



Institute of Strategic and International Studies (ISIS) Malaysia

**CURRENT ECONOMIC SITUATION
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The 'New Normal' Economy

The Davos forum explores implications of regulations amid discussions of a new world economic order

COURTESY OF WANG YONG



By WANG YONG

The 40th World Economic Forum, held in Davos, Switzerland, on January 27-31, drew more than 2,500 political, economic and academic leaders from around the world, amid an international spotlight and high expectations.

It has more than lived up to the hype: Indeed, the annual event offered a powerful, signature depth of understanding and a call to arms addressing the well-known frailties of the world economy.

With the theme of "improving the state of the world: re-thinking, re-establishing and reconstruction," this year's meeting was aimed at exploring the post-crisis global economy and, in particular, a "sustainable recovery roadmap."

New norms

The theme of the first symposium at this year's Davos forum addressed the question: What is the "new normal" in the world growth?

The "new normal," an idea conceived by Mohamed El-Erian, CEO of the global investment management company PIMCO, became a key term in the forum. The word "normal" alludes to the stability of the global economy prior to the financial crisis.

This "new normal" has proven controversial based on the questions it poses: What kind of lessons can we learn from the crisis? And how should the world develop new rules and mechanisms to ensure the continued development of the increasingly globalized economy?

Although a consensus was reached that the "new normal" will have to possess different meanings in different areas, post-crisis reform remains badly needed.

Regarding the post-crisis financial system, for example, the "new normal" would be a combination of lower financial leverage coupled with a more robust government intervention.

The world would embrace a different financial system, in which strict regulation would be the "new normal," said Michael Spence, a Nobel Prize laureate in economics. In this system, he added, capital requirements would be high, and the banking

system would be more effective.

For the global macro-economy, the "new normal" will signify a higher degree of uncertainty.

Some participants argued, for instance, that after the crisis, the global economy will be hard pressed to revert to its previous rate of strong, steady growth. As the economic recovery will remain slow, moreover, the pain will continue.

But White House chief economic adviser Lawrence Summers did not ascribe to this pessimistic view. The U.S. economy, he said, will probably not fall prey to this "new normal," and that the likelihood of rapid growth still exists.

Regulation controversies

Whether and how to strengthen financial supervision was another focus at Davos. A week before the forum started, U.S. President Barack Obama's "financial reform plan" made the subject white hot. Political leaders with a mandate for popular reform suddenly found themselves at odds with major banking and financial institutions.

Barney Frank, Chairman of the U.S. House of Representatives' Financial Services Committee, said at the Davos forum that financial institutions are inherently unable to self-regulate. To prevent a larger-scale financial meltdown in the UK or the United States in the future, he added, more stringent financial regulation and supervision are strongly needed.

President Nicolas Sarkozy of France, which has been an active member of the Group of Eight and the Group of 20 (G20), clearly ex-

pressed his support for Obama's financial "New Deal" at the opening of the forum.

The rules of the 20th century cannot apply to the management of the 21st century, Sarkozy said.

The weak supervision, associated with ceaseless, dogged quests for profits, has permitted excessive speculation. In the end, what followed was a global catastrophe.

In such desperate times, according to Sarkozy, it is unacceptable for large financial institutions to be receiving government assistance while doling out bonuses to senior management.

George Soros, on the other hand, struck a different note, saying it is still too early for governments to exert such tight regulatory measures. These policies, he noted, may well frighten banks into being more cautious in their lending practices—something that could well inflict heavy damage on the U.S. economy, which is still very much in its recovery stage.

Robert Diamond, President of the British financial services firm Barclays PLC, also expressed pronounced opposition to Obama's regulatory plans. Restrictive measures, he argued, cannot prevent another financial crisis, and that more regulations portend to adversely affect banks in London and New York.

Many bankers have long capitalized on the concerns of politicians about the economic recovery, as well as the competition from emerging markets, to minimize financial supervision. Forum participants, not surprisingly, had little good to say about those who have exploited such conventions to their own ends.

Indeed, according to electronic polling



SPIRITED DEBATES: Participants hold discussions at the annual meeting of the World Economic Forum in Davos on January 31

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at the event, only 12 percent of participants expressed worries that a shadow of excessive regulation over the financial system could lead to another financial collapse.

This directly contrasts survey data recently released by the U.S. professional services firm PricewaterhouseCoopers on January 26, which indicated that 60 percent of bankers strongly fear increased government regulations.

International bankers should be reminded of the numerous missed opportunities to avert the current global crisis. After a serious financial crisis rippled from Asia to Russia and Brazil from 1997 to 1999, European regulators and their Japanese counterparts rightly called for more stringent supervision of capital flows, while China and other developing nations proposed the establishment of a "new international financial order."

Regrettably, these far-sighted proposals were cast aside by Washington. In fact, so pronounced was the sway of Wall Street lobbyists, that the U.S. Government actually exerted more efforts toward refusing to accommodate these requirements than simply ignoring them altogether.

Similar political struggles will continue, of course. But it is imperative that a new consensus on financial supervision should be reached between the government, the financial sector and the general public. Such an agreement will allow for a more sustainable growth for the global economy well into the future.

Banks and other financial institutions also have an obligation to understand that a tighter, more properly designed supervision system is in their own long-term interest.

Global coordination

Recently, international economic institutions have inflated their forecasts for the global economy this year. For example, in its 2010 economic forecast, the International Monetary Fund (IMF) raised its estimation of global economic growth this year to 3.9 percent from 3.1 percent.

Moreover, different forecasts have predicted that developing countries will likely become locomotives of the global economic recovery.

Not surprisingly, the UN has predicted that China and India will produce the fastest economic growth—at 8.8 percent and 6.5 percent, respectively. On the other hand, growth for most developed countries, according to UN statistics, will be generally modest and unstable.

This trend is underscored by data that predicts the U.S. economy will increase by a mere 2.1 percent, while the EU and Japan are expected to witness growth of only 0.6 percent and 0.9 percent, respectively.

On the eve of its opening session, the Davos forum released its global risk report for 2010. The report warns that all nations remain vigilant against the possibility of a second wave of financial crisis.

It is clear that were there a second global recession, the vast majority of optimism surrounding economic growth would cease. Given the seriousness—and possibility—of such a scenario, Davos forum participants called for greater international cooperation.

For instance, Jaime Caruana, General Manager of the Bank for International Settlements (BIS), called for more balanced macroeconomic policies and increased private sector involvement.

More importantly, he argued, coordination between the Financial Stability Board, the G20, the BIS and other international financial agencies must be strengthened.

Justin Lin, chief economist at the World Bank, noted that one of the biggest challenges the world community faces is how to conduct a

transformation from a stimulus-based recovery to market-oriented growth, while reducing unemployment. IMF delegates also warned rescue plans should not be abandoned prematurely.

To enhance international coordination, we need platforms like the Davos forum with which to forge a consensus among nations. Moreover, we should try to make these international mechanisms more practical and effective.

Judging by the current situation, the G20 can clearly be a practical choice.

Today's challenge is to fortify the G20 mechanism, while reaching a compromise between its developing members and industrialized members. Also, cooperation mechanisms must be developed along with a universal financial regulatory framework.

Undoubtedly, leaders of industrial nations with formerly advantageous positions under the old world order—especially the United States—must now stand up to domestic pressure to oppose damaging policies like trade protectionism. At the same time, these nations must embrace a new economic order. Only in this way, will we be able to see the formation of a just and sustainable global economy. ■

Diplomatic Dynamics

China Condemns U.S. Arms Sales to Taiwan

China has decided to postpone military exchange programs and security talks with the United States over Washington's recent approval of a multibillion-dollar weapons sale to Taiwan, according to the Chinese Foreign Ministry.

In addition to delaying exchange programs between the two countries' military forces, Beijing said that it will put off the China-U.S. Vice-ministerial Consultation on Strategic Security, Multilateral Arms Control and Non-proliferation, which had originally been slated to take place in the coming months.

Beyond that, China will also impose sanctions on U.S. firms involved in the sales. The two countries' cooperation on some significant international and regional issues will likewise be affected, the ministry said.

On January 29, Washington unveiled a plan to sell a package of arms worth nearly \$6.4 billion to Taiwan—including *Black Hawk* helicopters and *Patriot III* anti-missile interceptors.

In an urgent meeting the following day, Chinese Vice Foreign Minister He Yafei told John Huntsman, U.S. Ambassador to China, that the arms sales will seriously damage China-U.S. relations and cause havoc on bilateral exchanges in diverse areas. The consequences for the deal, he added, will be ones neither side wishes to see.

"The Chinese side strongly urges the United States to fully recognize the great harm of arms sales to Taiwan," he said, urging an "immediate cancellation" of the decision.

China Pledges Assistance to Afghanistan

China will offer assistance to conflict-ridden Afghanistan in various forms—including funding for development, personnel training and help in establishing joint ventures, said Chinese Foreign Minister Yang Jiechi.

Yang made the pledge on January 28 after attending the London Conference on Afghanistan.

Representatives from more than 60 countries and international organizations took part in the daylong convention, which focused on Afghanistan's security, governance and development as well as regional and international aid to the country.

Strengthening Afghanistan's sovereignty and development capacity is of critical importance in laying the groundwork for a full transition to "governance of Afghanistan by the Afghan people," Yang said.

Retrospect and Outlook

The Chinese economy owes its success and survival from the economic meltdown to the series of responsive Central Government stimulus projects initiated in 2009. And as the new year progresses, the government's responses in the past year can be used to cast a positive outlook for the Chinese economy in 2010. **Zheng Xinli**, Vice Chairman of the China Center for International Economic Exchanges, offered his insights at the First Annual Meeting of the Chinese Economy held on January 17 in Beijing. Edited excerpts follow:

Last year, the world economy faltered amid the most serious economic crisis since the Great Depression. Even though some countries have been able to rally their economies, the world's major economies, in the long run, will undergo a long, drawn-out process in their recoveries that will most likely feature significant adjustments to their economic policies.

The sweeping financial crisis posed many challenges to China and its economic development in 2009, with the economy showing the following characteristics:

A higher growth rate was scored in the second half of the year than in the first half. Data collected throughout the year showed a V-shape recovery.

While the economic rally last year was largely propelled by investment, gratifying changes took place in domestic consumption.

Commodity prices remained low whereas asset prices saw a rapid increase.

Unemployment was fundamentally mitigated and employment, especially for migrant workers, improved dramatically.

Exports suffered from decreases, but a rebound is at hand.

The banking system stayed fit, laying a solid foundation for the economic haul.

The Chinese economy's rapid recovery was mainly attributed to the government's stimulus measures.

Unfavorable factors handicapping the Chinese economy still exist, from the economic pick-up's dependence on investment to the calls for further adjustments to the economic structure, as well as the low proportion of residential income compared with total income, the prevalence of overcapacity, potential pressures on the finance, and greater stress on the banking system due to credit defaults, especially growing risks for local government loans.

Outlook in 2010

Only if the current proactive fiscal policy and moderately easy monetary policy continue, will the Chinese economy maintain a steady

and comparatively rapid growth rate this year.

To be more specific, the Chinese economy will score a higher growth rate in the first half of this year than in the second half. The annual GDP growth is expected to reach 9 percent. The growth of investment will remain high, but may experience a slowdown compared to 2009. The growth for fixed assets is expected to exceed 20 percent this year.

Consumption will see a rapid growth and play a relatively steady role in promoting economic development. It is expected to account for 4 percent of the annual GDP growth.

Foreign trade will improve and play a positive role in driving up economic increases, with imports expected to rise by 13 percent and exports by 10 percent year on year.

Industrial production will continue to grow along with the adjustment of the industrial structure in line with demand changes.

Commodity prices will stay stable whereas production materials and some industrial goods will face mounting pressures

as prices increase. The consumer price index is expected to reach 3 percent and the producer price index 5 percent.

This year, credit will not shrink dramatically. Monetary liquidity will still suffice. It is estimated the M2 increase will hit 18 percent, and new loans will total 8 trillion yuan (\$1.17 trillion).

In an effort to realize steady and rapid economic growth in 2010, policymakers should adhere to the following criteria:

1. Macroeconomic policies should focus on domestic demand and sustaining a steady and rapid economic growth. Equal importance should be attached to expanding domestic demand and stabilizing overseas demand. As for expanding domestic demand, especially consumption, unjustified taxations levied on rural and urban residents should be cleared out, and exemption standards for personal income tax should be increased from 2,000 yuan (\$294.1) to 3,000 yuan (\$441.1) or even higher. National income distribution should also be reformed to adjust the relationship between primary distribution and secondary distribution. What's more, urbanization should be the driving force in enhancing consumption growth.

2. Macroeconomic policies should be adjusted in a timely manner to appropriately deal with the relationship between sustaining, rapid and steady economic growth and inflation expectation management. More flexibility and pertinence should be given to the proactive fiscal policy and moderately easy monetary policy. Both the fiscal and monetary policies should be open to micro-



SHOPPING SPREE: Shoppers in Minhou County of southeast China's Fujian Province browse home appliances. Subsidized sales following the government's "home appliances to the countryside" project reached 1.5 billion yuan (\$226.5 million) in 2009.

adjustments in line with changing situations. Moreover, the priority of the fiscal policy should be shifted to expanding consumption and improving people's livelihoods, while the core issue for the monetary policy should be focused on optimizing the credit structure instead of increasing credit quantity.

3. Adjustments to the economic structure should be given a significant position in forming the power growth of the Chinese economy. Currently, the adjustment of the economic structure should be focused on three major aspects. First, consumption should hold a larger share in propelling economic growth in addition to investments and exports. Second, primary, secondary and tertiary industries should achieve coordinated development. Third, the current energy- and resource-oriented economic growth mode should be replaced by one oriented to technological innovation, management improvements and labor force quality.

4. Intensive efforts should be made to advance reforms of the resources and energy price system, the income distribution system, the fiscal and taxation system and the financial system.

5. Priority should be given to cultivating new emerging industries. In a bid to assume the leading role in a new round of international competition, China must develop a series of industries as new economic growth points, such as information technology, new energy, new materials, biological, aeronautical, marine and environment protection industries.

6. Fiscal and financial risks as a result of the large-scale economic stimulus policy should be avoided. The possible risks include decreases in banks' capital adequacy ratios, increasing non-performing credit and a high fiscal deficit. In 2010, inflation expectations should be managed while we stick to the general tone of a loose monetary policy. Introducing a stimulus withdrawal policy could become an option when the timing is right.

7. Monopolies must be broken as soon as possible, and opening to private investment should be a viable alternative to realize sustainable growth. We should further enhance the market reform in monopolized industries and create a fair environment for the competition of private enterprises, state-owned companies and foreign-funded businesses.

8. Importance should be attached to enhancing the country's international economic coordination and cooperation to create a better external environment. China should tighten up cooperation with G20 countries in order to establish a new international financial order, strengthen international cooperation in the effort to prevent trade protectionism and promote free trade, and actively participate in the international cooperation to combat global climate change. ■

CRISIS FOCUS

Bubbling Out of Control

Jim Chanos, founder of the U.S. hedge fund Kynikos Associates, characterized the property bubble in China as "Dubai times 1,000—or worse." Many Chinese economists agree. Yi Xianrong, a senior researcher at the Institute of Finance and Banking under the Chinese Academy of Social Sciences, said the property bubble in China was far worse than the Dubai crisis in an interview with the Beijing-based *International Herald Leader*. Edited excerpts follow:

It is simply a matter of time before the Chinese real estate bubble bursts.

Chanos did not exaggerate in his comparison of the current Chinese property bubble situation and that of Dubai last fall. The National Bureau of Statistics estimated that average housing prices grew 24 percent in 2009. Housing prices in metropolitan areas like Beijing, Shanghai and Shenzhen are much higher than those in Dubai, which should make the problem all but apparent.

The Dubai debt crisis taught us that we must pay close attention to the real estate bubble, and re-evaluate the real estate industry's function and status in the national economy because the industry is too important to take for granted. A bubble burst in China would deal a fatal blow not only to our own economy, but would also extinguish the world's hope for recovery.

As it stands, the real estate bubble seems certain to pop and nobody can stop it. The sooner the government takes measures, the less damage the bubble can cause to our national economy.

The U.S. subprime mortgage bubble took almost 20 years to burst. Based on this, the Chinese bubble may take more time to expand and burst.

But before the U.S. mortgage crisis, economists had warned and cautioned the government and the people that a catastrophe loomed large, only to have their pleas fall on deaf ears. Ordinary citizens only became aware of the seriousness of the bubble when Wall Street giants began collapsing one after the other. The same could happen in China.

The current danger is property

market speculation. The government recently lifted the down payment requirement buyers of a second apartment or house need to pay. But speculation is not based solely on the purchase of a second residence. The government holds a false perception the first house is for the buyer's family and the second house is reserved for speculation. The fact is people can buy the first house for rental purposes, choosing to live elsewhere.

Therefore, it is important that the government does not mix up but come to understand these basic concepts.

The root cause for the 2009 housing price surge was the extremely favorable credit policies adopted by the government. The government has to some extent realized the potential damage, but its new policies to control property do not touch the fundamentals of the overly favorable policies.

If the government is truly determined, it should no longer allow the speculators to enjoy ultra-low loan interest rates. Why should the government support their harmful speculative activities by lending easy money to them? Why does the government cap the deposit interest rate to the minimum so speculators can abuse the money they borrow? This has quickly turned into a major problem threatening China.

Current regulations essentially allow speculators to borrow other people's money to make property speculation. If this does not change, matter will only get worse, leading to a potential Chinese equivalent of the U.S. crisis in the housing market. ■

A Year of Diminutive Development

The world economy struggles to regain growth amid uncertainties in 2010

By ZHEN BINGXI

In 2010, hopefully, the world economy will emerge from recession and progress toward an overall recovery. But the process will be anything but easy—and, if nothing else, replete with abundant uncertainties.

Slowest recovery

Last year was the first time the world economy experienced negative growth since the end of World War II. In fact, according to data from the International Monetary Fund (IMF), the growth rate of the global GDP in 2009 was negative 1.1 percent—a sharp drop compared with 5.2 percent in 2007.

Thanks in no small part to policy coordination and a series of large-scale economic stimulus packages, industrial countries, such as the United States, those of the eurozone and Japan, as well as the world economy at large, began to step out of the recession in the second half of 2009.

Consequently, the IMF projected that the growth rate of the global GDP would increase to 3.1 percent in 2010.

This recovery has been predicted to bear far different characteristics from previous ones. Indeed, it may well be the slowest one since the end of World War II.

In the United States for example, in the following year after each recession, America's GDP growth has always rebounded sharply, illustrated on charts by a "V" shape.

The average GDP growth rate in the United States was 6.2 percent in the first four quarters after the recession of 1973-75. The figure stood at 7.7 percent in the first four quarters after the 1981-82 recession. But following the 2008-09 recession, the average annual GDP growth rate is projected at lower than 3 percent in the United States.

This recovery therefore may well resemble something akin to a Nike logo on data charts. Worse still is the fact that it not be accompanied by an increase in employment.

Also noteworthy is the fact that this recovery is being led by emerging economies in Asia. Since World War II, economic recoveries have traditionally been led by the United

States and Europe. After that, developing countries recovered under their umbrella.

This time, however, Asia's emerging economies recovered first. These nations not only enjoyed the highest growth rates, but also made the most significant contributions to world economic growth.

But there remain great uncertainties within the scope of this global recovery. Currently, the recovery mainly emanates from the large-scale economic stimulus packages carried out by governments. That is, this latest growth is not motivated by the economies themselves.

This year, not surprisingly, the world economy faces many risks. In the previous recoveries, developed countries usually witnessed a surge in spending. This time, though, developed countries, led by the United States, adjusted their growth mode through increasing savings and reducing consumption. This will inevitably lead to a weak, and even a shrinking, global demand.

What's more, the surplus of production capacity remains severe in developed countries. Meanwhile, the bank credit continues to tighten.

Consequently, fixed asset investments—the foundation of economic recoveries—are unlikely to rebound as quickly as before.

Still, the handling of huge toxic assets and the adjustment of balance sheets remain incomplete within many major U.S. and European financial institutions. This only adds to the difficulties.

The major economies also face a serious dilemma when it comes to putting a brake on stimulus policies. If they stop their stimulus packages too early, the recovery will die prematurely; if too late, inflation and asset bubbles will be exacerbated.

In the end, if these countries cannot effectively transfer economic recovery from government-driven growth to self-sustaining growth, they will not be able to achieve the means to support a real global economic recovery.

Financial risks

Since the second quarter of 2009, the international financial situation has stabilized. However, a number of risks will continue to constrain the vitality of the financial market over the course of this year.

Housing market in the United States and Europe, very importantly, has yet to fully stabilize. Many banks have gone bankrupt, too. In 2009, more than 140 American banks declared bankruptcy—nearly five times more



ROUNDTABLE DISCUSSIONS: Finance ministers and central bank governors from the Group of Seven leading industrialized countries attend a meeting in Iqaluit in northern Canada on February 6

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New York
on December 9,
2009

than that of the previous year. At present, there are still more than 550 "problem banks" in the United States.

There is also the hidden risk in the explosion of bubbles in either housing markets or stock markets in many parts of the world. Potential dangers include the debt crisis of the Dubai World Company in the United Arab Emirates, as well as the debt crises facing Spain, Greece, Portugal and Austria, among other EU countries. They may well cause new fluctuations in the international financial system.

Growing protectionism

World trade has been severely shattered by the international financial crisis and the global economic recession. According to the World Trade Organization (WTO), world trade volume plummeted by 40 percent in the first quarter of 2009.

In the second quarter, meanwhile, although the situation began to improve, the rate of decrease remained in the double-digits. The WTO predicted that world trade volume would decrease by 10 percent in 2009.

According to the IMF, world trade volume is expected to increase by 2.5 percent in 2010—far less than 7.3 percent in 2007.

In addition to the slow economic recovery and developed countries' reduction of imports in order to decrease consumption and foster savings, trade protectionism has also proven a huge threat to the recovery of international trade.

Trade protectionism has spread from trade to other fields, such as investment, finance and environmental protection. This is underscored by the fact that the United States and the EU are considering imposing a carbon tariff on imports from countries that have not taken measures to cut their greenhouse gas emissions.

In order to achieve recovery as soon as possible, major economies will focus more on themselves. As they go out of their way

to promote employment and boost industrial development at home, they tend to adopt a variety of trade restrictions and protective measures.

It is also worth noting that public support for free trade has weakened because of mounting employment pressure and escalating social problems associated with the financial crisis.

A rebound in capital flows

In the next year or two, with the recovery of the world economy and international trade, international capital flows will increasingly activate.

In fact, according to the UN Conference on Trade and Development, global foreign direct investment will hopefully slowly revert to \$1.4 trillion in 2010. It will regain momentum in 2011, reaching \$1.8 trillion—slightly higher than in 2008.

It is noteworthy that, with their rapid economic recovery and increased national strength, emerging economies now are not only recipients of foreign direct investment, but will soon also become major investors in their own right.

Economic restructuring

The financial crisis has resulted in several major adjustments in the global economy.

The most prominent one is that economic growth will change from government-driven to demand-driven. Following the crisis, with the weakening of government stimulus, economic recovery should be based on increases in private demand. Otherwise, the recovery will be neither stable nor sustainable.

Moreover, in the next few years, the United States will continue to adjust its growth mode by maintaining a savings rate at about 4 percent—thus reducing consumption and expanding exports.

This requires that Asian economies, including China, adopt opposite measures. They will have to reduce savings, expand imports and increase consumption. But it will be im-

possible for them to fill in the gap caused by shrinking consumption in the United States.

The United States will need more time to strike a balance once more. During the period, the growth rate of the U.S. economy—as well as the world economy—will be lower than it was before the financial crisis.

Meanwhile, trade frictions and exchange rate frictions will increase between the United States and Asian emerging countries including China.

Finally, the world economy is fast transforming to a low-carbon economy. Developed nations, led by the United States, have increased research and development input in alternative energy, energy conservation and environmental protection.

They also are striving to upgrade traditional industries with low-carbon technologies. The thriving of green industries will possibly lead to a new round of industrial restructuring worldwide.

In fact, all countries are faced with the challenges of climate change as well as energy and resource shortages. Developing countries, in particular, will have to bear higher costs of economic development because of energy conservation and greenhouse gas emissions reduction requirements.

G20 governance

At the Pittsburgh summit, leaders indicated that the G20 should replace the Group of Eight to become "the premier forum" for international economic cooperation.

This change has had significant implications for major developing countries. It means they can convene with industrial nations as equals to discuss global economic matters.

However, the G20 remains merely a platform for policy coordination, rather than a decision-making body. Agreements achieved under its auspices are not legally binding and lack enforcement power.

The United States and the EU, meanwhile, are unwilling to surrender their leading position when it comes to global economic affairs. If anything, it is quite likely they will join hands to safeguard their traditional advantages and interests. This is a direct challenge to the G20 mechanism.

In addition, a lot of small and medium-sized countries have found themselves left out of the mechanism. Compared with the UN, the G20 has yet to fully reflect the voices and concerns of the world at large.

As to whether the G20's policy coordination should be extended from the economic field to political and security fields, there remain considerable differences between the United States and emerging powers. Washington advocates expansion, while the latter continues to insist that that degree be limited to the realm of economic and financial areas. ■

OUTSIDE SHOT

By JOHN LEE

Don't Underestimate India's Consumers

Western multinationals are often attracted to China's size, but they're bypassing Asia's true shopping powerhouse

The scale of China has always fascinated merchants. In 19th century England, spinning-mill owners were convinced they would reap profits beyond their dreams if they could just get every Chinese to buy one handkerchief. Alas, the one man one handkerchief plan never took, and for multinationals hoping to tap China's masses, the country continues to disappoint. Since the global economic crisis, Beijing has constructed a way around a slump. Roads, ports, railways: Name it, and China is likely building it. But its consumers aren't pitching in. As a percentage of gross domestic product, Chinese consumption is the lowest of any major economy, at less than one-third. Almost all the country's growth this year has come from infrastructure spending or speculation in domestic assets.

Western multinationals should consider fantasizing about India instead. The momentum for its bounceback comes from Indians, including the poor, buying their way to growth. The demand for handbags, air travel, and fine dining in Mumbai may have eased, but domestic consumption accounts for two-thirds of the Indian economy, twice China's level.

China's problem is that its top-down, state-led model of development (not to mention its artificial suppression of the yuan) structurally impairs domestic spending. According to Minxin Pei, director of the Keck Center for Interna-



tional & Strategic Studies, three-quarters of China's capital goes to 120,000-odd state-controlled entities and their many subsidiaries, leaving 40 million-plus privately owned businesses to fight for scraps. The upshot: Business profits tend to end up in state coffers, not Chinese wallets. Wage and income growth, even for China's urban residents, hovers at about half the level of GDP growth over the past 15 years.

India's bottom-up private sector model, for all its chaos and bureaucracy, provides a stark contrast. While the nation badly needs infrastructure, its consumers are in a far better position to spend. India can now boast of an overwhelmingly independent middle class about 300 million strong, vs. China's 100 million to 200 million, depending on the parameters. Profits from India's businesses, large and small, go into Indian pockets rather than the state's.

The contrast sharpens outside these two nations' cities. Half of China and two-thirds of India live in rural areas. That's about 700 million people in each. The rural half of China is falling behind. Back in the mid-1980s, the mainland's urban-rural income ratio was 1.8. It now stands at about 3.5. Although per-capita incomes have risen, an estimated 400 million mainly rural residents have seen net income stall or decline over the past decade. Yasheng Huang, a professor at the Massachusetts Institute of Technology's Sloan School of Management, estimates that China's absolute levels of poverty and illiteracy have doubled since 2000.

In India, they've been halved. The urban-rural income gap has steadily declined since the early '90s. Over the past decade, economic growth in rural India has outpaced growth in urban areas by almost 40%. Rural India now accounts for half the country's GDP, up from 41% in 1982. World Bank studies show that rural China accounts for only a third of GDP and generates just 15% of China's growth. Meanwhile, rural India is chipping in about two-thirds of overall growth.

Jagmohan S. Raju of the University of Pennsylvania's Wharton School points out that every major Indian consumer company knows it can't succeed without reaching the villages. That's why Indian companies arguably lead the world in innovative low-income products. Telecom provider Bharti offers the world's lowest call rates; Tata Motors sells the world's cheapest car. And the push for the villages has led to a well-developed consumer marketplace throughout India.

For Western brands chasing the luxury market, both China and India offer abundant opportunities. But when what you sell is suited to—and scaled to—millions of city and country dwellers, it makes sense to aim your efforts at India, at least for now. **BW**

John Lee is a fellow at Australia's Center for Independent Studies, a visiting fellow at Washington's Hudson Institute, and the author of Will China Fail?

some interest payments with debt and currently owes \$4.75 billion on the securities. The bonds are trading at less than 77¢ on the dollar, according to Trace, the price reporting system of the Financial Industry Regulatory Authority. Lisa Singleton, an Energy Future spokeswoman, says the debt allows the company to maintain liquidity and increase financial flexibility.

Recent bond buyers say they're being cautious, paying close attention to the fundamentals. "Is it the early signs of froth and excess?" says William Cunningham, global head of credit strategies and fixed-income research at State Street's investment unit. "Not when you look at the numbers."

Then there are derivatives. Some banks are again pushing the simplest forms of synthetic collateralized debt obligations that bet on the severity of corporate defaults. Morgan Stanley and Bank of America strategists recommended such investments to clients in December. "Most people we speak with are taking a very cautious approach," says Sivan Mahadevan, a Morgan Stanley derivatives strategist. "What you don't want is for investors to jump in indiscriminately." While the banks say such instruments help companies raise capital, former Federal Reserve Chairman Paul Volcker has blamed complex derivatives for taking the financial system to the "brink of disaster."

Leverage is also on the rise. Investors who buy mortgage securities backed by jumbo home loans now can borrow as much as \$10 for every \$1 in capital, amplifying returns. While a healthy economy needs some leverage, there's a dark side. As asset values plunged in 2007 and 2008, hedge funds that relied on borrowed money were forced to dump holdings or were wiped out altogether, such as London-based Peloton Partners. "I've got to be honest, leverage coming back this quickly is a little frightening," says Jim Shailcross, who oversees \$12 billion in bonds at Declaration Management & Research in McLean, Va. "You can't assume everybody is going to do stuff rationally." **BW**
—With Bryan Keogh, John Glover, and Tara Kalwarski

Stretching Every Rupee

India is grappling with its worst inflation in a decade

By Bruce Einhorn and Cherian Thomas
Movie night and restaurant meals are out for Vinod Kumar. As prices for sugar, onions, and other staples have surged after poor monsoon rains damaged harvests, Kumar has been forced to cut back to keep food on the table for his family of four. "It's never been so bad in my working life," the 35-year-

old mechanic says as he shops at Bangalore's Johnson Market, a century-old tangle of food stalls.

cember, could hit double digits within two months, predicts brokerage CLSA. That would spur even higher consumer prices and dent the spending power of ordinary Indians.
India's central bank governor, Duvvuri Subbarao, is trying to cool things down. To lower the amount of capital available for lending, the Reserve Bank of India on Jan. 29 increased the cash reserve ratio for banks (the minimum they have to keep on hand) by 0.75 percentage points, to 5.75%. Tighter interest rates are probably next. The bank has moved from "managing the crisis to managing the recovery," Subbarao told reporters on Jan. 29.

Despite India's thriving tech sector, it remains beholden to the vagaries of the monsoon. Less than half of India's fields have irrigation, so a drought last summer led to food shortfalls in several states. Poor railroads and highways make it tough to transport food, leading to shortages and higher prices in many cities. "You don't have enough roads, you don't have enough railroads, you don't have enough ports," says Nikhilesh Bhattacharyya, an economist with Moody's Economy.com. "That amplifies any price shock."

Rising prices are a big headache for Prime Minister Manmohan Singh. In the past 15 years, Indians have ousted two national governments after inflation eroded spending power. Higher interest rates will make it harder for companies to expand, and with the budget deficit at a 16-year high, the government can scarcely afford to boost spending on infrastructure. Indian companies meanwhile, fear higher labor costs. "The rise in food prices will have a cascading effect," says M.S. Unnikrishnan, managing director of Thermax, a Pune-based maker of heating and cooling equipment. "We can't keep paying people the same amount if their cost of living is increasing." **BW**
—With Natalie Obiko Pearson



A drought has sent food prices spiraling at markets across India

old mechanic says as he shops at Bangalore's Johnson Market, a century-old tangle of food stalls.

It's not just food that's getting more expensive. Inflation in India is at a decade high, with consumer prices rising faster than in any other major economy. Industrial output in January increased at the fastest pace in 17 months, pushing up prices for raw materials. Cotton has jumped by 13% since October, while other commodities are rising fast. The benchmark wholesale price index, up 7.3% in De-

Banyan | Asia's never-closer union ✓

Regional economic integration has a long, long way to go



DOES an "Asian project", comparable to the European one, exist? And is it desirable? Professors on Singaporean campuses, diplomats with ASEAN (the ten-country Association of South-East Asian Nations), the bosses of the Asian Development Bank (ADB) in Manila, and even the odd Japanese prime minister: all give an emphatic yes on both counts. Asian integration—with a common market, free trade and even a single currency as its ultimate goals—is no longer a glimmer in a few madmen's eyes.

Those indulging in such projections insist they are hard-nosed realists: no United States of Asia for them. They know no Asian precedent exists for greater integration. The spreading religions—Buddhism, Hinduism and Islam—that once brought Asians closer to each other no longer bind. Asian commerce, for much of history, has formed no dense fabric but rather thin ribbons strung out along the Silk Road and along Asian coasts and island chains. Even today Asia's phenomenal growth is mainly a littoral story.

The spread of prosperity into the hinterlands, through flows in trade and investment, underpin the dream of integration. Yet even here, the projectors concede the weakness of regionalism's institutions. Prickly nation-states are loth to cede sovereignty to any regional body. The flip side of Asia's famous taste for consensus is an allergy to enforceable rules and obligations. The EU has a body of such rules with a fancy French name. In Asia, try saying "*acquis communautaire*" with a straight face.

And yet, says Rajat Nag, the ADB's managing director, for the past 20-odd years a pan-Asian conversation about the benefits of deeper integration has only grown. The end of cold-war tensions within Asia allowed the conversation to begin. An early prize, says Mr Nag, was the "Greater Mekong Subregion", created in 1992. It grouped five South-East Asian countries (and two Chinese provinces) with the aim of building a transport and energy infrastructure shared by all. The breakthrough, says Mr Nag, came with the acceptance that though all member countries would benefit, they would not all do so equally or at the same time.

Similar subregional initiatives are proliferating in South, Central and South-East Asia. For the moment, says Mr Nag, these subregions are separate "garlands", that need to be strung together. There is a practical aspect to this. Customs points throw up huge obstacles to trade. No pan-Asian road exists, let alone a railway.

Even if one did, the widespread rejection of other countries' driving licences would stop a single person from travelling along it.

A dozen years ago, many thought that the financial crisis breaking over Asia would destroy the early shoots of economic co-operation. On the contrary, co-operation grew, as countries sought common ground to guard against future crises. In 2000 ASEAN along with China, Japan and South Korea launched a multilateral arrangement of currency swaps, the Chiang Mai Initiative. Its point was to pool members' foreign-exchange reserves to help crisis-hit countries suffering liquidity crunches.

On the trade front, after the Asian crisis ASEAN redoubled efforts not just to create free trade in merchandise goods but, by 2015, an ASEAN Economic Community in which goods, skilled workers and capital are supposed to move freely about. The present global crisis provided a fresh spur. In March CMI countries will boost pooled reserves by more than 50%, to \$120 billion. A new monitoring and surveillance mechanism will reassure lenders. And it is hard to keep count of Asia's free-trade agreements. A decade ago little more than a dozen involving at least one Asian country had been signed. Now around 230 have been signed or proposed. On January 1st China's FTA with ASEAN, the world's biggest by population, came into effect.

If all this marks progress, it is less than meets the eye. Since the Asian financial crisis, the abundant central-bank reserves that make for a viable Chiang Mai Initiative have also made it look superfluous; no country has yet drawn on it. As for Asia's noodle bowl of proliferating FTAs, a recent survey found only 22% of firms taking advantage of trading preferences offered by such agreements. The best that can be said is that this is a higher proportion than previously thought. In the main, the rules of origin are complex and the paperwork time-consuming. And in nearly all Asian FTAs, sensitive sectors remain protected.

Some point out that one reason why not all East Asian firms take advantage of FTAs is that tariffs are already low. They say that the competitiveness of its intricate production networks makes East Asia a powerful example of integration. Intraregional trade in Asia climbed from a fifth of the region's total trade after the second world war to a third in the 1980s to over half today.

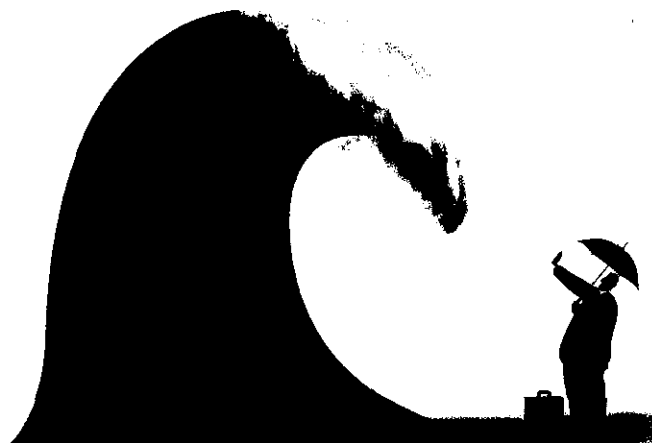
Yet the integration applies only to production, so-called "factory Asia". There, three-fifths of manufactured exports go to Europe and the United States. Meanwhile Asian consumers—unlike counterparts in Europe, who compare prices for goods and even services across borders—inhabit fragmented markets. No sense of regionalism for them. Asian capital markets, too, are more closely bound to global markets than to each other.

And communautaire pigs may fly

Asia's elites agree with the common analysis: that a rebalancing of growth is needed away from exports to the West and more towards fostering local demand instead. They also call for financial integration to spur much-needed regional investment. But countries' huge accumulation of dollar reserves does little to help either aspiration. Meanwhile, for all that its national leaders acknowledge that Asia is growing daily more interdependent, few yet accept the logical corollary: monetary and fiscal policies need to be better co-ordinated, shaped with as much of a sense of the regional good as the national one. Only with signs of that will the Asian project be really credible. ■

Schumpeter | The silver tsunami

Business will have to learn how to manage an ageing workforce



MARTIN AMIS and Christopher Buckley are writers who are entering their silver years and are worried about the costs of an ageing population. Mr Amis, who has a new novel out (see page 84), recently compared the growing army of the elderly to "an invasion of terrible immigrants, stinking out the restaurants and cafés and shops". Mr Buckley devoted a novel, "Boomsday", to the impending war of the generations. They have both touted the benefits of mass euthanasia, though Mr Amis favours giving volunteers "a martini and a medal" whereas Mr Buckley supports more sophisticated incentives such as tax breaks.

Novelists will have their jokes. But Messrs Amis and Buckley are right to warn about the threat of the "silver tsunami". Most people understand about the ageing of society in the abstract. But few have grasped either the size of the tsunami or the extent of its consequences. This is particularly true of the corporate world.

Companies in the rich world are confronted with a rapidly ageing workforce. Nearly one in three American workers will be over 50 by 2012, and America is a young country compared with Japan and Germany. China is also ageing rapidly, thanks to its one-child policy. This means that companies will have to learn how to manage older workers better. It also means that they will be confronted with a wave of retirements as the baby-boomers leave work in droves.

Most companies are remarkably ill-prepared. There was a flicker of interest in the problem a few years ago but it was snuffed out by the recession. The management literature on older workers is a mere molehill compared with the mountain devoted to recruiting and retaining the young.

Companies are still stuck with an antiquated model for dealing with ageing, which assumes that people should get pay rises and promotions on the basis of age and then disappear when they reach retirement. They have dealt with the burdens of this model by periodically "downsizing" older workers or encouraging them to take early retirement. This has created a dual labour market for older workers, of cosseted insiders on the one hand and unemployed or retired outsiders on the other.

But this model cannot last. The number of young people, particularly those with valuable science and engineering skills, is shrinking. And governments are raising retirement ages and

making it more difficult for companies to shed older workers, in a desperate attempt to cope with their underfunded pension systems. Even litigation-averse Japan has introduced tough age-discrimination laws.

Companies will have no choice but to face the difficult problem of managing older workers. How do you encourage older people to adapt to new practices and technologies? How do they get senior people to take orders from young whippersnappers? Happily a few companies have started to think seriously about these problems—and generate insights that their more stick-in-the-mud peers can imitate. The leaders in this area are retail companies. Asda, a subsidiary of the equally gerontophile Wal-Mart, is Britain's biggest employer of over-50s. Netto, a Danish supermarket group, has experimented with shops that employ only people aged 45 and over.

Many industrial companies are also catching the silver wave. Some are rejigging processes to accommodate older workers. A forthcoming article in the *Harvard Business Review* by Christoph Loch of INSEAD and two colleagues looks at what happened when BMW decided to staff one of its production lines with workers of an age likely to be typical at the firm in 2017. At first "the pensioners' line" was less productive. But the firm brought it up to the level of the rest of the factory by introducing 70 relatively small changes, such as new chairs, comfier shoes, magnifying lenses and adjustable tables.

Some companies, particularly in energy and engineering, are also realising that they could face a debilitating loss of skills when the baby-boomers retire en masse. Bosch asks all retirees to sit down for a formal interview in an attempt to "capture" their wisdom for younger workers. Construction companies such as Sweden's Elmhults Konstruktioner and the Netherlands' Hazenberg Bouw have introduced mentoring systems that encourage prospective retirees to train their replacements.

Older and poorer

Companies will have to do more than this if they are to survive the silver tsunami. They will have to rethink the traditional model of the career. This will mean breaking the time-honoured link between age and pay—a link which ensures that workers get ever more expensive even as their faculties decline. It will also mean treating retirement as a phased process rather than a sudden event marked by a sentimental speech and a carriage clock.

There are signs that this is beginning to happen. A few firms have introduced formal programmes of "phased retirement", though they usually single out white-collar workers for the privilege. Some, notably consultancies and energy companies, have developed pools of retired or semi-retired workers who can be called upon to work on individual projects. Asda allows employees to work only during busy periods or take several months off in winter (a perk dubbed "Benidorm leave"). Abbott Laboratories, a large American health-care company, allows veteran staff to work for four days a week or take up to 25 extra days of holiday a year.

But there is one big problem with such seemingly neat arrangements: the plethora of age-discrimination laws that have been passed over the past few years make it harder for companies to experiment and easier for a handful of malcontents to sue. It would be an irony worthy of Messrs Amis and Buckley if laws that were passed to encourage companies to adapt to the demographic revolution ended up having the opposite effect. ■

of 1990, the price in 2016 should be €20-40. If the EU opts for a 30% cut the range would be €30-60.

Becalm as they are, however, current prices are clearly not achieving the policy aims which led politicians to create them in the first place. The most obvious short-term way in which carbon prices in the ETS can reduce emissions is by encouraging electricity generators to switch from cheaper high-carbon fuels, like coal, which require them to buy more credits, to more expensive low-carbon fuels, like natural gas. At the moment, though, with gas prices comparatively low and coal prices

creeping up, any such switching is going to be done anyway, according to Sabine Schels of Bank of America Merrill Lynch.

To encourage more profound changes in energy generation, such as the development of new types of nuclear-power stations or of coal plants that store away their carbon, the carbon price would have to be a great deal higher and have a pretty firm floor. As it is, current prices may be making industrialists more aware of their carbon footprints, but they are not having a huge effect on the world at large.

The biggest effect that carbon markets have had on emissions so far, according to

Kristian Tangen of Point Carbon, has been on investment in developing countries. The Kyoto protocol, a 1997 agreement on emissions, set up a "clean development mechanism" (CDM) by which reductions in greenhouse gases in developing countries could generate a carbon credit that can be traded alongside the E.U.A.

A successor to the Kyoto protocol could greatly increase the size of this market, as could a cap-and-trade system in America. But neither is coming soon. At the moment the Kyoto protocol is due to run out in 2012, and may take the CDM with it. "The CDM will either be consigned to the dustbin for »

Buttonwood

The markets, and developed economies, are too dependent on government action

AS JANUARY goes, so goes the year. That old stockmarket saying does not augur well for 2010, given that the MSCI World index fell by 4.2% in the month, the biggest decline since February 2009, and emerging markets dropped by 5.6%.

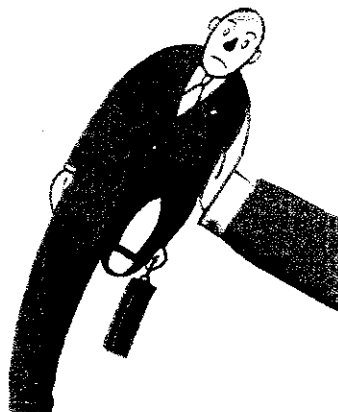
Although markets rallied a bit in early February on better-than-expected economic data, the poor start to the year reflected an inherent contradiction to the rebound of 2009. That rally seemed to be dependent both on extraordinary stimulus measures by governments and central banks, and on a vigorous economic recovery. But both cannot co-exist for long: either the recovery will not last or, if it does, the stimulus will be taken away.

In addition, governments' ability to provide that stimulus is dependent on the markets' own willingness to fund huge deficits at very low yields. But why would investors accept meagre yields if they expected a vigorous recovery? In a sense, the market seemed to be hauling itself up by its own bootstraps.

Sure enough, the bullish story has started to unravel, if only at the edges. In the developing world China has attempted to tighten monetary policy. That has caused some alarm because China was acting as the engine of global growth.

And in the developed world investors have started to question the ability of governments to keep financing their deficits. The obvious example is in Greece, where ten-year bond yields reached 7% late last month. At that level, which is well above likely Greek GDP growth, the country's indebtedness would grow very rapidly. However unpopular it may prove to be, an austerity package is needed to prevent Greece from falling into this debt trap (see pages 67-69).

So even in places where governments may wish to maintain fiscal stimulus, the



markets may force them into corrective action. Britain, France, Ireland, Spain, Portugal and others have all indicated their determination to keep deficits under control, with varying degrees of conviction.

But withdrawal of even small parts of the stimulus packages can send an economy back into the doldrums. As an example, American new-home sales slowed sharply after an initial end-of-November deadline for the expiry of a buyers' tax credit. Although the credit has since been extended until April, December's sales were just 342,000, compared with 329,000 in January 2009, at the height of the crisis.

The stimulus may have prevented the global economy from slipping into depression. In the medium term, however, academic studies suggest that higher government spending leads to slower economic growth. A 2008 paper by Antonio Afonso of the European Central Bank and Davide Furceri of the University of Palermo calculates that for every one-percentage-point rise in government spending as a proportion of GDP, the growth rate falls by 0.12-0.13 percentage points.

