA WAS MAKING more money than he ever dreamed he would; more money, indeed, than he thought he'd ever need. After joining Yamaichi Securities straight out of high school, Matsushita had worked his way up from lowly office boy scribbling stock prices on a chalkboard to fully fledged stockbroker in Yamaichi's nationwide army of salesmen—and what a golden time it was to be trading stocks for one of Japan's largest securities firms. Japanese companies like Toyota and Sony were becoming globally dominant, while the country's businessmen, flush with cash, fanned out across the world, snatching up iconic properties like New York City's Rockefeller Center, the fabled Pebble Beach golf course and Hollywood's Columbia Pictures. Matsushita himself was earning an annual salary of \$150,000 plus a bonus that often exceeded his base pay. Everyone was getting rich. The Nikkei 225 stock index soared to an all-time high of 38,916 on Dec. 29, 1989. "It was a kind of miracle, I suppose," says Matsushita.

It was the kind of miracle that doesn't last: an economic bubble that soon burst. What followed was collapse and years of torpor that came to be known as Japan's "lost decade." Neither Tokyo property prices nor Japanese stocks—nor the Japanese people, for that matter—have ever fully recovered. The Nikkei index on June 15 closed at 10,040, an astonishing 75% below its 1989 peak. And Matsushita, now 73, is working the night shift at a convenience store just to make ends meet.

Looking back, it's odd that so few people saw the bust coming. I certainly didn't. In 1989, I was Tokyo bureau chief for *Newsweek*, and I lived through the bubble years acutely aware of what strange days they

Photographs for TIME by Andreas Seibert

TIME: JUNE 29 - JULY 6, 2009

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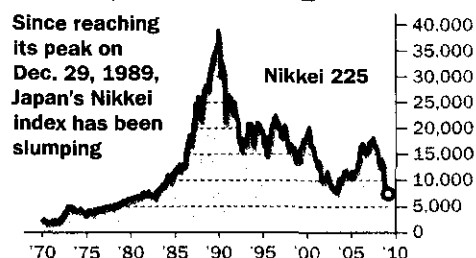
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Photographs for *TIME* by Andreas Seibert



Now and Then
View photos
of Japan at
[time.com/
journey/japan](http://time.com/journey/japan)

were, yet without quite realizing those days were numbered. It should have been obvious that such excess was unsustainable. At one point, the combined value of Tokyo real estate was said to eclipse that of the entire U.S. In Japan you could easily spend more than \$1,000 on a round of golf or on an evening in a hostess bar in Ginza. All this reinforced the notion that Japan was an industrial giant that seemed able to outcompete even the mighty U.S. George H.W. Bush, then U.S. President, came to Japan with trade at the top of his agenda, only to famously throw up on Kiichi Miyazawa, Japan's Prime Minister, during a state dinner. Miyazawa gently cradled Bush's head as the stricken President slumped in his chair, an image that we journalists couldn't resist using as a metaphor. The country that had been vanquished militarily now seemed poised to conquer the world economically. The *Atlantic Monthly* captured the angst this caused in a two-part series entitled "Containing Japan."

Why did serious publications think Japan needed to be contained? Because at the time, it seemed as if its politicians, policymakers and business leaders had patented a superior brand of capitalism. In less than two generations, the country had climbed out of the wreckage of war to become the world's second largest economy. Books like *Japan as Number One* detailed how different its economic system was from that of the laissez-faire U.S.—the government directed capital into key industries and allowed powerful business groups, called *keiretsu*, to exclude competitors from domestic markets, while Japanese companies made relentless inroads into Western markets. Americans who once scared themselves silly watching news footage of phalanxes of Soviet troops parading through

Red Square instead made themselves queasy by watching phalanxes of Toyota workers performing calisthenics before hitting the factory floor.

Technology and money and power were flowing across the Pacific to Japan, and salarymen—guys like Jin Matsushita—were among the lucky beneficiaries.

Tokyo in those days was a gilded city, where restaur-

rants sold sushi sprinkled with gold flakes. Other foreign correspondents would cover wars and risk getting shot. In Tokyo, as the dollar sank in value against the yen, the greatest risk I faced was having a heart attack when the bill for dinner arrived.

Japan was exotic, and it could also be insular and xenophobic. When foreigners stayed out past midnight, after the subways in Tokyo closed, they risked being unable to get a cab home. I was once out carousing into the morning hours with a couple of friends from Japan's Ministry of Finance—the elite among Japan's powerful bureaucrats—when we tried to flag a taxi. I told my friends no driver would stop unless I



hid in the shadow of a nearby building. "No, that's not true," one of them protested. I hid, and within seconds a cab pulled up for my Japanese companions. I jumped into the backseat, much to the dismay of the cabbie. My buddy expressed shock. "What a racist country we are," he muttered. I laughed. This wasn't racism, it was capitalism. Cab drivers assumed a foreigner wasn't going very far, whereas the average salaryman lived some distance from the center of town, guaranteeing a big fare. Like everything during the bubble, it was all about the money.