What's more, the packages have not

really dealt with the problem of excessive debt, but merely transferred it from the private to the public sector. This buys time, but is akin to those debt-consolidation plans that are sold to consumers on TV. The pain is spread out over a longer period. But pain there will be, in the form of higher taxes, higher bond yields, slower growth or a combination of all three.

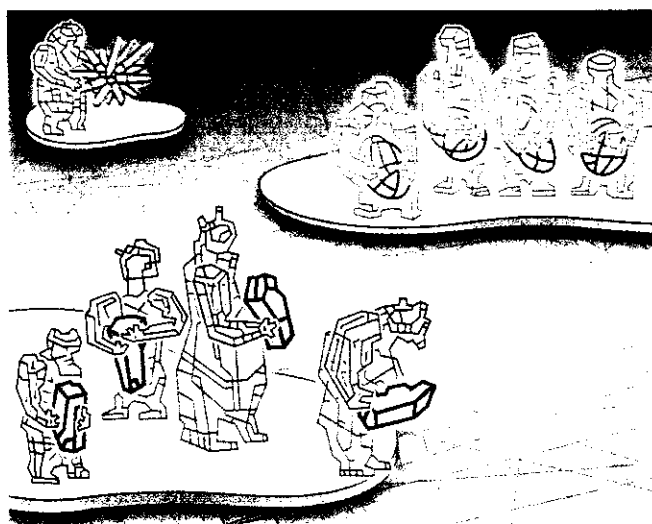
The authorities face a dilemma. Reduce the stimulus now and they risk plunging the economy back into recession, as happened in America in 1937 and Japan in 1997. But leave the stimulus in place for too long, and they risk damaging long-term growth prospects.

The bulls hope that the economy can escape from this trap by the simple expedient of private-sector growth. That is why they welcomed the rise in manufacturing activity signalled in this week's latest purchasing managers' indices. If the private sector rebounds of its own accord, unemployment will fall and budget deficits will decline.

But hopes for a strong private-sector recovery are undermined by the data on credit growth. In the year to December, the broad measure of money supply fell by 0.2% in the euro zone and grew by just 3.4% in America. In Britain the annual growth rate is higher (6.4% in December), but David Owen, an economist at Jefferies International, estimates that quantitative easing (QE), whereby central banks create money to buy assets, has been boosting the figure by an annualised rate of 10%. If the Bank of England stops QE entirely, the credit-growth rate could collapse. For the stockmarket rally to resume properly in 2010, economies in the developed world need to show they can stand on their own two feet.

Economics focus | Diversity training

Some developing economies are rich but crude, while others are poor but sophisticated



ONCE a sleepy fishing port, the industrial city of Yanbu, on Saudi Arabia's Red Sea coast, is now a monument to the country's efforts to diversify its economy. Its petrochemical plant is a sprawling palace of pipes. Propane tanks and cracking towers shimmer in the heat like domes and minarets. The facility's engineers live with their families nearby in a leafy enclave, their shady balconies reminiscent of the traditional rowshan windows of old Jeddah. At the local mall, shoppers can buy any flavour of Holsten Pils they like (strawberry, apple, pomegranate), so long as it is non-alcoholic.

Like many developing countries, Saudi Arabia has long struggled to wean itself off its dependence on a handful of commodities, in this case oil. Yanbu was built by a royal commission, set up in 1975 as part of a concerted effort to move the Saudi economy beyond crude into downstream industries, such as refined petroleum and petrochemicals. The policy has enjoyed some success: Saudi petrochemical exports exceeded \$14 billion in 2008. The kingdom is more ambivalent about some of its other forays. It is, for example, now phasing out efforts to grow wheat in the desert.

Saudi Arabia's obsession with its industrial mix is not shared by most development economists. They traditionally judge the success of an economy by the volume, not the variety, of output per head. Two exceptions are Ricardo Hausmann of Harvard and his colleague, Cesar Hidalgo, a physicist. In a series of papers with various collaborators, they have explored the composition, as well as the quantity, of production, and have taken into account what countries produce, as well as how much.

Just as economies differ in size, the two authors show, they also vary in complexity. Some are eclectic, making a wide range of products. Others are esoteric, producing idiosyncratic goods that few other countries can make. The authors have created a measure of the sophistication of an economy based on two criteria. How many products does a country export successfully? And how many other countries also export those products? Sophisticated economies, by the pair's definition, export a large variety of "exclusive" products that few other countries can make.

Income and sophistication tend to rise in tandem, as you would expect. But some economies are surprisingly sophisticated, given their level of income. They tend to grow quickly, per-

haps because they have mastered industries that are mostly the preserve of richer, and therefore costlier, rivals. Other economies, by contrast, are surprisingly crude, given their prosperity. Saudi Arabia, for example, ranks below the Philippines and Indonesia in sophistication, despite having a higher income per head.

In its recent efforts to diversify, Saudi Arabia has placed less faith in royal commissions and more in entrepreneurs. It is busy cutting red tape and streamlining procedures in a bid to become one of the world's ten most "competitive" economies by 2010, as ranked by the World Economic Forum and the World Bank's "Doing Business" league tables. Saudi Arabia hopes that the private sector, newly unencumbered, will sniff out fresh opportunities, diversifying the economy in response to market signals rather than royal decrees. The work of Messrs Hausmann and Hidalgo, however, suggests that the kingdom's entrepreneurs have their work cut out for them. As they point out, economies find it easier to master new products that are similar to ones they already make. It is easier to graduate from assembling toys to assembling televisions than to jump from textiles to laptops.

The two authors measure the proximity of one product to another based on the probability that a country makes both. In other words, if an economy that makes T-shirts is also likely to make bedsheets, the authors infer that T-shirts and bedsheets are closely related. They have displayed their results on an ingenious map of the industrial landscape, in which similar products cluster tightly together and unrelated products stand apart (see www.chidalgo.com/productspace/).

The territory their map reveals is far from uniform. It resembles a woodland, in which isolated knots of trees surround a few dense thickets of forest. An economy that already exports a few products in the thickest clusters can diversify quickly, hopping from one closely related product to the next. Saudi Arabia, by contrast, is stranded on one of those lonely clumps of products that seem only distantly related to anything else.

To cross these gaps, entrepreneurs need help. But royal commissions are not the answer. In work with Dani Rodrik of Harvard and Charles Sabel of Columbia University, Mr Hausmann argues that governments should emulate venture funds, backing new enterprises in the hope that one will make the leap into a more densely forested area. They should spread their bets widely, monitor progress closely, and cut losses promptly.

Do something different

Two hours' drive down the coast from Yanbu, Saudi Arabia's latest experiment in diversification is in progress. The King Abdulrah Economic City (KREC) was conceived by the Saudi government. But it is supposed to be built, run and paid for by the private sector. Taking the lead is Emaar.E.C, the local offshoot of a big Dubai developer, which raised 2.55 billion riyals (\$680m) on the Saudi stockmarket in 2006.

In addition to a port, Emaar.E.C plans resorts, residences, schools and a financial centre. But it has left vast tracts of the site empty for other companies to fill, in the hope of attracting a cluster of light industries. Progress is slow. According to Reuters, Emaar.E.C received a loan of about 5 billion riyals from the government last month to stop it falling further behind on the project. What distinguishes a good diversification strategy, Messrs Hausmann, Rodrik and Sabel argue, is not the ability to pick winners; it is the guts to let losers go. But it is not easy to remain aloof from a city that bears the king's name. ■

New dangers for the world economy

When the crisis started, governments helped save the world economy. Now they are the problem



LAST year it was banks; this year it is countries. The economic crisis, which seemed to have eased off in the latter part of 2009, is once again in full swing as the threat of sovereign default looms.

Europe's leaders are struggling to avert the biggest financial disaster in the euro's 11-year history (see pages 22-24). This week all eyes have been on Greece. If it defaults, it will be the first EU member to do so. As *The Economist* went to press EU leaders were meeting to discuss what to do, and there was talk of a German-led rescue scheme. If it happens, other European candidates may be queueing up. Bond markets are worried about the capacity of Spain (see next leader), Ireland and Portugal to repay their debts, forcing these countries to increase taxes and cut spending, even as they remain mired in recession.

Europe's troubles have given investors good reason to worry; but they are not the only cause for concern. Policy changes around the world have also spooked investors. China's government began to rein in its lending binge last month, worried about accelerating inflation and asset bubbles. India's central bank has raised reserve requirements and Brazil's fiscal stimulus is being phased out (see page 38). The rich world's big central banks are gradually unwinding the emergency liquidity facilities they introduced at the height of the crisis. "Quantitative easing", the process of printing money to buy longer-dated securities, is coming to an end—or at least being put on hold.

All this has knocked asset prices. Stockmarkets are down sharply, commodity prices have tumbled and volatility is up. The MSCI World Index of global share prices has fallen by almost 10% from its peak on January 14th. Optimism about a "v"-shaped recovery is being replaced with pessimism about a double-dip recession, as fears grow that policymakers will be forced, or will mistakenly choose, to remove monetary and fiscal props too soon.

Acropolis now?

Three factors will determine whether such fears are justified. The first is the strength of the recovery—whether it is self-sustaining, or still propped up by government stimulus. The second is the scale of the sovereign-debt problems—whether Greece is a basket-case all of its own, or investors lose confidence in other heavily indebted governments. The third is the deftness with which the world's central bankers and finance ministers design and co-ordinate the withdrawal of policy stimulus (see pages 73-75).

The picture on global growth is increasingly split. Big emerging economies are in the best shape, with strong growth in domestic demand and scant spare capacity. Countries such as India and Brazil have largely put the downturn behind them. Given the scale of its government-directed lending binge, China's economy is vulnerable to a sudden clampdown by bureaucrats. But, for all the markets' worries, there are few signs that it will tighten too much too fast. A slowing is possi-

ble, indeed desirable, but a serious stumble seems unlikely.

Not so in the rich world, where there are still few signs of strong private-demand growth. America's latest, buoyant, GDP figures are misleading. Output grew at an annualised rate of 5.7% in the fourth quarter of 2009 mainly because firms were rebuilding their stocks. With the economy still shedding jobs (albeit at a lower rate), share prices falling, the housing market still wobbly and household debt shrinking, consumer spending is likely to remain subdued. Nor, with plenty of capacity sitting idle, are firms likely to go on an investment binge. In Europe and Japan the situation is far grimmer. Though exports are recovering, Japan has slipped back into deflation. In the euro zone, recovery was faltering long before the Greek crisis hit. Domestic demand has stalled even in countries, such as Germany, where households have no excess debt to pay off.

Searching for the exit

This disparity between the rich and emerging worlds should be reflected in their macroeconomic policies. Emerging economies can, and should, unwind their stimulus and raise interest rates before inflation takes off. But in big, weak, rich economies it is still too soon to tighten. The dangers of repeating the mistakes made in America in 1937 and Japan in 1997—when premature tax increases and tighter monetary policy pushed fragile economies back into recession—are greater than the risks of inaction. With output so far below potential and credit growth stagnant, there is little chance of sustained inflation. Nor, in most countries, should fear of bondholders lead to sudden fiscal austerity. The right lesson to draw from the travails of Greece, Spain and Portugal is not that all deficits today are dangerous, but that governments need to do more to control their deficits and boost economic growth in the medium term in order to make room for looseness today.

Most big, rich economies have absorbed half that message. At their gathering on February 6th, the G7's finance ministers concluded, rightly, that it was too early to begin withdrawing stimulus. But no rich country has laid out a credible, medium-term fiscal plan. Top of the list should be reforms, like raising the retirement age or means-testing future benefits, which improve countries' fiscal outlook without crimping demand today. France is leaning in the right direction, with its mooted overhaul of the pension system. America's new budget, which simply punted on the medium term, was a shocking failure in that regard.

Equally important is a more explicit agenda to boost growth in the medium term. To minimise the risk that they fall into a Japanese-style morass of high public debt and slow growth, the rich world's economies must spur productivity, encourage investment and foster competition. That points to a renewed focus on freeing trade, cutting spending rather than raising taxes and agreeing on new financial regulations.

Some of today's nervousness comes from "policy risk". Nobody—neither firms, banks nor individuals—is quite sure where government policy is going. The more that governments can do to reduce such uncertainty, the stronger the recovery is likely to be. ■

► The firm initially refused to acknowledge the problem; then, last year, it offered an explanation (badly fitting floor mats) that was greeted with scepticism; only last month did it change its mind and agree to replace the accelerator pedals in affected vehicles. Some people still doubt that it has really got to the bottom of the problem. As well as seeming indecisive, Toyota's bosses went to ground as the story erupted in newspapers, on television and online. Only on February 5th did Akio Toyoda, 53, the scion of the founding family, appear in public to bow in apology—and even then critics complained that he did not bow deeply enough.

Toyota's problems are its alone, but they highlight broader failings in Japanese corporate governance that make large companies particularly vulnerable to mishandling a crisis in this way. Such firms typically have a rigid system of seniority and hierarchy in which people are reluctant to pass bad news up the chain, thus keeping information from those who need to hear it in a misguided effort to protect them from losing face. In many firms, including Toyota, family ties make challenging the boss all but impossible. Any attempt to short-circuit the hierarchy is deemed an act of disloyalty and a violation of the traditional consensual corporate culture. Groupthink becomes entrenched because there is so little mobility between companies: hiring from outside is thought to disrupt a firm's internal harmony, and an executive willing to move will be stained as a disloyal "job-hopper". This further hinders firms' ability to take bold, decisive action. The preference for harmony crowds out alternative viewpoints.

The lack of an outside perspective is particularly striking in the case of Toyota's board. It is composed of 29 Japanese men—

all of them Toyota insiders, none of them independent. (Toyota's first and only non-Japanese board member, one of its American managers, who was appointed in 2007, was swiftly wooed away by an American carmaker.) Most of the rest of Japan Inc is just as lacking in diversity, apart from a couple of honourable exceptions, such as Sony and eAccess. Indeed, there is a greater percentage of women on boards in Kuwait than in Japan.

A fault with the Toyota model

For years, Japanese bosses rebuffed the idea of appointing outside directors on the grounds that Toyota seemed to be getting on perfectly well without them. That argument no longer holds water. Of course, Western-style corporate governance has problems of its own, highlighted by the Enron and WorldCom scandals and the failure of boards to monitor the activities of risk-taking financial institutions in the run-up to the financial crisis. But outsiders do at least bring in new ideas; and, because they have not been brought up in the company culture, are more likely to question the way things work. If Toyota's board had included, say, a female German boss, a former American senator and a high-flying Hong Kong lawyer, its response to the crisis might have been different.

Many large Japanese companies are now responding to Toyota's troubles by re-examining such matters as their use of outsourcing to drive down costs, their dependence on external suppliers (most of the accelerator pedals were supplied by an independent American partsmaker) and their relationships with non-Japanese firms. But they might want to use the incident to reconsider their own internal workings, too. ■

Banks

A better black-swan repellent

How banks can improve their approach to risk management



THE annual gathering of the Global Association of Risk Professionals, held this week in New York, had as its theme "Transforming Risk in a New World Order". Outwardly confident they may be, but those attending have been chastened by

the experiences of the past two years. In the good times, it had seemed that threats to stability were being held in check by financial innovation and technological advances. It appeared that the quality of banks' risk management had, like that of avionics, converged on a high standard, allowing banks to fly higher, more efficiently and more safely. In structured finance, however, giants such as AIG, Citigroup and UBS had been piling up "non-linear" bets, with a small—but, as it turned out, very real—likelihood of life-threatening losses. It was the equivalent of a plane that ekes out an extra few miles per tank of fuel but suffers engine failure in a storm.

Banks are scrambling to convince markets, regulators and politicians that lessons have been learned. Risk is now the hottest recruitment area in finance, with some large firms, such as Morgan Stanley, doubling the size of their teams. Industry groups are pumping out self-critical reports and are working

to bring centralised clearing to over-the-counter derivatives and improve underwriting and disclosure in securitisations. Pay is being aligned more closely with long-term performance, even if it still looks obscenely high to outsiders.

Yet there is scope for banks to do far more to improve their risk management. Some did better than others in coping with different aspects of the crisis, offering useful lessons. Admittedly, skill and luck are difficult to tell apart, and firms that were exemplary in some areas did badly in others. But several commonsense recommendations emerge from the crisis.

Consider risk governance: the relationships between traders, risk managers, executives and directors. The balance of power is now shifting back from risk-takers to those who police them internally. But a chief risk officer is impotent if he is nothing more than a glorified compliance chief, as is still the case at many banks. Ideally it should always be up to traders, not their risk managers, to prove their case if the two disagree. It helps if the latter command respect. Goldman Sachs, for instance, moves senior traders to risk positions, making clear that such moves are a step towards the top. Despite the firm's swashbuckling reputation, its senior people have a conservative streak, which explains Goldman's decision to pull back from mortgages in 2006 (though even its risk managers failed to spot the danger of being so heavily exposed to AIG). ►

Boards, too, need to monitor risk better. Many were not even asking the right questions—such as whether the boom in mortgage-backed markets was sustainable. A lack of relevant experience among independent directors did not help. The outsiders hired onto boards after the passage of the Sarbanes-Oxley Act in 2002 brought fresh perspectives, but could not always get their heads around collateralised debt obligations. As well as having a strong financial-services bent, boards should be pared down from the 12-16 members that are typical today, so they are less vulnerable to groupthink. Directors should also put in more time: five or six days a year is not enough to master a labyrinthine balance-sheet.

Ultimately, however, the tone on risk is set in the corner of office. The bosses of banks that suffered devastating losses, such as UBS and Royal Bank of Scotland, were generally more interested in striking deals and leaping up league tables than in rooting out danger. By contrast, the top brass at banks that fared better, such as JPMorgan Chase, encouraged managers to flag up potential problems and eyed highly profitable units suspiciously. Jamie Dimon steered JPMorgan through the crisis

by doggedly sticking to a few basic principles, such as not holding too much of anything. He also had a healthy scepticism of mathematical-risk models and metrics, even though his bank invented many of them. They seemed to work when asset prices were rising and volatility was low, but the meltdown exposed their inability to capture rare but catastrophic “black swan” events (see our special report, after page 50).

Geek drama

The answer is not to reject quantitative finance but to be honest about its limits. Models have their place, but they must be coupled with more subjective approaches to risk, such as stress tests and scenario-planning. Three years ago it might have seemed neurotic to fret about systemic liquidity shocks or the failure of a big investment bank. But the few firms that thought through the consequences of such events were better able to react when they occurred. Fixing finance will take more than sharper boards, greater scepticism towards “quants” and more powerful risk managers. But as the world awaits a regulatory panacea, those would be good places to start. ■

Ukraine

Bloodless orange

Ukraine's peaceful revolution turned sour because its leader was not ruthless enough



Five years ago in Kiev, as the snow fell, rock bands played and hundreds of thousands of people demonstrated for free elections and against corruption, Ukraine seemed poised to be transformed from a post-Soviet oligarchy into a modern democracy. Yet on February 7th the disgraced loser of 2004-05, Viktor Yanukovich (pictured right), won the presidency at the second attempt—even if Yulia Tymoshenko, his opponent (pictured left), is reluctant to concede (see page 45).

The election result feels like an extraordinary betrayal of the orange revolution. Yet the seeds of this outcome were planted even as the orange throng triumphed. Ukraine is a case study in how to entrench the gains of revolution—and how to squander them.

Too quiet by half

The revolution was mercifully peaceful; but it wasn't free. On the contrary, like all such upheavals it was hugely costly, not only or principally in money. Viktor Yushchenko, the now-outgoing president, was swept to power but incurred heavy debts: to his allies, chief among them Ms Tymoshenko, heroine of the orange crowds; to other politicians, such as the Socialists, with whom he cut deals; to the businessmen who bankrolled his campaign; and to his enemies, who extracted concessions in exchange for going quietly.

In office, Mr Yushchenko paid up. He made Ms Tymoshenko prime minister (a position she held twice). Alas, the qualities that had made her a formidable revolutionary proved a liability in government. She was relentlessly self-promoting, short-termist and populist, as for example when she imposed price caps on fuel. Meanwhile the Socialists were put in charge

of privatisation. Unsavoury businessmen were given jobs in the presidential administration. And the “bandits” whom Mr Yushchenko had promised to punish for various crimes—not least the poisoning that disfigured him before the election of 2004 and the attempted rigging of the outcome—remained free. One of the alleged villains, Mr Yanukovich, became prime minister in 2006-07 and will now be president.

Some of this was unavoidable. Mr Yushchenko faced a chaotic and venal parliament, a messy constitution and a cadre of politicians whose view of the proper authority of any given office depends on their chances of occupying it. Some of the compromises he made were necessary, if distasteful. It would be wrong for any leader in so fragile a country as Ukraine to renege on all the pledges he makes to avoid conflict. Mikheil Saakashvili of Georgia offers a good example of the opposite danger—of how what can initially seem like satisfyingly firm government can slip into over-mighty rule.

All the same, Mr Yushchenko repaid his debts too generously. Corruption among his cronies earned his administration almost as bad a reputation for graft as the regime it replaced—confirming the belief of many, especially in eastern Ukraine (Mr Yanukovich's stronghold), that all the pre-revolutionary talk of cleaner government was so much self-serving cant. The failure to punish almost anyone for the serious crimes Mr Yushchenko had denounced, or to overhaul the courts, led to disillusion among his supporters and boldness among his enemies. The orange coalition was plagued by rivalries and contradictions, collapsing on several occasions under their own weight. Especially at the beginning, when circumstances were propitious, Mr Yushchenko should have been tougher.

Instead, his presidency was crippled by his revolutionary debts. Rather than curing the fractious pathologies of Ukrainian politics, Mr Yushchenko succumbed to them, failing to build the institutions that underpin democracy. The people ►►

Settling trade disputes

When partners attack

China will test the WTO's dispute-settlement system

IN 2009 China overtook Germany to become the world's largest exporter. Exactly half the trade disputes that were filed at the World Trade Organisation (WTO) last year involved China. These facts are not unrelated. As Pascal Lamy, the WTO's chief, pointed out in January, the scope for trade friction increases as countries trade more. Disputes between China and other countries are only to be expected.

Mr Lamy did not have to wait long for evidence to back up his claim. On February 8th China complained to the WTO about the European Union's anti-dumping duties on Chinese-made shoes. This latest fracas over footwear follows recent complaints by the Chinese about restrictions on its exports of steel fasteners, car tyres and poultry. Having initiated just two disputes between joining the WTO in 2001 and September 2008, China has complained to the WTO another five times since then. Marc Busch of Georgetown University in Washington, DC, says that China has moved from "learning by watching", where it mainly observed others' trade tussles, to being an active participant in formal dispute settlement.

China's increasing propensity to bring disputes to the WTO is part of a broader shift. Although the average number of formal disputes per year has fallen since 2001, this is principally because rich countries spend less time fighting each other. Between the WTO's founding in 1995 and the end of 2000, America and the EU initiated exactly half of the cases brought to the WTO. But between 2001 and 2008 they brought only 27.2% of cases. Over half were initiated by developing countries.

That emerging markets, whose share of world trade is growing, feel confident enough in the dispute-settlement system to use it is welcome. The alternative—a series of escalating retaliations unconstrained by any rules—is far worse. The question is whether the WTO's mechanisms are up to the task of defusing rising trade tensions with China.

There are grounds for confidence. Unlike dispute settlement under the previous world trade regime, countries cannot simply brush away verdicts handed down by the WTO. If a country fails to comply with a ruling, the WTO can permit the complainant to hit back, for instance by restricting its adversary's access to its own market. Crucially, even when it does give permission to strike back, the WTO limits the

amount of retaliation based on the damage caused, preventing small skirmishes over a few million dollars of trade from becoming outright trade wars. Mr Busch points out that nearly 70% of disputes are settled by negotiation, presumably to the satisfaction of both parties.

The credible threat of WTO-authorised retaliation also deters countries from using trade barriers that are likely to be challenged. Chad Bown, a trade economist at the World Bank, has found America was less likely to slap anti-dumping duties on trading partners who were themselves big markets for American exporters. This does point to one obvious problem with the system: an aggrieved country with too small a market credibly to threaten serious retaliation against a big country has limited leverage. Even if it has cause for complaint, such a country is unlikely to file a case.

That ought not to be a big problem for China and America or the EU, which value each other's markets. But Mr Bown argues that America or the EU may still find disputes with China tricky. Countries often threaten to target their retaliation against politically-sensitive products, hoping that their manufacturers will convince their own governments to change course. But this sort of strategy may be more difficult in a dispute with undemocratic China. Exports derived from subsidiaries of American-based multinationals are clearly not good targets for retaliation. American consumers will be unhappy if disputes raise the prices of cheap Chinese exports. For its part, China may not import enough consumer goods to make its threats of retaliation credible. More disputes may be inevitable; resolving them successfully is not. ■



Shoes on the other foot

Financial psychology

Fair dues

Employees sniff out unfairness when money is involved

IF YOU can count your money you don't have a billion dollars, opined Jean Paul Getty, an oil magnate. You may feel peeved for other reasons, too. A study published this month in the journal *Psychological Science* reveals that employees' perceptions of how fairly they are being rewarded depend on whether they are getting bonuses in the form of goods or money.

Sanford DeVoe of the University of Toronto and Sheena Iyengar of Columbia University asked 268 participants to read a scenario about a manager handing out equal rewards to ten employees with vastly different performance records. In some scenarios the participants were told that the manager divided up 20 boxes of chocolates or 20 extra days of holiday equally among employees. In others, they were told that the managers divided up \$20,000 or \$20,000-worth of credit-card reward points equally. Participants were asked to rate the fairness of the manager's behaviour on a nine-point scale, where one was extremely unfair and nine was extremely fair.

The researchers found these egalitarian tactics won average fairness values of 6.66 and 6.63 respectively for chocolates and extra holiday, but much lower average values of 5.46 and 5.93 for money and points, a statistically significant difference. This suggested to the authors that something about these rewards made people feel more strongly that they should reflect individual effort.

To test this further, they ran a similar study on another 427 participants. This time they presented them with one of five scenarios involving credit-card reward points. Managers gave their differently performing employees equal amounts of points that could be used only on electronics, only on books, only on films, only on music, or on all four of these types of products.

When points could be spent on only a single type of product, participants rated managers' behaviour as 6.18 on the fairness scale. But this number dropped to 5.56 when credit-card points could be spent on all four of the product types. The authors suggest that the exchangeability of currency invokes a market mindset. "This is one reason why cutting all workers' hours equally, such as moving from a five-day to a four-day work week, can come off as a much fairer approach than making equal pay cuts across the board," says Mr DeVoe.

Debt sustainability

Not so risk-free

Which countries have the biggest problems?

MARKETS have suddenly woken up to the idea that not all government debt is risk-free. There is a long and not very honourable history of sovereign default, either explicitly or implicitly via inflation and currency depreciation.

So which countries are in the biggest trouble? The ability of a government to honour its debt depends on a number of factors, in particular the size of the debt burden relative to GDP, the interest rate paid on that debt relative to the economy's growth rate and the size of the government's primary budget balance—the surplus, or deficit, before interest costs.

If the interest rate paid on public debt is higher than the economy's growth rate, the stock of government debt will rise as a share of GDP unless governments run a primary budget surplus. The bigger the stock of debt, the bigger that surplus needs to be. This arithmetic suggests that coun-

tries with big primary deficits, big debt stocks and a big gap between interest rates and growth are most vulnerable.

This can be a self-fulfilling process. Investors will worry about governments' ability to service their debt and will push up yields, making debt servicing even harder. The shorter the maturity of the debt, the quicker this problem will arise. And if the debt is denominated in a foreign currency or held largely by foreign creditors, then a debt crisis can be compounded by a currency crisis.

The table shows the main sources of vulnerability for a range of OECD countries. The first column shows each country's primary deficit or surplus adjusted for the economic cycle. The second column shows the OECD's forecast for each country's net debt-to-GDP ratio in 2010. The third column measures the gap between bond yields on debt of average maturity for each country and the OECD's forecasts for growth in 2010 and 2011. The bigger the negative number, the bigger the problem (although longer-dated debt tends to pay higher yields, so this measure may disadvantage countries which have less refinancing risk). The countries are ranked by adding together their relative league-table positions on these three measures, a rough gauge of the scale of their debt problems.

The fourth column adds another source of risk—the average time to maturity of outstanding government debt. Countries with shorter maturities are more likely to face refinancing problems than those with longer ones. Two big borrowers stand out on this measure: America, for its short debt maturities, and Britain, which can draw some comfort from the lengthy duration of its debt.

Countries that come out badly from the tables may not default, of course. Japan looks worrying on many measures, for example, but has long been able to fund itself by issuing government debt to domestic investors. America's debt remains the sanctuary of choice when risk aversion rises. Some, like Ireland, have already taken tough decisions to get their finances under control. But as Greece and others are finding out, they will all face severe pressure from the markets to bring their deficits under control. And that may cause a political as well as a fiscal crisis. ■



Financial regulation in America

Another fine mess

NEW YORK

Bipartisan talks break down in the Senate as time gets tight

WITH health-care reform stalled, the White House would dearly love to see Congress approve an overhaul of financial regulation. But as Washington, D.C., struggles with snowstorms, a chill has descended on relations between Democrats and Republicans on the Senate Banking Committee, which has the job of shepherding through a mega-bill on financial reform, a version of which passed the House of Representatives in December.

On February 5th Christopher Dodd (pictured left), the committee's Democratic chairman, said he was giving up on two-month-old bilateral talks with its top Republican, Richard Shelby (pictured right), after reaching an "impasse". Mr Dodd apparently called it a day after making several concessions but receiving little in return. The White House's unexpected unveiling of a tax on bank liabilities and a ban on proprietary trading did not help matters, complicating discussions at a delicate time. The Democrats will now push ahead with their own bill in the hope of bringing the other party into the fold along the way. Having lost their Senate supermajority in an election in Massachusetts last month, they now need at least one Republican to back the bill, assuming all Democrats support it (and some are lukewarm). No Republicans voted for the House bill.

The window for reaching a cross-party consensus is closing fast. As winter turns to spring, senators will begin to focus more on the November mid-term elections than on outstanding legislation. Mr Dodd may have little more than a month to get a deal before attention turns elsewhere. There is a "real chance" of the bill still being stuck in ►►

From shakiest to safest

Countries ranked* by sustainability of debt position

	% of GDP, 2010, forecast		GDP growth less cost of finance†, %	Sovereign debt, years to maturity‡
	Primary budget balance, cyclically adjusted†	Net debt†		
Greece	-4.6	94.6	-3.2	7.7
Ireland	-7.0	38.0	-5.1	6.8
Britain	-6.7	59.0	-1.5	13.7
Japan	-5.9	104.6	0.1	5.4
Portugal	-2.7	62.6	-2.3	6.5
Spain	-4.3	41.6	-3.0	6.7
France	-3.8	60.7	-0.7	6.9
United States	-7.0	65.2	1.4	4.8
Poland	-5.3	32.4	-0.7	5.2
Italy	2.2	100.8	-1.0	7.2
Hungary	4.2	62.1	-3.5	3.3
Belgium	1.3	85.4	-0.6	5.6
Netherlands	-1.4	36.5	-0.6	5.4
Austria	-0.9	42.9	-0.6	7.0
Germany	-1.2	54.7	-0.5	5.8
Czech Republic	-1.9	5.3	0.0	6.4
Norway	-7.8	-143.6	2.4	4.9
Canada	-2.7	32.6	2.0	5.2
Denmark	-1.4	1.6	0.1	7.9
Australia	-0.7	-1.3	0.2	5.0
Switzerland	0.4	11.0	0.5	6.7
Finland	-0.9	-46.4	0.9	4.3
Sweden	-0.3	-13.1	1.5	6.4

*Based on the sum of the countries' rank for the first three debt measures

†General government ‡Forecast average nominal GDP growth

Sources: Bloomberg; for 2010-11 less latest yield on government bonds
EU; OECD; The Economist of average maturity §Weighted average



Sovereign risk and the banks

The safety-net frays

BERLIN

Governments used to worry about their banks. Now the reverse is also true

A SENIOR HSBC executive reminisces fondly about the day he was parachuted into Latin America, a decade or so ago, to help run a recently purchased but troubled local bank. As he arrived he passed people protesting against the acquisition, some of whom were being carried about in coffins. For a moment he wondered whether that would end up being his fate.

Until recently bankers' tales of deriding-do during the Asian, Latin American and Russian debt crises were kept for after-dinner drinks. Now, many of these old emerging-markets hands are in high demand during the day, as banks and investors ponder the potential effects of the euro zone's debt crisis. "Sovereign risk has supplanted regulatory risk as the primary focus of bank bondholders," says Jonathan Glionna at Barclays Capital.

The prospects of a full-blown default by a European government still seem remote, especially given rising talk of a bailout for Greece (see page 22). Yet were it to occur, the consequences could be nasty. Jörg Krämer of Commerzbank notes that the Greek government's outstanding debt securities of €290 billion (\$398 billion) dwarf the amount Lehman Brothers owed bondholders at the time of its collapse.

Greek banks would be most exposed to the fallout. They hold about €39 billion of government debt, roughly equivalent to the amount of capital they have. There are rumours that Greek banks have also been keen sellers of credit-default swaps on sovereign Greek debt, in effect doubling up on their exposure to a debt crisis.

Commerzbank reckons that about 60% of the Greek government bonds issued over the past few years were sold to non-Greek European buyers, half of whom may have been banks. Any restructuring of Greek, or other euro-zone, debt could result in European banks having to take "massive write-offs", says Mr Krämer. American banks are less exposed to wobbly euro-zone countries, but the numbers are still pretty big. Barclays Capital reckons that the ten biggest American banks have total exposures to Ireland, Portugal, Spain and Greece of \$176 billion.

The bigger concern, however, is not banks' direct exposure to government bonds, which average just 5% of euro-zone banks' assets, but the impact on their financing. The costs of funding for banks on Europe's periphery are rising in tandem with the allegedly "risk-free" benchmark rates on the bonds of troubled European

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governments. Steep downgrades of the sovereign-debt ratings of countries such as Portugal, Greece and Ireland would probably translate into immediate rating cuts for their banks, as well as higher capital charges on banks' debt holdings and bigger haircuts when using this debt as collateral. Regulators are busy designing rules forcing banks to hold more government bonds on the assumption that they are the most liquid assets in a crisis. That premise may not hold for every country's debt.

A second concern is that the premium that investors demand for holding bank debt may also widen above the benchmark "risk-free" rate. "If governments are either less willing, because of competing pressures on budgets, or are unable to provide support then that could have a material impact on bank ratings," says Johannes Wassenberg of Moody's, a rating agency. The consequences of even small changes in a bank's borrowing costs can be extreme. JPMorgan, an investment bank, reckons that an increase of just 0.2 percentage points in the borrowing costs of British banks such as Lloyds Banking Group and Royal Bank of Scotland would trim their earnings by 8-11% next year, assuming they could not immediately pass these costs on to customers.

Fearsome as the prospects of sovereign default are, bankers also fret about the impact of avoiding one. In countries such as Portugal, Greece and Ireland, where big government deficits have to be cut back, loan growth is likely to decline and bad loans to increase as economies slow. Sovereign risk is out of the bottle. There is no easy way of putting it back in. ■

The gods strike back

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Financial risk got ahead of the world's ability to manage it. Matthew Valencia asks if it can be tamed again

“THE revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature.” So wrote Peter Bernstein in his seminal history of risk, *Against the Gods*, published in 1996. And so it seemed, to all but a few Cassandras, for much of the decade that followed. Finance enjoyed a golden period, with low interest rates, low volatility and high returns. Risk seemed to have been reduced to a permanently lower level.

This purported new paradigm hinged, in large part, on three closely linked developments: the huge growth of derivatives; the decomposition and distribution of credit risk through securitisation; and the formidable combination of mathematics and computing power in risk management that had its roots in academic work of the mid-20th century. It blossomed in the 1990s at firms such as Bankers Trust and JPMorgan, which developed “value-at-risk” (VAR), a way for banks to calculate how much they could expect to lose when things got really rough.

Suddenly it seemed possible for any financial risk to be measured to five decimal places, and for expected returns to be adjusted accordingly. Banks hired hordes of PhD-wielding “quants” to fine-tune ever more complex risk models. The belief took hold that, even as profits were being boost-

ed by larger balance sheets and greater leverage (borrowing), risk was being capped by a technological shift.

There was something self-serving about this. The more that risk could be calibrated, the greater the opportunity to turn debt into securities that could be sold or held in trading books, with lower capital charges than regular loans. Regulators accepted this, arguing that the “great moderation” had subdued macroeconomic dangers and that securitisation had chopped up individual firms’ risks into manageable lumps. This faith in the new, technology-driven order was reflected in the Basel 2 bank-capital rules, which relied heavily on the banks’ internal models.

There were bumps along the way, such as the near-collapse of Long-Term Capital Management (LTCM), a hedge fund, and the dotcom bust, but each time markets recovered relatively quickly. Banks grew cocky. But that sense of security was destroyed by the meltdown of 2007-09, which as much as anything was a crisis of modern metrics-based risk management. The idea that markets can be left to police themselves turned out to be the world’s most expensive mistake, requiring \$15 trillion in capital injections and other forms of support. “It has cost a lot to learn how little we really knew,” says a senior central banker. Another lesson was that managing risk is as much about judgment as about numbers. Trying ever harder to capture »

Acknowledgments

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A list of sources is at

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► risk in mathematical formulae can be counterproductive if such a degree of accuracy is intrinsically unattainable.

For now, the hubris of spurious precision has given way to humility. It turns out that in financial markets "black swans", or extreme events, occur much more often than the usual probability models suggest. Worse, finance is becoming more fragile: these days blow-ups are twice as frequent as they were before the first world war, according to Barry Eichengreen of the University of California at Berkeley and Michael Bordo of Rutgers University. Benoit Mandelbrot, the father of fractal theory and a pioneer in the study of market swings, argues that finance is prone to a "wild" randomness not usually seen in nature. In markets, "rare big changes can be more significant than the sum of many small changes," he says. If financial markets followed the normal bell-shaped distribution curve, in which meltdowns are very rare, the stockmarket crash of 1987, the interest-rate turmoil of 1992 and the 2008 crash would each be expected only once in the lifetime of the universe.

This is changing the way many financial firms think about risk, says Greg Case, chief executive of Aon, an insurance broker. Before the crisis they were looking at things like pandemics, cyber-security and terrorism as possible causes of black swans. Now they are turning to risks from within the system, and how they can become amplified in combination.

Cheap as chips, and just as bad for you

It would, though, be simplistic to blame the crisis solely, or even mainly, on sloppy risk managers or wild-eyed quants. Cheap money led to the wholesale underpricing of risk; America ran negative real interest rates in 2002-05, even though consumer-price inflation was quiescent. Plenty of economists disagree with the recent assertion by Ben Bernanke, chairman of the Federal Reserve, that the crisis had more to do with lax regulation of mortgage products than loose monetary policy.

Equally damaging were policies to promote home ownership in America using Fannie Mae and Freddie Mac, the country's two mortgage giants. They led the duo to binge on securities backed by shoddily underwritten loans.

In the absence of strict limits, higher leverage followed naturally from low interest rates. The debt of America's financial firms ballooned relative to the overall economy (see chart 1). At the peak of the madness, the median large bank had bor-

rowings of 37 times its equity, meaning it could be wiped out by a loss of just 2-3% of its assets. Borrowed money allowed investors to fake "alpha", or above-market returns, says Benn Steil of the Council on Foreign Relations.

The agony was compounded by the proliferation of short-term debt to support illiquid long-term assets, much of it issued beneath the regulatory radar in highly leveraged "shadow" banks, such as structured investment vehicles. When markets froze, sponsoring entities, usually banks, felt morally obliged to absorb their losses. "Reputation risk was shown to have a very real financial price," says Doug Roeder of the Office of the Comptroller of the Currency, an American regulator.

Everywhere you looked, moreover, incentives were misaligned. Firms deemed "too big to fail" nestled under implicit guarantees. Sensitivity to risk was dulled by the "Greenspan put", a belief that America's Federal Reserve would ride to the rescue with lower rates and liquidity support if needed. Scrutiny of borrowers was delegated to rating agencies, who were paid by the debt-issuers. Some products were so complex, and the chains from borrower to end-investor so long, that thorough due diligence was impossible. A proper understanding of a typical collateralised debt obligation (CDO), a structured bundle of debt securities, would have required reading 30,000 pages of documentation.

Fees for securitisers were paid largely upfront, increasing the temptation to originate, flog and forget. The problems with bankers' pay went much wider, meaning that it was much better to be an employee than a shareholder (or, eventually, a taxpayer picking up the bail-out tab). The role of top executives' pay has been overblown. Top brass at Lehman Brothers and American International Group (AIG) suf-

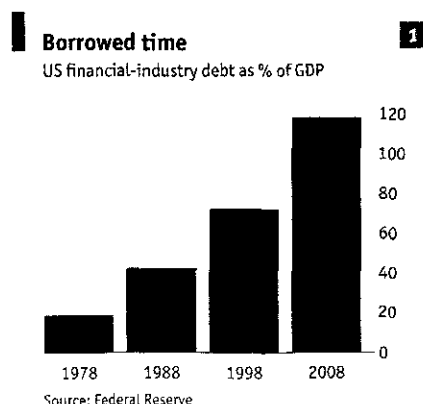
fered massive losses when share prices tumbled. A recent study found that banks where chief executives had more of their wealth tied up in the firm performed worse, not better, than those with apparently less strong incentives. One explanation is that they took risks they thought were in shareholders' best interests, but were proved wrong. Motives lower down the chain were more suspect. It was too easy for traders to cash in on short-term gains and skirt responsibility for any time-bombs they had set ticking.

Asymmetries wreaked havoc in the vast over-the-counter derivatives market, too, where even large dealing firms lacked the information to determine the consequences of others failing. Losses on contracts linked to Lehman turned out to be modest, but nobody knew that when it collapsed in September 2008, causing panic. Likewise, it was hard to gauge the exposures to "tail" risks built up by sellers of swaps on CDOs such as AIG and bond insurers. These were essentially put options, with limited upside and a low but real probability of catastrophic losses.

Another factor in the build-up of excessive risk was what Andy Haldane, head of financial stability at the Bank of England, has described as "disaster myopia". Like drivers who slow down after seeing a crash but soon speed up again, investors exercise greater caution after a disaster, but these days it takes less than a decade to make them reckless again. Not having seen a debt-market crash since 1998, investors piled into ever riskier securities in 2003-07 to maintain yield at a time of low interest rates. Risk-management models reinforced this myopia by relying too heavily on recent data samples with a narrow distribution of outcomes, especially in subprime mortgages.

A further hazard was summed up by the assertion in 2007 by Chuck Prince, then Citigroup's boss, that "as long as the music is playing, you've got to get up and dance." Performance is usually judged relative to rivals or to an industry benchmark, encouraging banks to mimic each other's risk-taking, even if in the long run it benefits no one. In mortgages, bad lenders drove out good ones, keeping up with aggressive competitors for fear of losing market share. A few held back, but it was not easy: when JPMorgan sacrificed five percentage points of return on equity in the short run, it was lambasted by shareholders who wanted it to "catch up" with zippiest-looking rivals.

An overarching worry is that the com- ►►



► plexity of today's global financial network makes occasional catastrophic failure inevitable. For example, the market for credit derivatives galloped far ahead of its supporting infrastructure. Only now are serious moves being made to push these contracts through central clearing-houses which ensure that trades are properly collateralised and guarantee their completion if one party defaults.

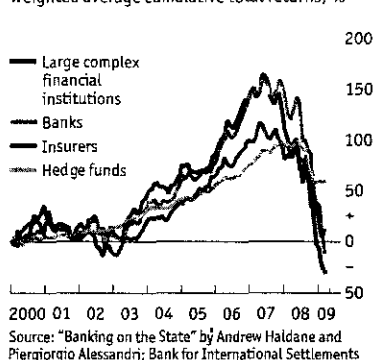
Network overload

The push to allocate capital ever more efficiently over the past 20 years created what Till Guldemann, the father of VAR and vice-chairman of SunGard, a technology firm, calls "capitalism on steroids". Banks got to depend on the modelling of prices in esoteric markets to gauge risks and became adept at gaming the rules. As a result, capital was not being spread around as efficiently as everyone believed.

Big banks had also grown increasingly interdependent through the boom in derivatives, computer-driven equities trading and so on. Another bond was cross-ownership: at the start of the crisis, financial firms held big dollops of each other's common and hybrid equity. Such tight coupling of components increases the danger of "non-linear" outcomes, where a small change has a big impact. "Financial markets are not only vulnerable to black swans but have become the perfect breeding ground for them," says Mr Guldemann. In such a network a firm's troubles can have an exaggerated effect on the perceived riskiness of its trading partners. When Lehman's credit-default spreads

In lockstep

Weighted average cumulative total returns, %



Source: "Banking on the State" by Andrew Haldane and Piergiorgio Alessandri; Bank for International Settlements

rose to distressed levels, AIG's jumped by twice what would have been expected on its own, according to the International Monetary Fund.

Mr Haldane has suggested that these knife-edge dynamics were caused not only by complexity but also—paradoxically—by homogeneity. Banks, insurers, hedge funds and others bought smorgasbords of debt securities to try to reduce risk through diversification, but the ingredients were similar: leveraged loans, American mortgages and the like. From the individual firm's perspective this looked sensible. But for the system as a whole it put everyone's eggs in the same few baskets, as reflected in their returns (see chart 2).

Efforts are now under way to deal with these risks. The Financial Stability Board, an international group of regulators, is trying to co-ordinate global reforms in areas

such as capital, liquidity and mechanisms for rescuing or dismantling troubled banks. Its biggest challenge will be to make the system more resilient to the failure of giants. There are deep divisions over how to set about this, with some favouring tougher capital requirements, others break-ups, still others—including America—a combination of remedies.

In January President Barack Obama shocked big banks by proposing a tax on their liabilities and a plan to cap their size, ban "proprietary" trading and limit their involvement in hedge funds and private equity. The proposals still need congressional approval. They were seen as energising the debate about how to tackle dangerously large firms, though the reaction in Europe was mixed.

Regulators are also inching towards a more "systemic" approach to risk. The old supervisory framework assumed that if the 100 largest banks were individually safe, then the system was too. But the crisis showed that even well-managed firms, acting prudently in a downturn, can undermine the strength of all.

The banks themselves will have to find a middle ground in risk management, somewhere between gut feeling and number fetishism. Much of the progress made in quantitative finance was real enough, but a firm that does not understand the flaws in its models is destined for trouble. This special report will argue that rules will have to be both tightened and better enforced to avoid future crises—but that all the reforms in the world will never guarantee total safety. ■

Number-crunchers crunched

The uses and abuses of mathematical models

IT PUT noses out of joint, but it changed markets for good. In the mid-1970s a few progressive occupants of Chicago's options pits started trading with the aid of sheets of theoretical prices derived from a model and sold by an economist called Fisher Black. Rivals, used to relying on their wits, were unimpressed. One model-based trader complained of having his papers snatched away and being told to "trade like a man". But the strings of numbers caught on, and soon derivatives exchanges hailed the Black-Scholes model, which used share and bond prices to calcu-

late the value of derivatives, for helping to legitimise a market that had been derided as a gambling den.

Thanks to Black-Scholes, options pricing no longer had to rely on educated guesses. Derivatives trading got a huge boost and quants poured into the industry. By 2005 they accounted for 5% of all finance jobs, against 1.2% in 1980, says Thomas Philippon of New York University—and probably a much higher proportion of pay. By 2007 finance was attracting a quarter of all graduates from the California Institute of Technology.

These eggheads are now in the dock, along with their probabilistic models. In America a congressional panel is investigating the models' role in the crash. *Wired*, a publication that can hardly be accused of technophobia, has described default-probability models as "the formula that killed Wall Street". Long-standing critics of risk-modelling, such as Nassim Nicholas Taleb, author of "The Black Swan", and Paul Wilmott, a mathematician turned financial educator, are now hailed as seers. Models "increased risk exposure instead of limiting it", says Mr Taleb. "They can be worse ►►

► than nothing, the equivalent of a dangerous operation on a patient who would stand a better chance if left untreated."

Not all models were useless. Those for interest rates and foreign exchange performed roughly as they were meant to. However, in debt markets they failed abjectly to take account of low-probability but high-impact events such as the gut-wrenching fall in house prices.

The models went particularly awry when clusters of mortgage-backed securities were further packaged into collateralised debt obligations (CDOs). In traditional products such as corporate debt, rating agencies employ basic credit analysis and judgment. CDOs were so complex that they had to be assessed using specially designed models, which had various faults. Each CDO is a unique mix of assets, but the assumptions about future defaults and mortgage rates were not closely tailored to that mix, nor did they factor in the tendency of assets to move together in a crisis.

The problem was exacerbated by the credit raters' incentive to accommodate the issuers who paid them. Most financial firms happily relied on the models, even though the expected return on AAA-rated tranches was suspiciously high for such apparently safe securities. At some banks, risk managers who questioned the rating agencies' models were given short shrift. Moody's and Standard & Poor's were assumed to know best. For people paid according to that year's revenue, this was understandable. "A lifetime of wealth was only one model away," sneers an American regulator.

Moreover, heavy use of models may have changed the markets they were supposed to map, thus undermining the validity of their own predictions, says Donald MacKenzie, an economic sociologist at the University of Edinburgh. This feedback process is known as counter-performativity and had been noted before, for instance with Black-Scholes. With CDOs the models' popularity boosted demand, which lowered the quality of the asset-backed securities that formed the pools' raw material and widened the gap between expected and actual defaults (see chart 3).

A related problem was the similarity of risk models. Banks thought they were diversified, only to find that many others held comparable positions, based on similar models that had been built to comply with the Basel 2 standards, and everyone was trying to unwind the same positions at the same time. The breakdown of the models, which had been the only basis for pricing

the more exotic types of security, turned risk into full-blown uncertainty (and thus extreme volatility).

For some, the crisis has shattered faith in the precision of models and their inputs. They failed Keynes's test that it is better to be roughly right than exactly wrong. One number coming under renewed scrutiny is "value-at-risk" (VAR), used by banks to measure the risk of loss in a portfolio of financial assets, and by regulators to calculate banks' capital buffers. Invented by egg-heads at JPMorgan in the late 1980s, VAR has grown steadily in popularity. It is the subject of more than 200 books. What makes it so appealing is that its complex formulae distil the range of potential daily profits or losses into a single dollar figure.

Only so far with VAR

Frustratingly, banks introduce their own quirks into VAR calculations, making comparison difficult. For example, Morgan Stanley's VAR for the first quarter of 2009 by its own reckoning was \$15m, but using Goldman Sachs's method it would have been \$158m. The bigger problem, though, is that VAR works only for liquid securities over short periods in "normal" markets, and it does not cover catastrophic outcomes. If you have \$30m of two-week 1% VAR, for instance, that means there is a 99% chance that you will not lose more than that amount over the next fortnight. But there may be a huge and unacknowledged threat lurking in that 1% tail.

So chief executives would be foolish to rely solely, or even primarily, on VAR to manage risk. Yet many managers and boards continue to pay close attention to it without fully understanding the caveats—

the equivalent of someone who cannot swim feeling confident of crossing a river having been told that it is, on average, four feet deep, says Jaidev Iyer of the Global Association of Risk Professionals.

Regulators are encouraging banks to look beyond VAR. One way is to use CoVAR (Conditional VAR), a measure that aims to capture spillover effects in troubled markets, such as losses due to the distress of others. This greatly increases some banks' value at risk. Banks are developing their own enhancements. Morgan Stanley, for instance, uses "stress" VAR, which factors in very tight liquidity constraints.

Like its peers, Morgan Stanley is also reviewing its stress testing, which is used to consider extreme situations. The worst scenario envisaged by the firm turned out to be less than half as bad as what actually happened in the markets. JPMorgan Chase's debt-market stress tests foresaw a 40% increase in corporate spreads, but high-yield spreads in 2007-09 increased many times over. Others fell similarly short. Most banks' tests were based on historical crises, but this assumes that the future will be similar to the past. "A repeat of any specific market event, such as 1987 or 1998, is unlikely to be the way that a future crisis will unfold," says Ken deRegt, Morgan Stanley's chief risk officer.

Faced with either random (and therefore not very believable) scenarios or simplistic models that neglect fat-tail risks, many find themselves in a "no-man's-land" between the two, says Andrew Freeman of Deloitte (and formerly a journalist at *The Economist*). Nevertheless, he views scenario planning as a useful tool. A firm that had thought about, say, the mutation of default risk into liquidity risk would have had a head start over its competitors in 2008, even if it had not predicted precisely how this would happen.

To some, stress testing will always seem maddeningly fuzzy. "It has so far been seen as the acupuncture-and-herbal-remedies corner of risk management, though perceptions are changing," says Riccardo Rebonato of Royal Bank of Scotland, who is writing a book on the subject. It is not meant to be a predictive tool but a means of considering possible outcomes to allow firms to react more nimbly to unexpected developments, he argues. Hedge funds are better at this than banks. Some had thought about the possibility of a large broker-dealer going bust. At least one, AQR, had asked its lawyers to grill the fund's prime brokers about the fate of its assets in the event of their demise. ►►

Never mind the quality

CDOs of subprime-mortgage-backed securities
Issued in 2005-07, %

	Estimated 3-year default rate	Actual default rate
AAA	0.001	0.10
AA+	0.01	1.68
AA	0.04	8.16
AA-	0.05	12.03
A+	0.06	20.96
A	0.09	29.21
A-	0.12	36.65
BBB+	0.34	48.73
BBB	0.49	56.10
BBB-	0.88	66.67

Source: Donald MacKenzie, University of Edinburgh

Some of the blame lies with bank regulators, who were just as blind to the dangers ahead as the firms they oversaw. Sometimes even more so: after the rescue of Bear Stearns in March 2008 but before Lehman's collapse, Morgan Stanley was reportedly told by supervisors at the Federal Reserve that its doomsday scenario was too bearish.

The regulators have since become tougher. In America, for instance, banks have been told to run stress tests with scenarios that include a huge leap in interest rates. A supervisors' report last October fingered some banks for "window-dressing" their tests. Officials are now asking for "reverse" stress testing, in which a firm imagines it has failed and works backwards to determine which vulnerabilities caused the hypothetical collapse. Britain has made this mandatory. Bankers are divided over its usefulness.

Slicing the Emmental

These changes point towards greater use of judgment and less reliance on numbers in future. But it would be unfair to tar all models with the same brush. The CDO fiasco was an egregious and relatively rare case of an instrument getting way ahead of the ability to map it mathematically. Models were "an accessory to the crime, not the perpetrator", says Michael Mauboussin of Legg Mason, a money manager.

As for VAR, it may be hopeless at signalling rare severe losses, but the process by which it is produced adds enormously to the understanding of everyday risk, which can be just as deadly as tail risk, says Aaron Brown, a risk manager at AQR. Craig Broderick, chief risk officer at Goldman Sachs, sees it as one of several measures which, although of limited use individually, together can provide a helpful picture. Like a slice of Swiss cheese, each number has holes, but put several of them together and you get something solid.

Modelling is not going away; indeed, number-crunchers who are devising new ways to protect investors from outlying fat-tail risks are gaining influence. Pimco, for instance, offers fat-tail hedging programmes for mutual-fund clients, using cocktails of options and other instruments. These are built on specific risk factors rather than on the broader and increasingly fluid division of assets between equities, currencies, commodities and so on. The relationships between asset classes "have become less stable", says Mohamed El-Erian, Pimco's chief executive. "Asset-class diversification remains desir-



able but is not sufficient."

Not surprisingly, more investors are now willing to give up some upside for the promise of protection against catastrophic losses. Pimco's clients are paying up to 1% of the value of managed assets for the hedging—even though, as the recent crisis showed, there is a risk that insurers will not be able to pay out. Lisa Goldberg of MSCI Barra reports keen interest in the analytics firm's extreme-risk model from hedge funds, investment banks and pension plans.

In some areas the need may be for more computing power, not less. Financial firms already spend more than any other industry on information technology (IT): some \$500 billion in 2009, according to Gartner, a consultancy. Yet the quality of information filtering through to senior managers is often inadequate.

A report by bank supervisors last October pointed to poor risk "aggregation": many large banks simply do not have the systems to present an up-to-date picture of their firm-wide links to borrowers and trading partners. Two-thirds of the banks surveyed said they were only "partially" able (in other words, unable) to aggregate their credit risks. The Federal Reserve, leading stress tests on American banks last spring, was shocked to find that some of them needed days to calculate their expo-

sure to derivatives counterparties.

To be fair, totting up counterparty risk is not easy. For each trading partner the calculations can involve many different types of contract and hundreds of legal entities. But banks will have to learn fast: under new international proposals, they will for the first time face capital charges on the creditworthiness of swap counterparties.

The banks with the most dysfunctional systems are generally those, such as Citigroup, that have been through multiple marriages and ended up with dozens of "legacy" systems that cannot easily communicate with each other. That may explain why some Citi units continued to pile into subprime mortgages even as others pulled back.

In the depths of the crisis some banks were unaware that different business units were marking the same assets at different prices. The industry is working to sort this out. Banks are coming under pressure to appoint chief data officers who can police the integrity of the numbers, separate from chief information officers who concentrate on system design and output.

Some worry that the good work will be cast aside. As markets recover, the biggest temptation will be to abandon or scale back IT projects, allowing product development to get ahead of the supporting technology infrastructure, just as it did in the last boom.

The way forward is not to reject high-tech finance but to be honest about its limitations, says Emanuel Derman, a professor at New York's Columbia University and a former quant at Goldman Sachs. Models should be seen as metaphors that can enlighten but do not describe the world perfectly. Messrs Derman and Wilmott have drawn up a modeller's Hippocratic oath which pledges, among other things: "I will remember that I didn't make the world, and it doesn't satisfy my equations," and "I will never sacrifice reality for elegance without explaining why I have done so." Often the problem is not complex finance but the people who practise it, says Mr Wilmott. Because of their love of puzzles, quants lean towards technically brilliant rather than sensible solutions and tend to over-engineer: "You may need a plumber but you get a professor of fluid dynamics."

One way to deal with that problem is to self-insure. JPMorgan Chase holds \$3 billion of "model-uncertainty reserves" to cover mishaps caused by quants who have been too clever by half. If you can make provisions for bad loans, why not bad maths too? ■

Cinderella's moment

Risk managers to the fore

IN A speech delivered to a banking-industry conference in Geneva in December 2006, Madelyn Antoncic issued a warning and then offered some reassurance. With volatility low, corporate credit spreads growing ever tighter and markets all but ignoring bad news, there was, she said, "a seemingly overwhelming sense of complacency". Nevertheless, she insisted that the firm she served as chief risk officer, Lehman Brothers, was well placed to ride out any turbulence, thanks to a keen awareness of emerging threats and a rock-solid analytical framework.

Behind the scenes, all was not well. Ms Antoncic, a respected risk manager with an economics PhD, had expressed unease at the firm's heavy exposure to commercial property and was being sidelined, bit by bit, by the firm's autocratic boss, Dick Fuld. Less than two months after her speech she was pushed aside.

Lehman's story ended particularly badly, but this sort of lapse in risk governance was alarmingly common during the boom. So much for the notion, generally accepted back then, that the quality of banks' risk regimes had, like car components, converged around a high standard. "The variance turned out to be shocking," says Jamie Dimon, chief executive of JPMorgan Chase.

The banks that fared better, including his own, relied largely on giving their risk-managing roundheads equal status with the risk-taking cavaliers. That was not easy. In happy times, when risk seems low, power shifts from risk managers to traders. Sales-driven cultures are the natural order of things on Wall Street and in the City. Discouraging transactions was frowned upon, especially at firms trying to push their way up capital-markets league tables. Risk managers who said no put themselves on a collision course with the business head and often the chief executive too.

At some large banks that subsequently suffered big losses, such as HBOS and Royal Bank of Scotland (RBS), credit committees, which vetted requests for big loans, could be formed on an ad hoc basis from a pool of eligible members. If the committee's chairman, typically a business-line head, encountered resistance from a risk

manager or other sceptic, he could adjourn the meeting, then reconstitute the committee a week or two later with a more pliable membership that would approve the loan.

Another common trick was for a business line to keep quiet about a proposal on which it had been working for weeks until a couple of hours before the meeting to approve it, so the risk team had no time to lodge convincing objections. Exasperated roundheads would occasionally resort to pleading with regulators for help. In the years before the crash the Basel Committee of bank supervisors reportedly received several requests from risk managers to scrutinise excessive risk-taking at their institutions that they felt powerless to stop.

Many banks' failings exposed the triumph of form over substance. In recent years it had become popular to appoint a chief risk officer to signal that the issue was receiving attention. But according to Leo Grepin of McKinsey, "it was sometimes a case of management telling him, 'you tick the boxes on risk, and we'll worry about generating revenue'."

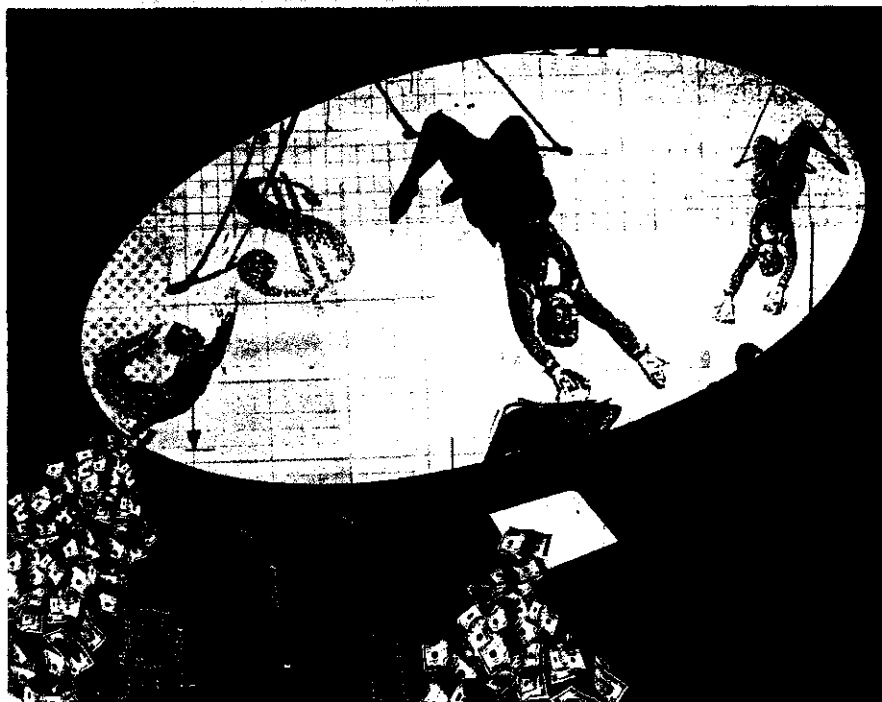
Since 2007 banks have been scram-

bling to convince markets and regulators that they will continue to take risk seriously once memories of the crisis fade. Some are involving risk officers in talks about new products and strategic moves. At HSBC, for instance, they have had a bigger role in vetting acquisitions since the bank's American retail-banking subsidiary, bought in 2003, suffered heavy subprime-mortgage losses. "Everyone should now see that the risk team needs to be just as involved on the returns side as on the risk side," says Maureen Miskovic, chief risk officer at State Street, an American bank.

Glamming up

Ms Miskovic is one of an emerging breed of more powerful risk officers. They are seen as being on a par with the chief financial officer, get a say in decisions on pay and have the ear of the board, whose agreement is increasingly needed to remove them. Some report directly to a board committee as well as—or occasionally instead of—to the chief executive.

For many, the biggest task is to dismantle the cumbersome "silos", says Ken Chalk of ▶



A matter of principle

Why some banks did much better than others

► America's Risk Management Association. Risks were often stuffed into convenient but misleading pigeonholes. Banks were slow to refine their approach, even as growing market complexity led some of the risks to become interchangeable.

Take the growth of traded credit products, such as asset-backed securities and CDOs made up of them. Credit-risk departments thought of them as market risk, because they sat in the trading book. Market-risk teams saw them as credit instruments, since the underlying assets were loans. This buck-passing proved particularly costly at UBS, which lost \$Fr36 billion (\$34 billion) on CDOs. Many banks are now combining their market- and credit-risk groups, as HSBC did last year.

For all the new-found authority of risk managers, it can still be hard to attract talent to their ranks. The job is said to have the risk profile of a short option position with unlimited downside and limited upside—something every good risk manager should avoid. Moreover, it lacks glamour. Persuading a trader to move to risk can be “like asking a trapeze artist to retrain as an accountant”, says Barrie Wilkinson of Oliver Wyman, a consultancy.

A question of culture

Besides, there is more to establishing a solid risk culture than empowering risk officers. Culture is a slippery concept, but it matters. “Whatever causes the next crisis, it will be different, so you need something that can deal with the unexpected. That's culture,” says Colm Kelleher of Morgan Stanley. One necessary ingredient is a tradition of asking and repeating questions until a clear answer emerges, suggests Clayton Rose, a banker who now teaches at Harvard Business School.

The tone is set at the top, for better or worse. At the best-run banks senior figures spend as much time fretting over risks as they do salivating at opportunities (see box). By contrast, Lehman's Mr Fuld talked of “protecting mother” but was drawn to the glister of leveraged deals. Stan O'Neal, who presided over giant losses at Merrill Lynch, was more empire-builder than risk manager. But imperial bosses and sound risk cultures sometimes go together, as at JPMorgan and Banco Santander.

A soft-touch boss can be more dangerous than a domineering one. Under Chuck Prince, who famously learned only in September 2007 that Citigroup was sitting on \$43 billion of toxic assets, the lunatics were able to take over the asylum. Astonishingly, the head of risk reported not to Mr

JPMORGAN CHASE managed to avoid big losses largely thanks to the tone set by its boss, Jamie Dimon. A voracious reader of internal reports, he understands financial arcana and subjects staff to detailed questioning. PowerPoint presentations are discouraged, informal discussions of what is wrong, or could go wrong, encouraged. These “soft” principles are supplemented by a hard-headed approach to the allocation of capital. Though the bank suffered painful losses in leveraged loans, it was not tripped up by CDOs or structured investment vehicles (SIVs), even though it had been instrumental in developing both products. Nor was it heavily exposed to AIG, an insurance giant that got into trouble.

This was not because it saw disaster coming, says Bill Winters, former co-head of the firm's investment bank, but because it stuck by two basic principles: don't hold too much of anything, and only keep what you are sure will generate a decent risk-adjusted return. The bank jettisoned an SIV and \$60 billion of CDO-related risks because it saw them as too dicey, at a time when others were still keen to snap them up. It also closed 60 credit lines for other SIVs and corporate clients when it realised that these could be simultaneously drawn down if the bank's credit rating were cut. And it took a conservative view of risk-mitigation. Hedging through bond insurers, whose finances grew shaky as the crisis spread, was calculated twice: once assuming the hedge would hold, and again assuming it was worthless.

Goldman Sachs's risk management stood out too—unlike the public-relations skills it subsequently displayed. Steered by its chief financial officer, David Viniar, the firm's traders began reducing their exposure to mortgage securities months be-

fore subprime defaults began to explode. More willing than rivals to take risks, Goldman is also quicker to hedge them. In late 2006 it spent up to \$150m—one-eighth of that quarter's operating profit—hedging exposure to AIG.

The firm promotes senior traders to risk positions, making clear that such moves are a potential stepping stone to the top. Traders are encouraged to nurture the risk manager in them: Gary Cohn, the firm's president, rose to the top largely because of his skill at hedging “tail” risks. Crucially, Goldman generally does not fire its risk managers after a crisis, allowing them to learn from the experience. Yet despite everything, it still needed government help to survive.

By contrast, UBS's risk culture was awful. Its investment bank was free to bet with subsidised funds, since transfers from the private bank were deeply underpriced. It confused itself by presenting risk in a “net and forget” format. Trading desks would estimate the maximum possible loss on risky assets, hedge it and then record the net risk as minimal, inadvertently concealing huge tail risks in the gross exposure. And it moved its best traders to a hedge fund, leaving the B-team to manage the bank's positions.

Publicly humbled by a frank report on its failings, the bank has made a raft of changes. Risk controllers have been handed more power. Oswald Gröbel, the chief executive, has said that if his newish risk chief, Philip Lofts, rejects a transaction he will never overrule him. If the two disagree, Mr Lofts must inform the board, which no longer delegates risk issues to a trio of long-time UBS employees. A new, independent risk committee is bristling with risk experts. Whether all this amounts to a “new paradigm”, as Mr Lofts claims, remains to be seen.

Prince or the board, but to a newly hired executive with a background in corporate-governance law, not cutting-edge finance.

Another lesson is that boards matter too. Directors' lack of engagement or expertise played a big part in some of the worst slip-ups, including Citi's. The “sociology” of big banks' boards also had something to do with it, says Ingo Walter of New York's Stern School of Business: as the members bonded, dissidents felt pressure to toe the line.

Too few boards defined the parameters of risk oversight. In a survey last year De-

loitte found that only seven of 30 large banks had done so in any detail. Everyone agrees that boards have a critical role to play in determining risk appetite, but a recent report by a group of global regulators found that many were reluctant to do this.

Boards could also make a better job of policing how (or even whether) banks adjust for risk in allocating capital internally. Before the crisis some boards barely thought about this, naively assuming that procedures for it were well honed. A former Lehman board member professes himself “astonished”, in retrospect, at how ►►

► some of the risks in the company's property investments were brushed aside when assessing expected returns. The survivors are still struggling to create the sort of joined-up approach to risk adjustment that is common at large hedge funds, admits one Wall Street executive.

Board games

Robert Pozen, head of MFS Investment Management, an American asset manager, thinks bank boards would be more effective with fewer but more committed members. Cutting their size to 4-8, rather than the 10-18 typical now, would foster more personal responsibility. More financial-services expertise would help too. After the passage of the Sarbanes-Oxley act in 2002 banks hired more independent directors, many of whom lacked relevant experience. The former spymaster on Citi's board and the theatrical impresario on Lehman's may have been happy to ask questions, but were they the right ones?

Under regulatory pressure, banks such as Citi and Bank of America have hired more directors with strong financial-ser-

vices backgrounds. Mr Pozen suggests assembling a small cadre of financially fluent "super-directors" who would meet more often—say, two or three days a month rather than an average of six days a year, as now—and may serve on only one other board to ensure they take the job seriously.

That sounds sensible, but the case for another suggested reform—creating independent risk committees at board level—is less clear. At some banks risk issues are handled perfectly well by the audit committee or the full board. Nor is there a clear link between the frequency of risk-related meetings and a bank's performance. At Spain's Santander the relevant committee met 102 times in 2008. Those of other banks that emerged relatively unscathed, such as JPMorgan and Credit Suisse, convened much less often.

Moreover, some of the most important risk-related decisions of the next few years will come from another corner: the compensation committee. It is not just investment bankers and top executives whose pay structures need to be rethought. In the past, risk managers' pay was commonly

determined or heavily influenced by the managers of the trading desks they oversaw, or their bonus linked to the desks' performance, says Richard Apostolik, who heads the Global Association of Risk Professionals (GARP). Boards need to eliminate such conflicts of interest.

Meanwhile risk teams are being beefed up. Morgan Stanley, for instance, is increasing its complement to 450, nearly double the number it had in 2008. The GARP saw a 70% increase in risk-manager certifications last year. Risk is the busiest area for financial recruiters, says Tim Holt of Heidrick & Struggles, a firm of headhunters. When boards are looking for a new chief executive, they increasingly want someone who has been head of risk as well as chief financial officer, which used to be the standard requirement, reckons Mike Woodrow of Risk Talent Associates, another headhunting firm.

The big question is whether this interest in controlling risk will fizzle out as economies recover. Experience suggests that it will. Bankers say this time is different—but they always do. ■

When the river runs dry

The perils of a sudden evaporation of liquidity

STAMPEDING crowds can generate pressures of up to 4,500 Newtons per square metre, enough to bend steel barriers. Rushes for the exit in financial markets can be just as damaging. Investors crowd into trades to get the highest risk-adjusted return in the same way that everyone wants tickets for the best concert. When someone shouts "fire", their flight creates an "endogenous" risk of being trampled by falling prices, margin calls and vanishing capital—a "negative externality" that adds to overall risk, says Lasse Heje Pedersen of New York University.

This played out dramatically in 2008. Liquidity instantly drained from securities firms as clients abandoned anything with a whiff of risk. In three days in March Bear Stearns saw its pool of cash and liquid assets shrink by nearly 90%. After the collapse of Lehman Brothers, Morgan Stanley had \$43 billion of withdrawals in a single day, mostly from hedge funds.

Bob McDowall of Tower Group, a consultancy, explains that liquidity poses "the most emotional of risks". Its loss can prove

just as fatal as insolvency. Many of those clobbered in the crisis—including Bear Stearns, Northern Rock and AIG—were struck down by a sudden lack of cash or funding sources, not because they ran out of capital.

Yet liquidity risk has been neglected. Over the past decade international regulators have paid more attention to capital. Banks ran liquidity stress tests and drew up contingency funding plans, but often half-heartedly. With markets awash with cash and hedge funds, private-equity firms and sovereign-wealth funds all keen to invest in assets, there seemed little prospect of a liquidity crisis. Academics such as Mr Pedersen, Lubos Pastor at Chicago's Booth School of Business and others were doing solid work on liquidity shocks, but practitioners barely noticed.

What makes liquidity so important is its binary quality: one moment it is there in abundance, the next it is gone. This time its evaporation was particularly abrupt because markets had become so joined up. The panic to get out of levered mortgage in-

vestments spilled quickly into interbank loan markets, commercial paper, prime brokerage, securities lending (lending shares to short-sellers) and so on.

As confidence ebbed, mortgage-backed securities could no longer be used so easily as collateral in repurchase or "repo" agreements, in which financial firms borrow short-term from investors with excess cash, such as money-market funds. This was a big problem because securities firms had become heavily reliant on this market, tripling their repo borrowing in the five years to 2008. Bear Stearns had \$98 billion on its books, compared with \$72 billion of long-term debt.

Even the most liquid markets were affected. In August 2007 a wave of selling of blue-chip shares, forced by the need to cover losses on debt securities elsewhere, caused sudden drops of up to 30% for some computer-driven strategies popular with hedge funds.

Liquidity comes in two closely connected forms: asset liquidity, or the ability to sell holdings easily at a decent price; and ►►

► funding liquidity, or the capacity to raise finance and roll over old debts when needed, without facing punitive "haircuts" on collateral posted to back this borrowing.

The years of excess saw a vast increase in the funding of long-term assets with short-term (and thus cheaper) debt. Short-term borrowing has a good side: the threat of lenders refusing to roll over can be a source of discipline. Once they expect losses, though, a run becomes inevitable: they rush for repayment to beat the crowd, setting off a panic that might hurt them even more. "Financial crises are almost always and everywhere about short-term debt," says Douglas Diamond of the Booth School of Business.

Banks are founded on this "maturity mismatch" of long- and short-term debt, but they have deposit insurance which reduces the likelihood of runs. However, this time much of the mismatched borrowing took place in the uninsured "shadow" banking network of investment banks, structured off-balance-sheet vehicles and the like. It was supported by seemingly ingenious structures. Auction-rate securities, for instance, allowed the funding of stodgy municipal bonds to be rolled over monthly, with the interest rate reset each time.

The past two years are littered with stories of schools and hospitals that came a cropper after dramatically shortening the tenure of their funding, assuming that the savings in interest costs, small as they were, far outweighed the risk of market seizure. Securities firms became equally complacent as they watched asset values rise, boosting the value of their holdings as collateral for repos. Commercial banks increased their reliance on wholesale funding and on fickle "non-core" deposits, such as those bought from brokers.

Regulation did nothing to discourage this, treating banks that funded themselves with deposits and those borrowing overnight in wholesale markets exactly the same. Markets viewed the second category as more efficient. Northern Rock, which funded its mortgages largely in capital markets, had a higher stockmarket rating than HSBC, which relied more on conventional deposits. The prevailing view was that risk was inherent in the asset, not the manner in which it was financed.

At the same time financial firms built up a host of liquidity obligations, not all of which they fully understood. Banks were expected to support off-balance-sheet entities if clients wanted out; Citigroup had to take back \$58 billion of short-term securities from structured vehicles it sponsored.

AIG did not allow for the risk that the insurer would have to post more collateral against credit-default swaps if these fell in value or its rating was cut.

Now that the horse has bolted, financial firms are rushing to close the door, for instance by adding to liquidity buffers (see chart 4). British banks' holdings of sterling liquid assets are at their highest for a decade. Capital-markets firms are courting deposits and shunning flighty wholesale funding. Deposits, equity and long-term debt now make up almost two-thirds of Morgan Stanley's balance-sheet liabilities, compared with around 40% at the end of 2007. Spending on liquidity-management systems is rising sharply, with specialists "almost able to name their price", says one banker. "Collateral management" has become a buzzword.

Message from Basel

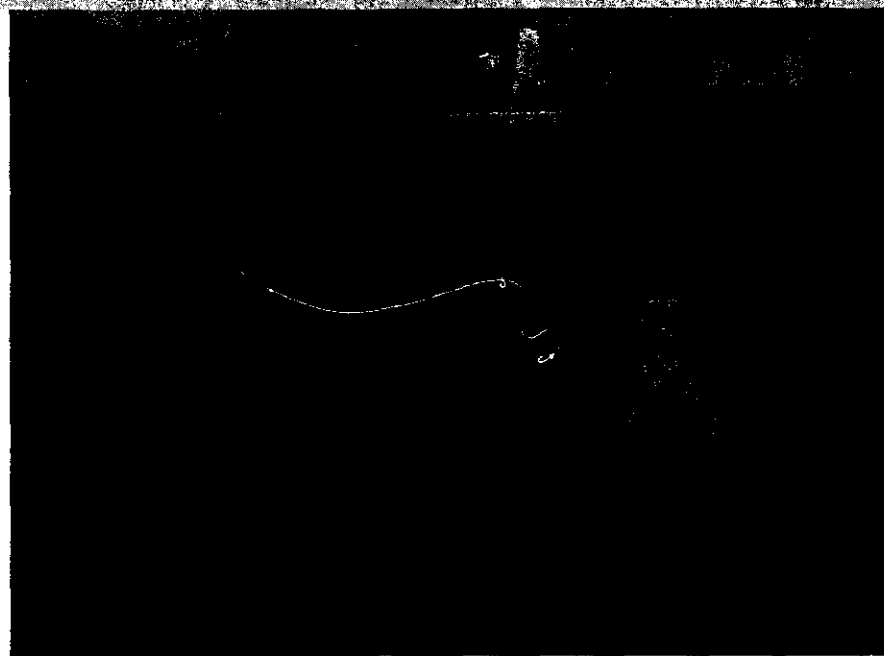
Regulators, too, are trying to make up for lost time. In a first attempt to put numbers on a nebulous concept, in December the Basel Committee of central banks and supervisors from 27 countries proposed a

global liquidity standard for internationally active banks. Tougher requirements would reverse a decades-long decline in banks' liquidity cushions.

The new regime, which could be adopted as early as 2012, has two components: a "coverage" ratio, designed to ensure that banks have a big enough pool of high-quality, liquid assets to weather an "acute stress scenario" lasting for one month (including such inconveniences as a sharp ratings downgrade and a wave of collateral calls); and a "net stable funding" ratio, aimed at promoting longer-term financing of assets and thus limiting maturity mismatches. This will require a certain level of funding to be for a year or more.

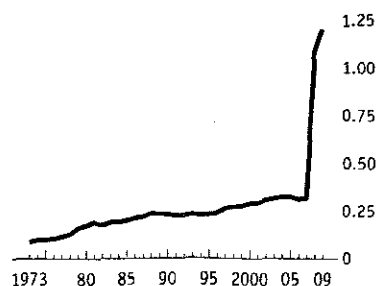
It remains to be seen how closely national authorities follow the script. Some seem intent on going even further. In Switzerland, UBS and Credit Suisse face a tripling of the amount of cash and equivalents they need to hold, to 45% of deposits. Britain will require all domestic entities to have enough liquidity to stand alone, unsupported by their parent or other parts of the group. Also controversial is the composition of the proposed liquidity cushions. Some countries want to restrict these to government debt, deposits with central banks and the like. The Basel proposals allow high-grade corporate bonds too.

Banks have counter-attacked, arguing that "trapping" liquidity in subsidiaries would reduce their room for manoeuvre in a crisis and that the buffer rules are too restrictive; some, unsurprisingly, have called for bank debt to be eligible. Under the British rules, up to 8% of banks' assets could be tied up in cash and gilts (British government bonds) that they are forced to hold, reckons Simon Hills of the British Bankers Association, which could have "a huge impact on business models". That, some ar-



Filling the pool

US banks' cash assets, \$trn



Sources: Federal Reserve; Goldman Sachs

gue, is precisely the point of reform.

Much can be done to reduce market stresses without waiting for these reforms. In repo lending—a decades-old practice critical to the smooth functioning of markets—the Federal Reserve may soon toughen collateral requirements and force borrowers to draw up contingency plans in case of a sudden freeze. Banks that clear repos will be expected to monitor the size and quality of big borrowers' positions more closely. The banks could live with that, but they worry about proposals to force secured short-term creditors to take an automatic loss if a bank fails.

Another concern is prime brokerage, banks' financing of trading by hedge funds. When the market unravelled, hedge funds were unable to retrieve collateral that their brokers had "rehypothecated", or used to fund transactions of their own; billions of such unsegregated money is still trapped in Lehman's estate, reducing dozens of its former clients to the status of unsecured general creditors. Brokers suffered in turn as clients pulled whatever funds they could from those they viewed as vulnerable. Temporary bans on short-selling made things even worse, playing havoc with some hedge funds' strategies and leaving them scrambling for cash. Regulators are moving towards imposing limits on rehypothecation.

Early reform could also come to the securities-lending market, in which institu-

tional investors lend shares from their portfolios to short-sellers for a fee. Some lenders—including, notoriously, AIG—found they were unable to repay cash collateral posted by borrowers because they had invested it in instruments that had turned illiquid, such as asset-backed commercial paper. Some have doubled the share of their portfolios that they know they can sell overnight, to as much as 50%.

Regulators might consider asking them to go further. Bond markets, unlike stock markets, revolve around quotes from dealers. This creates a structural impediment to the free flow of liquidity in strained times, argues Ken Froot of Harvard Business School, because when dealers pull in their horns they are unable to function properly as market-makers. He suggests opening up access to trade data and competition to quote prices. Some senior figures at the Fed like the idea, as do money managers, though predictably dealers are resisting.

Twin realities

The other brutal lesson of the crisis concerns the way liquidity can affect solvency. In a world of mark-to-market accounting, a small price movement on a large, illiquid portfolio can quickly turn into crippling paper losses that eat into capital. Highly rated but hard-to-shift debt instruments can finish you off before losses on the underlying loans have even begun to hurt your cash flows. If markets expect fire

sales, potential buyers will hold off for a better price, exacerbating fair-value losses.

In future banks will be more alert to these dangers. "We were looking at the bonds we held, focusing on the credit fundamentals. We lost sight of the capital hit from illiquidity and marking to market that can seriously hurt you in the meantime," says Koos Timmermans, chief risk officer at ING, a large Dutch banking and insurance group. "We now know that you have to treat the accounting reality as economic reality."

Another lesson is the "opportunity value" of staying liquid in good times, says Aaron Brown, a risk manager with AQR, a hedge fund. In an efficient market dollar bills are not left lying around. But in the dislocated markets of late 2008 there were lots of bargains to be had for the small minority of investors with dry powder.

For some, though, bigger liquidity problems may yet lie ahead. Some \$5.1 trillion of bank debt rated by Moody's is due to mature by 2012. This will have to be refinanced at higher rates. The rates could also be pushed up by an erosion of sovereign credit quality, given implicit state guarantees of bank liabilities. And, at some point, banks face a reduction of cut-price liquidity support from central banks—offered in return for often dodgy collateral—which has buoyed their profit margins. Mortgage borrowers on teaser rates are vulnerable to payment shock. So too are their lenders. ■

Fingers in the dike

What regulators should do now

THE Delta Works are a series of dams, sluices and dikes built in the second half of the 20th century to protect the low-lying parts of the Netherlands from the sea. They are considered one of the seven wonders of the modern world. The task facing global regulators is to construct the financial equivalent of this protective network, said Jean-Claude Trichet, president of the European Central Bank, in an interview last November.

This will require success in three connected areas: reducing the threat to stability posed by firms deemed too big to fail because their demise could destabilise markets; ensuring that banks have bigger cushions against losses; and improving system-wide, or macroprudential, regula-

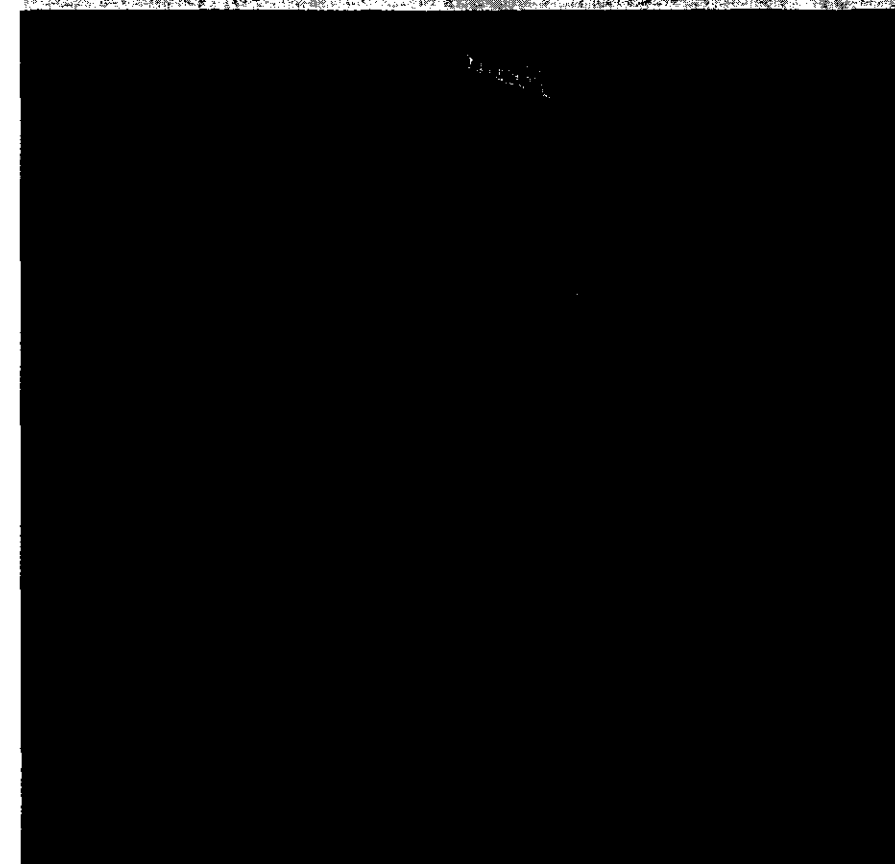
tion. The work is under way, but some bits are hobbled by a surfeit of architects, others by a lack of clear plans.

• **Too big to fail.** Dealing with "systemically important" giants is the thorniest problem. Having once been cornered into a choice between costly rescues and gut-wrenching failures, governments are determined to avoid a repeat. When markets swooned, they were obliged to stand behind the big and the highly connected (as well as their creditors), but found themselves ill-equipped. Tim Geithner, America's treasury secretary, said his administration had nothing but "duct tape and string" to deal with American International Group (AIG) when it tottered.

The problem has only worsened dur-

ing the crisis. After a quarter-century of ever-increasing financial concentration, the giants of finance grew even more dominant in 2008-09 thanks to a series of shotgun takeovers of sickly rivals (see chart 5, next page).

Regulators can tackle the issue either by addressing the "too big" part (shrinking or erecting firewalls within giants) or the "to fail" bit (forcing them to hold more capital and making it easier to wind down bust firms). Until recently the focus was on the second of these approaches. But since President Obama's unveiling of two initiatives last month—a tax on the liabilities of big banks and the "Volcker rule", which proposed limits on their size and activities—momentum has been shifting towards ►►



► some combination of the two.

The Volcker plan—named after Paul Volcker, the former Federal Reserve chairman who proposed it—calls for deposit-takers to be banned from proprietary trading in capital markets and from investing in hedge funds and private equity. The Financial Stability Board (FSB), a Basel-based body that is spearheading the international reform drive, gave it a cautious welcome, stressing that such a move would need to be combined with tougher capital standards and other measures to be effective.

The Volcker rule does not seek a full separation of commercial banking and investment banking. Nor is America pushing to shrink its behemoths dramatically; for most, the plan would merely limit further growth of non-deposit liabilities (there is already a 10% cap on national market share in deposits). Officials remain uneasy about dictating size limits. Citigroup's woes suggest a firm can become too big to manage, but JPMorgan Chase and HSBC are striking counter-examples.

For all the hue and cry about the Volcker plan, America sees it as supplementing earlier proposals, not supplanting them. The most important of these is an improved "resolution" mechanism for failing giants. Standard bankruptcy arrangements do not work well for financial firms: in the time it takes for a typical case to grind through court, the company's value will have evaporated.

America's resolution plan would allow

regulators to seize and wind down basket-cases. The challenge will be to convince markets that these measures will not turn into life-support machines. Worse, there is no international agreement on how to handle the failure of border-straddling firms, nor is one close. That was a huge problem with Lehman Brothers, which had nearly 3,000 legal entities in dozens of countries. And the struggle to retrieve \$5.5 billion that a bust Icelandic bank owes creditors in Britain and the Netherlands still continues.

Questions also linger over the treatment of lenders. America's plan wants it both ways, giving regulators discretion to override private creditors but also to subordinate the taxpayer's claims. This fuels concerns about handouts to politically fa-

voured groups, as happened in the government-orchestrated bankruptcy of General Motors. Another worrying precedent was the generous treatment of troubled banks' derivatives counterparties in 2008. All counterparty trading exposures, to the extent that they are uncollateralised, should be at the bottom of the capital stack, not at the top. Regrettably, the opposite happened. This prompted a wave of credit-default-swap buying because these contracts were underwritten by the state. "Today, too big to fail means too many counterparty exposures to fail," says Peter Fisher of BlackRock, a money manager.

• **Overhauling capital requirements.** In the hope of avoiding having to trigger their resolution regimes in the first place, regulators will force banks to strengthen their capital buffers. A number of countries are considering a punitive capital surcharge for the largest firms. A report from the Bank of England last November suggested various ways of designing this. It could vary by sector, allowing regulators to influence the marginal cost of lending to some of the more exuberant parts of the economy. Or it could reflect the lender's contribution to systemic risk, based on its size, complexity and the extent of its connections to other financial firms.

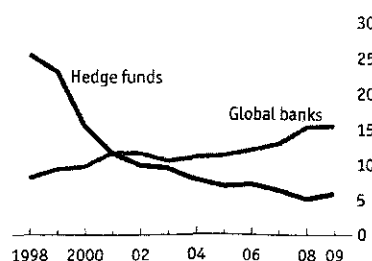
How such a penalty would fit with broader capital reforms is unclear. In December the Basel Committee of supervisors and central banks laid out proposed revisions to its global bank-capital regime. These could come into force as early as 2012-13. The new standards, dubbed Basel 3, are less reliant than the last set of reforms on banks' own risk models. Then the talk was of capital "efficiency". Now it is all about robustness. With markets already demanding that banks hold more equity, a reversal of a long trend of falling ratios is under way (see chart 6, next page).

Before the crisis banks could get away with common equity—the purest form of capital—of as little as 2% of risk-weighted assets. The new regulatory minimum will not be clear until later this year, but markets now dictate that banks hold four to five times that level. Hybrid instruments—part debt, part equity—will be discouraged since these proved bad at absorbing losses. Regulators are encouraging banks to issue a different type of convertible capital: "contingent" bonds that automatically turn into common shares at times of stress.

In another acknowledgment that relying too heavily on internal models was a mistake, the new rules will be supplemented by a "leverage ratio". Not weighted ►

Big banks get bigger

Top five global banks and hedge funds
Assets as % of industry total



Source: "Banking on the State" by Andrew Haldane and Piergiorgio Alessandri; Bank for International Settlements

to risk, this measure looks appealingly simple these days. One aim is to curb gaming of risk-based requirements: European banks, which unlike American ones were not subject to a leverage ratio, could take their borrowing to dangerous heights because many of their assets were highly rated securities with low risk weightings. One official likens the new approach to placing a net under a trapeze artist.

In an equally big philosophical shift, the new measures will lean against "procyclicality", or the tendency of rules to exaggerate both the good and the bad. Banks will be required to accumulate extra capital in fat years that can be drawn upon in lean ones. Until now the rules have encouraged higher leverage in good times and much lower in bad times, adding to distress at just the wrong moment. Securities regulators contributed to the problem, frowning on boom-time reserve-building as possible profit-smoothing in disguise. The new proposals will encourage "dynamic" provisioning, which allows banks to squirrel away reserves based on expected losses, not just those already incurred.

Addressing procyclicality will also require tackling issues that straddle capital rules and accounting standards. Critics of fair-value (or "mark-to-market") accounting, which requires assets to be held at market prices (or an approximation), complain that having to mark down assets to the value they would fetch in illiquid markets is likely to exacerbate downturns. The solution is not to abandon fair value, which investors like because it is less open to manipulation than the alternatives. But there is a case for decoupling capital and accounting rules, says Christian Leuz of the Booth School of Business. This would give bank regulators more discretion to accept alternative valuation methods yet still allow investors to see the actual or estimated market value.

There are lots of potential devils in the details of the proposals. A leverage ratio is pointless without strict monitoring of assets parked off balance-sheets. Contingent capital, meanwhile, could have the opposite effect of that intended if the bank's trading partners flee as its ratios near the trigger point. There are also worries over increases in capital charges for securitisations, exposure to swap counterparties and the like. These make sense in theory; to treat mortgage-backed securities as almost risk-free was nonsense. But the new rules swing too far the other way, threatening to choke off the recovery of asset-backed markets.