The Toll of a Long Slumber

BUBBLES ARE FUN, BUT WHEN JAPAN'S IMPLoded, IT sucked the life out of an entire country, stripped it of ambition and of the sense of rapid progress that had come to define its postwar history. Yoichi Funabashi, now the editor of the *Asahi Shimbun*, one of Japan's most influential daily newspapers, told me: "An entire generation has been born and grown up, and known nothing but slow economic growth and limited opportunity. Compare them to their father's generation, the generation that turned so many Japanese companies into household names all over the world. I don't think young people today have any idea what they are going to do, or what even they are supposed to be doing."

On a visit to Tokyo today, it's easy to miss this toll that the country's long slumber has taken. The city has always been orderly and efficient, and parts of it now seem even more prosperous than they did in 1989. The once drab business district around Tokyo

'An entire generation has been born and grown up, and known nothing but slow economic growth and limited opportunity.'

—YOICHI FUNABASHI, EDITOR,
ASAHI SHIMBUN



From high to low
A boisterous scene
at the Tokyo Stock
Exchange in 1989,
left; below, Jin
Matsushita, now
73, has seen far
better days



Station near the Imperial Palace is now full of high-end retail shops and pleasant pedestrian malls. Japan in some ways managed to spread the economic pain over 20 years, so that it is more like an endless dull ache than an open wound.

For many Japanese, though, the pain is not merely abstract and psychological. Consider Matsushita. Nine years after the Nikkei peaked, Yamaichi Securities—the company where Matsushita, in true Japanese fashion, spent his entire career—went under. It

had finally succumbed to the moribund stock market, as well as a scandal in which company officials got caught hiding trading losses. Matsushita had 90% of his life savings tied up in Yamaichi stock when it imploded. Although he was a financial adviser and ought to have understood the risk, this is not so surprising. Ask an American what he does for a living, and he'll usually describe his profession: I'm a banker, an engineer, an auto worker. Ask a Japanese, and he'll name his employer—I work for Toyota, I work for Sony—because he fiercely identifies with that organization. When I gently suggest to Matsushita that perhaps it was unwise for him to have put all his savings in one basket, he gets a bit defensive. "My wife and I had furious squabbles over this after Yamaichi went down," he says quietly. "She asked how I could do this. But I worked for Yamaichi Securities," he explains. "It never occurred to me, never, that one day our company would not exist." And then, to reinforce his point, he says to his American visitor: "One year ago, did you think it was possible for General Motors to go bankrupt?"

I don't have the heart to tell him yes. Americans today are learning only too well that industrial icons can fail when a bubble bursts. The crash of the debt-fueled U.S. real estate market and the subsequent financial crisis have plunged the country into the worst recession in decades. Although the U.S. is starting to show signs of stability, Japan's postbubble malaise demonstrates how long it can take for a damaged financial system to heal.

Twenty years on, Matsushita is still counting the costs of Japan's years of excess. Sitting in the community room of a residential complex east of Tokyo, where he now lives, he explains how he bought his apartment in 1996, the year he retired from Yamaichi. He paid 76 million yen (about \$775,000 at current exchange rates) for the place, borrowing 59 million yen of the total to finance it. That debt is the bane of Matsushita's existence. When Yamaichi failed in 1998, wiping out most of his savings, he had no way to pay off the note with just his meager income from social security. The price of his apartment collapsed soon after he had bought it, so he can't sell. And unlike in the U.S., where owners can take their lumps and walk away from mortgages without the debt following them, Matsushita's is a "recourse" loan—common in Japan—which means that harsh penalties await those who fail to keep making payments for any reason.

So eight years ago, Matsushita took a job at a local 24-hour convenience store to make enough money to live and pay off his mortgage. The septuagenarian works the graveyard shift—9:45 p.m. to 7:15 a.m.—for \$81 a day. "I usually do get to work overtime hours and make a bit more money," he says, "because the high school and college kids [who relieve him in the morning] aren't very responsible. They are always coming up with excuses as to why they can't make it in until 10 a.m. or so." And just before heading off for another night shift, he adds: "That never happened when I was young." But when Matsushita was young, Japan had its best days ahead of it.



Extra Money

To read Justin Fox's daily take on business and the economy, go to time.com/curiouscapitalist



The End of the Affair

Corporate America used to be enamored of China, and vice versa. The attraction is fading

IN MAY 2005, WHEN THE CORPORATE world's enthusiasm for China was at its peak, I spent a few days in Beijing in the company of a bunch of top business executives from the U.S. and Europe. The occasion was a conference sponsored by my then employer, *FORTUNE*, and as I sat through the speeches and panels and dinners, I was repeatedly struck by the almost puppy-like devotion to the Middle Kingdom voiced by Western CEOs.

This can't possibly last, I remember thinking. I had no real idea how it would end, though, just a vague sense that the Chinese mix of economic freedom and political repression might eventually prove combustible. Well, we're still waiting on the combustion—China is already motoring out of the global economic downturn, and its government seems as cohesive and entrenched as ever. But the economic romance between the world's most populous nation and the biggest multinational corporations is nonetheless on the rocks.

The Chinese government has begun turning a cold shoulder to Western corporations hoping to cash in on its consumers. Meanwhile, corporations are paying much closer attention to the risks and hidden costs of supplying their home markets with stuff made thousands of miles away in China. None of this necessarily means an end to the extraordinarily co-dependent economic relationship that China and the U.S. in particular have built up over the past decade. But it does mean big changes.

To understand why, let's go back to May 2005. Back then, CEOs loved China

because it had become the world's low-cost, increasingly high-quality manufacturing hub. They loved its vast and growing ranks of middle-class consumers. Most of all, the capitalist bosses loved working with officials of the nominally communist Chinese government, who were far easier to deal with than the politicians back home. And why not? On one side, you had autocrats who feared

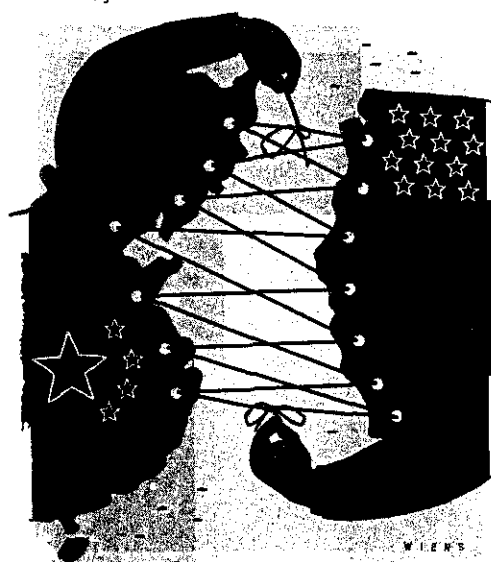
late last year, almost 90% said they were contemplating bringing some operations home or at least closer.

The sharp downturn in global trade has delayed action on those ideas. So far the only evidence of the shift is in consultant surveys like Ferreira's. In Beijing, though, the downturn has brought its own attitude adjustment. "The Chinese response is 'We are too coupled to the

American economy,'" says Ian Bremmer, president of the Eurasia Group, a political-risk consulting firm. That has led to more domestic spending by the government and attempts to boost Chinese consumers' spending. True, neither is necessarily bad news for foreign firms. It has, however, also meant an increasing reluctance to let U.S. companies call the shots in China. The most visible evidence of this was the denial in March of Coca-Cola's bid to buy juicemaker Huiyuan, but Bremmer says that's just the tip of the iceberg. "The ability of Western companies to do effective business in China over the next five years is going to be increasingly limited," he says.

To some extent, this is the inevitable cooling down of an overly

intense relationship. But in economics as in love, breaking up is hard to do. Bremmer recently co-authored the book *The Fat Tail*, which details the political risks facing the global economy. (Major, unlikely events that are difficult to fit into statistical models are known as fat tails.) He counts the U.S. relationship with China among the fattest of fat tails. American corporations may come to see China as a rival—meaning they'll be less likely to fight congressional crackdowns on trade. The U.S. investment banks that have been China's biggest boosters are not the powers they were two years ago. And in China, the troubles of the U.S. financial system have led to a growing mistrust of U.S. intentions and the American form of capitalism. The love affair was strange and overdone. The aftermath could be ugly. ■



losing their grip on power if the economy didn't keep growing; on the other were autocrats who feared losing their grip on power if profits didn't keep growing. They had a lot in common.

Over the past couple of years, though, the China equation got unbalanced. First came a spike in shipping costs that led manufacturers in the West to take a closer look at all the costs—time to market, quality control, etc.—of stringing their supply chains across oceans. While shipping rates have since subsided, the shift in mind-set among executives has stuck, says John Ferreira, head of the manufacturing practice at Archstone Consulting. No longer is there a herd mentality pushing them to China and other faraway places, he says. When Ferreira surveyed U.S. and European manufacturing execs

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ILLUSTRATION FOR TIME BY CARL WIESER

JACOB SILBERBERG—REUTERS