America's large banks, having repaid their debts to taxpayers, are sure to wage war on higher capital standards. An impact assessment stretching over several months will give them ample opportunity to look for holes—and to lobby. In Europe, where banks were more highly leveraged and thus face a more wrenching adjustment, even some supervisors are queasy.

• Improving macroprudential regulation. In the meantime regulators can make progress in other areas, such as overhauling day-to-day supervision. In both America and Europe they have stepped up comparisons of pay, lending standards and the like across big firms. They are also introducing peer review. Within the agency that oversees Swiss banks, for instance, the lead supervisors of Credit Suisse and UBS are now expected to scrutinise each other's work. America's Securities and Exchange Commission, whose failures included negligible supervision of investment banks and the Madoff scandal, has set up a new risk division packed with heavyweight thinkers such as Henry Hu, Gregg Berman and Richard Bookstaber. Part of their job will be to scan derivatives markets, hedge funds and the like for any emerging threats to stability.

This stems from a recognition that traditional oversight needs to go hand in hand with the macroprudential sort that takes account of the collective behaviour of financial firms, contagion effects and so on. "Finance is full of clever instruments that work as long as the risk is idiosyncratic, but can wreak havoc if it becomes systemic," says Frederic Mishkin of Columbia University. Moreover, the crisis showed how risk can cross traditional regulatory lines. Pension funds and insurers, previously seen as shock-absorbers, were revealed as potential sources of systemic risk.

However, there is no broad agreement

on how systemic regulation might work, or who should do the regulating. Most economists see the job falling naturally to central banks, because of their closeness to markets and because of the link between capital standards and monetary policy through the price of credit. But there are political obstacles, particularly in America, where a large and vocal contingent in Congress accuses the Fed itself of being a threat to stability, pointing to loose monetary policy as a cause of the housing mania.

International co-ordination is equally tricky. The FSB has singled out 30 of the largest banks and insurers for cross-border scrutiny by "colleges" of supervisors. There is, though, a natural limit to co-operation. It remains to be seen how well national risk regulators work with supranational bodies such as the European Union's systemic-risk council and the FSB. Private-sector groups want to have their say too: the Market Monitoring Group, a collection of grantees linked to a banking-industry group, is already issuing warnings about fresh bubbles emerging.

Another reason for scepticism is the difficulty of identifying a systemic event. AIG's liquidity crunch was thought to count as one at the time, hence the offer of an \$85 billion emergency loan from the Fed. But what exactly was the danger? That markets would be brought to their knees by the failure of its derivatives counterparties (who were controversially paid off at par)? Or by trouble at its heavily regulated insurance businesses? More than a year later, no one seems sure.

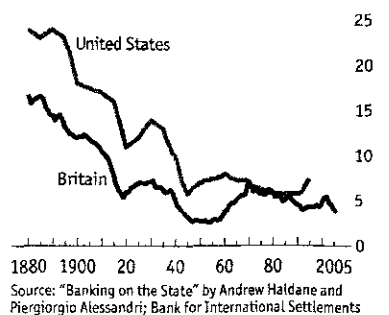
Pricking bubbles—another mooted role for systemic regulators—is also fraught with danger. Many central bankers consider it unrealistic to make prevention of asset-price bubbles a specific objective of systemic oversight. But thinking at the Fed has been shifting. Under Alan Greenspan its policy had been to stand back, wait for the pop and clean up the mess. But Ben Bernanke, the current chairman, recently backed the idea of intervening to take the air out of bubbles. This could be done mainly through stronger regulation, he suggested, though he did not rule out monetary policy as a back-up option.

Mr Mishkin, a former Fed governor, draws a contrast between credit-boom bubbles and irrational exuberance in stockmarkets, such as the dotcom bubble. The first is more dangerous, and the case for pre-emptive action stronger, he argues, because it comes with a cycle of leveraging against rising asset values.

In retrospect all crashes look inevitable. »

Threadbare cushion

Banks' capital ratios, %



► Even with the most insidious-looking bubbles, though, it is impossible to know at the time how devastating the pop will be. Many thought the economic fallout from the internet crash would be far greater than it turned out. The economic cost of prematurely ending a boom can be high. Even so, the worry is that a systemic regulator would be biased towards intervention, because it would face less criticism for puncturing a non-bubble than for failing to spot a real one.

Alex Pollock of the American Enterprise Institute (AEI), a think-tank, is concerned that the creation of an official systemic regulator would bring false comfort, just as the Fed's founding in 1913 did. According to the then Comptroller of the Currency, it had rendered further crises "mathematically impossible". Mr Pollock would prefer to see the task go to an independent advisory body, manned by economic

heavyweights to provide institutional memory of past crises. For similar reasons, Andrew Lo, director of MIT's Laboratory for Financial Engineering, suggests separating regulation from forensics, as happens in the airline industry. America's National Transportation Safety Board is seen as independent because its job is to investigate crashes, not to set rules after the event. That gives it more moral clout.

Whatever form it takes, systemic policing would face a problem. During booms, governments are loth to take the punch-bowl away, at least until the next election. Nor do they want to be criticised for their own contribution to systemic risk. They may have become even touchier now that they are, as Pimco's Mohamed El-Erian puts it, "market players as well as referees".

A way round this would be to introduce rules requiring the regulator to step in if, say, credit and asset prices are growing at

above-average rates. That would shield it from claims that the next boom is somehow different and should be left to run its course. But it comes at the cost of flexibility.

All of this suggests that although there is a strong case for a more system-wide approach to oversight, it could do more harm than good if poorly crafted. Meanwhile taxpayers will continue to underwrite financial giants; America's reforms in their current shape allow the authorities to pull apart those that pose a "grave threat", but also to bail out their creditors if they consider it necessary.

The danger is that the very existence of a systemic regulator creates an illusion of increasing stability even though it does the opposite by strengthening the implicit guarantee for the biggest banks—a "permanent TARP", as the AEI's Peter Wallison puts it. Too big to fail sometimes seems too hard to solve. ■

Blocking out the sirens' song

Money men need saving from themselves

RISK antennae twitch after a crisis. Bankers, regulators and academics, shaken from their complacency, jostle to identify the next tempest. Right now gusts are blowing from several directions. Many countries' fiscal positions are deteriorating fast after costly interventions to shore up financial systems and restore growth. There is talk of demanding collateral even on deals with formerly unimpeachable sovereign entities. Recent terrorist incidents have raised the spectre of external shocks.

Yet at least a fragile sort of optimism has surfaced, born of ultra-cheap money and relief at having avoided a depression. In some markets fresh bubbles may be forming. Stockmarkets have rebounded sharply. America's, though still well off their peaks, are up to 50% overvalued on a historical basis. Banks are once again throwing money at hedge funds and private-equity firms (though with tougher margin requirements). Issuance of structured-loan funds, which a few months back looked dead, is booming. Investment banks' profits, and bonus pools, are back near pre-crisis levels. International regulators have been issuing warnings to chief executives about a return of irrational exuberance. Banks have been ordered to run stress tests involving a sudden jump in interest rates,

in preparation for central banks' withdrawal of monetary adrenaline.

Many will already be doing this as they try to show that they have learnt their lessons. Like the best chess players, bankers insist that they are now concentrating as hard on avoiding mistakes as on winning. Those that sidestepped the worst mortgage-related landmines now top the industry's new order. Blackrock's Mr Fisher defines risk as "deviation from objective", on the upside as well as the downside. If your models tell you that a security is safer than its returns imply, as with CDOs, that might just suggest hidden risks.

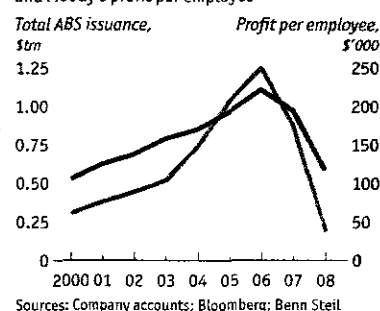
Fancy mathematics will continue to play a role, to be sure. But finance is not physics, and markets have an emotional side. In their struggle with the quants, those who would trust their gut instinct have gained ground.

Learning to tie knots

Governments are taking no chances. Bloomberg counts some 50 bills and other serious proposals for financial reform in America and Europe. Leaders in America's Senate hope to pass new rules by March. But there are limits to what can be expected from regulators and supervisors. Like bankers, they have blind spots. As the

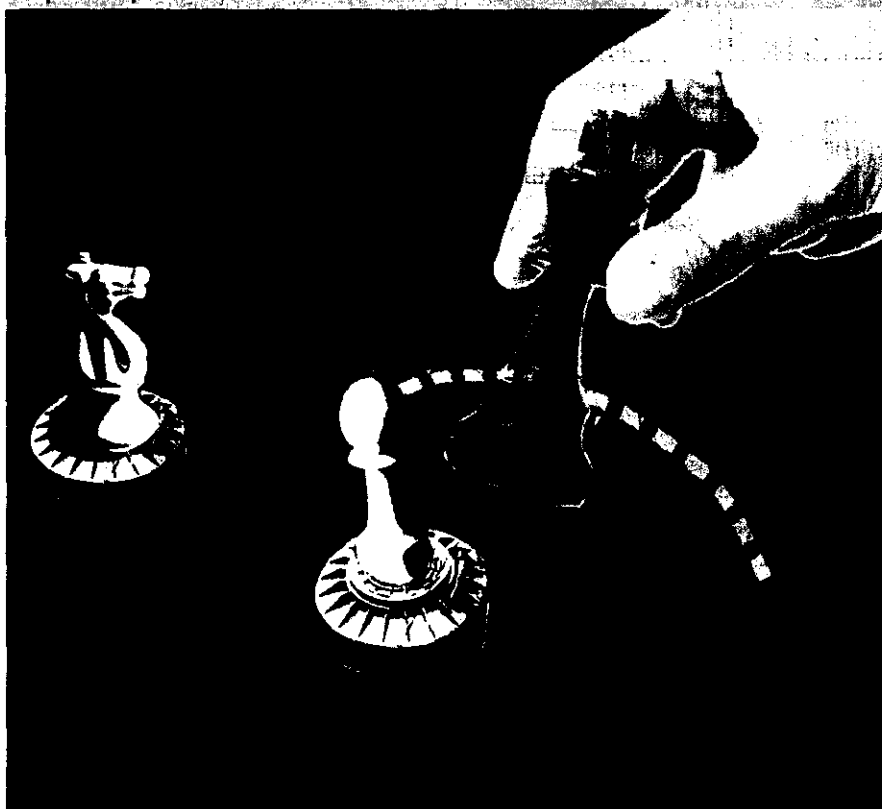
Parti pris

Global asset-backed-securities issuance and Moody's profit per employee



mortgage fiasco showed, they are vulnerable to capture by those they police.

Their job will be made easier if new rules tackle incentives for the private sector to take excessive risk. It is human behaviour, more than financial instruments, that needs changing, says Mr Mauboussin of Legg Mason. Like Odysseus passing the sirens, bankers need to be tied to a mast to stop them from giving in to temptation. Pay structures should be better aligned with the timescale of business strategies that run for a number of years and should not reward "leveraged beta", unremarkable ▶▶



► able returns juiced with borrowed money. In securitisation, originators will have to disclose more information about loan pools and hold a slice of their products.

Some of the worst abuses in securitisation stemmed from the use of credit ratings. Rating agencies systematically underestimated default risk on vast amounts of debt, resulting in puffed-up prices and a surfeit of issuance. Paid by issuers, they had every incentive to award inflated ratings and keep the market humming: average pay at the agencies rose and fell in tandem with the volume of asset-backed issuance (see chart 7, previous page).

An obvious way to deal with this would be to eliminate the agencies' official "nationally recognised" status, opening the business to unfettered competition. Raters would then have to persuade investors of their competence, rather than relying on a government imprimatur. This, in turn, would force investors themselves to spend more time analysing loans. Oddly, proposed reforms fall far short of this, with no sign of anything tougher on the horizon. CreditSights, a research firm, awarded ratings firms its "Houdini was an Amateur" award for 2009.

Nor, alas, is there much appetite to tackle some of the public policies that contributed to the crisis. The non-recourse status of mortgages in large parts of America, for instance, gives the borrower a highly attractive put option: he can, in effect, sell the house to the lender at any time for the principal outstanding. An even bigger problem is the favourable tax treatment of debt rela-

tive to equity. Phasing this out would discourage the build-up of excessive leverage. But the idea has little political traction.

There are, to be sure, risks to rushing reform. Post-crisis regulation has a long history of unintended consequences, from the pay reforms of the early 1990s (when new limits on the deductibility from corporate tax of executive salaries merely shifted the excesses to bonuses) to key parts of the Sarbanes-Oxley act on corporate governance. Another danger is the pricing of risk by regulation, not markets. The credit-card act passed in America last year leaves providers with a choice between underpricing for some products, which is bad for them, or restricting their

offerings, which is bad for consumers.

Most would agree, however, that markets need both tighter rules and better enforcement. The biggest question mark hangs over the fate of those institutions whose collapse would threaten the system. America's proposal to cap banks' size and ban proprietary trading has fortified those calling for radical measures to tackle the "too big to fail" problem.

The virtues of scepticism

By itself, though, the plan does little to back up Barack Obama's promise to stop such firms from holding the taxpayer hostage. Proprietary trading and investments are a small part of most big banks' activities and played only a minor role in the crisis. Nor does the plan cover brokers, insurers or industrial firms' finance arms, all of which had to be bailed out. To persuade markets that the giants no longer enjoy implicit state guarantees, whether they are banks or not, policymakers will need to present a cocktail of solutions that also include tougher capital and liquidity standards, central clearing of derivatives and credible mechanisms to dismantle firms whose losses in a crisis would overwhelm even a strengthened safety buffer.

Together, intelligent regulatory reforms and a better understanding of the limitations of quantitative risk management can help to reduce the damage inflicted on the financial system when bubbles burst. But they will never eliminate bad lending or excessive exuberance. After every crisis bankers and investors tend to forget that it is their duty to be sceptical, not optimistic. In finance the gods will always find a way to strike back. ■

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is denied a fair hearing. Although it gets the chance to put forward its side of the argument, it does so only to the case team, not to a neutral judge or hearing officer. As things stand, the role of the hearing officer is purely procedural. The third objection is that the final decision on culpability is taken on a vote by 27 politically appointed commissioners, only one of whom may have attended the defendant's hearing.

A fair hearing, please

In no other area of law would it be thought acceptable for the outcome of such important cases to be determined by a bunch of politicians. In America the antitrust division of the Department of Justice has to make its arguments in open court, while even the quasi-judicial commissioners of the Federal Trade Commission appoint a judge to preside over hearings and publish findings. The process is long-winded and expensive

but it is an intrinsically fairer way to establish the facts.

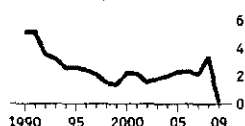
Even if Mr Almunia procrastinates, change is coming. Europe's Charter of Fundamental Rights will finally be ratified next year. It is highly probable that antitrust appeals to the European Court of Human Rights (based on the unfairness of a process that levies huge fines but falls far short of the standards expected of the criminal law) will succeed. Realistically, amending the treaty to remove the commission's role as the enforcer of competition law is a non-starter. A more modest change would, however, improve things greatly and bring European practice closer to America's without importing all its excesses. That is to give the hearing officer the power to make a factual and legal determination based on a proper examination of the evidence; the 27 commissioners would then have to accept or reject this. The system would still be far from perfect, but it would be a good deal more just. ■

Rethinking economics

Radical thoughts on 19th Street

A higher inflation target for central banks would be a bad idea

Consumer prices
Advanced countries
% increase on a year earlier



EVEN in economics, the guardians of orthodoxy are not given to capricious changes of mind. So when economists at the IMF question received wisdom and the fund's established views twice in a week, it is no small matter. Two new papers

have done exactly that. The first reversal, on inflation targets, makes less sense than the second, on capital controls.

The initial firecracker came on February 12th, with an analysis of the lessons of the financial crisis for macroeconomic policy, led by Olivier Blanchard, the IMF's chief economist. The report called for several bold innovations. The most radical of these is that central banks should raise their inflation targets—perhaps to 4% from the standard 2% or so.

The logic is seductive. Because inflation and interest rates were low when the crisis hit, central banks had little room to cut rates to cushion the economic blow. Once their policy rates were down to almost zero, the world's big central banks had to turn to untested tools, such as quantitative easing. Politicians had to boost enfeebled monetary policy by loosening their budgets generously. Had inflation and interest rates been higher, policymakers would have had more room to cut rates. That gain, Mr Blanchard argues, might outweigh the small distortions from modestly higher inflation, especially if countries reformed their tax systems to make them inflation-neutral.

Were central banks starting from scratch, such a cost-benefit analysis would indeed be the right way to set an inflation target. Even then, Mr Blanchard might be wrong. He may be understating the costs of higher inflation. Many studies suggest that inflation of 4% would do little, if any, harm to economic growth, but others reckon that the threshold at which distortions kick in is lower. And since higher inflation tends to mean more volatile prices, the risks increase as the target rate rises.

Nor is it obvious that starting with interest rates so low was either a crippling constraint on central banks' actions or the main reason for the weakness of monetary policy. Central

banks showed plenty of ingenuity with quantitative easing. Other tools, such as negative interest rates, could also be developed if need be. And with the financial system in crisis and debt-ridden consumers unwilling to borrow, monetary loosening might have been a feeble source of stimulus even if inflation had started higher.

A question of credibility

Yet the biggest problem with Mr Blanchard's idea is that central banks are not starting from scratch. They have spent two decades convincing the public that they are committed to price stability and, rightly or wrongly, have equated this with inflation of around 2%. The stabilisation of expectations has been remarkably successful—and it allowed policymakers to cut rates as fiercely as they did. But it cannot be taken for granted, especially when some rich countries' budget deficits are so vast. It would disappear fast if central bankers suddenly said that inflation of 4% was just fine after all. How could they convince investors that the change was intended to make policy more flexible, rather than to inflate away the state's debts? With their credibility undermined, the next crisis would be much harder to fight. As an intellectual exercise, Mr Blanchard's idea is intriguing. As a policy proposal, it is reckless.

That is not true of the IMF's second piece of revisionism. A note to be published on February 19th acknowledges that controls on capital inflows can be a useful tool for countries facing a surge of foreign funds (see page 67). For an organisation that has long focused on the distortions such controls create, the shift is significant. It is also timely. With rich-world interest rates at rock bottom, emerging economies are likely to face continuing surges of foreign capital. Until now, the IMF has sniffed in disapproval when countries have introduced controls. It would be more useful if it helped countries decide when such controls might work and designed them to do the most good and least harm. The new paper makes it easier for the fund's economists to get on with this. It may be less exciting intellectually than rewriting central banks' rule-books. But it is probably more useful and certainly less dangerous. ■



The politics of repression in China

What are they afraid of?

The economy is booming and politics stable. Yet China's leaders seem edgy

THE forces pulling China toward integration and openness are more powerful today than ever before," said President Bill Clinton in 1999. China then, though battered by the Asian financial crisis, was busy dismantling state-owned enterprises and pushing for admission to the World Trade Organisation. Today, however, those forces look much weaker.

A spate of recent events, from the heavy jail sentences passed on human-rights activists to an undiplomatic obduracy at the climate-change negotiations in Copenhagen last December, invite questions about the thinking of China's leaders. Has their view of the outside world and dissent at home changed? Or were the forces detected by Mr Clinton and so many others after all not pulling so hard in the direction they were expecting?

The early years of what China calls its "reform and opening" after 1978 were marked by cycles of liberalisation and repression. The turning-points were usually marked by political crisis: dissent on the streets, leadership struggles, or both. Now, however, the only big protest movements are repressed ones among ethnic minorities in Tibet and Xinjiang. China's big cities are hardly roiled by political turmoil. By the time Liu Xiaobo, an academic, was sentenced to 11 years in prison in December, dissident debate surrounding the reform manifesto he had issued a year earlier had long subsided. Yet it was the heaviest-

known penalty imposed on any activist for "inciting subversion" since such a crime was written into law in 1997.

China has so far survived the global economic downturn with hardly any of the agitation many once feared it might cause among unemployed workers or jobless university graduates. The economy grew at a very robust-sounding 8.7% last year and is predicted by many to be on course for similar growth in 2010.

Sweeping changes are due in the senior leadership in 2012 and 2013, including the replacement of President Hu Jintao and of the prime minister, Wen Jiabao. But if a struggle is brewing, signs of it are hard to spot. An unusually high-profile campaign against organised crime by the party chief of Chongqing municipality, Bo Xilai, has raised eyebrows. Some speculate that it is part of a bid by Mr Bo, who is a Politburo member, to whip up popular support for his promotion to the Politburo's all-powerful Standing Committee in 2012. An online poll by an official website chose Mr Bo as the "most inspiring voice" of 2009.

But Andrew Nathan of Columbia University in New York does not see this as a challenge to the expected shoo-in for Xi Jinping, the vice-president, as China's next leader, despite Mr Xi's failure last year to garner the leading military post analysts thought would form part of his grooming. Li Keqiang, a deputy prime minister, still looks set to take over from Mr Wen in 2013.

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Against this backdrop of political stability and economic growth, the most credible interpretation of the government's recent hard line is that the forces pushing its leaders towards greater liberalisation at home and sympathetic engagement with the West are weaker than had been hoped. Nor is there any sign that the next generation of leaders see their mission differently. As Russell Leigh Moses, a Beijing-based political analyst, puts it: "The argument in policy-making circles where reform is concerned is 'how much more authoritarian should we be?' not 'how do we embark on Western-style democracy?'"

Tough though the recent sentences of activists have been, they are hardly out of keeping with the leadership's approach to dissent in recent years. This has involved giving a bit of leeway to freethinking individuals, but occasionally punishing those seen as straying too far. Since late last year two activists have been jailed in an apparent attempt to deter people from organising the parents of children killed in shoddily built schools during an earthquake in Sichuan province in 2008. But another critic of the government's handling of the parents' grievances, Ai Weiwei, remains free in Beijing and just as outspoken.

The coming months are unlikely to see much change. Despite boasting of their country's resilience in the face of the global economic crisis, China's leaders still appear jittery. Mr Wen has forecast that 2010 will see "even greater complexity in the domestic and international situation". China's security chief, Zhou Yongkang, in a speech published this week said the task of maintaining social stability "was still extremely onerous".

Some Chinese economists worry out loud that China's massive stimulus-spending might have bought the country only a temporary reprieve. Bubbles, they fret, are

Texting in China

Well-red

BEIJING

Chinese communism's classic texts

THE year of the Tiger began this week as usual in China with cascades of fireworks and, as is now also the custom, of celebratory text messages on mobile phones. Like the pyrotechnics, Chinese text messages come in a variety of colours: yellow, grey, black and now, with official endorsement, red.

Yellow refers to the smutty type, and grey or black to spam messages, many of which offer products or services of various shades of legality. Recently the government has been stepping up efforts to eradicate such abuses. To steer public thinking, it is encouraging the sending of politically correct "red texts".

In mid-January the state-controlled press reported that Beijing, Shanghai and Guangzhou were trying a text-filtering system that could distinguish between the various hues. Those caught sending yellow ones risked having their phone's text function blocked. Restoring it would require a visit to the police and a written pledge not to text smut again.

This provoked howls of online protest. One popular social commentator, Han Han, complained on his blog that officials had not defined smut. He said he would keep sending text messages until he found out what words would get his service blocked. An article on the website of an unusually outspoken newspaper, *Southern Daily*, argued that such filtering was unconstitutional. Officials clarified that only those who send huge numbers of such messages need worry (over 300 an hour, an official in Guangzhou was quoted as saying).

The practice of "red-texting" is said to have begun in 2005 in Guangdong province, of which Guangzhou is the capital, when one operator, China Mobile, began organising competitions there to see who could devise the best red messages. This month a symposium for senior telecom officials in Beijing on the "red-text phenomenon" was portrayed in the state-owned press as a sign of high-level endorsement for the campaign.

The most famous red-texter is Bo Xilai, the party chief of Chongqing (see previous story). Last April he sent 13m-odd mobile-users a message bearing quotes from Mao Zedong such as "What really counts in the world is conscientiousness, and the Communist party is most particular about being conscientious." Enthused, or more likely bemused, users relayed his missive, reported the local press, 16m times.

forming in property markets, inflationary pressure is building up and reforms needed to promote sustained growth (including measures to promote urbanisation) are not being carried out fast enough. Occasionally, even the government's worst nightmare is mooted as a possibility: stagflation. A combination of fast-rising prices and low growth might indeed be enough to send protesters on to the streets.

Abroad, Chinese leaders are struggling to cope with what they feel to be an accelerated shift in the global balance of power, in China's favour. This has resulted in what Mr Moses describes as behaviour ranging from "strutting to outright stumbling". They reacted with oratorical fury in January, when America announced a \$6.4 billion arms deal with Taiwan. But while pandering to popular nationalism at home,

they remain aware of China's limitations. This week China allowed an American aircraft-carrier to pay a port call to Hong Kong, just a day before President Obama was due to defy grim warnings and meet the Dalai Lama in Washington.

Chinese leaders can be confident that the plight of dissidents and the ever-louder grumbles of foreign businessmen over the barriers they face in China will not keep the world away. From May China will be visited by a series of foreign leaders going to the World Expo in Shanghai. Among the first will be France's president, Nicolas Sarkozy, much reviled by Chinese nationalists for his stance on Tibet. China sees the Expo, like the 2008 Beijing Olympics, as a chance to flaunt its strength. But, as Mr Clinton noted of China in 1999, "a tight grip is actually a sign of a weak hand". ■

The war in Afghanistan

Crack open the fruit juice

KABUL

Coalition forces enjoy one of their better weeks

NO CHAMPAGNE, one assumes, for General Stanley McChrystal. To the chagrin of his German and Italian colleagues, the earnest American leading NATO forces in Afghanistan has banned alcohol at his Kabul headquarters. But he must be mightily satisfied with developments this week.

A much-trumpeted offensive in Afghanistan's bloodiest province, Helmand, was launched on February 13th, centred on the insurgent stronghold of Marja, and has so far gone rather well. Meanwhile, it emerged that the Taliban's deputy leader

and operational commander, Mullah Abdul Ghani Baradar, was recently captured in Karachi, Pakistan. Pakistani co-operation in his arrest marks a shift for a government that has tolerated Taliban leaders on its soil since they fled Afghanistan in 2001.

The assault on Marja, the biggest offensive ever mounted by the coalition, is a test of General McChrystal's strategy. This means having enough foreign troops to hold newly occupied territory; to give priority to protecting the population; and rapidly bringing in government services.

The operation may thus provide a mod- ►►



Does he come in peace?

Schumpeter | A different class

Would giving long-term shareholders more clout improve corporate governance?



THE spectacular collapse of so many big financial firms during the crisis of 2008 has provided new evidence for the belief that stockmarket capitalism is dangerously short-termist. After all, shareholders in publicly traded financial institutions cheered them on as they boosted their short-term profits and share prices by taking risky bets with enormous amounts of borrowed money. Those bets, it turns out, did terrible damage in the longer term, to the firms and their shareholders as well as to the economy as a whole. Shareholders can no longer with a straight face cite the efficient-market hypothesis as evidence that rising share prices are always evidence of better prospects, rather than of an unsustainable bubble.

If the stockmarket can get wildly out of whack in the short run, companies and investors that base their decisions solely on passing movements in share prices should not be surprised if they pay a penalty over the long term. But what can be done to encourage a longer-term perspective? One idea that is increasingly touted as a solution is to give those investors who keep hold of their shares for a decent length of time more say over the management of a company than mere interlopers hoping to make a quick buck. Shareholders of longer tenure could get extra voting rights, say, or new ones could be barred from voting for a spell.

In the early 1980s shares traded on the New York Stock Exchange changed hands every three years on average. Nowadays the average tenure is down to about ten months. That helps to explain the growing concern about short-termism. Last year a task force of doughty American investors (Warren Buffett, Felix Rohatyn and Pete Peterson, among others) convened by the Aspen Institute, a think-tank, published a report called "Overcoming Short-Termism". It advocated various measures to encourage investors to hold shares for longer, including withholding voting rights from new shareholders for a year.

An advisory committee in the Netherlands has proposed loyalty bonuses for long-term shareholders, such as increased dividends or additional voting rights after holding a share for four years. Likewise, Britain's minister for financial services, Paul Myners, has suggested that short-term holders of shares should have inferior voting rights. Roger Carr, the chairman of Cadbury until it was taken over recently by Kraft, suggested earlier this

month that investors who bought shares in a firm after it had received a takeover bid should not be allowed to vote on the offer.

The theory behind these proposals is that those who hold shares longer are more likely to behave like owners than those who trade frequently to bet on short-term movements in prices. Disenfranchising the punters would not only give investors an incentive to hang onto their shares for longer, the argument runs, but would also encourage those with voting rights to use them, as they would know their votes would be more likely to count in board elections and so forth.

Would it work? Happily, an experiment in dual classes of shareholders has long been under way in France, where shares often gain double voting rights after being held for a specified period—usually two years, although sometimes as long as ten. A recent paper, "Disclosure and Minority Expropriation: A Study of French Listed Firms", by Chiraz Ben Ali, an economist at the University of Paris Dauphine, found that the main impact of the dual-class structure was to increase the exploitation of minority shareholders (which tended to own the shares with weaker voting rights) by the controlling majority. Accounting practices, for example, tend to be much less transparent. Admittedly, France's feeble safeguards for minority shareholders may be partly responsible for this result—but at the very least that suggests that extra voting rights are no cure-all.

Although no American firms have dual classes of shareholders, they do sometimes resort to another device designed to resist pressure to pursue short-term goals: "staggered boards", in which only a minority of directors face re-election each year. According to Lucian Bebchuk of Harvard Law School, who has studied their impact, they are strongly associated with lower long-term returns.

Short-term vigour, long-term neglect

Equally, there is some evidence, albeit not conclusive, that short-term shareholders from activist hedge funds and the like can improve the performance of poorly run companies through brief campaigns to improve their strategy or management. As Colin Melvin, the boss of Hermes Equity Ownership Services, an advisory firm with activist leanings, points out, "Disproportionate voting rights can (and often do) serve to insulate management and make it less accountable to shareholders." In short, the length of time that an investor holds a share does not tell you a lot about how much interest he will take in the management of the firm concerned. Many long-term index investors hold shares for years without taking the slightest interest in how the firms they invest in are run, let alone doing anything to improve matters. There is also a moral argument, of course, against depriving property-owners of their rights, no matter how seldom they make use of them.

The real issue is not how to encourage investors to keep hold of their shares for longer, but how to encourage more of them to take their duties as owners seriously, irrespective of the length of their tenure. Instead of creating multiple classes of shareholders, governments and regulators may want to think about how they define fiduciary duties in the financial realm. Better yet, the investing public, whose retirement savings have atrophied in the financial crisis thanks in part to the short-term way in which they were invested, may sort things out themselves, by demanding a longer-term perspective from the pension and mutual funds that they have entrusted with their money. ■



Sovereign-debt worries

Domino theory

WASHINGTON, DC

Assessing the risk that Greece's woes herald something far worse

HOW far is it from Athens to America and which countries lie on the way? That may sound like an esoteric geography question, but it is being asked by investors as Greece's debt crisis creates global jitters about the safety of sovereign debt. So far Portugal, Ireland and Spain, the other high-deficit countries on the periphery of the euro zone, are thought to be next in line. In most big rich economies, yields have been stable and well below their long-term average (see chart).

But nerves are fraying elsewhere. The cost of insuring against sovereign default (see Buttonwood) has risen in 47 of the 50 countries for which these instruments exist. Dubai's sovereign credit-default-swap spreads soared to their highest level in a year this week, amid concern about the terms of a debt restructuring by a state-owned conglomerate. There is increasingly shrill commentary arguing that Greece is the start of a far bigger problem. "A Greek crisis is coming to America", blared the headline on a recent *Financial Times* article by Niall Ferguson, a financial historian.

The stakes are high. A sudden loss of confidence in all sovereign debt, and especially in American Treasuries, the world's benchmark "risk-free" asset, would have calamitous consequences in a still-fragile recovery. Equally, an exaggerated fear of

sovereign risk could prompt governments into premature fiscal austerity, which might itself push the world economy back into recession.

Neither the shrill nor the sanguine arguments can be dismissed out of hand. Fiscal pessimists point both to past experience and to the arithmetic of public debt for evidence that sovereign-debt crises could spread far beyond Greece. The lesson of history, as documented in a magisterial study of financial crises by Carmen Reinhart and Ken Rogoff, is that public debt tends to soar after financial crises, rising by an average of 86% in real terms. Sovereign defaults have often followed.

The arithmetic argument for pessimism is equally compelling. Virtually no rich country has a "sustainable" debt position, in the narrow sense that none is running a tight enough budget or is growing quickly enough to stop its debt burden from rising. The worst offenders on this count are the euro area's peripheral economies, as well as Britain and America.

Greece stands out for the size of its debt stock, the scale of its budget deficit and the grimness of its growth prospects given high domestic costs and an inability to devalue. Worries about where growth will come from are the main reason why fears have, so far, focused on the other weak

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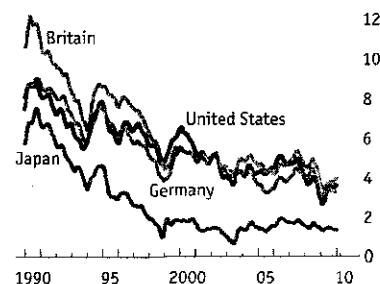
members of the euro zone (although Spain attracted decent demand for a 15-year bond sale on February 17th).

America and Britain, having their own currencies, are in a different position. But they are not immune to concerns about growth and debt dynamics. On February 18th Britain reported a deficit for January, a month of surplus since records began in 1993. Pessimists also fret about the sheer scale of America's public borrowing and, especially, China's role in funding it. News that foreign demand for Treasuries fell sharply in December and that Beijing was a big seller has fanned their concerns.

Nonsense, says the sanguine camp, whose members include Paul Krugman, a prominent *New York Times* columnist. In their view, those who fear a sudden rise in sovereign risk, particularly for America, misunderstand the reasons for the build-up of sovereign debt and underestimate the role of Treasuries as a safe haven. Sovereign-bond yields are low because private demand for capital is weak. And it ►►

Yield of dreams

Ten-year government-bond yields, %



Source: Thomson Reuters

is likely to stay that way as Anglo-Saxon households rebuild their savings and firms hold back from investing.

On this view, America and Britain are better compared to Japan than to Greece. Japan's public debt—almost 200% of GDP on a gross basis—has risen steadily in the two decades since its asset bubble burst. It is far higher than in any Anglo-Saxon economies. Despite several downgrades, Japan has not had a debt crisis.

It is true that Japan, as a big creditor nation, can tap into ample savings at home, whereas America relies more on foreign investors. But the breadth of the financial cri-

sis across the rich world, and hence the surfeit of savings relative to investment, means this distinction can be overdone. What is more, investors still flee to, not from, American assets when they worry about risk. The dollar has risen by 4.8% against the euro since the start of the year. Existing investors in American debt, such as China, have no incentive to drive down its value with a fire sale of their holdings.

If Greece's plight shows that investor sentiment can change quickly and Japan's history shows that it need not, where do other sovereigns stand? So far low yields have vindicated the sanguine view for all

but those on the very edge of the euro zone. But there are three reasons to believe that could change.

The first lies in the strength of emerging markets. A gradual reorientation of their economies towards domestic spending will slowly reduce the global supply of savings, even if rich-country growth remains weak. Other things being equal, that ought to push up the cost of capital. At the same time rapid growth means most emerging economies' sovereign-debt ratios, already much lower than those in the rich world, will fall. True, rich countries can point to a far superior payment record. ▶▶

Buttonwood

Politicians blame the speculators again

A LITTLE boy was arrested yesterday for saying that the European emperor had no clothes. "This kind of speculation only causes panic and should be stopped," said a minister, who refused to comment on reports that the emperor was being treated for hypothermia.

Hans Christian Andersen's tale is worth remembering as politicians apportion blame for sovereign-debt scares. Take suggestions that the market in sovereign credit-default swaps (CDSs) should be restricted. These instruments allow investors to hedge the risk that a country reneges on its debt and let others bet that such a default will happen.

Christine Lagarde, the French finance minister, has suggested that the "validity" of these contracts should be looked at. There are certainly some issues that need to be examined. To reduce risk to market participants, the contracts should be traded on an exchange or via a central counterparty. Investors should also ask whether it makes sense to insure against a default on Treasury bonds. If the American government defaults, which bank will still be good for the insurance claim?

But you suspect this is not what Ms Lagarde meant. She probably thinks that "speculators" are manipulating the prices of these swaps. In turn, the higher cost of default insurance pushes up the bond yields of European debt and makes the plight of weak governments even worse.

Are CDSs driving the market? Trading activity in European sovereign CDSs jumped to almost \$60 billion in January, making it the most active month so far, according to Barclays Capital. But a rise in volumes is hardly surprising since the headlines have been dominated by sovereign risk. Turnover in government bonds rose as well. Barclays calculates that only in Portugal are CDS trading volumes big-



ger than 10% of cash-bond volumes. The bond and CDS markets tend to move together, rather than one moving the other. JPMorgan says net euro-zone bond issuance this year will be €425 billion (\$580 billion); net CDS positions (removing offsetting contracts) are just €64 billion.

Politicians rarely concede that adverse market movements are driven by a rational assessment of the economic fundamentals. Harold Wilson, a British prime minister, used to blame the "gnomes of Zurich" for attacks on the pound. Nowadays the Spanish government mutters darkly about a conspiracy involving the "Anglo-Saxon media". According to *El País*, its intelligence services are investigating the plot. Perhaps they have not read the bile being directed against British and American economic policy in the local press. But Buttonwood would say that, wouldn't he? The editor of *The Economist* presides over leader meetings while stroking a white cat and dispatches dissident journalists, via a trapdoor, into a shark tank.

Go back a decade and speculators were much more helpful to the euro project. One of the biggest market bets in the late

1990s was the "convergence trade" under which investors bought the government bonds of habitually high-inflation European economies (Greece and Spain included) on the grounds that yields would fall to German levels once the euro zone was in full swing. Back then speculators were lowering the debt costs of many European nations, which seemed happy enough to accept their money.

In fact investors have been remarkably tolerant of fiscal deficits in recent years. The bond-market vigilantes who so intimidated the Clinton administration either were asleep or were overwhelmed by the actions of Asian central banks, which seemed prepared to buy some government bonds regardless of yields.

But the credit crunch has transferred debt from the private to the public sector and has made investors ponder whether all governments will be able to bear the burden. Understandably they have focused on the euro zone, where several countries have high primary deficits and debt-to-GDP ratios and no monetary room for manoeuvre. As Greece's finance minister, George Papaconstantinou, remarked this week: "People think we are in a terrible mess. And we are."

A counterpart to this focus on sovereign risk has been a decline in the euro against the dollar. This market movement has been welcomed by one euro-zone minister, who remarked that: "We have always said we want a strong dollar. The US dollar has appreciated in the last few days and European exporters can only be pleased about it." A big cheer, then, for the speculators from the politician in question, one Christine Lagarde. When markets move the way governments want, the "validity" of trading is not an issue.

► Over the past 50 years sovereign defaults have been confined to the emerging world. But the definition of what is a "safe" borrower could shift, benefiting Brazil, say, and hurting America and Britain.

Second, the debt problems in big rich economies go well beyond the temporary effects of the crisis. It is thanks to an ageing population and soaring health and pension costs that America's debt ratio will still be rising in a decade. Investors have long shrugged off this structural deterioration. Insouciance seems less likely when the starting point is much higher debt.

Third, the rise in interest rates that should naturally accompany an economic recovery and increased investment demand might itself spawn a higher risk pre-

mium on sovereign debt, especially in America. The average maturity on federal debt is less than five years, so higher yields translate relatively quickly into bigger interest payments, worsening the fiscal position. Richard Berner of Morgan Stanley expects ten-year bond yields to reach 5.5% by December, up from 3.7% now.

None of these possibilities suggests that America or Britain is at risk of a debt crisis, in the sense that bond yields soar as investors suddenly flee. But they do suggest that a bigger rise in yields than expected and a subsequent worsening of their debt position is possible. That demands a credible medium-term plan to cut deficits. Otherwise Greece's problems could be the start of something much bigger. ■

The European Central Bank

German shepherding

The head of the Bundesbank, Axel Weber, emerges as slight favourite to become the ECB's next chief

CYNICS have a rule about European appointments: the most qualified contenders never get them. This week's decision by the Eurogroup of euro-area finance ministers to nominate Vitor Constâncio as the next vice-president of the European Central Bank (ECB) certainly looks like a stitch-up. Luxembourg's prime minister, Jean-Claude Juncker, who chairs the Eurogroup, moaned that there had been no discussion of the merits of each candidate. The spurned included the head of Luxembourg's central bank, Yves Mersch.

The biggest winner from this contest may not be Mr Constâncio but Axel Weber, the president of Germany's Bundesbank. Mr Constâncio, who is head of Portugal's central bank, got the nod largely because of what he is not. An inflation hardliner from one of the euro zone's "core" countries, such as Mr Mersch, would make it trickier for Germany to get its man into the ECB's top job when Jean-Claude Trichet steps down next year. Mr Weber is its as-yet-undeclared candidate.

As an academic economist, Mr Weber was not an obvious choice for the Bundesbank when his predecessor, Ernst Welteke, was forced to quit over an expenses scandal. Mr Weber had steadily built his career at the University of Siegen, before moving to Bonn, Frankfurt and Cologne. Academic snobs say such places hardly rank with MIT or Princeton, where Ben Bernanke, the Federal Reserve's chief, earned his spurs. That is too sniffy. Mr Weber has a solid body of publications to his name. By his industry he raised the profile of every university he worked at. "He's no lightweight," says a British academic.

Mr Weber also stands apart from the stereotype of the theory-driven German academic. He made his name as an empirical economist. His speciality was applying heavy-duty statistical models to new data. His papers have a strong policy bent. "If you asked him how quickly changes in interest rates affect each economy, or how persistent inflation in Europe is compared to America, he'd know," says an economist who works in the same field.

Supporters say his empirical approach

makes Mr Weber a pragmatic policymaker, even if he is usually branded an inflation hawk. He was active in the bank's decision to raise interest rates, from 4% to 4.25%, in July 2008, just weeks before the world economy went into a tailspin. But when he grasped how troubled the banks were, he softened his hawkish rhetoric.

His strong academic grounding gives Mr Weber an assurance that others on the ECB's governing council may lack. He also has the weight of the Bundesbank behind him—not only its reputation but also its research muscle, which he has consciously built up. Were he to become ECB president, "you can expect a degree of leadership based less on consensus than on the feeling of a good argument," says one of his former colleagues.

Mr Weber's confidence can spill over into arrogance. "The other side of that is he doesn't take criticism easily," says one ECB-watcher. He may lack the personal skills to be a good ECB president. Mr Trichet has striven to build consensus on the rate-setting council, sometimes calling up members to iron out problems. Mr Weber is a better economist but less of a diplomat.

For now, he is merely a front-runner for the job, edging ahead of his main rival, Mario Draghi, governor of the Bank of Italy. But ECB-watchers are already puzzling over the bank's set-up under a Weber presidency. Mr Trichet's departure will create a space for a French appointee, perhaps as chief economist, to the ECB's six-strong executive board. Sadly, nationality, not merit, will again be the main criterion. ■

European bank results

The brighter side

Bad debts are peaking and pay is falling at Europe's banks

TWO years ago banks began to include tables in their results announcements that were designed to reassure investors that their exposure to toxic securities was under control. The crisis has moved on. Now one European financial firm's presentation includes a slide that pleads "limited exposure to sovereign debt [of] Portugal, Ireland, Greece and Spain".

Yet whatever Europe's macroeconomic woes, a more optimistic picture is emerging from its lenders. Setting aside disappointing results from Société Générale of France, which was hit by more write-downs on American assets, the evidence from fourth-quarter results is that the pace at which loans are souring has peaked.

Many of the big banks that had reported full-year results by February 18th, in-



Axel to grind

cluding BNP Paribas, another French bank, showed a sequential quarterly decline in bad-debt provisions. Most of those that did not, such as Britain's Barclays, said that their bad-debt charges were lower than expected. Almost all made soothing sounds about the credit cycle having peaked.

This picture even appears to extend to one of the dodgiest bits of banks' loan books: eastern Europe. Bad-debt charges there remain high. But from Belgium's KBC to Norwegian and Swedish lenders, most banks active in the region hinted that the pace at which loans are turning sour is slowing, even if there is still a big stock of rubbish to clean up. If so, then overall loss rates on eastern European loans will be far

below the 10% or so projected by the IMF in the depths of the crisis last year.

If their balance-sheets are looking cleaner, however, there is little sense of business as usual. Pay is the obvious example. Barclays' investment-banking unit, which has been pretty unapologetic about pay until now, gave out 38% of its revenue in compensation, down from 44% in 2008. The bank's two top executives have also declined any bonus for the second year running. BNP's investment-banking division went further, cutting compensation to 28% of its revenues from a normal rate of about 40%. At those banks which got state bail-outs, the medicine is far harsher. ING of the Netherlands has so far cut its bank-

ing arm's assets by a fifth from their peak, and is preparing for a full separation of its banking and insurance units. In Belgium KBC aims to shrink its risk-adjusted assets by a quarter and is exiting some international activities.

The overall result of lower pay and peaking bad debts, as well as the closure of flaky divisions, should be higher profits. What is notable is how little of those profits are being distributed in dividends. BNP is handing out 32% of its 2009 earnings but has given shareholders the option of receiving those dividends in shares, which conserves capital. Barclays is paying out less than 5% of its 2009 profits in cash.

This restraint in part reflects great uncertainty over the ongoing overhaul of rules governing banks' capital, dubbed Basel 3. Most European banks are now running with core capital ratios of 8-10%, but the changes are likely to penalise trading assets and force through a tougher definition of what counts as core equity.

Banks are also still nervous about the continuing impact of bad debts. These tend to fall quite quickly once a credit cycle has turned. Simon Samuels, an analyst at Barclays Capital, reckons that since 1980 European banks' impairment losses typically drop to about half of their peak within a year of that peak being reached. But there is still enough economic fog around to make banks very cautious indeed. Given speculation about supposedly risk-free governments defaulting, such conservatism looks merited. ■

Cooling the property market

Slow Canada

OTTAWA

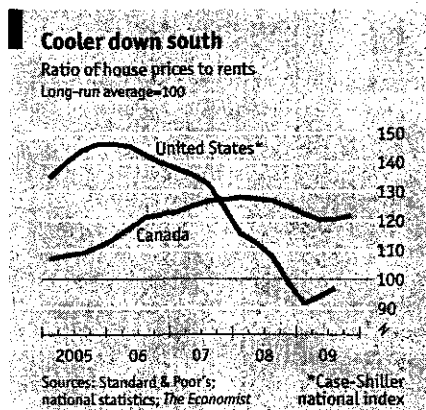
The government tries to rein in the housing market

CANADA has had an easier time than most during the recent global recession, in part because of a conservative and well-regulated banking system. But dangers still lurk. According to data compiled by the Canadian Real Estate Association, average house prices rose by almost 20% in 2009, propelled by low interest rates and generous government incentives. House prices look overvalued on *The Economist's* price-to-rents ratio, which stands roughly 20% above its long-run average (see chart).

Jim Flaherty, the finance minister, dismisses talk of a bubble. But egged on by a chorus of bankers, economists and commentators, he is still letting some air out of the market. On February 16th, in what he called a preventive move, the finance minister announced rules that make it more expensive to buy an investment property, raise the financial bar that mortgage borrowers must meet, and reduce the amount that existing homeowners can borrow against equity in their home.

A year ago the federal government was busily encouraging more people to enter the housing market, with a tax credit for first-time homebuyers and an increase in the amount they could borrow from their registered retirement-savings plan. It also indirectly encouraged home-equity loans through a tax credit for home renovations.

Now that fears of recession are dissipating, Mr Flaherty says he wants "to discourage the tendency some people have to use a home as an ATM, or buy three or four condos on speculation." When the new rules come into effect in April, buyers of investment properties will need to stump up a deposit of 20%, not the 5% minimum required for residential properties. Homeowners who refinance their mortgages will be limited to taking



out 90% of the equity in their property, down from 95% now.

Raising interest rates would have been another, much blunter solution to the problem of an overheating housing market. But the Bank of Canada is sticking to its promise to keep its overnight rate at a record low of 0.25% until July, inflation permitting, arguing that an increase "would be dousing the entire Canadian economy with cold water".

That makes sense. Economic recovery is not yet entrenched. The new rules are more targeted, and can be tightened further if need be. And they are designed to discourage households from increasing their already-record debts rather than to puncture a housing bubble. In particular Mr Flaherty worries that homeowners are taking on more debt than they will be able to handle when interest rates eventually rise. The measures will also require applicants for short-term mortgages at today's low rates to meet the higher income standards needed for a five-year, fixed-rate loan.

Japan's fragile economy

Kabuki economics

TOKYO

A set of positive indicators hides troubling realities

PICK a number, any number. Statistics released this week show that the Japanese economy staged a vigorous rebound in the fourth quarter of last year. Real gross domestic product grew by 1.1% from the previous quarter, which amounted to an annualised rate of 4.6% (see chart on next page). The economy is growing, but the closer you look the murkier things get.

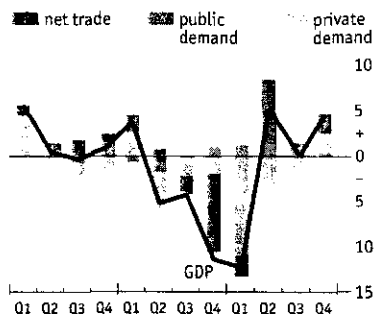
The bounce in fourth-quarter GDP partly reflects the economy's starting point. In the previous quarter growth had been nil, having been readjusted downward twice, from an initial estimate of 1.2% in November and a revised one of 0.3% in December. (If the latest numbers are to be believed, Japan's GDP ended up contracting by 5% last year.)

Similar revisions are possible this time round. Japan's number-crunchers contin- ►►

Parts of the sum

Japan's GDP, % change on previous quarter
Annualised

Contributions of:



Source: Cabinet Office of Japan

ually update the economic numbers using new information and eschew statistical methods to smooth the figures, as in other countries. Like Japanese *kabuki* theatre, in which characters use exaggerated gestures to enliven the audience, the country's statistics unrealistically magnify both good news and bad.

The uncertainties do not end there. The big drivers of growth last quarter were domestic demand, which contributed 2.1 percentage points to annualised GDP growth, and exports, which contributed 2.2 percentage points. (The balance came from public-sector demand.) This might suggest that Japan's economy is gradually rebalancing away from a dependence on external demand. Not so.

Nearly all the growth in consumer spending came from durable goods like cars and electronic gadgets, which have benefited from government subsidies introduced last year. These subsidies are ending in September (for cars) and December (for electronics and appliances). Once durable goods are removed from the data, consumer spending in the fourth quarter was flat. That is unsurprising. Wages are falling and unemployment, though below its peak of 5.7% last July, remains above 5%, high by Japanese standards. Household consumption fell in 2009 as a whole but sales of beansprouts, a classic belt-tightening purchase in Japan, jumped by more than 10%.

What about investment? Capital expenditure rose by 1% in the final three months of 2009, the first increase in seven quarters. But that came after a cumulative 25% decline since mid-2008. Firms' capacity-utilisation rate, which measures the usage of existing equipment, is low. This suggests that capital expenditure has stabilised but not recovered, says Hiroshi Shiraishi of BNP Paribas.

That leaves exports, Japan's normal route out of recessions. Exports produce the bulk of corporate profits, even though domestic consumption accounts for about 60% of GDP. The recovery is fragile here too. The country's biggest export destination last quarter was China, sales to which increased by 43% in December alone. As Beijing tamps down on bank lending to address potential overheating, that number may yet turn out to be another illusion. ■



place. Prior research has shown that the maturity structure of a country's external liabilities gets longer as a result of capital controls. The composition of inflows also seems to matter. Countries with a larger overall stock of debt had bigger credit booms and suffered bigger growth collapses during the crisis. So too did countries with more foreign direct investment (FDI) in the financial sector. Unlike other types of FDI, these flows contribute to debt growth because they include lending from parent banks to local subsidiaries. "The use of capital controls," the fund's economists write, "was associated with avoiding some of the worst growth outcomes."

The economists are also candid about situations in which capital controls may be needed. In the past the fund has urged countries facing surging capital inflows to allow their exchange rates to appreciate or to accumulate reserves. But exchange rates can overshoot, with consequences for the competitiveness of a country's exports. And if reserves are adequate, then further accumulation is not optimal.

If allowing exchange rates to adjust is not a viable option, the fund has typically advocated cutting interest rates to make the country less attractive to foreign funds. One reason for the resurgence in capital flows to emerging markets—which the Institute of International Finance, a financial-industry association, thinks will rise to \$721.6 billion in 2010 from \$435.2 billion last year—is the difference between their interest rates and the very low rates of the rich world. But some countries would risk overheating if they cut any further.

The fund's reconsideration of capital controls suggests that it is trying to adapt its advice to global economic realities. That is welcome. But the paper has little to say about what an effective and non-distortional system would look like. Now that the IMF views controls on inflows more kindly, perhaps it could help countries to design them more cleverly. ■

Capital controls

Fundamental questions

The IMF changes its mind on controls on capital inflows

LEFTOVER piles of slushy snow from the heaviest snowfall in over a century make it hard to take sharp turns on the roads of Washington, DC, these days. But the past couple of weeks have seen plenty of ideological swerves at the IMF's downtown headquarters.

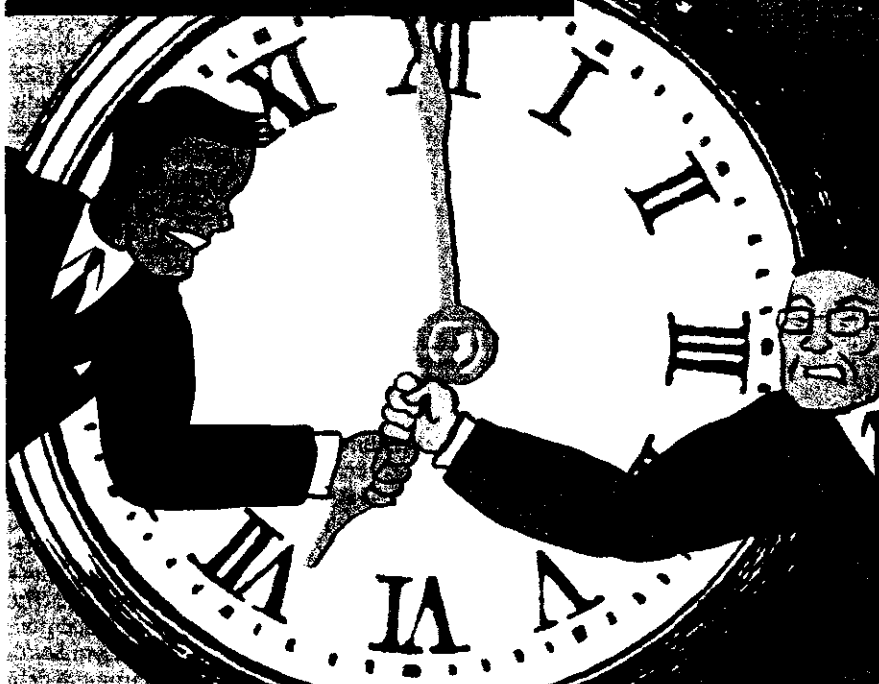
Earlier this month the fund's chief economist, Olivier Blanchard, questioned the focus of modern macroeconomic policy on keeping inflation low, arguing that central banks should aim at an inflation rate of 4%, rather than the conventional goal of 2%. Now a paper* by a group of IMF economists suggests that the fund has substantially rethought its position on the use of restrictions by emerging markets on capital inflows. It concludes that controls are sometimes "justified as part of the poli-

cy toolkit" for an economy seeking to deal with surging inflows.

This is surprising. The fund has historically opposed capital controls, even trying in 1997 to amend its articles of agreement to allow it explicitly to promote capital-account liberalisation. Its economists have argued both that capital controls are costly because they induce distortions to resource allocation and that they are not effective because they are easily evaded. But there is a contradiction between these arguments: if controls have no effect, how can they be distortionary?

The new paper provides some welcome clarity on the effectiveness of inflow controls. Its authors find that GDP fell less sharply during the financial crisis in countries that already had such policies in

* "Capital Inflows: The Role of Controls" by Jonathan Ostry, Atish Ghosh, Karl Habermeier, Marcos Chamon, Mahvash Qureshi and Dennis Reinhart.



The balance of economic power East or famine

HONG KONG

Asia's economic weight in the world has risen, but by less than commonly assumed

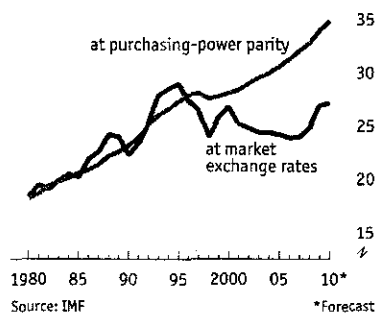
THE idea that the world's economic centre of gravity is moving eastward is not new. But the global financial crisis, many argue, has given the shift in economic power from America and western Europe to Asia a big shove. Emerging Asia rebounded from recession much faster than the developed world; its banking systems and debt dynamics (see next story) are much healthier. In 2009 China overtook Germany to become the world's biggest exporter. On one measure it now looks likely to become the world's biggest economy within ten years. But just how far has power really tilted towards Asia?

The region has certainly become more important to bankers and businessmen, accounting for a record share of many companies' profits last year. Several senior executives have relocated to Asia, the latest being HSBC's chief executive, Michael Geoghegan, who officially moved from London to Hong Kong on February 1st. Since 1995 Asia's real GDP (even including less sprightly Japan) has grown more than twice as fast as that of America or western Europe. Morgan Stanley forecasts that it will grow by an average of 7% this year and next, compared with 3% for America and 1.2% for western Europe.

Yet a closer look at the figures suggests that the shift in economic power from

Oriental express

Asia's share of world GDP, %



West to East can be exaggerated. Thanks partly to falling currencies, Asia's total share of world GDP (in nominal terms at market exchange rates) has actually slipped, from 29% in 1995 to 27% last year (see chart 1). In 2009 Asia's total GDP exceeded America's but was still slightly smaller than western Europe's (although it could overtake the latter this year). To put it another way, the output of the rich West is still almost twice as big as that of the East.

As for the popular belief that Asian producers are grabbing an ever-larger slice of exports, the region's 31% share of world exports last year was not much higher than

in 1995 (28%) and remains smaller than western Europe's. Indeed, the shift towards Asia appears to have slowed, not quickened. Its share of world output and exports surged during the 1980s and early 1990s. Although China's share has grown since then, this has been largely offset by the decline in Japan, whose share of output and exports has halved.

What about Asia's financial muscle? Asian stockmarkets account for 34% of global market capitalisation, ahead of both America (33%) and Europe (27%). Asian central banks also hold two-thirds of all foreign-exchange reserves. That sounds impressive, but their influence over global financial markets is more modest, because official reserves account for only around 5% of the world's total stash of financial assets. The bulk of private-sector wealth still lies in the West. The fact that Asian currencies make up only 3% of total foreign-exchange reserves indicates how far Asia still lags in financial matters.

The "rise of Asia" is no myth, however. GDP figures converted at market exchange rates understate Asia's real expansion. Many currencies tumbled during the Asian financial crisis in the late 1990s, slashing the dollar value of their economies. Japan's nominal GDP has been squeezed by deflation. More importantly, prices of many domestic products, from housing to haircuts, are always cheaper in low-income countries, implying that households' real spending power is bigger.

If GDP is instead measured at purchasing-power parity (PPP) to take account of these lower prices, Asia's share of the world economy has risen more steadily, from 18% in 1980 to 27% in 1995 and 34% in 2009. By this gauge, Asia's economy will

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► probably exceed the combined sum of America's and Europe's within four years. In PPP terms, three of the world's four biggest economies (China, Japan and India) are already in Asia, and Asia has accounted for half of the world's GDP growth over the past decade.

Some economists claim that PPP measures exaggerate Asia's economic clout. What really matters to Western firms is consumer spending in plain dollar terms. Although over three-fifths of the world's population live in Asia, they only account for just over one-fifth of global private consumption, much less than America's 30% share. But official figures almost certainly understate consumer spending in emerging Asia, because of the poor statistical coverage of spending on services. Figures from the Economist Intelligence Unit, a sister company of *The Economist*, suggest that Asia accounts for around one-third of world retail sales. Asia is now the biggest market for many products, accounting for 35% of all car sales last year and 43% of mobile phones. Asia guzzles 35% of the world's energy, up from 26% in 1995. It has accounted for two-thirds of the increase in world energy demand since 2000.

Many Western firms are more interested in Asia's capital spending than its consumption, and here Asia is undoubtedly the giant. In 2009, 40% of global investment (at market exchange rates) took place in Asia, as much as in America and Europe combined. In finance, Asian firms launched eight of the ten biggest initial public offerings (IPOs) in 2009 and more than twice as much capital was raised through IPOs in China and Hong Kong last year as in America.

Winston Churchill once said: "The longer you can look back, the farther you can look forward." The new economic order is in fact a resurgence of a very old one. Asia accounted for over half of world output for 18 of the past 20 centuries (see chart 2). And its importance will only increase in the coming years. Rich countries' growth rates are likely to be squeezed over the next decade as huge household debts dampen spending, and soaring government debt

and higher taxes blunt incentives to work and invest. In contrast, growth in emerging Asia (almost four-fifths of the region's total output) is likely to remain strong. Robust growth should also give governments in emerging Asian economies the confidence to let their currencies rise, which would further boost the relative size of their economies in dollar terms.

By 2020 Asia could well produce half of some big Western multinationals' sales and profits, up from a typical proportion of 20-25% today. Asian staff eagerly await the day when they can fix the times for international conference calls, so Europeans and Americans have to put up with after-midnight discussions with the Beijing office. That may be the best test of whether economic power has really shifted east. ■

Emerging-market sovereign debt

Risk redefined

HONG KONG

The new problem with Asian sovereign debt—scarcity

ELEVEN months ago Indonesia's government paid almost 12% to raise long-term money on the international capital markets, while America was financing its own debt for less than 3%. By early January the rate on America's debt had climbed a bit, but Indonesia's financing costs had plunged to a shade under 6%.

This remarkable shift in financing costs is not unique to Indonesia. The Philippine government issued a dollar-based bond in January carrying an interest rate of 5.7%. A year earlier, its outstanding bonds carried an effective rate of 8.4%. Malaysia and South Korea are also rumoured to be in the market for debt, and in sharp contrast to some rich-world issues, the buyers are likely to be at least as eager as the sellers.

Nor is investor enthusiasm confined to Asia. Yields on emerging-market sovereign debt globally are approaching all-time lows (see chart). According to Fernando Garrido, who co-ordinates public-debt operations at Brazil's Treasury, the past three auctions of ten-year bonds have attracted record demand. Foreign ownership of Brazil's domestic bonds reached its highest-ever level in January, he says.

A large part of emerging markets' appeal lies in the structure of countries' balance-sheets. In Asia, a combination of debt forgiveness, fast growth and restraint in government spending has helped the debt-to-GDP ratio contract sharply in almost every country since 2001. According to Standard & Poor's (S&P), a ratings agency, Indonesian public debt has dropped from 65% of GDP in 2001 to less than 30% now.

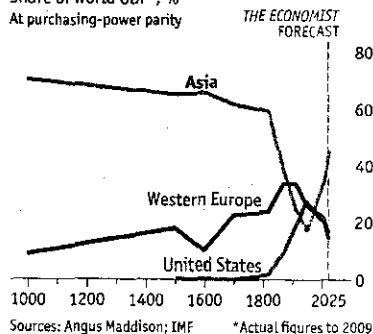
There are exceptions to this rosy picture, the obvious one being Asia's most developed market, Japan, whose gross public debt is almost 200% of GDP. Malaysia and Vietnam have seen rising debt stocks, too. In neither case is their debt-to-GDP ratio particularly high—less than 50% for Malaysia and below 30% for Vietnam—but any increase in this ratio could prompt a re-evaluation, particularly for Vietnam, which also suffers from high inflation and a weak banking sector.

Still, it is hard to underestimate the appeal of expanding economies, particularly in the current environment. That has prompted a scramble for Asian securities, revealing another large shift to have taken place over the past decade. Since the 1997-98 Asian financial crisis, when falling currencies made it much more expensive to pay off foreign creditors, many emerging markets have been careful to raise funds for sovereign debt locally. The amounts they raise on global capital markets are pretty trivial: less than 2% of South Korean and Singaporean government debt is denominated in foreign currency, for example. "The impact of that scarcity is substantial," says Ronan McCullough, head of debt syndication for Asia at Morgan Stanley, an investment bank. Unlike European and American sovereign debt, which is all too available, Asian debt commands favourable prices in part because it is rare.

It is possible for outside investors to buy Asian debt locally, but it is not easy. Some countries apply withholding taxes. There is little liquidity. And buying sovereign debt locally inevitably means taking on currency risk. There are, however, compensating factors. Yields on sovereign debt issued within Indonesia, the Philippines and other Asian countries are significantly higher than yields on dollar-based bonds. Governments are willing to bear these higher costs to avoid the kind of dumping and capital flight that took place during the Asian crisis, but it is curious that local investors require more compensation than international investors. Perhaps their closeness to the market gives them an insight international punters lack? ■

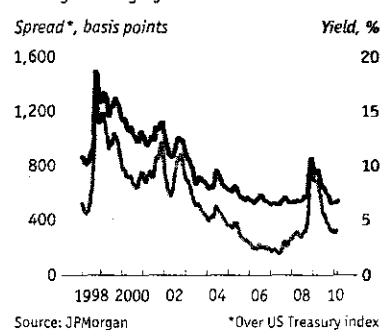
The sun rises again

Share of world GDP*, %
At purchasing-power parity



Cutprice

JPMorgan emerging-market bond index



► The outlook for market rates is even more uncertain now because massive liquidity support has taken economies into uncharted waters. After amassing over \$1 trillion of mortgage securities, the Fed will stop buying them at the end of March. Some think mortgage rates will leap by a full percentage point as a result, making life more difficult for borrowers. Others disagree. All worry that the eventual sale of these securities could wreak havoc.

Most banks would still place interest-rate risk some way down their list of priorities. Bad loans remain their top worry, underlined by news this week that the number of banks on the Federal Deposit Insurance Corporation's "problem" list had jumped to 702, its highest level in 17 years. A sharper-than-expected fall in consumer confidence reinforced the chances that rates will be left on the floor for many more months. But when they do rise, they will trip up more than a few banks. ■

Chinese banks

Hole sale

HONG KONG

Capital calls by Chinese financial institutions elicit questions

THE bill for China's bank-lending spree is coming due. An announcement on February 23rd by China's fifth-largest lender, the Bank of Communications (BoCom), of a 42 billion yuan (\$6.15 billion) rights offering, created a stir in Asian financial markets—not because it was unexpected, but because it represents the biggest fund-raising effort by a mainland company since the heady days of 2007.

The move follows similar announcements by two other Chinese financial institutions, the Bank of China and China Merchants Bank. Smaller institutions have also been busily raising money, either through initial public offerings or direct placements to state-owned industrial companies. All told, some 200 billion–250 billion yuan has been raised in the past six months, according to Bill Stacey, an analyst with Aviate Global, a Hong Kong brokerage firm.

At the very least the money is needed to offset a massive lending boom last year. To augment stimulus spending by the central government, China's state-controlled banks expanded their balance sheets by one-third, or almost 10 trillion yuan. An increase in loans inevitably requires an increase in capital in

Short-selling rules

Shackling the scapegoats

NEW YORK

American regulators approve long-awaited restrictions on short-selling

THE main cause of the financial crisis may have been reckless optimism, but the pessimists are hardly being hailed as heroes. When stockmarkets tumbled in 2008, short-sellers—those who borrow shares and sell them in the hope of buying them back later at a lower price, thereby profiting from a fall in their value—were cast as villains. Politicians have wanted to clip their wings ever since. On February 24th, after a year-long debate, America's Securities and Exchange Commission (SEC) responded with fresh curbs on shorting.

The restrictions will be triggered when a stock has fallen by 10% or more in one day. At that point, short-selling would be allowed only if the sale price is above the best available "bid" in the market. This provision could affect a fair number of shares—4% of the market on an average day, and much more in turbulent times, the commission calculates.

The rule falls short of a full reintroduction of the "uptick" rule that some had called for. That restriction, which was repealed in 2007 (just before the crisis erupted), covered all stocks, not just those under severe pressure, and allowed shorting of a share only when its last price move had been upward.

Despite being a compromise, the new rule is controversial within the SEC. Two of the five commissioners voted against it. One of the dissenters, Kathleen Casey, complained that the move was guided "less by empirical analysis and more by

public relations" and that "we should resist the urge to act merely to say we have acted." Some will see this as a reference to the huge political pressure the commission has faced to crack down on short-sellers, while others will see it as a dig at Mary Schapiro, the commission's newish chairman. Ms Schapiro has spent her first year in the job trying to rush through a bunch of new initiatives to counter criticism that the SEC lacks spine.

There are reasons to doubt that the new rule will be effective. Studies suggest that temporary bans on the shorting of financial shares in late 2008 had little if any impact. More worryingly, curbing shorts could harm the market integrity and efficiency that Ms Schapiro claims to want to promote. Short-sellers increase market liquidity. They also play a crucial role in finger-firms with dodgy finances—think Enron or Lehman. Manipulative shorting (for instance, by borrowing non-existent shares) is different, but the SEC has already outlawed that.

Awkward compromises are the order of the day in financial reform, however. A bigger example is the mega-bill that is currently grinding its way through the Senate. Having already seen its cherished consumer financial-protection agency come under fire, the White House now reportedly faces the prospect that its proposed ban on proprietary trading (the "Volcker rule") will be watered down, too. Short-sellers are not the only ones who are getting squeezed.

order to maintain prudent buffers. When expansion of credit occurs gradually, this can come from reinvested profits. When lending explodes as it did in China, fresh funds are a necessity.

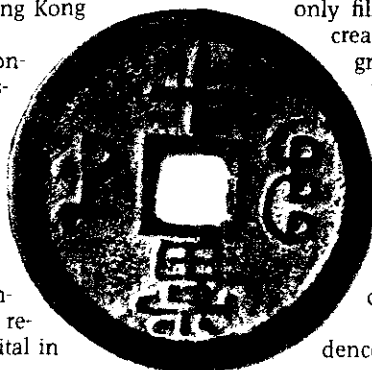
By raising money, BoCom's core Tier-1 capital ratio will jump from a barely adequate 8% to more than 10.4%. Believers in

China's banking system will say this not only fills the capital hole but creates room for yet more growth ahead. Sceptics will lean toward another conclusion, wondering whether the capital boost is an effort to get ahead of a massive surge in bad debts that will emerge from the remarkable surge in credit last year.

There is no hard evidence yet for this concern.

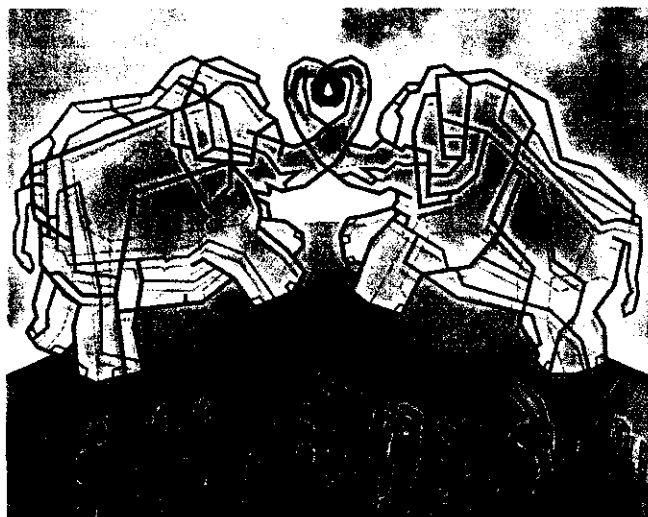
Quite the opposite. Ratios tied to non-performing loans held by Chinese banks have been improving. But that is arguably a worry in itself: turbocharged credit creation rarely, if ever, comes without a cost. Anecdotal reports abound that regulators are requiring banks to put aside reserves for as much as 200% of non-performing loans, an egregious amount unless the underlying accounts are suspect.

Such opacity in book-keeping may have been common several years ago, say the system's supporters, but is less feasible now because Chinese banks are part-listed on big exchanges, and so answer not only to the Chinese government but also to shareholders, who would not permit credit to be subject to political goals. Reports this week that Chinese banks have been instructed by their regulators to lend more to small businesses and less to the financing arms of local governments suggests that the truth is rather different. ■



Economics focus | Low definition

Trustbusters want to put less emphasis on market definition when assessing mergers



WHAT line of business are you in? It is hard for a lot of people to answer this question with a straight face. As tasks become more specialised and firms occupy ever-smaller market niches, job titles and business categories can sound comically obscure. It is a source of embarrassment for antitrust agencies, too. To assess whether there is enough competition in a market, trustbusters must first decide what the market is. The results can be risible. For instance, Britain's Office of Fair Trading (OFT) said this month that the purchase of a job-lot of theatres by the Ambassador Theatre Group did not raise competition concerns. The OFT's definition of the relevant market in this case (the "provision of regional theatres for medium-scale national touring productions") is unlikely to be found on anyone's business card.

Some economists doubt whether defining a market is useful at all when judging marriages between very specialist firms. The issue has a growing saliency because America's trustbusters are currently rewriting the guidelines for "horizontal" mergers (tie-ups between firms that offer the same sorts of products). The update is partly an exercise in good housekeeping: the current guidelines were written in 1992 and do not reflect advances in economic theory and changes to actual practice since then. It is also an opportunity for American policymakers to shift the analysis of mergers away from an obsession with "structure"—the size of the combined market share of merging firms—to focus instead on how big a constraint each firm is on the other's pricing.

The emphasis on structure in the current guidelines is a legacy from another era. Trustbusters used to worry most about the scope for firms making standardised products in concentrated markets to arrive at an unspoken agreement on prices. In principle a merger in such a market supplied by, say, just five firms might harm competition. After the tie-up the four remaining firms would find it much easier to monitor the others' prices than before. This could lead to a cosy arrangement where each firm is less inclined to compete on price.

In practice, the conditions for such tacit collusion are quite rare. Incumbents would have to be safe from challenge by new entrants. They would also have to sell similar products at similar margins. Otherwise there is the temptation for the firm with the lowest costs, or the best products, to break ranks and steal market

share from others. Because these conditions are so specific, trustbusters fret less and less about the "co-ordinated effects" of mergers and more about the "unilateral effects"—the loss of competition between merging partners.

The focus on market definition has nevertheless made it harder for trustbusters to stand in the way of some mergers. In June 2007 America's Federal Trade Commission (FTC) applied to the courts to stop the tie-up between Whole Foods and Wild Oats, two upmarket food retailers. At the time Whole Foods and Wild Oats had around 300 shops, a small fraction of the 34,000 supermarkets across America. The FTC argued that the relevant market was "premium, natural and organic supermarkets". The court thought that definition was much too narrow: didn't less fancy outlets, such as Safeway, also sell organic food? It denied the FTC's request. The appeals court later ruled that the two firms were far closer competitors with each other than with more humdrum stores, but by then the merger had been consummated.

The case highlights a flaw in using a market definition to frame a competition concern. The FTC's narrow definition played up the likely effect on prices from the loss of that rivalry but ignored the more distant challenge from ordinary supermarkets. But defining the market broadly as "all supermarkets" would have exaggerated the pressures faced by both firms.

If market-share analysis can be a poor guide to the likely effect of mergers on prices, what might be put in its place? One suggestion* comes from Joseph Farrell and Carl Shapiro, two professors at the University of California, Berkeley, who happen also to be the chief economists at the FTC and the antitrust arm of the Department of Justice (DOJ) respectively. They advocate a measure of "upward pricing pressure" (UPP) as a screen for judging the probable impact of a merger.

Their gauge provides an estimate of the benefits of keeping the two merger candidates apart. These benefits depend on how many consumers switch between the two firms when one of them cuts prices (the diversion ratio). They also depend on how fat the profit margins are in the firm that loses custom, since that determines how much each consumer gains from switching. Multiplying the diversion ratio by the profit margin gives a measure of the lost benefits of competition should the firms merge. If this benefit is greater than a plausible estimate of the efficiency savings from the merger, then it should be halted.

Upp and away

This sort of approach, which is already used by Britain's OFT, has its critics. One concern is that diversion ratios are hard to measure in practice: trustbusters sometimes have to rely on consumer surveys, which can be unreliable. Another fear is that the use of UPP and the like will give trustbusters too much leeway to block mergers that might benefit consumers. A third worry is that the UPP gauge ignores the effect of third parties who may be only slightly less close competitors to the merging firms than they are to each other. The market-share measure of competitive pressure also has all the advantages of incumbency: American legal precedents are built upon it and judges find it a useful check. But changes are needed and the horizontal-merger guidelines, the most cited antitrust document of all, are the best place to start. ■

* "Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition" by Joseph Farrell and Carl Shapiro, February 2010. <http://faculty.haas.berkeley.edu/shapiro/alternative.pdf>

CHINA'S \$2.4 TRILLION STASH

BY ROBERT J. SAMUELSON

CHINA DISCLOSED THE OTHER DAY THAT ITS FOREIGN-exchange reserves had increased to about \$2.4 trillion in 2009, a gain of \$453 billion for the year. These stupendous figures—and the likelihood that the country's foreign-exchange reserves will rise by a comparable amount this year—have now become a financial, economic, and geopolitical reality of surpassing significance. The significance is not, as many imagine, that China might suddenly “dump” its dollars and dethrone the dollar as the world's major international currency, undermining American economic power and prestige. Two thirds or more of China's reserves are estimated to be held in dollars. As an economic strategy, dumping the dollar would boomerang. It would amount to a declaration of economic war in which

The fear that China will ‘dump’ dollars is unfounded. China uses its dollar reserves to bolster its economy.

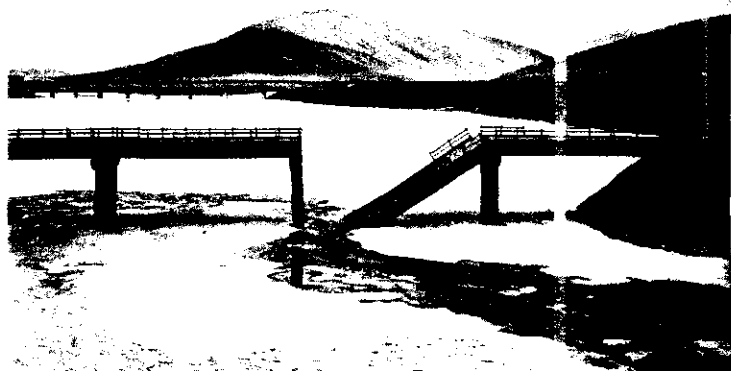
everyone—Chinese, Americans, and many others—would lose.

Consider what would happen, hypothetically. China would first sell securities in which its dollars are invested. That would include an estimated \$800 billion in U.S. Treasury bonds and securities, plus billions in American stocks and corporate bonds. After unloading the securities and collecting dollars, it would sell the dollars on foreign-exchange markets for other currencies: the euro, the Japanese yen, and who knows what else.

The massive disgorging of dollars could trigger another global economic collapse. As China's selling became known (as it would), other foreign and American investors might jump on the bandwagon, abandoning dollar securities and shifting currencies. If panic ensued, markets would fall sharply. Banks and investors would see their capital and wealth erode. The resumption of the global recession, even the onset of a depression, would shrink foreign markets for China's exports (in 2009, its exports fell 16 percent). To protect jobs, other countries might impose quotas or tariffs on Chinese imports.

Why would China do this to itself? The answer: it wouldn't.

The significance of the huge foreign-exchange reserves lies elsewhere. First, they measure China's mercantilist trade poli-



cies. A country that practices mercantilism strives to increase exports at the expense of its trading partners. China has done this by keeping its currency, the renminbi (RMB), at an artificially low rate that gives its exports a competitive advantage on world markets. Huge trade surpluses have resulted, although last year's surplus declined as a result of the global slump.

It's often said that the United States “borrows” from China, because the Chinese hold so many Treasury bonds. This inaccurately describes reality. When China receives dollars, it could use those dollars to buy imports. Or it could limit the dollar inflow by allowing the RMB to appreciate, making its exports more expensive and its imports cheaper. In 2005, China began a modest appreciation of the RMB against the dollar; in mid-2008, it stopped. The large trade surpluses cause China to “lend” to us and other countries, regardless of whether we want the “loans.”

China's foreign-exchange reserves serve another of its strategic purposes: they're used to make investments in raw materials (oil, food, minerals) and important technologies around the world or to buy political influence with foreign aid or favorable loans. In effect, China has a \$2.4 trillion stash to use as it pleases.

The irony: despite complaints about big Treasury holdings, these holdings advance China's economic aims of job creation through exports and protection against scarcities of critical commodities. The purpose is to bolster the government's grip on power by ensuring rapid economic growth. True, China is trying to generate more growth from domestic spending; still, it remains wedded to strong exports until that happens.

But what's good for China may not be good for the rest of the world, including the United States. It's not simply a redirection of economic power but a question of how that power will be used to shape the global economic order. Already, China's huge reserves—invested in U.S. bonds—are cited as one reason for the low interest rates that brought on the financial crisis. The artificially low RMB hurts exports from other developing countries and not just the United States, Europe, and Japan. The manipulation of trade subverts support elsewhere for open trading policies. For now, China has no desire to substitute the RMB for the dollar as the primary global currency. Its ambition is more sweeping: to create a world economy that serves China's interests and, only as an afterthought, anyone else's.

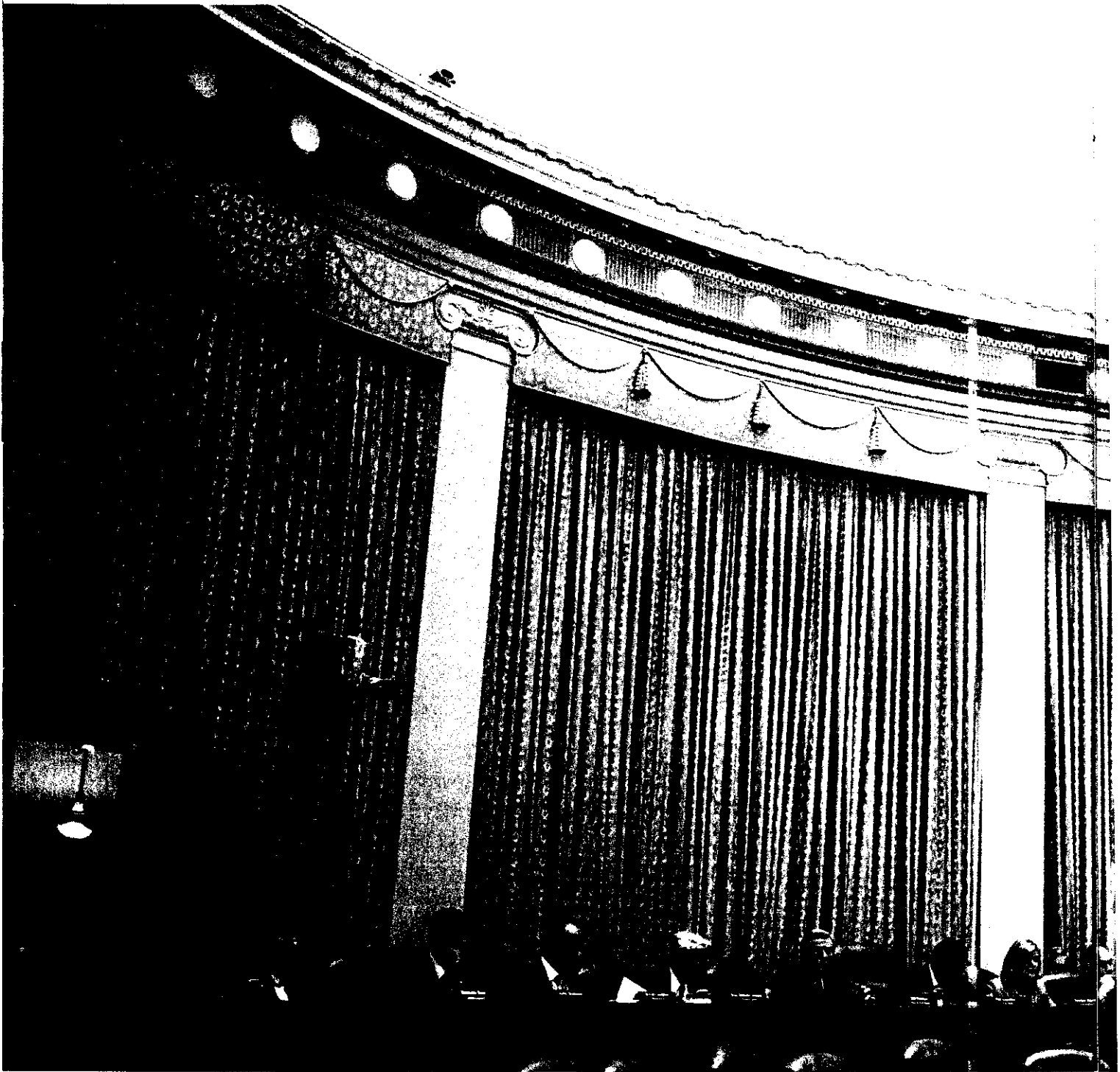
NEWSWEEK

ECONOMY

MARKETS

POLITICS

ECONOMICS' IDENTITY



NEWWEEK

CRISIS

WITH THE MARKETS-KNOW-BEST MODEL IN TATTERS, ECONOMISTS ARE DESPERATELY SEARCHING FOR A BRAND-NEW THEORY OF EVERYTHING

BY RANA FORDOHAR

OOPS
ON CAPITOL HILL,
PUZZLING WHAT
WENT WRONG.

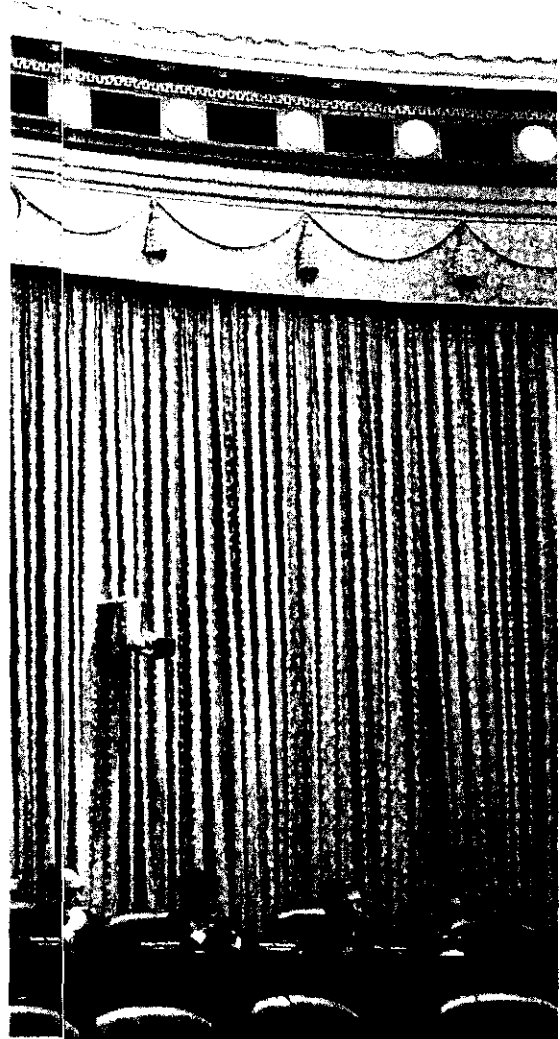
ECONOMISTS AREN'T TYPICALLY AN emotional bunch. The dismal science attracts more sober-suited math geeks than poetic seekers. But in Atlanta earlier this month, the annual meeting of the American Economic Association was home to more soul-searching than number crunching. Hundreds of the profession's most eminent thinkers turned out to hear panel after panel discuss how, exactly, they'd gotten things so wrong. Why did most of the world's top economists fail to forecast the financial crisis? Should the teaching of economics in universities be entirely rethought? While past stars at the AEA have been conservative, finance-oriented intellectuals, this year belonged to the liberal realists—Paul Krugman, Robert Shiller, and the man of the hour, Nobel laureate Joseph Stiglitz. Stiglitz delivered a keynote debunking the profession's key tenet—namely, that markets can be trusted. Leading into the crisis, Stiglitz said, “markets were not efficient and not self-correcting, and now, huge costs in the trillions of dollars are being borne by every part of society.”

The hand-wringing will continue this week at the World Economic Forum in Davos, Switzerland. Last year the buzz at Davos focused on how to pull the world back from the brink. But the key topic this time will be the crisis of conscience in economics itself. For the first time in decades, the profession is rethinking all of the big questions. How do we create growth? How do we raise employment? How do we spread wealth? At least since Reagan, the consensus was that you just had to make the pie grow, and the best way to do that was to unshackle markets and investors, and then get out of the way. Wealth, and thus health, happiness, and all other good things would eventually trickle down to all.

Now that this view has been proved false, a whole slew of new theories are competing to take its place. All are based, to one extent or another, on the idea that people are irrational actors, and that markets aren't always efficient. And in many cases, the new theories blend economics with entirely different disciplines. The adaptive-markets hypothesis, for instance, proposes a new way of looking at the economy, and in particular the financial markets—through the prism of evolutionary biology. The idea is simple enough: adherents view the economy and financial markets as an ecosystem, with different “species” (hedge funds, investment banks) vying for “natural resources” (profits). These species adapt to one another, but also go through periods of sudden mutations (read: crises), which dramatically alter the makeup of the ecosystem. To advocates of this theory, cell biology could hold the key to a new unifying theory of economics; policymakers like Larry Summers can craft better policy, they suggest, by considering all market players as parts of a living organism.

The theory, which first emerged in 2004 but has gained importance since the crisis, is now heralded in the international business press, and was recently employed by the Federal Reserve to explain the behavior of foreign-exchange markets. The idea of introducing Darwin to Adam Smith has captivated many of the best minds. “Cell biologists are much more interesting to me than economists right now,” says Yale professor Robert Shiller, one of the handful who predicted the crisis.

Another hybrid field that's gaining steam is neuroeconomics, which combines brain science and economics: researchers map subjects' brain patterns to confirm how economic deci-



MELISSA GOLDEN—REDOUX

THE OBAMA ADMINISTRATION HAS USED BEHAVIORAL ECONOMICS TO STRUCTURE POLICIES SUCH AS THE STIMULUS PACKAGE AND SAVINGS PLANS.



sion making takes place. Their work provides a scientific grounding for the more familiar field of behavioral economics. This school of thought tries to account for the imperfect economic decision making of real people (like those of us who waste money by driving farther away to get "cheaper" gas). It's been around for 30-odd years, and has recently produced numerous best-sellers (*Freakonomics*, *Predictably Irrational*, *Nudge*, etc.). But post-crisis, it's being taken much more seriously by academic economists themselves, even the more conservative ones, and under the Obama administration has started to have a measurable impact on policy.

The last time the world experienced this sort of reset was after the Great Depression. Prior to that, economists saw capitalism as a perfectly self-regulating system, an idea overturned by the crash. That's when British economist John Maynard Keynes articulated all the ways in which government could and should help bail out an economy. Keynesian economics eventually lost its mojo in the 1970s, when an oil shock and political unrest led to high inflation and unemployment, something the theory didn't account for. The changing of the ideological guard was complete when Ronald Reagan rode in to unshackle the rich, and inflation fighter Paul Volcker was replaced at the head of the Federal Reserve Bank by fizzy free-market enthusiast Alan Greenspan. The laissez-faire "Chicago School" economics—embodied by University of Chicago professor Milton Friedman—would remain dominant for the next three decades.

The consensus didn't change even under the Democratic administration of Bill Clinton. "I think that a couple of key moments [came] when James Carville said he wanted to be reincarnated as the bond market, and [Treasury Secretary] Robert Rubin and his crowd began to

overshadow the social-democratic faction led by [Labor Secretary] Robert Reich," says Robert Johnson, a former fund manager for George Soros who now heads up economic policy for the Roosevelt Institute in New York. Financial economists built complex models that assumed that all you needed to know about a stock was already built into its price. Bubbles came and went in currency, tech stocks, and emerging markets, but they were seen as temporary and relatively harmless. When they popped, it was the job of central bankers to get the party going again. Since the core assumption was that man is rational and markets are efficient, concern about risk took a back seat to concerns over how to make the good times last. It was a simple and elegant way of looking at the world, but one in which, as Nobel laureate Paul Krugman has pointed out, beauty trumped truth.

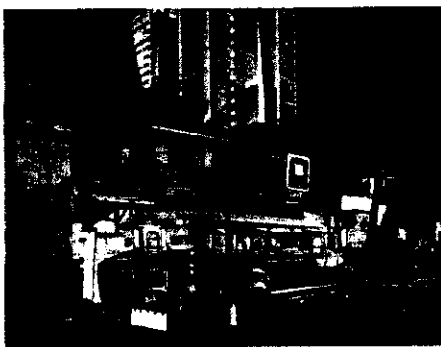
The new economics is already having real-world impacts. Stiglitz, who won his Nobel for saying way back in 1986 that markets really weren't that efficient (heresy at the time), is currently racking up frequent-flier miles advising governments around the world about how to restructure their financial systems. The country that has perhaps traveled the furthest in this respect is Britain. At the height of the bubble days, the City was arguably more freewheeling than Wall Street. Now, Bank of England chief Mervyn King wants to split up banks "too big to fail" and talks about his concern over the "moral hazard" problem of bailouts. Chief regulator Adair Turner, who also says Britain's financial industry is too big, wants to clamp down on financial innovation. He's a big fan of Paul Woolley, a reformed speculator now pouring millions into a research institute he founded at the London School of Economics. (Tellingly, it's called the Centre for the Study of Capital Market Dysfunctionality.) In some ways, the City is seeing a return to the days of old-style British

banking, in which concerns about risk helped balance the scramble for reward.

In the United States, Obama's new regulation czar, Cass Sunstein, is a behavioral economist. The administration has used behavioral ideas to structure policies such as the stimulus package, and they will likely inform any new banking regulation, which Obama has indicated should be based on real data rather than abstract models. Behavioral economics is also behind the new push for prohibitive taxes on cigarettes, trans-fat-rich foods, and dirty energy usage. "Behavioral economics just isn't radical for anyone under 40," says Richard Thaler, coauthor (with Sunstein) of *Nudge*. Given that many of the up-and-coming stars of the profession are now behavioralists, the theory's policy influence will only grow.

None of this means that the ideas of the Chicago School aren't still useful; even irrationality can and should be mathematically modeled and studied. But it will no longer dominate as it once did. No one knows which school of thought will come out on top next—it's worth remembering that although the New Deal started in 1933, Keynes didn't write his *General Theory* until 1936. And those looking for the next grand, unifying theory of economics should perhaps consider the possibility that the greatest lesson of this downturn is that we shouldn't rely on just one tidy idea to encompass a world of human complexity. "We know that efficient-markets theory isn't completely right, but neither is anything else," says Thaler. The only real consensus view expressed at the AEA meeting was that economics is in for a difficult, yet potentially very fruitful period of questioning and cross-pollination. What finally emerges is likely to be more accurate than what came before—and less rational.

With BARRETT SHERIDAN in New York and STEFAN THEIL in Berlin



ECONOMICS

ASIA'S LAGGARD

BY RUCHIR SHARMA

THE WORLD HAS BEEN PASSING THE Philippines by, literally. Back in 1960, the country had the second-highest per capita income in Asia, lagging behind only Japan. But by the following decade, South Korea and Taiwan had surpassed it, and by the 1980s, Malaysia and Thailand had, too. China overtook it in the late 1990s. And now—an event that many Philippine elite thought they would never live to see—Indonesia has sailed past the Philippines.

A recent visit to Manila after a 12-year gap confirmed that little had changed. I was back at the same hotel, as no other worthwhile option had surfaced in the interim. There were hardly any new companies to meet with, and the same handful of family-owned businesses still dominated the market. Jeepneys that trace their origin back to World War II remain the preferred mode of public transportation. While most other Asian cities boast fancy new airports, international travelers to Manila still have to trudge through a piece of work commissioned in the 1970s.

All this marks a severe fall from grace for a nation that was billed in the 1950s and '60s as Asia's most promising story, alongside Burma and Sri Lanka. The Philippines is now a somber reminder of how long-term projections often go awry and why economic catch-up is not inevitable, even for a country rich in human capital and natural resources. From Brazil in the 1970s

and '80s to Thailand more recently, history is littered with instances of countries that lose their way following a few years of success because of weak institutions and the lack of political will to enact tougher reforms. After growing at an average pace of 6 percent in the 1950s and '60s, the Philippines missed out on the successive waves of investment-led booms in the region due to constant political instability and failure to liberalize the economy. Investment as a share of GDP is merely 15 percent—the lowest in its post-World War II history. Although the economy has expanded at an average 4 percent annually in the post-Marcos era, it has translated into little progress for a nation with a population growth of more than 2 percent a year.

The continuing saga over the opening of the new airport is a prime example of why the country remains a laggard. It was originally scheduled to start operating in 2002, but legal disputes between the government and the project's main contractor have continuously delayed its final completion and full opening. The controversy surrounding the project again shows that the interpretation of laws is a highly subjective exercise in the Philippines and that the rules can often be changed midway through the game. Little wonder, then, that flows of foreign direct investment (FDI) remain anemic. Both Indonesia and the Philippines attracted just over \$1 billion in annual

FDI a decade ago. Last year Indonesia sucked in nearly \$8 billion in FDI, while the current run rate in the Philippines of \$1.2 billion in FDI a year is unchanged from the levels of the late '90s. On several other metrics, too—from auto sales to cement consumption—the Philippine economy has flatlined for many years.

The question now is whether the presidential election set for May can be a game changer in the same way that Susilo Bambang Yudhoyono's ascension to power was for Indonesia in 2004. Six years ago, Indonesia and the Philippines were not far apart in terms of per capita income, and had other similarities, from political turmoil to an untapped domestic consumer base. Indonesia is hardly a paragon of economic virtue, but its relative success over the past few years shows that it takes only a modicum of political stability and some basic economic reform in a low-income country to usher in the good times.

A free and fair presidential election would be a start. The agenda for a new government is fairly clear-cut. Investment has long been the missing component in the growth equation, so the government needs to begin by creating a better environment for investment. This means stronger contract enforcement, less judicial interference, and breaking up the stranglehold of some oligarchs in key businesses. An important measure of the country's success will be if it manages to slow the pace of emigration. More than 10 million Filipinos have left the country since the early 1980s for better prospects abroad. The country needs some of that talent to return home and add to the economy's underlying productivity.

OLD SCHOOL
NOTHING MUCH
HAS CHANGED.

KEVIN COOLEY—REDUX (3)

WORLD VIEW

A HIPPOCRATIC OATH FOR DAVOS MAN

BY RANA FOROOHAR

AS THE WORLD ECONOMIC FORUM IN DAVOS CONCLUDED LATE last week, people were left wondering, Did it matter? It's a question Davos raises every year, when the great and the good trek three hours up a Swiss mountain to spend four days in mediocre hotels drinking lots of espresso and talking about the state of the world. In some ways, the answer is always no. Sure, the event offers minor thrills to the consultants, bankers, and corporate types who get a chance to bump into Niall Ferguson in the bathroom or share a shuttle-bus ride with Sergey Brin. But it's not like anything concrete gets done there. It's just a bunch of VIPs chatting among—and largely, about—themselves.

But, though it might sound odd, this is exactly why Davos does matter. The confab acts as a weather vane for the global

Captains of industry are finally beginning to think differently about themselves and their work. 'First, do no harm with CDOs...'

economy—whatever the pervasive feeling there is, it tends to reflect the mood of the year to come and to shape how people think about the issues. "Davos is the Frankfurt Book Fair of economics," says Canadian author Margaret Atwood, one of the token cultural figures brought in to add a bit of color to rooms filled largely with somber men in dark suits. What she means is that Davos is a place you go to put a finger to the wind.

Last year, that wind blew chaos. The world was still reeling from the financial crisis that had begun four months earlier, and there was a palpable sense of panic in the Davos Congress Center. Endless panels were held on terrifying disaster scenarios: there were talks on diminishing oil reserves, on how the world was running out of food and water, and whether banks would ever lend again. Even the politicians were jittery. Turkish Prime Minister Recep Tayyip Erdogan angrily stormed out of a debate with Israel's Shimon Peres. The crisis vibe, of course, helped motivate world leaders to actually do something about it. Post-Davos, the world's central bankers quickly started helicoptering in cash to the major economies, and U.S. officials snapped up trillions of failing mortgage-backed securities.

That's one reason that things are a bit calmer on the Magic



Mountain this year. The crisis mood has passed since the major economies are now out of recession. Yet a vague sense of unease prevails. Things are changing, but no one's sure quite how. China seems to be in (CCTV tents dominate real estate once held by the BBC), while the U.S. looks to be on the outs. Laissez-faire capitalism seems dead. As the University of Chicago finance professor Raghuram Rajan put it, "We've gone from a period of economic uncertainty to a period of political uncertainty." World leaders seem stunned by the swell of public anger over the way bankers have returned to business as usual even as ordinary folks still struggle.

In the rich West, this anger has led to greater regulation and even a rethinking of free trade and migration. Worries over populism and protectionism abound. There was plenty of grumbling this year about Obama's new bank regulatory plan, about British caps on banker pay, and French president Nicolas Sarkozy's promise, in his keynote speech, to rethink market capitalism in its entirety. "We're moving to another era, one in which we must shift the focus from global corporations to global citizens," he said, calling for new ways of calculating economic growth that would account for people's happiness as well as their wealth.

That would be a jarring switch for Davos Man. Yet there are other nascent signs that the world's captains of industry are finally beginning to think differently about themselves and their work. Embarrassed by bankers like Goldman Sachs's chairman Lloyd Blankfein, who likes to joke about doing "God's work," a number of young financiers in Davos started talking about creating a financial Hippocratic oath ("first, do no harm with CDOs..."). There was much discussion of "stakeholder capitalism" and how corporate leaders need to stamp out short-term, speculative thinking. That has people like Robert Shiller—the behavioral economist who predicted the housing crisis—feeling optimistic. "People are beginning to think about economic issues within a moral framework," he says. "It's not too often that it happens in my profession."

Of course, no one's singing "Kumbaya" yet and bankers are grumbling over the newly heavy hand of the state. But to the extent that this penny dropped at the World Economic Forum this year, it will probably make the world a better place. And because of that, Davos does still matter.

OBAMA'S CURRENCY CONUNDRUM

BY MICHAEL FREEDMAN

U.S. AMONG THE PROMISES made by President Obama in the State of the Union address was his eye-popping commitment to doubling U.S. exports in the next five years. Certainly, that would be good for the U.S. economy, and since 1960 the feat has been accomplished a dozen times. But doing so today would be trickier. Last year, the U.S. exported roughly \$1.5 trillion in goods and services. Getting to \$3 trillion by 2015 would mean annual increases of 15 percent—three times the rate of global GDP growth—and most of that is out of Obama's control. Ratification of pending free-trade agree-

ments with South Korea, Colombia, and Panama would add maybe \$15 billion annually in exports, and Washington can't very well manufacture upticks in global demand. That means the crucial variable is the U.S. dollar. As it depreciates, U.S. exports look more attractive, with every 1 percent decline in the dollar's value translating into a \$20 billion increase in U.S. exports, according to C. Fred Bergsten of the Peterson Institute for International Economics. So achieving Obama's goal would have to mean either a steep dollar drop, or a big rise in a major currency that is now being artificially held down. Over to you, Mr. Hu.

AHMADINEJAD'S WORST ENEMY YET

BY BABAK DEHGHANPISHEH

IRAN'S PRESIDENT MAHMOUD Ahmadinejad is in a tough spot: opposition protesters are planning a big rally on Feb. 11, and talk of new sanctions against the country has picked up steam in recent weeks. But his largest problem is something more banal: inflation.

Iran's official inflation rate is 13.5 percent, but some analysts estimate it could actually be twice as high. The looming threat to the economy is a plan to cut government subsidies on basic goods and give cash directly to poor families, which could send inflation rates soaring and cause even more political instability. Just last week, Central Bank head Mahmoud Bahmani announced that the banking system is facing a potential crisis because of \$48 billion in overdue loans.

The measures Tehran appears to be taking to combat inflation may only accelerate the crisis. Two weeks ago, Ahmadinejad announced the government would knock three zeroes off the rial in order to "bring its real value back." The following day, the Finance Ministry declared that no one could remove more than \$15,000 from a bank account in a single day—ostensibly to combat money laundering, though analysts say the move was an attempt to curb inflation. Either way, many ordinary Iranians are reading between the lines. Opposition Web sites report that banks in Tehran and Isfahan have been swamped by customers desperate to withdraw money. If ordinary Iranians fed up with the dismal economy hit the streets, too, Ahmadinejad will have to do a lot more than cut zeroes to stabilize the situation.

BY THE NUMBERS TASTE FOR LUXURY

China's luxury market is expected to become the world's largest within the next five years, a new report shows, thanks to steadily rising incomes and an appetite forbling among the country's young urban professionals.

3

Ranking of China's luxury market globally in 2005, behind the U.S. and Japan.

1

Projected ranking of China's luxury market in 2015.

30

Average age of China's typical luxury-goods consumer.

46

Percentage growth in high-net-worth households in China expected for 2010.

DAVOS KNOCKOUT

BY RANA FOROZHAR



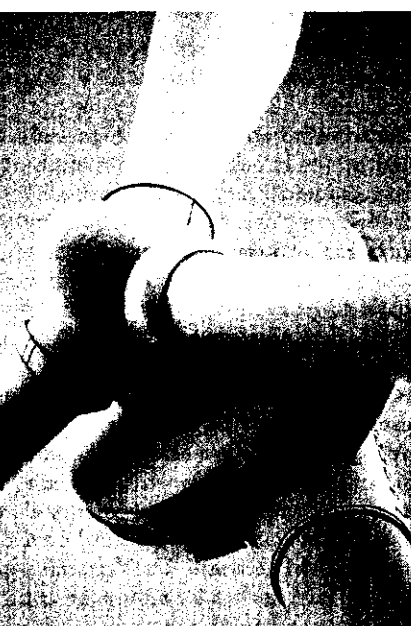
IF THERE WAS ANY REMAINING DOUBT THAT THE ERA OF FINANCIAL capitalism is over and the age of big government has begun, French President Nicolas Sarkozy dispelled it with his keynote speech last week at the World Economic Forum in Davos. Sarko was in fighting form, bashing everything from overblown banker pay to the dysfunctional economic relationship between the U.S. and China. He also called for new global regulation of banks, bankers, and markets: "If we don't reform the system, we'll be taking unforgivable risks in the future."

True, yet easier said than done. Much of the buzz at Davos has been about how regulation must be done at a global level. Yet already, the U.S. is going one way, the Brits another, and the Chinese—increasingly rich and confident—are setting their own rules in practically every sector. Indeed, Sarko got in a few punches at Beijing, promising that the currency issue (read: a supercheap yuan's distorting effect on trade and current accounts) would be front and center when France took over the G8 leadership in 2011. Sarko also called on world leaders to rethink the moral framework of capitalism. "The system can't exist unless it is embedded in a system of values." Finally, he indulged in a bit of schadenfreude at the expense of Davos Man. "A few years ago, [corporate leaders] told us that we were seeing the end of nations and the beginning of an era of global nomads. Yet when the boat was rocked last year, all those companies ... remembered quite well which countries they came from." By the time the French president is done throwing down the regulatory law, they'll be unable to forget.

LEADING INDICATOR

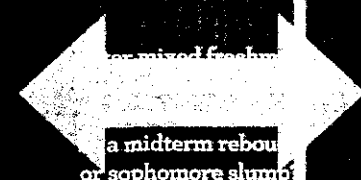
39%

Growth in America's wind-power capacity in 2009, the largest jump on record. Earlier this decade, the industry grew at an annual rate of less than 5 percent.



NEWSWEEK

CONVENTIONAL WISDOM
THINK AGAIN



a midterm rebound
or sophomore slump?

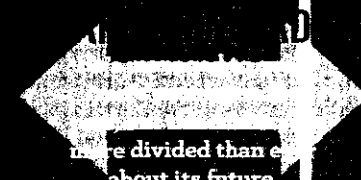
JIABAO

Unpopular in Pakistan
and abroad, but if he
topples, chaos
for the interim
insurgents plans.

LULA

ARZ

He's urging U.S. to buy
off the Taliban for peace.
This is the hardest
compromise to sell
out Afghanistan?

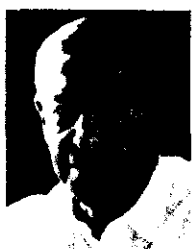


more divided than ever
about its future.

No Bubbles in Beijing

Why the China bears are wrong.

BY BARTON BIGGS



FOR THE CHATTERING classes, spotting financial bubbles has become their favorite global sport, and currently China is the hot game. Fears of Chinese "tightening" have terrorized trad-

ers, particularly in Asia and commodity-sensitive markets. If Beijing slams on the brakes by raising interest rates and cutting back loans, the locomotive that has been pulling the global recovery train could falter, producing the widely dreaded "double dip" recession. The bears are licking their chops at this prospect.

The first thing you have to realize about China is that nobody knows a true thing about it, including me. It's simply too opaque. But it's also too big to ignore, so here goes my best uneducated guess. I don't think it's a bubble.

By the latter part of 2009 the Chinese economy—thanks, in part, to immense monetary and fiscal stimuli—was expanding at a 10 percent rate. In the late fall, the Chinese authorities began to gently pull back on the fiscal stimu-

lus. Then in early January, the banks made a huge volume of new loans. While loan surges early in a quarter are not unusual, this one apparently was alarmingly large. Meanwhile, headline inflation jumped from 0.6 percent in November to 1.9 percent in December. But with most of that jump coming from food prices, due partly to severe winter storms, this is no cause for panic. Responding to the hints of inflation in an economy growing at 10 to 11 percent,

the People's Bank of China moved quickly to slow down the monetary stimulus. The last thing the central bank wants is an economy that overheats and subsequently busts with dire social consequences. They, of course, are aware that there is a chorus of doomsayers and short sellers who are screaming that this is exactly what is about to happen. On the other hand, they have studied the history of the 1930s and don't want to overreact and prematurely abort a still-fragile economic recovery.

Accordingly, the authorities have gently raised the three-month and one-year bill-auction rates and advised the banks to pace themselves on loan growth. The one-year auction rate was raised eight basis points in each of the first two weeks of January. There is no question that this is "tightening," but it's a pretty gentle and tender squeeze. Perhaps to make

sure everyone understood, last week one of the most influential deputy governors reaffirmed the commitment of the PBOC to a "moderately loose" monetary policy. Since China runs a "command" economy, admonitions have a lot of weight. For all the obvious reasons, it seems the PBOC wants to engineer

a soft landing in which growth slows to 7 to 8 percent, not a hard landing in which real GDP sags to 4 or 5 percent. They are mindful that there are some 200 million to 300 million restless Chinese out there who are unemployed or underemployed.

The bears also argue that China is like Japan in the late 1980s, with gross overinvestment and overvalued asset prices. In actuality, China's profile is more like Japan in the 1970s. Chinese stocks, according to

MSCI, sell at a reasonable 13.4 times this year's estimated earnings and 2.6 times book value. Japan in the madness of its bubble traded at 70 times earnings and more than five times book. The Japanese real-estate bubble also was of epic proportions and is still deflating 20 years later. In China, prices of luxury apartments in Beijing and Shanghai soared by 50 percent last year, but the average of home prices in 70 cities rose a more modest 8 percent. Only the richest 25 percent of the urban population are involved, and a quarter of the buyers pay cash. Mortgages are about half of the property value; owner-buyers have to make a 20 percent cash down payment, and investor-buyers must put up 40 percent. Commercial real-estate prices have risen, but financing practices are under similar restraints. The Chinese real estate is being financed by savings not borrowed money.

The bears also say China is investing way too heavily in capital stock, particularly roads, rail, and other infrastructure. But as *The Economist* has pointed out, China cannot have excess capacity when its capital stock per person is about 5 percent of what America or Japan has. China can't be laying down too many rail lines when it has the same land mass as the U.S. but only 110,000 kilometers of track, compared to the 400,000 kilometers the U.S. had in 1916. As for paved roads, 40 percent of Chinese towns do not even have a paved road to the nearest market town.

What could go wrong? If the U.S., European, and Japanese economies collapse back into a prolonged double dip, of course China's exports will be severely affected. Otherwise both the economy and the stock markets look good to me.

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

Fear of China slamming on the breaks has terrorized traders, particularly in Asia and in commodity-sensitive markets.



ASIA ECONOMICS POWER

Selling South Korea

Lee Myung-bak wants to move his country to the center of the world.

BY B. J. LEE

PHOTOGRAPHS BY GUEORGUI PINKHASOV

FOR THE FIRST TIME IN MODERN HISTORY, South Korea is laying claim to lead the club of rich nations. South Korea became the first member of the Organization for Economic Cooperation and Development—the group of 30 wealthy nations—to emerge from the global recession when it recorded 0.4 percent growth in the third quarter of last year. This year the OECD expects South Korea's GDP to expand by 4.4 percent, the highest growth rate of any of its members.

Now President Lee Myung-bak wants

to turn the end of the economic crisis into an opportunity. He knows the crash has accelerated the decline of American might, as well as the rise of China and other emerging powers, and he aims to exploit the gap between them. His goal is to transform South Korea from a successful but self-involved economic power into a respected global soft power with the clout to mediate between rich and poor nations on global issues such as climate change and financial regulation. In particular, Lee is pushing to revive momen-

turn on a global free-trade deal—stalled in large part due to hostility from poor nations—while defending the poor by pushing for more international supervision of the global financial system. At the same time, he is trying to establish South Korea as a leader in the fight against global warming by agreeing that the country will cut emissions by 30 percent by 2020—one of the most aggressive targets in the world—even though it is not obligated to do so because it is still considered a developing nation under the Kyoto Pro-

NEW WEEK :



**BUILDING
THE BRAND**
A TRENDY
BUSAN DISCO

tol. To many in South Korea, the selection of Seoul as the site of the November 2010 summit of the G20—the group of 20 leading economic powers—is an acknowledgment of how well it has managed the current economic and environmental crises. “The old order is being dismantled and replaced by the new order,” Lee said from the Blue House in a televised New Year’s speech. “We have to make our vision the world’s vision.”

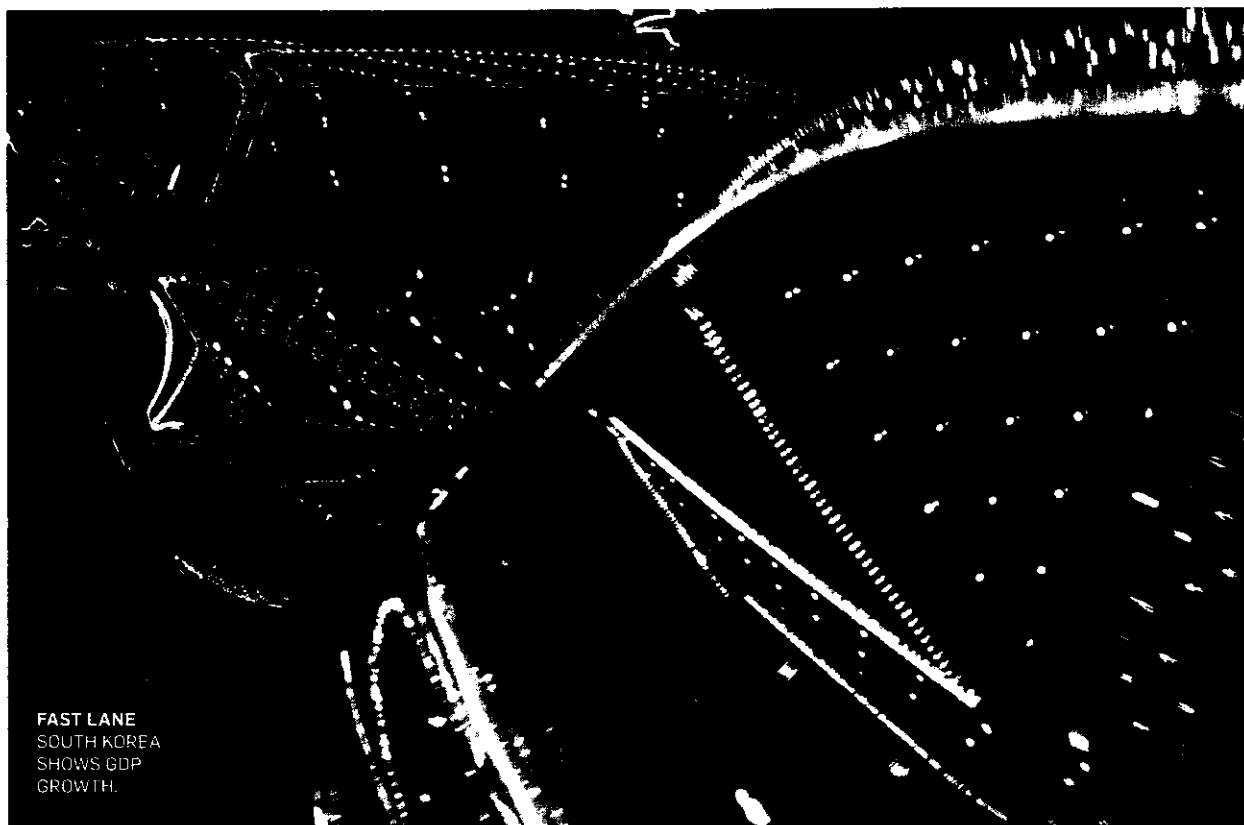
Lee is one of only two former CEOs to lead a major trading power—Italy’s Silvio Berlusconi is the other—and he runs South Korea like the just-do-it boss he was at Hyundai, where staff called him “the Bulldozer.” At Hyundai he led a company known for fearless forays into foreign markets, whether it was building huge bridges in Malaysia or selling cars with stunning success in the crowded U.S. market. Now he is trying to make South Korean culture—still on the defensive after a long history of colonial occupations—as cosmopolitan as Hyundai’s culture. He’s pushing for greater use of English and generally trying to open up South Korea to the world. In his first big political job, as mayor

of Seoul, he created a huge ruckus when he ripped up the downtown to expose a boarded-up stream—but it is now a major draw for commerce and tourism. Lee’s grand domestic ambition as president is a multibillion-dollar plan to refurbish South Korea’s four major rivers despite protests from environmentalists and opposition members. Lee believes the project will boost local economies by creating jobs and promoting tourism and commerce. Lee’s popularity ratings, after an early plummet driven by a decision to allow U.S. imports of beef, are now at more than 50 percent as voters warm to his vision of newly developed South Korea as a model nation to be emulated by many developing countries.

South Korea’s successful management of the economic crisis surely helps. Early on, the country was battered like the rest of the world. The South Korean won dropped 30 percent in the first three months of the crisis, the stock market dropped by half, and foreign investors left in droves. But unlike most other rich nations, South Korea had recent experience with a major financial meltdown. Many of its current leaders are veterans

of the Asian crisis that crippled the country’s economy in 1998, and they knew how to manage a free fall. Lee’s team immediately moved to save threatened banks and companies by setting up \$200 billion in various funds to guarantee payment of their debts and for other forms of emergency aid. They struck currency-swap deals with major economies such as the U.S. to secure dwindling reserves of foreign currency and front-loaded public spending so that 65 percent of the country’s \$250 billion budget was spent during the first half of 2009, ensuring that the money got into the economy rapidly—but without adding new debts. A government focus on protecting jobs kept consumer sentiment relatively high, and the Bank of Korea cut interest rates by 3.25 percentage points to 2 percent, a historic low.

All the while, Lee worked relentlessly to quiet calls for protectionism at home and abroad, at a time when many other leaders, including Barack Obama and Hu Jintao, were beginning to succumb. Lee’s administration is pushing for a slew of free-trade agreements with the U.S., the European Union, Peru, Colombia, Can-



ada, Australia, and even China and Japan, if possible, says Abraham Kim, a Korea analyst at the political-risk consultancy Eurasia Group. Lee also lobbied hard at the Pittsburgh meeting of the G20 last year to have Seoul selected as the site of the next summit this autumn, an event he hopes to organize as a coming-out party. "He is trying to use the crisis to enhance the reputation of South Korea and help it to be widely recognized as a developed-world state," says Kim. "This is partly a nationalism thing, but more importantly, they are trying to get out from under Japan's and China's shadow. South Korea needs to find its niche for its long-term competitive survival."

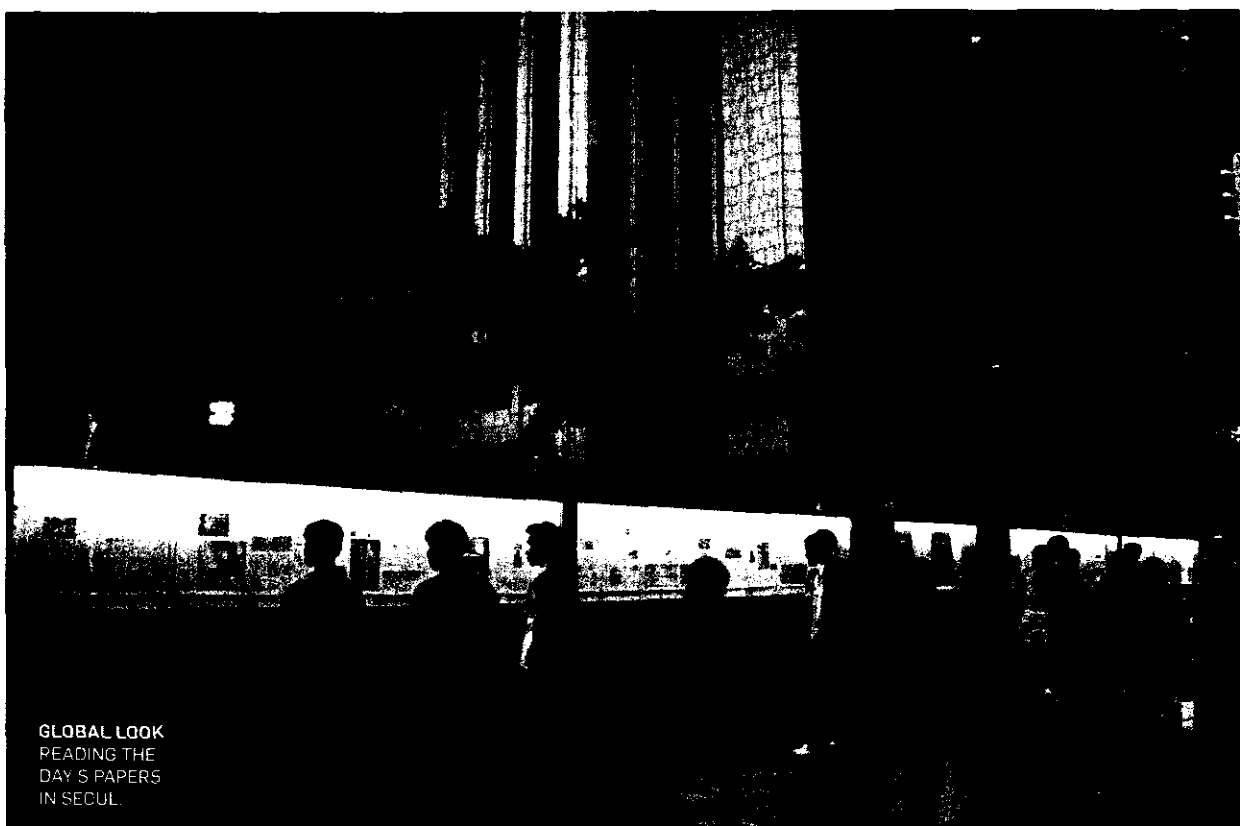
South Korea was further protected from the crisis because its economy was built on pillars other than the collapsing financial-services industry. Decades of government efforts to nurture globally competitive conglomerates through massive infusion of capital had helped build export machines such as Samsung, Hyundai, and LG. As the crisis unfolded, the weakening currency allowed these companies to expand global market share, especially against key Japanese

and other rich-world competitors. As a result, South Korea registered a record trade surplus of \$42 billion last year, surpassing that of Japan for the first time. South Korean companies and banks were also ready to compete because the crisis of the 1990s had forced them to improve corporate governance, get their finances in order, and invest heavily in new technology. "We just had to dust off the old measures we used a decade ago and use them again," says Vice Finance Minister Hur Kyung-wook.

In short, the South Korean model is a more mature cousin of China's—a hybrid economy, part free market, part state-controlled—but with more freedom for the market and for political dissent. Now Lee is positioning South Korea within Asia as a dynamic alternative to both China's mighty command economy and Japan's no-growth economy. In Southeast Asia, South Korea has long been admired for completing an economic miracle in just one generation, moving its 48 million people out of poverty and entering the ranks of fully industrialized nations, with average per capita income that surpassed \$20,000 in 2007. And, unlike China,

South Korea has achieved economic and political growth at the same time, with an increasingly well-established multiparty democracy that respects free speech and election results. South Korea, says U.S. Ambassador Kathleen Stephens, is "the best example in the post-World War II era of a country that has overcome enormous obstacles to achieve this kind of success."

Many Southeast Asian nations, alarmed by the harsh sides of the China model, look to South Korea as an alternative. Vietnam is sending civil servants there, studying how in the 1970s and '80s Seoul used massive government support, such as cheap loans, to develop strategic industries such as steel and petrochemicals as the backbone of its export economy. As part of Vietnam's effort to develop capital markets, it also now runs a stock exchange in Hanoi, built with the help of the Korea Stock Exchange. Officials from Vietnam, Cambodia, Indonesia, and Uzbekistan regularly visit South Korea to join training programs that teach economic and business management. "Developing countries are eager to learn South Korea's economic model because of its relevance to them," says Euh Yoon-dae,



GLOBAL LOOK
READING THE
DAY'S PAPERS
IN SEUL

a Korea University economist currently heading a presidential committee to promote the national brand. "Our open economic system is more appealing to them than, say, that of China."

Surrounded by bigger powers—China, Russia, and Japan—South Korea needs to carve out a global role for itself to "ensure its prosperity and security," says David Straub, a Korea expert at Stanford University. So, in his first year in office, Lee made a point of systematically reaching out to foreign leaders in the United States and other major powers. The following year he headed to Europe. This year, Straub says, Lee is expected to target Africa. At the same time, he is upping South Korea's profile abroad, posting 3,000 volunteers from its version of the Peace Corps to Asia and Africa, where they will focus on public health and childhood education, with plans to increase that number to 20,000 by 2013. Last year South Korea officially became the first former recipient of international aid to graduate to the donor ranks, sending \$1 billion to dozens of poor countries, and it plans to triple that sum within five years. Likewise, the number of troops it

commits to U.N. peacekeeping operations will jump from 400 in 2009 to 1,000 this year and will work in roughly 10 nations, including Lebanon and Pakistan.

Lee has big plans for Brand South Korea, too. At Hyundai, he turned what had been a small contractor into a global manufacturing powerhouse. He speaks English, unlike his predecessor as president, and he is comfortable playing national pitchman. Just after Christmas, following six rounds of telephone calls with United Arab Emirates President Khalifa bin Zayed Al Nahyan and a last-minute visit to the country, Lee helped South Korea beat out a French and a joint U.S.-Japan consortium to win its biggest foreign contract ever: a \$40 billion nuclear-power-plant contract in the U.A.E. While Hyundai and Samsung have overcome the perception abroad that "made in South Korea" still means poorly made, many other South Korean brands have not. According to a survey by Simon Anholt, a British expert on national branding, the country ranks 33rd in global branding power, although its economic size ranks 13th in the world. What's more, more than half of U.S. college students believe Hyun-

dai and Samsung are Japanese brands. "Our job is to narrow the perception gap between the national and corporate brands," says Euh, the head of the branding committee.

Lee plans to build on that success at the G20 summit. He has already distinguished himself from his predecessors by embracing foreign investment and free trade, rather than focusing on rigid ideology, and he intends to use the meeting to showcase the rewards of that strategy. Lee's hope is that he can send a message to smaller, poorer countries, particularly in Asia, that South Korea's less insular, more global approach can be a model they can follow, too. Of course, as his opponents are quick to point out, the fate of his country will not change because the leaders of 20 advanced nations get together for a few days. But Lee says it is part of a larger effort to move his country "away from the periphery of Asia," as he put it recently, "and into the center of the world."

NEXT ►

FOLLOW THE LEADER

The U.S. elected Obama to do the right thing—not take dictation.

BY ANNA QUINDLEN

SCOPE InternationalList

JAPAN DOESN'T GET IT

BY KATIE BAKER



TRADE

ONE OF THE MOST STRIKING turns in the fall of Toyota is how the recall scandal is playing with much of the Japanese public: as a bewildering American frenzy. Yes, they are concerned about the recall, but many assume Americans must have some malign reason for kicking up a fuss, when in fact recalls happen all the time. Some read the recommendation from U.S. Transportation Secretary Ray LaHood to Toyota drivers—"stop driving them"—as proof of a Japan-bashing Washington conspiracy. They are quick to point out

that the faulty brake pedals were actually made in Indiana, not Japan. And until very recently, at least, they seemed convinced that the frenzy would fade away without lasting damage to Japan. Look at BMW: its 2008 recall of 200,000 cars for possible airbag failure left no marks on Germany's engineering reputation.

Note to Japan: you don't get it. Recalls for minor technical problems are common, but recalls of millions of vehicles for problems that can produce nightmarish, fatal crashes are not. Toyota's recall of 6.6 million cars is the sixth largest in

U.S. history so far, and one of the scariest. Most automakers have learned to handle these PR disasters forthrightly, but Toyota CEO Akio Toyoda performed a duck-and-denial routine not seen since Ford tried to evade responsibility for exploding Pintos in the 1970s before he belatedly apologized last week. Americans have, so long since given up on Japan bashing, have lionized Toyota as the ultimate in manufacturing quality, and have welcomed Japanese plants, even in the Deep South. Toyota would never have conceded, before the recall, that its vaunted quality controls did not cover its U.S. operations, so it's a bit disingenuous to blame "American made" parts now.

This is a global company. It needs to take global responsibility. The investigation has targeted not only those Indiana-built accelerator pedals, but floor mats and computer systems, too. The U.S. National Highway Traffic Safety Administration is still investigating. And now Japanese officials are beginning to investigate, and sentiment in Japan seems to be turning, perhaps a bit too late. Gene Grabowski of Levick Strategic Communications, which advises firms facing recalls, calls this "the worst-handled auto recall in history," and that's saying something. The exploding Pinto became a symbol of the U.S. quality problems that allowed Toyota to flourish in America, and the runaway Prius may mark another turning point, this one less auspicious for Japan.

CLOSING THE GULAGS

BY ANNA NEMTSOVA

RUSSIA

CHANGE IS FINALLY COMING to Russia's notoriously harsh jails. Last month President Dmitry Medvedev announced a major prison overhaul after public outrage erupted over a young lawyer's death from lack of medical treatment while he awaited trial. Russia's system is plagued with the world's second-highest incarceration rate (some 900,000 people at present), and conditions have

changed little since Stalin's time. Among the reforms, Medvedev plans to punish minor crimes with house arrest or bail, to soften sentences for first-time offenders and house them separately from career criminals, and to close 755 of the country's most decrepit prison colonies.

For almost half of Russia's incarcerated, though, the reforms will make life much harder. Closing rural camps will concentrate 400,000 repeat offenders into overcrowded central prisons. Their living quarters will change from large barracks to cramped four-person cells. Most of them will lose their rights to work, study, and conjugal visits. One prisoner's "reform" is about to become another's gulag nightmare.



NEWSWEEK

WORLD VIEW

GROWING PAINS

BY FAREED ZAKARIA



DESPITE THE RECENT SQUALL IN U.S.-CHINESE RELATIONS, the fact remains that both countries have powerful reasons to cooperate with one another. These have grown over the last two decades, something that both countries seem to recognize. China's reaction to the Obama administration's decision to sell arms to Taiwan has been furious, but has mostly involved symbolic gestures. Compare this with 1992, when the Bush Sr. administration sent Taipei weapons, and soon afterward Beijing reportedly sold missiles to Pakistan and signed a nuclear-cooperation agreement with Iran.

This time China's strongest threat—to "retaliate" against U.S. companies involved in arms sales—is likely to be targeted at those firms, like Raytheon, that have been longtime suppliers to

Today, China commands respect across the globe and doesn't really need a godfather.

Taipei and as a consequence have written off the China market. Beijing will likely not punish the three American giants involved in the deal: Boeing, General Electric, and United Technologies.

Similarly, Beijing's indignant reaction to President Obama's decision to meet with the Dalai Lama is posturing. The Chinese government could not have been surprised. Every U.S. president in recent memory has met with the Dalai Lama, and Obama told China's President Hu Jintao directly that he was going to meet with the Tibetan leader.

On Washington's part, despite Hillary Clinton's criticisms of China over Internet freedom and President Obama's declaration that he will get tough with Beijing over its currency, it is unlikely that this strong rhetoric will be matched with equivalent actions. The United States has few arrows in its quiver, and the administration knows well that public admonition of Beijing rarely works. In fact, both countries might well be playing the same game: feigning public outrage to satisfy domestic audiences.

But there are two trends that could take a manageable situation and make it something more worrisome. The first is a growing perception in China that it is no longer as reliant on

the West, and in particular the United States, as it was. In the 1980s, Deng Xiaoping brought China out of the cold by embracing America and opening up to foreign investment. This was different from the somewhat predatory, export-driven strategy of Japan and South Korea. But, the China scholar Minxin Pei argues, this was not an ideological conversion to free-market capitalism. Ravaged by the Cultural Revolution, Beijing desperately needed Western managerial know-how, technology, and capital to develop its economy.

Today, China is awash in capital, has many top-notch local companies, and this year for the first time, the primary engine of Chinese growth has been its domestic market, not exports. As China expands, that internal market will probably become its dominant concern.

A similar reality applies in foreign policy. Mao restored relations with the United States in some measure to buy himself an ally against the Soviet Union. China has needed the United States as a political ally ever since; Jiang Zemin's fuzzy embrace of the United States was part of a strategy whose goal was concrete: membership in the World Trade Organization. Today, China commands respect across the globe. It is confident, even cocky, in bilateral and multilateral fora.

None of this is nefarious. But Beijing's newfound arrogance is not joined with a broader vision. The country does not appear ready to play a global role. In international summits Beijing has been largely focused on pursuing its interests in a fairly narrow sense. At the April G20 summit, for example, China participated actively on only one issue: to make sure that Hong Kong was kept off the list of offshore tax havens being investigated. Perhaps it's too soon to expect China to play a broader role, taking on responsibilities for global order and making concessions for broader interests. But given its impact on the global system, this is likely to produce paralysis on several fronts. American isolationism during the 1920s was understandable, too, but it had unhappy effects on the world.

The second factor that could exacerbate Sino-U.S. tensions is America's economic fate. Right now there's great fear that the U.S. economy is in deep structural decline. If American politicians cannot muster up the courage to make the U.S. economy competitive again, and Beijing perceives that it is dealing with a superpower in inexorable decline, relations between China and America will change fundamentally. Of course, if that happens, America will have plenty else to worry about as well.

CASTROCRATS TAKE OVER CARACAS

BY MAC MARGOLIS

LATAM CUBA MAY BE A FADING star in the socialist firmament run by a sclerotic dynasty, but don't tell Hugo Chávez. The Venezuelan president is giving the Castro franchise a second life by farming out more and more of his crisis-battered government to Havana. A growing number of corner offices in his bureaucracy—including defense, national security, police, immigration control, and energy—are now occupied by Castrocrats. Ramiro Valdés, Castro's former comrade in arms and an ex-interior minister, was recently named to coordinate Venezuela's response to an energy emergency causing widespread

blackouts. (Critics note that Cuba has long been afflicted by power failures.) Chávez's foes suspect that Valdés, famed for controlling the Internet in Cuba, was hired to spy on contrary Venezuelans. Other Havanians are serving as key advisers in the Defense Ministry and the newly reformed Bolivarian National Intelligence Service, and dealing on Caracas's behalf with trade unions, coffee growers, and hospitals (apparently prompting the health minister to quit on Feb. 10). Chávez argues that no one is better prepared to handle domestic crises than the Cubans. Most Venezuelans shudder for the same reason.

A THREAT TO THE NEXT BIG EMERGING MARKET

BY SOLENN HONORINE

ANALYSTS SCANNING the globe for the next big emerging market look increasingly to Indonesia. Last June, Morgan Stanley said it was time to count Indonesia, and its 4 percent GDP growth rate, among the BRICs. Shortly after, President Susilo Bambang Yudhoyono, architect of the renaissance, won a second term, and he still enjoys a 70 percent approval rating. Yet backward elements in his ruling coalition are targeting key members of his team, threatening to derail vital reforms.

Late last year high-ranking police and judicial officials cooked up a plot to decapitate the Corruption Eradication Commission, a key actor in the fight against graft. On the heels of that failed attack, Parliament began gunning for two internationally renowned reformers over their role in the 2008

bailout of the small Bank Century: Vice President Boediono, then-director of the central bank, and Sri Mulyani, minister of finance—both apolitical economists widely credited for Indonesia's economic rise. Their push for free-market reform is a threat to an old guard that came of age in the era of crony-capitalist dictatorship. In particular, the leader of the country's second-largest political party, businessman Aburizal Bakrie, is pushing to prosecute Sri Mulyani, who opposed the bailout of a Bakrie coal company in 2008.

If Yudhoyono fails to confront the anti-reformers, the stalemate “will continue on for the next five years and we won't be able to achieve anything,” says Jusuf Wanandi, head of the Jakarta-based think tank CSIS. Quelling the old guard won't be easy. But backing off could kill the next big emerging market.

STALLING AN INCOME GAP

China's income gap has stopped widening for the first time in almost three decades, says a new study from the OECD, which credits welfare policies and migration for jobs. China's income gap, measured by the Gini index, has leveled off at 41, means complete eradication of income high compared to developed nations.

China's current Gini score, down from 41 in 2005

U.S. score, compared to 38 in 2005

OECD member-state average score, compared to 31 in 2005

Latin America's average score, the world's most unequal region



ECONOMY

IS EUROPE'S JOB MIRACLE FOR REAL?

Northern Europe has trumped America in terms of crisis job creation, but it may not last.

BY RANA FOROOHAR

WHAT CAN EUROPEANS TEACH AMERICANS about increasing employment? Until the financial crisis and recession of the last two years, the answer very clearly would have been "nothing." The European social-democratic model has many virtues, but getting people into work and keeping them there has never been chief among them. Until now. Much ink has been spilled in recent months over the fact that the American and European unemployment rates are now roughly on par at about 10 percent, while a number of Northern European economies—including Germany (7.5 percent), Denmark (7.4 percent), Austria (5.4 percent), and the Netherlands (4 percent)—are well below that. Even as U.S. multinationals send jobs abroad,

big European companies like Siemens are adding them at home. Every day seems to bring news of a new turbine factory being built in Denmark or Germany. Newspaper headlines proclaim the European "jobs miracle." As American unemployment figures stay high, economists on both sides of the Atlantic are debating whether the U.S. should start adopting a more continental approach to labor policy.

To answer this, it's important to understand the nature of the "miracle" and whether it has legs. Unlike downturns past, European nations have kept unemployment figures low relative to the U.S. this time around because Europe's labor markets have evolved to depend less on subsidies

that keep people on the dole than government schemes to put them back to work quickly. What's more, rather than focusing solely on jump-starting their economies via stimulus, as the U.S. has, Northern Europe has thrown its resources at keeping people at work—by any means necessary.

In the Scandinavian countries, that has involved large and successful retraining schemes to get laid-off workers back into jobs quickly. But in these and other nations, namely Germany, jobs have also been kept by cutting hours. Rather than laying off workers, a number of European companies have opted to cut full-time schedules by a third or more as part of larger government schemes to avoid mass layoffs.



ROBERT PRATTA—REUTERS

NEWWEEK

STANDSTILL
EUROPE HAS
ITS OWN JOB
PROBLEMS.

the construction and real-estate sectors are huge employers—and, in this respect, the U.K., Spain, and Ireland share more in common with the U.S. than with the rest of Europe. Also, certain small European nations enjoy unusually comfortable niches in the global economy. Tiny Norway can keep growth high and unemployment low because it is blessed with oil, gas, and an enormous sovereign wealth fund, unique factors that make it useless as a model for others. Sweden is also uniquely positioned: because it deregulated smartly in the 1990s, it became a chief supplier of key capital goods, like telecom infrastructure to big emerging markets, that are still growing fast. China's buoyancy, along with some well-structured state subsidies, is a key reason Sweden will grow 2 to 3 percent in the next two years, after contracting 4.7 percent last year.

All this underscores the fact that while Northern Europe has handled the crisis relatively well up to now, the future is hardly bright. Indeed, economists say that Europe's usual slower-growth, higher-unemployment trend line will reemerge in the years ahead, not only because Europe is moving faster to tackle its mound of crisis-related debt (which will constrain its ability to grow over the short and medium term), but also because of demographic facts. As Holger Schmieding, Merrill Lynch's head of European economics, notes, "Americans are having and will have more babies than Europeans in the future, which will keep them growing faster for a long time." Bottom line: cooperation among the state, companies, and workers in Northern Europe has stemmed the job problem in the short term. But it doesn't erase the transatlantic facts of life.

With STEFAN THEIL in Berlin

NEXT ►

**THE COMING
BOOM**

And why it's gonna hurt.

BY GREGG EASTERBROOK

Companies save money on salaries because the government picks up the cost of the pay cuts, including payroll taxes. It's a successful stopgap, but one that adds to the national debt and also has the potential to distort European labor markets. Since the subsidies aren't linked to whether jobs are productive, they could inadvertently prop up bloated payrolls in industries that need to slim down—such as, for example, the automobile industry. "These schemes are successful now, but they could become very risky if the recovery is prolonged," says economist Paolo Guerrieri of the University of Rome.

What's more, economists note, European unemployment trends tend to lag behind those of the U.S.—meaning

that while American unemployment will probably peak this year, the big European economies will see numbers continue to rise into 2010 and 2011. Germany, for example, is on track to rise 2 full points, hitting 9.5 percent unemployment by 2011, according to Deutsche Bank. The U.S. rate is expected to fall by roughly the same amount over that period. Meanwhile, the U.S. economy will grow about 3 percent per year, the euro zone around 2 percent. Even nimble Denmark won't move past 1.8 percent. So, who's really solved the problem of creating jobs and growth?

The Europe-versus-America comparisons fall short in other ways, too. For starters, nations that had real-estate bubbles suffered more job losses because

THE SONIC BOOM

Why the coming recovery will hurt like hell.

BY GREGG EASTERBROOK

HOME PRICES KEEP FALLING, BUT PRODUCTIVITY IS RISING FAST. GDP GREW 5.6 PERCENT IN THE FOURTH QUARTER, YET UNEMPLOYMENT REMAINS STUBBORNLY HIGH. INFLATION IS NONEXISTENT, WHILE THE CONSUMER CONFIDENCE INDEX JUST ROSE TO 55.9 FROM 53.6—WHATEVER THAT MEANS. CAN'T MAKE SENSE OF THESE ECONOMIC INDICATORS? DON'T WORRY, BECAUSE NOBODY ELSE CAN, EITHER.

Here is what you really need to know: a Sonic Boom is coming. It will be caused by globalization. And while globalization may be driving you crazy, it's just getting started. Thirty years ago, Shenzhen, China, did not exist; today, it has nearly 9 million residents, roughly the same as New York City. In a single generation, it has grown from a village of tar-paper shacks into an important urban center. It has become the world's fourth-busiest port, busier than Los Angeles and Long Beach combined. Never before has a great city been built so fast, nor a productive economy established from so little.

The international recession that began in 2008 made the Sonic Boom quieter, but it shows that when a crisis ends, the trends in place before the crisis resume. The world's economic growth, after a brief period of stagnation, is about to pick up, creating rising prosperity and higher living standards for most people in most nations. The world will be far more interconnected, leading to better and more affordable

products, as well as ever better communication among nations.

But there's a big catch: just as favorable economic and social trends are likely to resume, many problems that have characterized recent decades are likely to get worse, too. Job instability, economic insecurity, a sense of turmoil, the fear that even when things seem good a hammer is about to fall—these are also part of the larger trend. As world economies become ever more linked by computers, job stress will become a 24/7 affair. Frequent shake-ups in industries will cause increasing uncertainty. The horizon has never been brighter, but we may not feel particularly happy about it. Here are five things to keep in mind during these dizzying times:

Dramatic economic change will happen at the same time as climate change. Either one would be a challenge in itself. Now, they're going to occur simultaneously, which will cause economic convulsions unparalleled by any event other than World War II. Winners are likely to be those in high-latitude regions. Yakutsk, Russia, located in Siberia just below the Arctic Circle, is currently home to the world's leading museum of woolly-mammoth fossils. But what if Siberia were to become a temperate expanse? The minerals and oil thought to lie beneath the permafrost could boost the global supply of commodities, not to mention Russia's national wealth.



The factory-based economy is nearly over, because of technological improvements. Fifteen years ago, Boeing took 22 days to build a 737 airliner; today, it takes 12 days. Such changes mean fewer factory jobs, even as production rises. China is losing factory jobs much faster than the United States, as efficiency improves. Soon there won't be any nation with a factory-based economy, and that would have happened regardless of whether there was trade liberalization. Higher productivity, in turn, generates the social wealth that creates more jobs for teachers, health-care providers, and other essential needs. The world is actually better off with declining factory employment, which is no consolation if you lost a job.

College is more valuable to the future economy than petroleum. America leads the world in many areas—economics, military power, loud music—but nowhere is the lead more important than higher education. The United States has more great colleges than the rest of the world combined. Yet California, Texas, and other states are cutting back their public-university systems. This is a terrible mistake. In the long run, extra college may even cost society less, because people with college educations are better suited to look after themselves in a turbulent economy, rather than asking the government to subsidize them.

SONIC BOOM

GLOBALIZATION
AT MACH SPEED



GREGG
EAST: RBROOK

FROM SONIC BOOM: GLOBALIZATION AT MACH SPEED.
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PUBLISHED BY RANDOM HOUSE

In Western nations, women's education levels and personal freedom already are on track to equal men's; in much of the developing world, this could happen in the next two generations. Throughout history, most women have been denied a fair shot at contributing to research, engineering, business-management, and leadership roles. As this changes, there will be twice as many people applying their brainpower to the world's problems.

Iraq, Afghanistan, and Darfur are awful exceptions to a two-decade trend of fewer wars and less combat in the world. Right now a person's chance of dying because of war (via combat or through indirect causes) is the lowest it has been in human history; nuclear warheads are being disassembled instead of built; per capita global arms spending has declined 40 percent in the last quarter century. Some of the reason is economic: nations are more interested in acquiring market share than in acquiring territory. But that's good! And there has never been a superpower relationship like the one evolving between the United States and China. The world's two leading powers are not arming against each other; rather, they're cooperating on economic production.

Many of these developments are far-reaching positive consequences of

they will all add to our uncertainty. One reason our economic anxiety soared during the recent crisis is that it seems like no one is in charge of the U.S. economy. In fact, there is no one in charge. The president doesn't "run" the economy—no one does. In a way, this is a source of stability. There is no one person who can make a fatal economic blunder. Think of all the crazed, conflicting statements about the economy that were made by government officials, Democratic and Republican alike, in the fall of 2008, as economic grand plans and emergency theories changed daily. Imagine if any one of them had actually been in charge of the economy—surely he or she would have made the situation considerably worse.

Because no one runs the economy, no one knows where the economy is headed. And that means that even when most things are OK for most people, the sense that everything is about to fall apart is palpable. Americans have had this sense before. At many points in our history, it was commonly felt the nation was about to enter a cycle of sharp decline. Probably this won't happen, but we can't know that for sure. Today, this fear manifests as collapse anxiety: the worry that resource exhaustion, or international chaos, or something we haven't even thought of will bring down the Western way of life.

Bear in mind the seeming inevitability of human events—new technologies, new ideas to replace the old, the

the economic downturn ends, and what comes next is a flowering of productive efficiency and higher material well-being. The same forces likely to bring about these desirable ends also will cause economic tumult to grow more frequent. Job anxiety will be endless. Celebrity inanity, political blather, targeted advertising, scream-and-shout discourse, the paving over of nature—they're going to get worse. Winner-take-all wealth accumulation at the top, already the worst fault of capitalism and among the least-attractive aspects of American society, may worsen in the West while infecting newly free nations.

Plus, every little thing that goes wrong anywhere in the world will scare us. Now if something explodes in Pakistan or a new product from Malaysia challenges a Midwestern product, we have live television images within minutes. The terrific aspects and the anxiety-inducing aspects will be intertwined.

and we're just going to have to live with this. No matter how crazy and chaotic events become with each passing year, the world will be a better place. The point in the future when the world becomes predictable, stable, and well-ordered is a long way off. The world is a better place than it has ever been.

NEXT ▶

THE WORLD'S MOST SUCCESSFUL FAILURE

A company's genetic discoveries couldn't keep it from going broke.

BY MARY GARMICHAEL

TIME: FEBRUARY 1, 2010

WORLD ECONOMIC FORUM



Seeing Light Through tl



Losing steam *The financial crisis has challenged the capitalist myths justifying Wall Street's wealth and clout*

the Gloom

As political and business leaders gather for the World Economic Forum in Davos, they will be breathing a sigh of relief. But be in no doubt; the world has changed

BY MICHAEL ELLIOTT AND
MICHAEL SCHUMAN

WORLD ECONOMIC FORUM

IN LATE JANUARY, the Graubunden, Switzerland's most easterly canton, is not where you go to see signs of spring. In its high valleys, along whose paths armies trudged from the lowlands of Italy to the German heartland during the Thirty Years' War, snow lies thick on the ground. Off the main roads, hamlets sit silent under the weight of it, reminders that until the 20th century, this part of Europe—so obviously prosperous now—was a rural backwater, its people as much as its livestock spending the long winter in a sort of quiet hibernation.

But as the global business and political elite prepare for their annual trek to this winter wonderland—making the journey from Zurich to Davos by train, car or, if they are still very rich, helicopter—they will think that they can detect some signs of life in the ground beneath their feet. Not yet gentians and edelweiss—they are months away. But scrabble under the snow, and you'd find some of those famous green shoots.

BENJAMIN NORMAN IN DAVOS

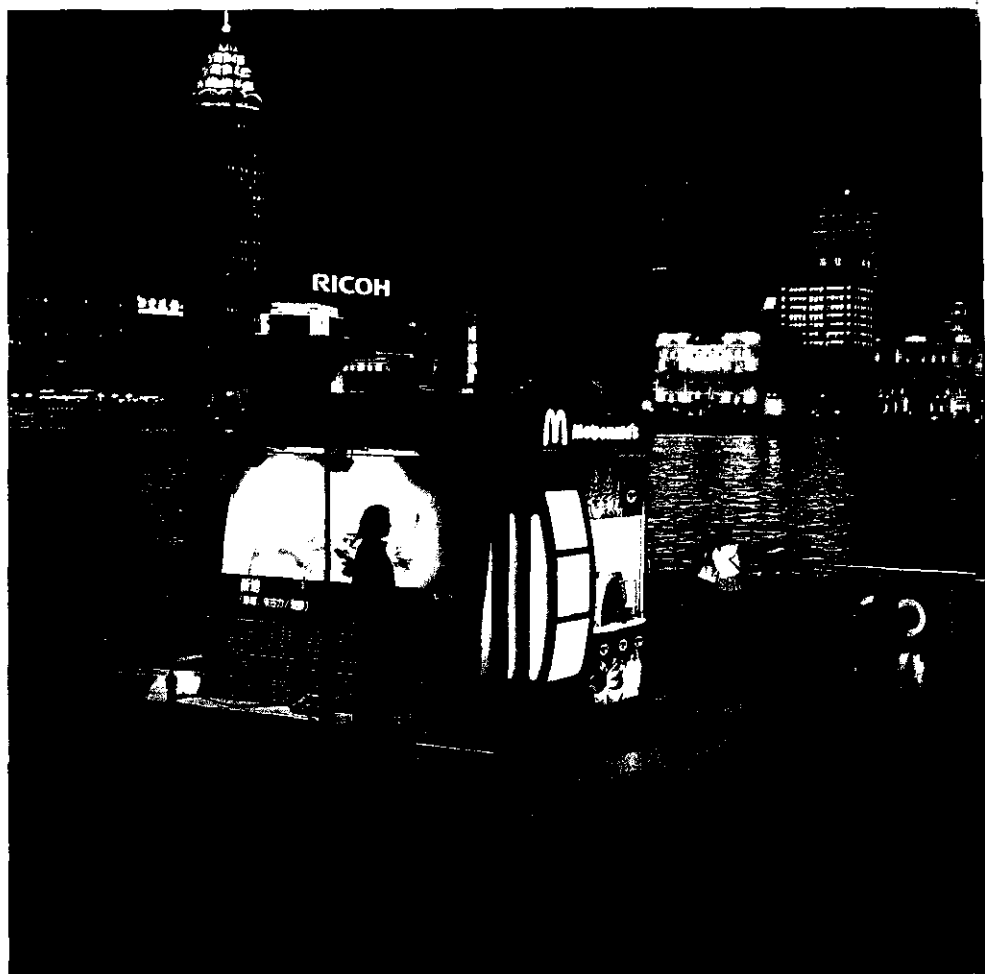
They weren't there a year ago. At the World Economic Forum's 2009 annual meeting, the mood was dire. As growth contracted, credit froze and trade evaporated, attendees at Davos fretted over rising protectionism and the loss of confidence in the world's economic and political leadership, lamented the hardship brought upon the poor and unemployed, and warned of the unthinkable consequences if the global community failed to take drastic action. Russian Prime Minister Vladimir Putin said the world economy was in "the first truly global economic crisis," one that was "continuing to develop at an unprecedented pace." A rare expression of optimism came from China's Premier, Wen Jiabao, who predicted that his nation would reach 8% growth in 2009, despite plunging exports and millions of job losses—though he admitted that reaching that target would be tough.

Today, as leaders collect in Davos for this year's meeting, they can breathe more easily. The prospects for the world economy have brightened. Trade is recovering, banks are repairing themselves and consumers are returning to shopping malls. Dominique Strauss-Kahn, managing director of the International Monetary Fund (IMF), said recently that "the recovery goes faster than expected." Wen now appears prophetic, as China is expected to meet, or even exceed, his bold prediction of a year ago. The recessions in the world's biggest economies, including the U.S., Japan and Germany, have ended. Even some of the worst-hit are showing signs of life. Taiwan's chip fabs and LCD factories are humming again after the island's economy experienced record quarterly GDP contractions at the height of the crisis.

Of course, the perfect storm that struck the world economy in 2008 is not yet over. Many of the conversations in Davos this year will concentrate not on the elements of recovery but on the risks that lie ahead. But it would be surprising if the delegates did not also concern themselves with two other matters, linked to but distinct from the recession: a change in the intellectual climate in which the global economy operates, and the geopolitical consequences of the crisis and recession.

Walking a Tightrope

IN STRICTLY ECONOMIC TERMS, IT'S NOT hard to display a snapshot of where things stand now. After declining an estimated



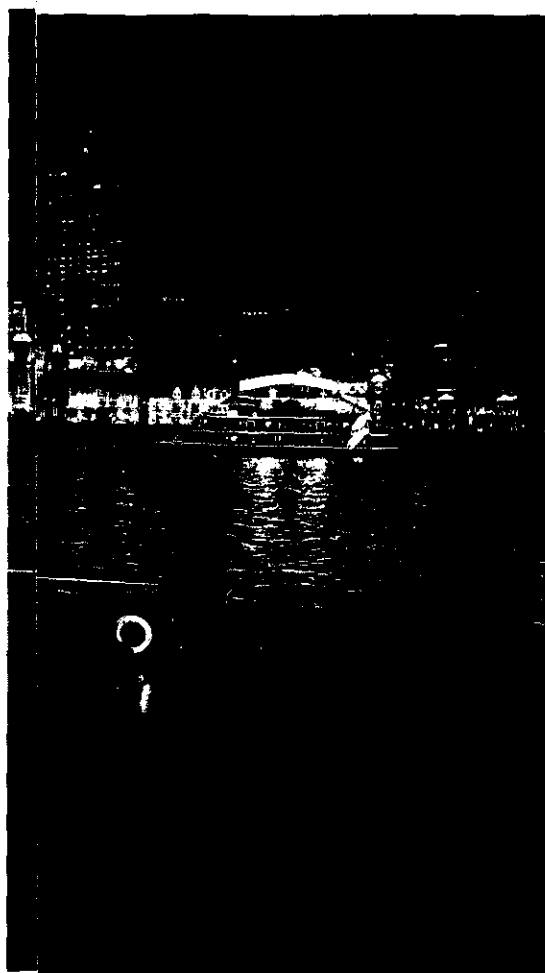
Poised and ready In gleaming Shanghai, above, and elsewhere in Asia, millions of potential new consumers may buoy the global economy

Policymakers have cast doubt on the central justification for financial capitalism: that it assists those who work in the 'real' economy

2.2% in 2009, the global economy is projected to expand 2.7% in 2010, according to the World Bank. But recovery is fragile. Excess capacity continues to dampen expectations of growth, and the unemployment crisis in the Western world—especially in the U.S.—is likely to get worse before it gets better. The debt overhang from the boom years of the mid-2000s is still there. A recent study by the McKinsey Global Institute analyzed previous periods of deleveraging and found that they often take six to seven years to play out. Charles Roxburgh, the London-based director of the institute, says that in the current crisis "the process is only just starting or is about to start," which means the world is potentially facing "a several-year period where the deleveraging process will act as a drag on GDP growth." "The worst of the downturn may well be over," Roxburgh adds, "but the impact of this crisis is not over yet."

That's why many economists harbor serious concerns about the strength of the recovery. Stephen Roach, chairman of Morgan Stanley Asia, has maintained that the deleveraging of the U.S. consumer

JULIEN DANIEL / MCDONALD'S



will continue to weigh on global growth. He figures that the bursting of the housing bubble, combined with the recession's shock to employment, will reduce trend growth in real consumption in the U.S. to 1.5% to 2% over the next three to five years, compared to 4% in the precrisis decade. As a result of such headwinds, Roach forecasts the global economy will experience "the weakest recovery of the modern era," as he wrote in a recent report, with trend growth of world GDP at about 2.5% on average over the next three years. Such an anemic recovery, Roach argues, is close to the "stall speed" for the world economy, making it more susceptible to a double-dip recession—which even Strauss-Kahn of the IMF does not rule out.

The uncertainty about the rebound is complicating the most pressing single issue facing policymakers today: how and when to exit from the stimulus measures governments employed during the downturn. Getting it wrong could be disastrous. Pull back too soon, before the private sector has regained its muscle, and economies could tumble back into recession. Wait too long,

and you risk fueling inflation or asset-price bubbles that could burst down the line. Making matters more complex are the divergent ways in which economies are emerging from the recession. China, worried about inflation and a property bubble, has already begun scaling back its easy-money policies, while Japan, where the main concern is deflation, may require even easier money. Australia has hiked its benchmark interest rate three times, while the U.S. is mulling a second stimulus package.

Whatever the underlying conditions of the world economy, the stimulus will have to end at some point. When that's done, attention will surely turn to the rapidly deteriorating position of public finances, as governments struggle to fund bank bailouts and stimulus programs even as the recession eats into tax revenues. From Greece to the U.S., from Britain to Spain, economies face years of fiscal deficits, the unwinding of which will just add to the sense that the recovery from the Great Recession will be long and slow. We are not over this yet.

Paradigm Shift

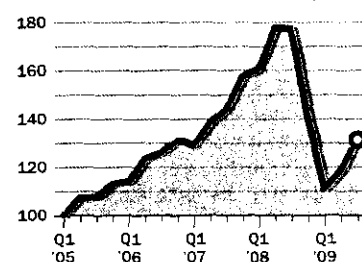
A PURELY ECONOMIC ANALYSIS OF THE nature of the crisis, and the recovery, is, however, only part of the story. Just as important for the future is a change in the context in which the global economy is now discussed.

It is now more than 20 years since Tom Wolfe coined the phrase "masters of the universe" for the Wall Street wizards he celebrated and satirized in his novel *The Bonfire of the Vanities*, and since Michael Lewis detailed the workings of the Street (to those for whom it had otherwise been a mystery) in his nonfiction book *Liar's Poker*. For all that time, the global economy has been shaped by a set of coherent behaviors and beliefs about the virtues of financial capitalism—among them the ideas that markets efficiently price risk; that innovation in financial markets benefits the broader economy and indeed makes it more stable rather than more prone to crisis; that light-touch regulation of such markets is best; and, not least, that those economies that pursue such policies will prosper more than those that do not. Along the way, the financial-services industry became the defining sector of modern capitalism, appropriating an extraordinary proportion of available high-powered human capital—and making many of those who worked in the industry

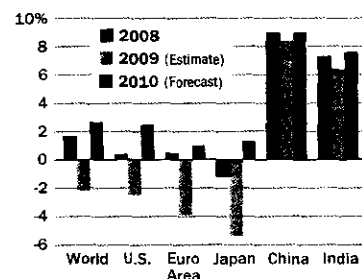
Looking Up

Trade and growth are rebounding after gut-wrenching plunges at the height of the financial crisis

Index of World Merchandise Exports



Real GDP Growth Rates



Sources: World Trade Organization; World Bank

not just rich beyond the dreams of avarice, but the heroes of the age.

This worldview has been challenged by the financial crisis and the Great Recession. In the past few years, a series of academic papers and books—one of the most rightfully praised, *The Myth of the Rational Market*, by TIME's own Justin Fox—have punctured the intellectual basis on which the explosion of the financial-services industry's innovations rested. But more than that, in the past few months a series of policymakers have cast doubt on the central justification for financial capitalism: the belief that it assists those who work in what used to be called the "real" economy, not just those lucky enough to work for investment banks.

The trend began with a remarkable roundtable interview that the British magazine *Prospect* conducted last August with Adair Turner, the chairman of Britain's Financial Services Authority. Turner noted that the financial crisis of 2008 amounted to "a fairly complete train wreck of a predominant theory of economics and finance"—the idea, as he put it, that "more

markets are always better." But beyond that, Turner went on to challenge the very idea that 20 years of innovation in finance—securitization, derivatives and the alphabet soup of securities that turned out to be either riskier than thought, or for which there were no liquid markets—had done the world much good. "The fact that the financial-services sector can grow to be larger than is socially optimal," said Turner, "is a key insight." And if you had missed the point, he continued with the observation that some financial innovation amounted to nothing more than "socially useless activity." Where Turner led, Paul Volcker, the revered chairman of the Fed from 1979 to 1987, was quick to follow. "I wish somebody would give me some shred of evidence linking financial innovation with a benefit to the economy," he told a *Wall Street Journal* conference in November, going on to say that his favorite such innovation of the past 25 years was not a CDO or a junk bond but the humble ATM.

In nations around the world—but especially in the U.S. and Europe—this intellectual assault on financial capitalism is already bearing fruit. Regulators and legislatures are grappling with ways of recasting regulatory regimes so that the financial system continues to provide those flows of capital without which innovation is impossible—what has been called the "utility" aspect of a financial system—while controlling the overleveraged risk-taking that can bring a whole economy crashing down. As current Fed Chairman Ben Bernanke told *TIME* in December, "We do need to have an effective, comprehensive financial regulatory system that will essentially allow us to tame the beast so that it provides the benefits, the growth and development, without creating these kinds of crisis."

A New Landscape

GOOD LUCK WITH THAT, MR. CHAIRMAN. Given the lobbying resources that Wall Street can deploy in Washington—and the difficulty of getting any comprehensive reform of anything through an increasingly dysfunctional American political system—the prospect that a shift in the intellectual climate will lead to meaningful regulatory change is far from assured. We have, after all, been here before. In 1997-98, the time of the Asian financial crisis, Russia's default and the collapse of Long-Term Capital Management, the quintessential highly leveraged, efficient-market-hypothesis hedge

fund, there was a similar intellectual backlash against market fundamentalism. It delayed a new wave of risky innovation in financial markets, by, oh, at least a few weeks.

Yet there is a crucial difference between the late 1990s and the present. In the earlier financial crisis, the source of the world's economic problem was widely thought to lie in the developing economies—in Southeast Asian nations whose supposed economic growth had masked a "crony capitalism," in a Russia that could no longer pay its debts. The U.S., at the height

It is not just the U.S. economy and storied U.S. financial institutions that have been humbled; it is an American way of thinking about the world

of the long Clinton-era boom, was (as—remember?—the French used to say at the time) the world's hyperpower. It was U.S. action—the willingness of Americans to act as consumers of last resort—that would, and indeed, did, pull the world away from the risk of global meltdown.

That is not remotely how things look now. First, the origins of the financial crisis lie in the U.S.; it was Americans who dreamed up the mathematical models that supposedly proved the efficient-market hypothesis, Americans who preached to the world the virtues of light-touch regulation of financial markets. Second, the American consumer, desperately rebuilding domestic balance sheets after gorging on debt for a generation, is tapped out, in no shape to carry the burden of global economic recovery. And third, it is not developing Asia that stands as the exemplar of economic policymaking gone wrong, as it did in 1997; on the contrary, it is developing Asia—China and India especially—that is leading the world into recovery.

That is why the crisis of 2008 and the Great Recession is more than an economic phenomenon with its roots in an interesting moment in intellectual history. It is a geopolitical event of profound significance. It is not just the U.S. economy and storied U.S. financial institutions that have been humbled; it is an American way of thinking about the world. And that will have—has already had—consequences. "In the short term," said Lee Kuan Yew, Minister Mentor of Singapore, last November, "I'm certain that what's happened will accelerate the shift of economic weight from the Atlantic to the Pacific."

The U.S., it bears reminding ourselves, is by far the world's largest, most open and most innovative economy. Any list of the companies most likely to shape society in the next generation would be dominated by American ones. Western Europe remains the most populous region of peace and widely shared prosperity in the world. Asia's continued success is not assured. India faces enormous problems over the next generation: relieving dire poverty, improving a barely functioning education system, building a modern infrastructure. China's astonishing growth in the past year has been fueled by a central government that has forced banks to lend money to enterprises like a drunken sailor. Morgan Stanley's Roach figures that 95% of China's GDP growth in the first three quarters of 2009 was from fixed investment, a sign that China's economy is still led by investment, not consumption. It is only when the Chinese consumer starts spending more, and the U.S. one saving more (the latter, it should be noted, is already happening) that the imbalances in the global economy will start to even themselves out.

Yet a shift in world economic and political power since the crisis took hold in 2008 is already apparent. It can be seen in the way that the G-20, including representatives of the developing economies, has supplanted the G-8 as the primary forum for discussion of global economic issues; in the new confidence that developing nations bring to debates on everything from climate change to global economic policy. The world really has changed since the last time Davos devotees made their way up the mountain. You would not expect it in Switzerland, but those green shoots under the snow of the Graubünden might just turn out to be bamboo. ■

Big City Shakeout

In 2008, TIME explored the ways in which “Nylonkong”—the three linked cities of New York, London and Hong Kong—defined globalization. How has Nylonkong fared in the Great Recession?

New York Wall Street may have lost the swagger of the boom years, but the Big Apple still has a lot to boast about

AS THE POET SAID: “IT IS NOT now as it hath been of yore.” Merrill Lynch—original address, back in 1914, 7 Wall Street, and you can’t get more New York blue-blooded than that—is now owned by a bank headquartered in Charlotte, N.C. The huge neon video screens that used to proclaim the charms of Lehman Brothers at the corner of 50th Street and Seventh Avenue are now Barclays Capital blue. Bear Stearns? Gone. Citi? Humbled. Sure there are survivors—Goldman Sachs, JPMorgan Chase, Morgan Stanley among them, and pretty well they are doing.

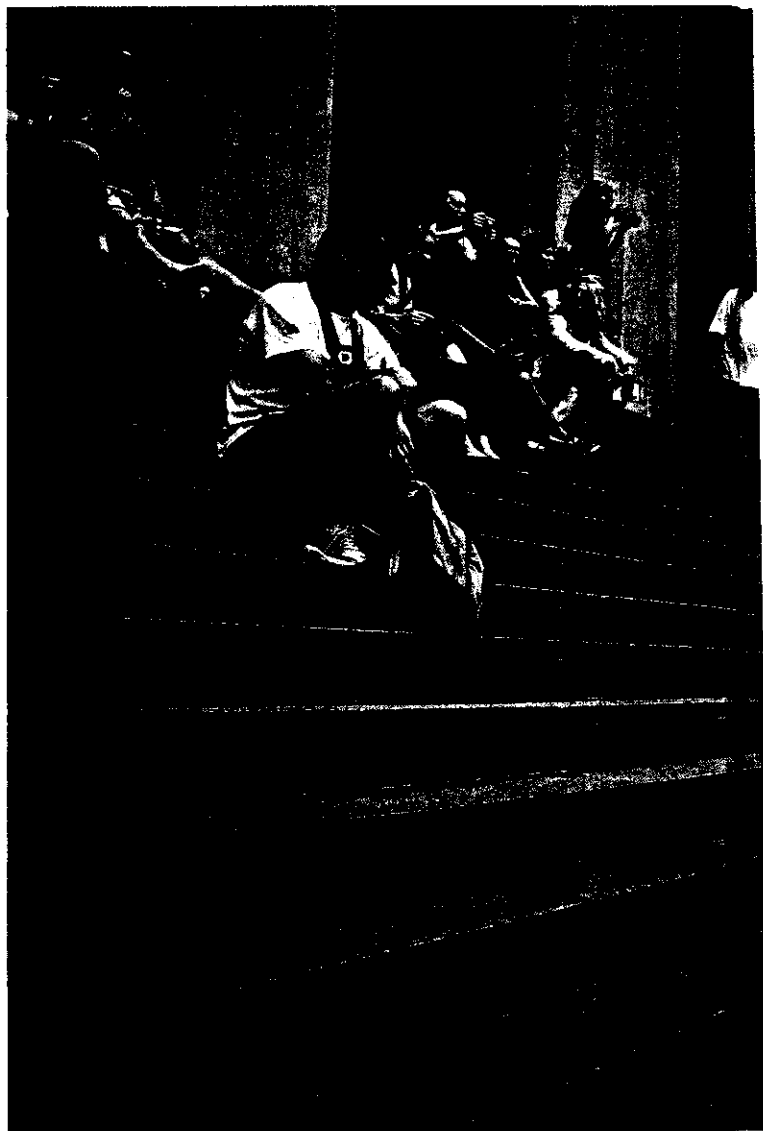
But buffeted by congressional inquiries and populist cable TV motormouths, fending off pressure for tougher regulatory regimes and having to justify their compensation practices over and over and over again, even the biggest beasts in the New York City jungle can sound a little defensive these days.

Still, here’s the headline for the city that thinks of itself as the financial capital of the world: It could have been a lot worse. New York was hit hard by the financial crisis and the Great Recession. But on the whole, the city has proved resilient—and by more than one

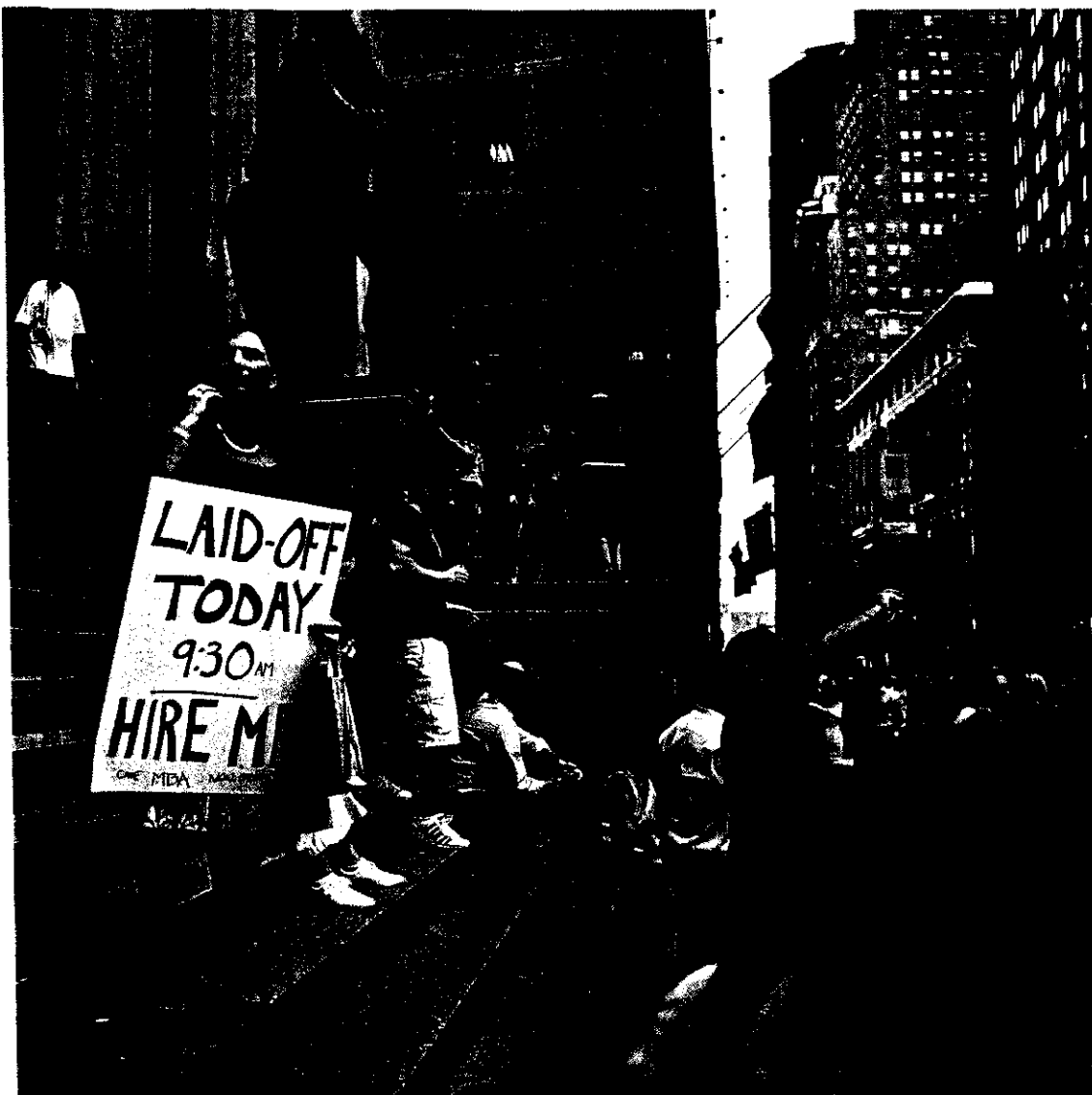
measure, it’s on its way back.

Unemployment—in common with the whole of the U.S. economy—is not one of those buoyant indicators. In February 2008, the high point of the employment cycle, there were 170,000 New Yorkers out of work, at an unemployment rate of just 4.4%. By September last year, the raw number of unemployed had soared to 413,000, and the rate was 10.3%, though it fell back a little in November.

About 40,000 of those lost jobs were on the Street. In August 2008, just before Lehman collapsed, the finance and insurance sector in the city



Helluva town New York's poor and middle class have been hit hard, but workers in its



limiting their mealtime alcohol intake. The abstemiousness has had its consequences: the landmark Tavern on the Green restaurant in Central Park—the country's top-grossing eatery as recently as 2007—closed its doors on New Year's Eve after 75 years. But more restaurants opened than closed from September 2008 to September 2009. And the relatively hard times may even have done something to improve New Yorkers' manners: 38% of diners say they now feel "more appreciated" when going out to eat than they did in better times.

Attendance at pricey Broadway shows dropped, with summer theater attendance falling 9.3% from 2008 levels, to 3.3 million. But traffic at museums, which offer families a cheaper way of enjoying the city, was robust. The Museum of Modern Art—one of the city's priciest, at \$20 a ticket—drew 2.8 million visitors from June 2008 to June 2009, notching the best year in its 80-year history, and its membership swelled to a record 120,000. The Guggenheim Museum, meanwhile, broke its 2008 attendance record of just above a million visitors, and mounted its best-attended show in history: a Frank Lloyd Wright retrospective that drew 372,000 people.

All told, employment in the arts and entertainment sector—which for many people defines New York just as much as Wall Street does—dropped from 71,000 to 64,000 between the summer of 2008 and February 2009, though it has rebounded since. There are nearly 30% more people employed in the city's entertainment sector today than there were at the height of the Clinton boom in the late 1990s.

With all the arty date possibilities, is it any wonder

employed 351,000 people. That had declined to 313,000—a drop of 11%—by October 2009. New York has drawn on an \$11 million "national emergency grant" to help laid-off denizens of Wall Street transition into new fields, such as education or health care. But despite all the schadenfreude-larded headlines devoted to bankers' woes, the city's elite has done comparatively well. The worst job numbers have not been uptown or in the manicured suburbs of Westchester County, where the lawyers, brokers and bankers live. On the Upper East Side, in the depths of the

recession in third-quarter 2009, unemployment hovered around just 5%, while at the same time in East New York, a predominantly African-American Brooklyn neighborhood, it neared 20%.

Despite the pain, though, the things that make New York, New York—its nightlife, its cultural scene—have fared pretty well. Yes, according to Zagat's 2010 New York City Restaurant survey, New Yorkers reported eating out just three times a week in 2009, compared with 3.3 times a week the year before. Some 41% say they dine at cheaper establishments, and 19% are

515

Stalled construction projects in New York City as of Nov. 2009.

Source: NY Building Congress

in its financial industry have been relatively unscathed

that last July, *Forbes* magazine voted New York the top U.S. city for singles? So long as they have jobs, those singles make up one group which has done well from the downturn. Young people on low salaries, the kind who in years past have often jumped ship to Brooklyn and Queens in search of cheaper digs, got a chance to stay in Manhattan. In the fourth quarter of 2009, median Manhattan apartment rents were down 9.4% from a year earlier, and island neighborhoods such as Chinatown and Hell's Kitchen gave outer borough locations like Bushwick and Astoria a run for their money as the up-and-coming spots for hipsters. (Meanwhile in Greenwich, Conn., home of the hedge funds, house prices dropped 15.9% between fall 2008 and 2009—though you still needed \$1.68m to buy a median home there.)

Tourists, too, saw the bargains to be had. Despite dismal forecasts, in 2009 New York City was the top U.S. tourism destination for the first time since 1990. (The average hotel room cost \$70 less than it had the year before.)

Once in town, visitors could get into that classic New York act of the haggle, which came back into style; one woman reported bargaining a \$260 cashmere sweater down to \$100 at Bloomingdale's. And they could rejoice in the fact that in 2009, one correlation often seen in past downturns did not come to pass; the economy turned down, but crime did not go up. Astonishingly, in 2009, there were fewer murders (466) in the city than in any year since reliable records were first kept in 1963. Has the crisis turned New York into a run-down, crime-ridden, poor, no-fun shadow of itself? Fuhgeddaboutit. —BY LAURA FITZPATRICK/NEW YORK CITY



Rain check London's place as one of the most important financial hubs in the world will remain, despite the recent

London The City was always going to lose ground to Asia. Still, London is not as broken as doomsayers make out

FOR MORE THAN 800 YEARS, the church of St. Helen's in London's Bishopsgate has offered spiritual solace to those in need. Today, enveloped by the City, as London's financial quarter is known, St. Helen's has never seemed more like a sanctuary. As bankers lost their shirts amid the financial crisis, "We had individuals just walk in and say, 'My life's a mess, I don't know how I'm going to cope,'" says the Rev. Mark O'Donoghue, once a City lawyer but now a minister at St. Helen's.

With faith in finance at an all-time low, the clamor to put things right in the City is under way. As a crucial hub in the global financial system, Britain's financial-services industry has won itself few admirers in recent months. Undercapitalized and overextended before the crisis, once proud banks such as Royal Bank of Scotland (RBS) have been largely nationalized. The City's reputation for

light-touch regulation now haunts it. Britain's economy, far too reliant on finance in recent years, contracted by an estimated 4.5% last year.

With politicians and regulators eager to restore order, the market in suggestions for how the City should emerge from the crisis is buoyant. "It's important we don't get bogged down with, 'Oh my God, it's all over!'" says John Griffith-Jones, chairman of KPMG in the U.K. "As opposed to, 'O.K., that wasn't our finest hour, but bloody hell, we've gripped the issues.'" So how will London emerge from its toughest test in decades?

The City didn't cause the crisis; nor is it the only financial center tarnished. But as arguably the most internationally focused of the world's financial capitals, London has suffered an outsize share of the pain.

Self-inflicted injuries made things much worse. Debt-fueled growth meant



mt economic storm

some British banks quickly found themselves in a funding pickle as credit markets seized up. Others admitted to enormous trading losses. All told, taxpayers have stumped up \$1.4 trillion in support for Britain's banks since the crisis began. Some 60,000 financial-services jobs have been lost.

Guarding against a repeat means tightening the rules that banks play by. Gone is the featherlight supervision of the Financial Services Authority (FSA), Britain's regulator. In its place, banks now expect far more rigorous scrutiny of their business models—and the extent to which they export risk to the rest of the financial system. While holding more capital and trustier assets should make banks less risky, it could also make for less money to pass around. "There will be a smaller banking sector," says Julian Franks, a finance professor at the London Business School. "And it's probably a good thing."

Much more contentious: regulating future pay for bankers. The FSA's get-tough approach includes moves to stop bankers' rewards from encouraging excessive risk-taking. And the British government has gone further, last month unveiling a new 50% tax on bonuses over roughly \$40,000—adding to plans for a higher rate of income tax on those earning more than \$245,000 a year.

The bonus levy has stirred threats of an exodus from London. Tullett Prebon, a major brokerage, said it would help staff eager to relocate to places with "more certain taxation regimes"; Goldman Sachs began a review of its London operations, in part because of the new tax. Swiss authorities have hosted several seminars in London on the good life in Zurich and Zug. New York City Mayor Michael Bloomberg hailed the British levy last month as "an opportunity to ... bring those

[from London], but what won't come here."

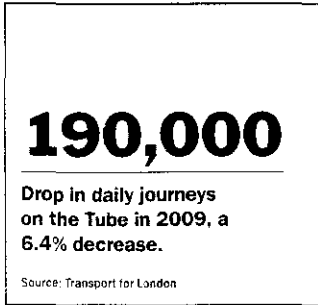
No one in London wants to lose a penny of business, but doing so hardly means the end of the City. London still has a lot going for it. Its location midway between the U.S. and Asia, flexible employment laws and its use of English all act as a long-term hedge against the impact of temporary taxes. Then there's the invisible infrastructure of the Big Smoke; the City is home to three of the world's top four law firms, countless insurance houses, accountants, consultants, skilled secretaries and good schools.

All of this explains why about half of Europe's investment-banking activity takes place in the City, and why it is still a world leader in cross-border lending. As Deutsche Bank CEO Josef Ackermann told the *Financial Times* in December, "London is a very attractive place to do business."

The truth is, the biggest threat to the City's status has little to do with the financial meltdown. The more that emerging economies like China and Brazil grow, the more their domestic stock and bond markets will expand. In the past, London picked up lots of that lucrative emerging market business. In the future, "as the Asian economies in particular mature, more international business will be settled out of there than out of London," says author Philip Augar. "There will be a gradual loss of market share for the City."

To the bankers marching past London's St. Helen's one recent lunchtime, that message seems to have been carried in the wind. Above its narrow bell tower, the church's weather vane held steady in a chilly wind. Its direction: steadfastly south.

—BY ADAM SMITH/LONDON



companies here."

Inevitably, some workers will move. Still, few right now could confidently predict a race to Heathrow (if you could race there, which, given London's awful traffic, you can't.) The real worry for London is the insidious effect of such changes. "If carbon-trading took off, where would its HQ go?" says KPMG boss Griffith-Jones. "It's not so much what they'll take away



Hong Kong Asia's financial capital is benefiting from China's rise. It should guard against complacency

JENNIFER FALCO HAD dreamed of a career in high finance, though she never expected that dream to take her to Hong Kong. The 28-year-old American quit her Wall Street job to get an M.B.A. in Milan, then headed to London. But with the financial crisis setting in, there was no full-time job to be had. After a short stint at Goldman Sachs, her boss gave her some valuable advice: "Go East, young woman." So Falco packed up and moved to Hong Kong, where she found an internship in equity finance at HSBC in September 2008 that later became a permanent position. "There's a lot of hiring now. Business is picking up," Falco says. "People are like, let's move to Asia and see what we can do."

With good reason. Hong Kong is benefiting at the expense of its Western rivals. While New York and London suffered through bank failures, controversial government bailouts and large-scale job losses, Hong Kong's stature as a capital of world finance has been enhanced by the lure of continued big deals and big money in a fast-rising Asia. Initial public offerings on Hong Kong's stock exchanges raked in over \$31 billion in

2009—more than the markets in New York and London combined, according to PricewaterhouseCoopers. Even more importantly, the attitude of Hong Kong's politicians and regulators towards its financiers is more supportive than in the West. There's no talk here of confiscatory penalties on bonuses or extra taxes, and no public hearings on the evil-doings of big finance. "There have never been economic and political conditions as favorable as they are today to take a much more advantaged position against New York and London, when they're down and we're up," says Benjamin Hung, CEO of Standard Chartered Bank in Hong Kong. "It's the chance of a lifetime."

Hong Kong's biggest edge is its special relationship with China. Shanghai may dominate the country's domestic financial industry, but Hong Kong is still China's premier international finance center. That crucial role helped Hong Kong piggyback on China's performance last year. Hong Kong's stock market was buoyed by Chinese firms tapping foreign investors, as well as international companies looking to list China-linked assets. American gaming giants Wynn Resorts and Las Vegas Sands completed IPOs of their Macau operations in Hong Kong, raising a combined \$4.3 billion.

Now Hong Kong has a front-row seat for one of the next waves of financial globalization—the emergence of the developing world onto the stage of international finance. For the past decade, Beijing's leaders have looked first to Hong Kong when testing financial reform, seeking global expertise or reaching out to the international investor community. That policy looks set to continue. "Hong Kong," says Richard



Bright lights Hong Kong sees opportunity in other cities' crises

Vuylsteke, president of Hong Kong's American Chamber of Commerce, "is now the logical gateway for investment out of China."

The potential can be seen in the city's burgeoning business in China's currency, the renminbi (or RMB). Beijing's leaders are experimenting in Hong Kong with the liberalization of its tightly controlled currency, with the eventual goal of making it more widely used in international finance and trade. Hong Kong banks have amassed \$8.4 billion in RMB-denominated deposits since 2004, after they became the first financial firms outside mainland China that Beijing allowed to offer RMB accounts, credit cards and other services. Last September, the government chose Hong Kong to offer its first international RMB-denominated sovereign bond. Tse Kwok-leung, head of economic research at the Bank of China in Hong Kong, says that the RMB business "is a new driver that gives new momentum to the Hong Kong financial sector going forward."

The world's bankers are taking notice. One of the key ways in which Hong Kong appears to be benefiting from its robust outlook is an inflow of expertise—the lifeblood of a finance center's competitiveness. Hung of Standard Chartered says that the bank was able to lure top-notch talent to Hong Kong due to the severe impact of the financial crisis on the West. While the Western money capitals have witnessed tens of thousands of job losses, the number of people employed in finance and insurance in Hong Kong dipped only slightly in late 2008, then began to recover last year. More importantly,

Hong Kong, with low taxes, a pleasant lifestyle and strong business opportunities, is becoming more desirable for many than New York or London. Instead of just a brief résumé-building stop on the way to Wall Street or the City, bankers are beginning to consider the Asian hub as a base for long-term careers. "People see Hong Kong as a springboard to participate in the Asian growth story," says Kelly Driscoll, senior managing director at State Street Global Advisors in Hong Kong. "With the prospects here in Asia and Hong Kong, this is the place to be in coming years."

Credit Suisse, for example, has brought several senior bankers into its Hong Kong operations. But the city's most notable new resident is HSBC CEO Michael Geoghegan, who is relocating from the megabank's headquarters in London to Hong Kong. The move "further positions the Group for the shift in the world's center of economic gravity from west to east," HSBC said in a statement.

To keep capitalizing on that seismic shift, however, Hong Kong still has work to do. Though strong in equities and currencies, Hong Kong's finance industry is weaker in other important segments, such as bonds and commodities. And Hong Kong has to guard against counting on China alone, no matter how bright its outlook may be. For more than 150 years, Hong Kong has excelled at linking China to the outside. Now its financial industry must continue to find new ways to do so, if it wishes to lead the next developments in global finance. "Hong Kong cannot just look up to the north," says Hung of Standard Chartered. "It has to remain connected to the rest of the world." —BY MICHAEL SCHUMAN/HONG KONG

\$31.3 BILLION

Money raised in IPOs
in Hong Kong in 2009.

Source: PricewaterhouseCoopers



Extra Money

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



Statistophobia. We are besieged by a blizzard of often contradictory economic data. Is there any escape? Probably not

THE MONTH OF JANUARY OFFERED THOSE who track the ups and downs of the U.S. economy 92 significant data releases and announcements to digest. That's according to a calendar compiled by the investment bank UBS. The number doesn't include corporate earnings, data from abroad or informal indicators like, say, cardboard prices (a favorite of Alan Greenspan's back in the day).

It was not always thus. "One reads with dismay of Presidents Hoover and then Roosevelt designing policies to combat the Great Depression of the 1930s on the basis of such sketchy data as stock price indices, freight car loadings, and incomplete indices of industrial production," writes the University of North Carolina's Richard Froyen in his macroeconomics textbook.

But that was then. The Depression inspired the creation of new measures like gross domestic product. (It was gross *national* product back in those days, but the basic idea is the same.) Wartime planning needs and advances in statistical techniques led to another big round of data improvements in the 1940s. And in recent decades, private firms and associations aiming to serve the investment community have added lots of reports and indexes of their own.

Taken as a whole, this profusion of data surely has increased our understanding of the economy and its ebb and flow. It doesn't seem to have made us any better at predicting the future, though; perhaps that would be too much to ask.

The profusion of data surely has increased our understanding of the economy. It doesn't seem to have made us any better at predicting the future, though

But what is troubling at a time like this, with the economy on everyone's mind, is how misleading many economic indicators can be about the *present*.

Consider GDP. In October, the Commerce Department announced—to rejoicing in the media, on Wall Street and in the White House—that the economy had grown at a 3.5% annual pace in the third quarter. By late December, GDP had



been revised downward to a less impressive 2.2%, and revisions to come could ratchet it down even more (or revise it back up). The first fourth-quarter GDP estimate comes out Jan. 29. Some are saying it could top 5%. If it does, should we really believe it?

Or take jobs. In early December, the Labor Department's monthly report surprised on the upside—and brought lots of upbeat headlines—with employers reporting only 11,000 jobs lost and the unemployment rate dropping from 10.2% to 10%. A month later, the surprise was in the other direction—unemployment had held steady, but employers reported 85,000 fewer jobs. Suddenly the headlines were downbeat, and pundits were pontificating about the political implications of a stalled labor market. Chances are, the disparity between the two reports was

mostly statistical noise. Those who read great meaning into either were deceiving themselves. It's a classic case of information overload making it harder to see the trends and patterns that matter. In other words, we might be better off paying less (or at least less frequent) attention to data.

With that in mind, I asked a few of my favorite economic forecasters to name an indicator or two that I could afford to start ignoring. Three said they disregarded the index of leading indicators, originally devised at the Commerce Department but now compiled by the Conference Board, a business group. Fore-casters want new hard data, and the index "consists entirely of already released information and the Conference Board's forecasts," says Jan Hatzius of Goldman Sachs. (The leading-indicators index topped a similar survey by the *Chicago Tribune* in 2005, it turns out.) The monthly employment estimate put out by payroll-service firm ADP got two demerits, mainly because it doesn't do a great job of predicting the Labor Department employment numbers that are released two days later. And consumer-sentiment indexes, which offer the tantalizing prospect of predicting future spending patterns but often function more like an echo chamber, got the thumbs-down from two more forecasters.

The thing is, I already ignore all these (relatively minor) indicators. I had been hoping to learn I could skip GDP or the employment report. I should have known that professional forecasters wouldn't forgo real data. As Mark Zandi of Moody's Economy.com put it in an e-mail, "I cherish all economic indicators."

Most of us aren't professional forecasters. What should we make of the cacophony of monthly and weekly data? The obvious advice is to focus on trends and ignore the noise. But the most important economic moments come when trends reverse—when what appears to be noise is really a sign that the world has changed. Which is why, in these uncertain times, we jump whenever a new economic number comes out. Even one that will be revised in a month.

ESSAY

The China Fix

Why the Google controversy is a tipping point for foreign businesses in China

BY JAMES MCGREGOR

IN MY MORE THAN TWO DECADES IN CHINA, I HAVE seldom seen the foreign business community more angry and disillusioned than it is today. Such sentiment goes beyond the Internet censorship and cyber-spying that led to Google's Jan. 12 threat to bail out of China, or the clash of values (freedom vs. control) implied by the Google case. It is about the perception that antiforeign attitudes and policies in China have been growing and hardening since the global economic crisis pushed the U.S. and Europe into a tailspin and launched China to its very uncomfortable stardom on the world stage.

Visiting CEOs' banquet-table chatter is now dominated by swapping tales of arrogant and insolent Chinese bureaucrats and business partners. The litany includes purposefully inconsistent and nontransparent enforcement of regulations, rampant intellectual-property theft, state penetration of multinationals through union and Communist Party organizations, blatant market impediments through rigged product standards and testing, politicized courts and agencies that almost always favor local companies, creative and selective enforcement of WTO requirements ... The list goes on.

The foreign business community in China has deep respect and affection for the Chinese people and their hard-earned success. But more than a few foreign business leaders are asking themselves if they have been bamboozled by the system. Multinationals have been solid citizens in China, handing over heaps of capital, technology, training, source code, best practices and proprietary products to joint-venture partners they were forced into bed with. They have funded schools, orphanages, disaster reconstruction, overseas scholarships and all manner of poverty-alleviation programs. But now that the China market matters more to them, it appears that China couldn't care less. Increasingly difficult China-market access is the immediate worry. But many are looking ahead and losing sleep over expectations that their onetime partners are morphing into predators—and that their own technology and know-how will be coming back at them globally in the form of cut-price products from subsidized state-owned behemoths.

At the same time, I have also seldom seen the Chinese government and business community more unsettled and uncertain. There is an arrogance borne of insecurity. The global financial chaos and China's rocketing global

status threw off the meticulous national development schedules carefully crafted by the risk-averse and surprise-allergic engineers who run the Party.

The pressures on Chinese President Hu Jintao and Premier Wen Jiabao are overwhelming. They are white-knuckling their way through their final two years in office, focusing on 8% or higher growth and crushing any dissent that could derail it. The Chinese people are generally pretty happy, but the Party leadership is terrified of their outsized expectations. People under age 40, the progeny of the one-child policy, didn't live through Maoist poverty and upheaval. They are pampered, impatient and demanding. They consider exponential growth as a basic benchmark of life, and access to information to

be a civil right. China's rich are powerful opponents of further reform and opening. They made money the local way and are determined to block foreign competition so this can continue.

In their spare time, China's leaders are reaching under the carpet to tackle the country's endemic corruption, epidemic pollution, emaciated health care, shredded social services, entrenched industrial overcapacity and swiftly aging population, to

name a few. They have little remaining bandwidth, and no experience or desire to be the visionary and magnanimous world leaders who can look beyond China's own often desperate needs that the world wants them to be.

So both Chinese and non-Chinese have legitimate challenges and understandable phobias. Google is just a proxy in this intensifying dispute. It's really about rebalancing the economic and political dynamic between China and the developed world, with the U.S. as the key negotiator for the West. It won't be easy. China and the U.S. are past masters at blaming their domestic policy failings on outsiders. Finger-pointing politicians and chest-beating nationalists in the two nations will make rational discussion nearly impossible. Yet it is time for leaders on both sides of the Pacific to lift their heads above overwhelming domestic concerns and fix China's deteriorating relationship with foreign business and the developed world before things get out of control. One thing's certain: they won't find the answers through Google. ■



The information age Young Chinese Netizens in Beijing

McGregor, a senior counselor for APCO Worldwide, is a former chairman of the American Chamber of Commerce in China and author of One Billion Customers: Lessons from the Front Lines of Doing Business in China

TIME: FEBRUARY 8, 2010.

Global Business

INSIDE

No matter what the dispute, quiet backroom diplomacy is the only way to deal with the rulers in Beijing

BILL POWELL ON GOOGLE'S FIGHT WITH CHINA

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

Big questions Michael Elliott, center, editor of TIME International, chairs our panel of economists



WORLD ECONOMIC FORUM

Hopeful but Wary. As world leaders and business heads gather in Davos, TIME's Board of Economists searches for signs of life in the global economy

BY BARBARA KIVIAT/DAVOS

WORLD
ECONOMIC
FORUM

COULD IT BE TIME TO exhale? Cautious optimism about the state of the global economy pervaded conversation at the annual meeting of the World Economic Forum, the gathering of financial and political elite in snowy Davos, Switzerland. On the eve of the conference, Britain announced that it had officially (and finally) followed France, Germany, Japan and the U.S. out of recession with positive

'2010 will be a very impressive year for Asian countries. China's GDP will exceed that of Japan, definitely.'

—HEIZO TAKENAKA, KEIO UNIVERSITY, JAPAN



'I've had conversations with senior bankers who said, "We didn't suffer enough pain. We did wrong but we didn't get punished."'

—ARIF NAQVI, CEO OF INVESTMENT FIRM ABRAAJ CAPITAL



'Some people on the panel expressed concern about overregulation. My concern is the opposite—that we're going back to business as usual.'

—NOURIEL ROUBINI, NEW YORK UNIVERSITY



growth in the last three months of 2009. The same day, the International Monetary Fund raised its forecast for global expansion in 2010 to 3.9%. There was, it seemed, plenty of reason to dare to breathe easier.

But at the opening morning Davos session of TIME's Board of Economists, it was plain that nobody was ready to say the global economy was out of the woods. Participants looked to the future with hope and enthusiasm very much kept in check. The worst of the financial crisis and the global recession may be over; but they have left a painful and troubling legacy, and there are still large uncertainties about how the global economy will develop. Among them: whether emerging economies can truly shoulder the burden of recovery; how reform of financial-sector and banking regulation will take shape; and the ramifications (both economic and political) of continued high unemployment,

especially in the U.S.

The discussion kicked off with a sober view of top-line GDP figures. New York University economist Nouriel Roubini—the Cassandra of Washington Square, the man who had warned long before September 2008 that there was a fundamental instability in the U.S. and global economy—cautioned that the U.S., Europe and Japan could see a fresh decline in growth in the second half of the year as the effect of government stimulus funds tapers off. Since many countries have pursued increased spending, worries about inflation could impact recovery; financial markets are already beginning to wonder how long nations such as the U.S. can sustain huge fiscal deficits. "There is debate about the shape of this recovery," said Roubini. Those who are optimistic think the recovery will be swift and substantial, in a classic V shape. Roubini said he was

in the camp of those who think it will be U shaped.

Few in Davos would dissent from that view. The prevailing mood on the first day of the conference was somber. But David Rubenstein, co-founder and managing director of the Carlyle Group, a leading private-equity shop, pointed out that there had been something of a return of confidence. "I'd say it's a pretty attractive time to invest," Rubenstein said, "because prices are relatively low. I think the risk of systemic failure in the United States, financial system or the global financial system is gone. And as a result I think investors are now willing to put capital to work again and to get reasonably attractive rates of return."

Many of those investors will be looking to opportunities in what used to be called the developing world. As Raghuram Rajan of the University of Chicago pointed out,

'Bottom line: cash flow is king. An intense focus around liquidity is very much at the core of everything that people are focused on.'

—DENNIS NALLY, CHAIRMAN OF PRICEWATERHOUSECOOPERS



'There could be a move towards populism. There could be a move towards protectionism. And I think that's a worry.'

—RAGHURAM RAJAN, UNIVERSITY OF CHICAGO



'Most investors are worried that governments are going to overreact. We'd be better if we have less of an overreaction.'

—DAVID RUBENSTEIN, MANAGING DIRECTOR OF PRIVATE-EQUITY FIRM THE CARLYLE GROUP



in the U.S., the figure 10% is shorthand for referring to the unemployment rate, but in China it more closely resembles the sizzling pace of annual economic growth. While few countries can match China, there are plenty of other buoyant spots around the globe, from India to Brazil.

Yet the panel struck a note of caution there, too. Consumer demand in the developing world is not yet ready to carry the load the American consumer did during other periods of global economic turmoil, such as after the Asian financial crisis of 1997. "My sense is that what we've had is a situation of excess demand being created by the industrial countries, and now the hot potato is being shifted to the emerging markets," said Rajan. "Historically, they've never managed it well." If a country such as India, where domestic demand is strong, is to continue to grow, it needs to manage huge challenges posed by inad-

equated infrastructure and a massive shift of population from rural to urban areas.

For the time being, though, the question of whether domestic demand in emerging markets can be sustained is something of a theoretical one. The sickly pace of job creation, especially in the U.S., is very real—and shapes the political debate, which in turn impacts proposals for reform of the financial sector. Dennis Nally, chairman of PricewaterhouseCoopers, reported the results of a recent survey of nearly 1,200 business leaders worldwide. Some 39% of companies planned to hire within the next year; yet 25% still planned to cut jobs. Cost management remained a global corporate imperative. "I think that tells you something about how the business community is looking at the next 12 months," said Nally. Without hiring and the money it puts into consumers' pockets, the recovery in consumption-driven countries like

the U.S. is only going to get so far.

From the audience, a venture capitalist wondered if a skills mismatch might be part of what's holding back job growth in the U.S., a country in which a full 17% of workers are either unemployed or underemployed. "In the 40-some years I've been in Silicon Valley, I've never seen more core innovation," he said. "But we don't have the talent we need in the U.S.—programmers, chip designers, the people who can make these things work." Rajan thought the uptick in innovation and the recent economic malaise were possibly related: "If you look back on history, you see crises tend to be around times of big technological change." But whether or not the U.S. is in a position to take advantage of that change—to produce the workers able to exploit new technologies—is a question without a clear answer. Through a combination of individual initiative,

market forces and best-in-the-world higher education, the U.S. has traditionally proven flexible in reallocating its human capital to more productive sectors. But flexible doesn't necessarily mean fast. Even if the shift to a new breed of jobs does come, it's not coming immediately.

That reality—of tens of millions of jobless Americans and Europeans—is shaping up to be a game changer. Ordinary, hardworking Joes (and Josefs) watched as one company after another, this industry and that, got bailed out by governments without getting much, if any, help with their own economic struggles. "I've had lots of conversations with very, very senior bankers in the last couple of years who said, 'Look, we didn't suffer enough pain—we did wrong but we didn't get punished,'" said Arif Naqvi, CEO of the investment firm Abraaj Capital, based in the United Arab Emirates.

That's a sentiment large sectors of the developed world understand very well, which is one reason why politicians across the rich world are finding an appeal in populism, and why bankers need to understand where it comes from. Those in the banking community who opposed the proposed reforms of the Obama Administration, mega-investor George Soros told a lunch later that day, were "tone deaf."

Anger and resentment, however, are

rarely a sensible driver of policy—especially in an area as complex as financial market reform and regulation. Taking back fat-cat banker bonuses plays well on the farm, but it's not a particularly meaningful structural change if what you're going for is preventing the next near collapse of the financial system. Bringing transparency to the shadow banking system is more difficult to wedge into a sound bite—Heizo Takenaka of Keio University in Japan said the need to regulate the shadow banking system was one of the key lessons of his time as a policymaker—but would be a wiser goal.

Or consider the movement now afoot, thanks to the so-called Volcker rule, to impose size limits on banks as well as to prohibit deposit-taking banks from trading on their own account. At first blush, that seems like a simple and sensible policy solution, said Rajan. The problem: a quick look at history shows that the sheer size of banks isn't necessarily the culprit. In the 1930s, at a time when thousands of small, localized banks were failing across the U.S., the problem was not Too Big to Fail but Too Many to Fail. The right policy solution almost certainly exists deep in the weeds. Yet the more policy is driven by politicians trying to appeal to the (rightfully) outraged crowd, the less room there's likely to be for nuance. "In

the democratic process, the support of the general public is very much needed," said Takenaka. "The education of the general public is indispensable."

One reason for that is because when it comes to the global economy, there is a need for a coordinated, international response to the desire for regulatory change. "In the long run," said Soros, "you can't have global markets without global regulation." But international cooperation can easily fall foul of national politicians anxious to preserve, or at least appear to preserve, sovereignty. And, as we have been reminded in the wake of crisis, institutions like the G-20 find it difficult to make even the simplest proposals stick. "At the World Economic Forum," said Rubenstein, "you should always say, yes, multilateralism is possible and we should come together. But getting national solutions is difficult enough."

Those difficulties suffused the mood in Davos. It's a certain type of person who comes to this spectacular valley—surrounded by steep mountains, bitterly cold at night. And even those hardy souls, this year, kept a lucky rabbit's foot in their pocket. "I think most people that find their way to Davos are just naturally optimistic," said Naqvi. "But we've been through such a massive shock in the global system that we can't expect to recover from it overnight." ■



Talking shop Naqvi and Rajan confer, while Rubenstein makes a point. The economy's looking better, they say, but dangers lie ahead



Stone-faced
Critics say China
isn't listening to
foreign business

CHINA

Hold Fire. Nobody, not even China, can afford to let the row over Google intensify into a broader dispute

BY BILL POWELL/BEIJING

WE WERE SUPPOSED TO BE ENTERING THE era when there would be just a party of two at the grown-ups' table: the place where the real power lies and where the key decisions get made. The U.S. and China—the world's strongest developed nation and the world's fastest-growing major developing economy—were going to partner quietly to resolve some of the world's biggest ills. Climate change. Rebalancing the global economy. Reworking the world's financial architecture. No one ever called it the G-2 in public—why insult Europe, Japan, India and everyone else? But every time a senior U.S. official went to Beijing for meetings, the point was pretty clear: Now, the important business gets done.

That era is on hold. The U.S. and China aren't solving problems; they are trading trans-Pacific insults that have given a jarring, Cold War-era tinge to a distinctly 21st century debate: Just how free should the Internet be, and to what lengths can governments go to exploit it for its own

aims? The trigger, of course, for the current war of words between Washington and Beijing was Google's Jan. 12 declaration on its website that it would no longer agree to censor its search engine in China. Google said it believed the authorities were behind a series of cyberattacks against its computers, including probes designed to steal the Gmail addresses of human-rights activists and other dissidents inside China. (Beijing denied any state involvement in the cyberattacks.) U.S. Secretary of State Hillary Clinton then followed with a high-profile speech on "Internet freedom," which took direct aim at Beijing, among others.

In 2009, China was lauded for keeping its economy humming. But the Google issue has crystallized a whole range of discontent, economic and otherwise

In the immediate aftermath of Google's announcement, Beijing was conspicuously quiet. In part, this was because the authorities were unclear over how to respond. Says one Chinese Internet executive: "Are there security types in the government who would shut down the Internet tomorrow if they could? Sure there are. But there are also [policymakers] who want China to be a modern, tech-savvy country, and having Google threaten to walk out isn't exactly helpful." However, once it became clear to Beijing that this was not only Google's fight but one that Washington would adopt, China fired back. Said a Jan. 25 editorial in a state newspaper: "In the eyes of American politicians, only when information is controlled by the U.S. does it count as free information."

International commercial spats involving China are increasingly common as it becomes ever more integrated into the global economy. But none have so quickly attained the white-hot intensity of the Google fracas. The Mountain View, Calif., Internet giant openly flouted one of the cardinal rules of

dealing with China: no matter what the dispute, quiet backroom diplomacy is the only way to deal with the rulers in Beijing. That is truer for large corporations than it is for governments, because the China market just doesn't stop growing, not even, as 2009 demonstrated, in the teeth of steep global recession. For one of the most powerful companies in the world to publicly assail the Chinese government, and effectively threaten to abandon the China market unless Beijing stops censoring the Internet, was not only unprecedented, "it was astonishing," says the head of China operations for a FORTUNE 500 company.

The Bigger Picture

THE PUBLIC DÉMARCHÉ PROVIDED MORE than shock value. For much of 2009, China was rightly lauded for keeping its economy humming, enabling it to be a growth engine for the rest of the world. But in a way that could not have been anticipated—least of all by Beijing's leaders—the Google issue has crystallized a whole range of discontent with China, economic and otherwise. "To a degree, it has put a punctuation mark on what has been a very bad run of publicity for China," a top Western diplomat in Beijing says. Some of that discontent has been very public. The sentencing of dissident Liu Xiaobo to 11 years in prison and the controversial execution of a British citizen of Pakistani descent, convicted of being a drug trafficker, angered human-rights activists, while many environmentalists—fairly or not—hung the failure of the Copenhagen climate-change summit around China's neck. With awareness, as well as concern, growing about the country as a world power, China's global role is certain to be dissected and debated at gatherings like the World Economic Forum in Davos.

Less public, but not necessarily less intense, has been frustration building in segments of the international business community operating in China. Many foreign businessmen interviewed by TIME in the wake of the Google announcement concede they are deeply conflicted by what has happened in the China market since

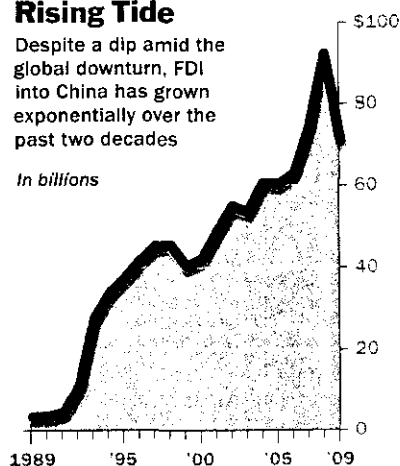
the onset of the international financial crisis and the global slump that followed. On the one hand, many of their companies are leveraged to China's growth as never before. Ask General Motors, which is in bankruptcy in the U.S. but enjoys surging sales in what is now the largest market for cars in the world. At the same time, among many business executives, there is a sense that China is moving backward on issues of key concern to foreign businesses, from anti-trust enforcement to intellectual-property protection to market-entry issues. As China prospered while much of the rest of the world slumped, attitudes among policymakers in Beijing and even in far-flung provinces have shifted noticeably, many foreign business executives say. Some call it arrogance. Some say it's simply increased confidence. But as Kent Kedi, a Shanghai-based consultant at Technomic Asia who



Rising Tide

Despite a dip amid the global downturn, FDI into China has grown exponentially over the past two decades

In billions



Source: Ministry of Commerce, PRC

In friendlier times *The G-2 convenes on the sidelines of last year's G-20, held in Pittsburgh*

Coke had been, in other words, close to a perfect corporate citizen in the country, and on the merits probably should have been able to acquire Huiyuan. But sources close to the aborted merger suspect the government's ruling was partly tipped by pressure from a local company that did not want Coke to acquire Huiyuan. Says an adviser to the deal: "It was home cooking, pure and simple, and it didn't taste real good."

Home cooking, of course, doesn't just exist in China when it comes to business deals. Uneven playing fields can be a fact of life pretty much anywhere business is done. The current angst among foreign businesses operating in China is that a fundamental precept for their investments there—particularly since 2001, when Beijing joined the World Trade Organization—is that on key business issues (intellectual-property protection, tariff barriers to entry, antitrust enforcement) things would slowly but surely continue to improve as the China market grew. And for a time, in the wake of WTO entry, they did. Now, some executives say, the problem is not simply that the momentum has slowed, but that it has gone into reverse.

The Google-driven Internet fight comes at a deeply awkward moment for China and the outside world. Trade clashes of the more prosaic kind—the U.S. steel industry filed another antidumping allegation against China in early January—were already intense. And that's not Beijing's only problem. China's trade relations with the E.U.—the country's biggest trading partner—are even worse than they are with Washington, because in a period when the U.S. dollar has been weak against the euro, China's de facto peg of the renminbi to the dollar has put excruciating pressure on many European companies trying to compete with Chinese producers.

Nobody ever said managing China's rise was going to be easy, not for Beijing and not for the rest of the world. There's never a good time for a trade war, but absolutely no one—Beijing, Washington, Brussels—can afford one now. Someone's got to reconvene the grown-ups' table. ■

helps foreign businesses navigate the China market, puts it, "Beijing's attitude is, My house, my toys, my rules."

An Emerging Backlash

THAT PERCEPTION HAS BEEN SHAPED IN part by some high-profile incidents last year. Many foreign companies were (and remain) stunned by the 2009 arrest of four executives from Rio Tinto, the minerals company, about a month after the Anglo-Australian giant decided not to accept a \$19.5 billion investment from China's state aluminum company, Chinalco. Beijing insists the case against the men revolves around commercial bribery allegations, and has nothing to do with the Chinalco deal. But the widespread belief among foreign businesses is that the case represents little more than a fit of pique from jilted Chinese authorities.

Or consider antitrust regulation. In 2008, Beijing put into effect a muscular new antimonopoly law that, while in many ways an improvement over what had existed before, allows the state to protect "national brands." The Ministry of Commerce later blocked Coca-Cola's proposed acquisition of a well-known juice company called Huiyuan. The ruling befuddled independent lawyers who had looked at the proposed merger. Competition-wise, "this would not have [negatively] affected the nonalcoholic-beverage market at all," says Michael Gu, an attorney at the Zhong Lun Law Firm in Shanghai. Coca-Cola executives were privately shocked. The company, before the ruling, had unveiled a \$90 million "global technology and innovation center" in Shanghai and committed to invest \$2 billion in China over the next three years.

Global Business

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Carnival of delights An English painting of a frost fair on the Thames in the winter of 1683-4

GLOBAL ECONOMY

A Changing Order. At this year's Davos, the U.S. seemed troubled, China confident, and Nicolas Sarkozy fire-breathing

BY MICHAEL ELLIOTT

WORLD
ECONOMIC
FORUM

ON THE AFTERNOON following the close of the annual meeting of the World Economic Forum in Davos, Switzerland, the town starts to return to normal. Local children, bundled up against the cold, play in the snow; a man who a few days ago was managing tables in a fronti-

cally busy restaurant runs up the Thomas Mann Weg, a steep path that I have trouble walking down; ski boots appear outside hotel bedrooms; tour guides are overheard describing the best runs to new arrivals. And on their way to Zurich and flights home, some of them dozing, some of them nursing sore heads, those who have spent the last week in this alpine valley try to make sense of what they've heard.

They won't all come to the same conclusions; at Davos, there are too many competing attractions for that. "My London is not your London," the novelist Paul Theroux once wrote, "though everyone's Washington, D.C. is pretty much the same." Davos is a London, not a Washington, so take my sense of what happened there at a discount of your choosing. That said, this is Davos, perhaps the only place on earth where packed crowds jostle outside a room—"Just like English soccer fans," said Robert Hormats, U.S. Undersecretary of State for Economic Affairs—to hear six academics and George Soros muse on the need to "rebuild economics." The dismal science, and its real-world applications in the global economy, are properly at the heart of the week.

As to that central topic, the overwhelming mood at Davos was one of relief. After the financial crisis took hold in the fall of 2008, the world did not sink into a miasmic depression, though more than one senior official present thought it had come very close. Massive and coordinated fiscal stimuli and efforts to prop up global banking systems averted the worst. But nobody, at least from the developed world, thought the crisis was over. The key sound bite of the week was provided by Larry Summers, the director of President Barack Obama's National Economic Council. The U.S. and other leading economies, Summers said, were experiencing a "statistical recovery and a human recession." Unemployment, especially in the U.S., remains intolerably high; 1 in 5 men of prime working age in the U.S., Summers noted, were unemployed; in the mid-1960s, the figure was 1 in 20.

More than that, there were few voices arguing that the rich world would see a sustained burst of growth, the kind of expansion needed to make the recession a dim memory and bring jobs aplenty. There was something of a consensus that the stimulus packages that have fueled the



'By prioritizing short-term logic, we have paved the way for our entry into a time of scarcity.'

—NICOLAS SARKOZY,
PRESIDENT OF FRANCE

economy can't be scaled back too soon—that way lies the dreaded double-dip recession—but at some point, enormous deficits will have to be addressed, and the belt-tightening that implies will have an impact on social expenditures.

That looming reality in turn fed a sustained anger at those who made out like bandits during financial capitalism's glory days. Certain "indecent behaviors will no longer be tolerated by public opinion," said French President Nicolas Sarkozy in a fire-breathing opening address, saving particular scorn for "excessive profits" and "remuneration packages that bear no relationship to merit." Worse, according to some, was the fact that some of those who once enjoyed those fat paychecks have had to be bailed out at the taxpayer's expense. "People are outraged and angry," said Philip Jennings, general secretary of the international labor union UNI, "that taxpayers' money has been diverted from education, health and social safety nets to bankers."

The Senate of Lords

AH, THE BANKERS. NOT ALL OF THEM turned up—no Jamie Dimon of JPMorganChase, no Lloyd Blankfein of Goldman Sachs. In public, those who did mostly

repeated the standard line, with which investigating committees have become familiar. They understand why people are angry; they recognize that something went wrong with the global financial system; they see that there has to be a fresh look at regulatory structures; they get it.

But I'm not sure that they do. Perhaps the most authentic insight into the banking mentality came in a comment made by Josef Ackermann, the CEO of Deutsche Bank. "Seldom," he said, in a line with Churchillian echoes, "have so few done damage to so many." By "so few" he meant the financial institutions who had either failed or been rescued by government action. But by "so many" he did not—as you might think—mean taxpayers or those who had lost their jobs in the economic downturn; he meant other bankers whose reputation had been unfairly sullied. More than once in private (many of the most interesting comments on Davos, one should say, are off the record) I was assailed by bankers whose message was, in essence "We did everything right; it was *they* who are to blame."

At one level, that reaction is understandable. It must indeed be irksome if you work honestly for an institution of which you're proud, which has oiled the wheels of capitalism with credit, only to be pilloried for your pains. The point even "good" bankers miss, I think—especially American ones, who take refuge in the bedrock conviction that the politics of envy doesn't play in the U.S.—is those "remuneration packages that bear no relationship to merit" of Sarkozy's speech. Many in the financial-services industry, good, bad or indifferent at their jobs, got as rich as Croesus in the last 20 years, at just the time when middle-class wages have stagnated. They can't really be surprised that those who have not done as well as bankers now want their pound of flesh; nor does it suffice to dismiss public ire at the bankers' good fortune as nothing more than (dread word) "populism."

That term was heard a lot in Davos, sometimes in reference to the new proposals for banking reform that Obama, with Paul Volcker by his side, had announced just days before the meeting began. Summers apart, there were few top American officials present in Davos this year. But the state of the U.S. political system was a constant theme of pub-

lic and private meetings. The proximate cause of the chatter was the loss of the Democrats' supermajority in the Senate as a consequence of the Massachusetts special election, but it went deeper than that. Whether discussing climate change, or regulatory reform, or progress on trade issues—bilateral as well as multilateral—delegates worried about an institutional paralysis in the U.S., and a political system that had got so gummed up that it was hard to get anything done. It wasn't just non-Americans who voiced such concerns. When, at a BBC debate, I asked Barney Frank, chairman of the House Committee on Financial Services, about the chances of getting financial-services reform through Congress this year, he said he thought such legislation would pass into law. But Frank made no bones about the state of Washington or the impact of the supermajority rule in the Senate. "We are suffering a constitutional crisis in the U.S.," Frank said. "To some extent, we are England in 1910 before they reformed the House of Lords."

The Two Faces of China

IF THE U.S. WERE SWEDEN, WORRIES ABOUT the health of its political system would be an interesting topic for a Ph.D. thesis. But the U.S. is the U.S.—the nation without which no item on the global agenda can be addressed. Its internal political difficulties spill outside its borders, affecting those far away. Moreover, there was a clear sense in Davos that just when the U.S. is looking like a hobbled power, a rival is galloping along. In Britain after 1945 it was common to hear that such and such a man—Denis Healey, say, or Ian Fleming—had had a "good war." China has had a good crisis. Buoyed by spectacular economic growth, basking in its role as America's banker, modernizing its infrastructure at sci-fi speed, a large Chinese delegation arrived at Davos expecting—one assumes—to have a good conference.

They did, sort of. There was a self-confidence to the Chinese in Davos I have never seen before. Immediately outside the conference hall, a chalet which in the old days had been the headquarters of Sun Microsystems had been taken over by CCTV, China's state broadcaster. Inside, young journalists, dressed as if they were ready to hit one of Beijing's smarter nightclubs, poured tea and took photographs



'It is critical that we rein in the budget deficits we've been accumulating for far too long.'

—LARRY SUMMERS, HEAD OF PRESIDENT OBAMA'S NATIONAL ECONOMIC COUNCIL

of their interviewees. Yet that strange defensiveness that so often typifies official Chinese interventions in international arenas was on display, too. Vice Premier Li Keqiang, a member of the Standing Committee of the Politburo, and the man who is expected to be China's next Premier (the second-ranking position in the leadership) gave a long speech at a plenary session and said... not very much. The usual platitudes about China's growth strategy and commitment to peaceful development were trotted out. On the topics the audience turned up to hear—exchange-rate policy, Google—Li said nothing. As a Chinese friend lamented to me after the speech, it was hardly inspiring.

Why are China's leaders (with the exception, in my experience, of economic boss and former mayor of Beijing, Wang Qishan) so stilted when they address foreign audiences? Part of the reason, I think, is the confusion that flows from the fact that China projects itself internationally in two different styles. In the first, China's leaders—as Li did at Davos—never miss an opportunity to say that it is really just a big developing country, with massive challenges, regional disparities of wealth and hundreds of millions of poor people. It's

only just started to modernize; it shouldn't be asked to do too much. As Zhu Min, who recently moved from the Bank of China to become deputy governor of the central bank, pointed out, Britain took 150 years, and the U.S. 80, to develop the consumption-driven economy that comes from having a mass middle class. China's been going at it for only a quarter century.

One understands the point, even if it ignores the fact that pre-communist China was developing a middle class in the 1920s and '30s. But it's hardly the whole story. Plenty of business leaders—though not all, as a well-known European CEO emphatically told me—say that China, of late, has been tough as nails with investors. The China style they see is less that of a poor, developing country and more that of a bully. Beijing's unveiled warning on Feb. 2 that for Obama to meet the Dalai Lama "would damage trust and cooperation between our two countries, and how would that help the U.S. surmount the current economic crisis?" falls squarely into the second style of dialogue. Besides, developing country though it may be, China now has a position of great power in the global economy, and with that power comes responsibility—a responsibility that is not discharged by a nakedly mercantilist, cheap-currency economic policy, or by free-riding on an international system in which the U.S. carries a heavy load. There were some in Davos who thought the world has been too polite to China since the financial crisis took hold, and my guess is that the tone of Beijing's comments on the Dalai Lama will have added to their number.

Let's Get Together

FOR ALL THAT, IT WAS GOOD TO HEAR FROM senior non-Chinese finance officials how impressed they are by the professionalism of their counterparts in Beijing. One very clear impression with which I left Davos was that since the crisis broke, coordination between finance-ministry officials, central bankers and leaders of the international financial institutions has been sustained and effective. (Though I would bet the price of a Swiss watch that not a single non-American official was given advance warning of Obama's adoption of the Volcker rule for bank regulation.)

It's easy to be cynical about the need for international coordination of policy,



Out of the valley This year, conference goes in Switzerland discussed how to achieve a better balance between growth and stability

especially at the WEF, which exists in part to advance that very thing. "At the World Economic Forum," said David Rubenstein of private-equity firm the Carlyle Group, "you should always say, yes, multilateralism is possible and we should come together. But getting national solutions is hard enough." This, though, is one of those moments when cynicism should not determine policy. It really is important that international coordination continue as the world moves from recession into recovery—coordination on when stimulus packages are unwound, on exchange rates and on legal reform, so that banks do not play a game of regulatory arbitrage between different supervisory regimes.

The process of coming to international agreement on policy is bound to be a messy affair. Sarkozy called for "a new Bretton Woods" and promised to place the "reform of the international monetary system on the agenda" when France chairs the G-8 and G-20 in 2011. But I don't think that's going to happen. The unhappy outcome of the Copenhagen summit on climate change last December has soured many observers on the (always foolhardy) hopes for big-bang solutions to complex global problems. Tim Wirth, president of the United Nations Foundation, told me that we were moving into a world of "ad-hocery" in international affairs, with various coalitions of nations coming together to sort out economic, political and environmental issues. That may not satisfy the desire for institutional neatness and clarity that is so marked in Paris, but it's not the end

of the world. So far, the G-20—which few had heard of two years ago and which still doesn't have a full-time secretariat—has performed remarkably well.

Davos wasn't all about the economy, and China, and the G-20, of course; it never is. Often wrongly dismissed as nothing more than a gabfest for fat cats, the annual meeting has, in the last 10 years, become a focus for global philanthropic efforts, epitomized this year by Bill Clinton's call for a long-term commitment to rebuilding Haiti (when he's there, the Davos crowd can feel like Clinton's extended family), the Gates Foundation's pledge of \$10 billion to develop vaccines, and Ukrainian mogul Victor Pinchuk's annual philanthropy summit. This philanthropic thrust of Davos may turn out to be one of the most enduring legacies of Klaus Schwab, the WEF's founder and executive chairman.

And there was fun to be had, too. With the football World Cup—the global event beyond all others—due to start in just a few months, an enormous South African delegation took over the town. There have been other nations that have used Davos to "brand" themselves, but—from the

ubiquitous scarves in South African colors, the music at the closing night's party, and a screening of Anant Singh's wonderful film *More Than Just a Game*, about the football played by political prisoners on Robben Island—none have ever done so much with such brio as the South Africans. The "Davos kickoff" of the World Cup, when a collection of luminaries (including Schwab) lined up in South African football shirts and blew vuvuzelas was quite simply the most joyous moment I have ever seen on the main Davos stage—and, thanks to a perfectly judged short speech by Trevor Manuel, Minister in the Presidency of the South African government, one of the most moving, too.

As it enters its 40th year—the event started as the European Management Forum in 1971—Davos can expect to continue to be overanalyzed, as it has been for years. Whatever you hear, remember that it's not just about economics, it's not a plutocrats' paradise (as anyone who has stayed in a certain type of Davos hotel knows), and it's not a weeklong party. I think of its winter charms, rather, as akin to those that London's frost fairs must have had in the 17th century, when the Thames froze solid and countless stalls were set up on the ice with hot pies, fortune tellers, dancing bears and a hundred other attractions. We really need a latter-day Bruegel to paint Davos, and a diarist as great as Pepys to write about it. But for that, I fear, we will have to wait for more than another 40 years.—WITH REPORTING BY BARBARA KIVIAT/DAVOS

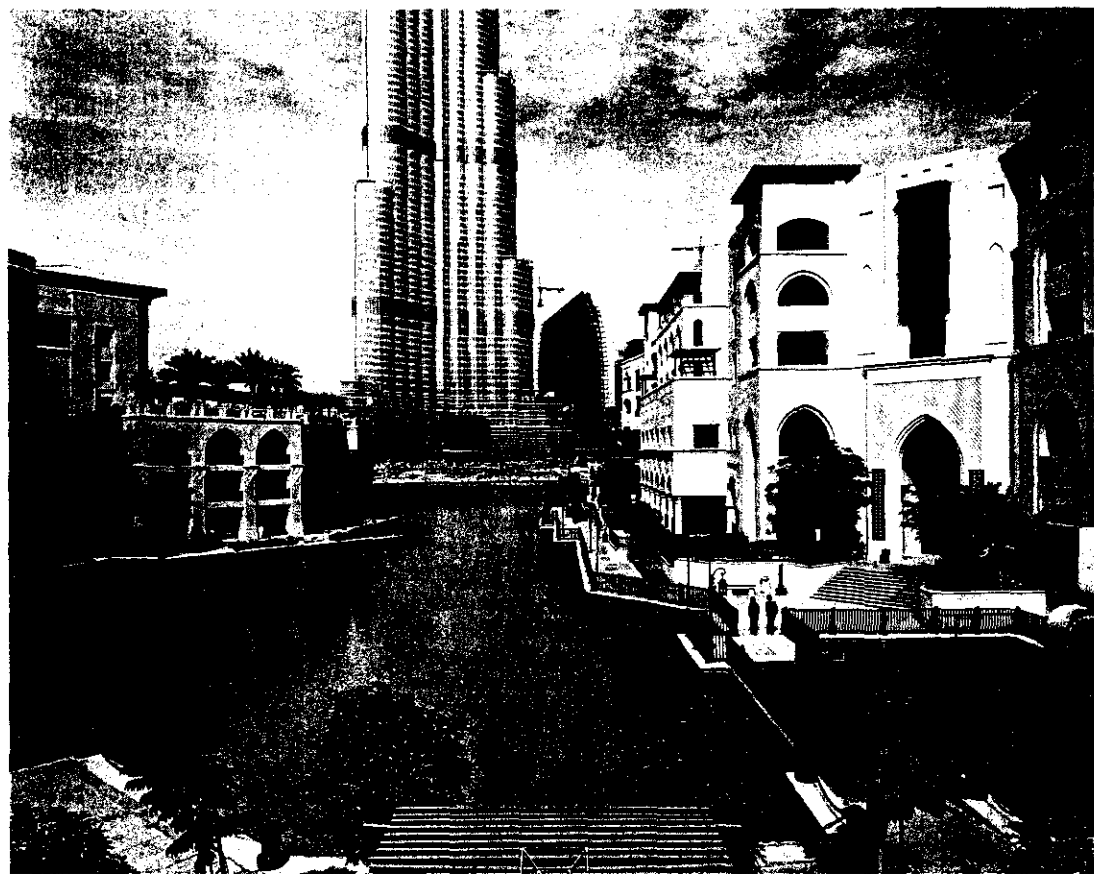
'We are suffering a constitutional crisis in the U.S. To some extent we are England in 1910.'

—BARNEY FRANK, CHAIRMAN OF THE U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

Bissell lays out India's problems
in devastating detail and
suggests ways to fix them
JYOTI THOTTAM ON MAKING INDIA WORK

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Wonderland
Dubai's huge
developments
helped fuel
the property
bubble

ARABIAN GULF

The Lessons of Dubai. As the glitz capital of the Middle East begins to pull itself out of its hole, neighbors look and learn

BY ANDREW LEE BUTTERS/DOHA

IF THE RULERS OF DUBAI CRINGE AT THE bad publicity the emirate city-state has copped since its go-go economy burst in 2008, they have only themselves to blame. After all, it was they who courted the media glare in the first place. Little more than empty desert a generation ago, Dubai had no logical reason to build a Manhattan-style skyline, let alone the world's tallest

building. No reason, that is, except the kind of grandiose ambition that turned what was a backwater into one of the world's most dynamic cities.

When construction began on the Burj Dubai—as the record-breaking tower was originally called—Dubai was in the midst of an epic boom, fueled by foreign speculators and one luxury development project after another. By the time the tower opened on Jan. 4 with a lavish fireworks display,

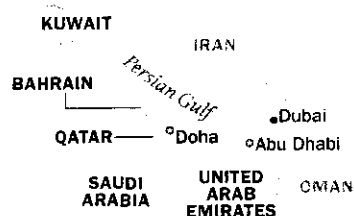
though, the showmanship had faded. Weeks earlier, Dubai's biggest state-owned development company had declared it was unable to pay its debts. Officially, Dubai owes its creditors \$80 billion, though a recent report by regional investment bank EFG-Hermes estimates that the city may be in the hole for as much as \$170 billion. After Sheik Khalifa al-Nahyan, the oil-rich ruler of neighboring Abu Dhabi, stepped in with \$10 billion to stave off an embarrassing

default, the skyscraper's owners changed the building's name to Burj Khalifa. For a city used to grand statements, it was a remarkable comedown.

In all the panic, finger-pointing and schadenfreude that has ensued, though, it's easy to forget that the gulf is more than just Dubai. Neighborhood rivals—some of them much wealthier than Dubai thanks to much bigger oil and gas deposits—have emerged from the financial crisis in better shape than their badly bruised neighbor. The gulf region is poised not only to recover from the global slump this year, but could become the second most important center of world economic growth after the economies of east and south Asia, according to John Sfakianakis, chief economist for Banque Saudi Fransi in Riyadh and Crédit Agricole in Paris. "The world has always been too focused on Dubai, but Dubai is not the GCC," he says, referring to the Gulf Cooperation Council, a loose political and economic union of gulf nations. "In the short term, Dubai's problems may impact how the world sees the region. But over the long term, the region has and will show a tremendous amount of growth."

Among those best placed to profit from the recovery—and from Dubai's mistakes—is Qatar. While Europe and the U.S. are still struggling for growth, it's almost business as usual in Doha, the capital. Just ask Kevin Lamb, assistant dean of Carnegie Mellon Qatar. Located in Education City, a gleaming new complex under construction on the outskirts of the capital, his school is one of six American universities that have set up shop in the country over the past few years. Thanks to the deep pockets of the Qatari government, Lamb has more space in the college's new building than he knows how to use. "It's an administrator's dream," he says. Or ask Oliver Watson, director of Doha's new Museum of Islamic Art. Unlike most museum heads around the world, Watson hasn't had to ask for a penny to build or run the magnificent I.M. Pei-designed museum on Doha's waterfront. "We haven't felt the financial crisis at all," he says.

It helps that Qatar sits on a massive natural gas field. The country is the world's third largest producer of natural gas, behind Russia and Iran and, with a population of just 1.5 million, has one of the highest per capita incomes in the world. That wealth has allowed Qatar's rulers to chart a pragmatic and flexible foreign policy that has them making friendly with Iran and Syria while hosting American



A Growing Gulf

As the onetime boom city of Dubai struggles, neighboring states hope they can do a better job of balancing growth and stability. A snapshot of a region in the midst of change:

DUBAI

SIZE OF ECONOMY: \$82 billion
MAIN EARNERS: Real estate, trade, financial services, tourism
POPULATION: 1.8 million
SOCIETY: Relatively open
KNOWN FOR: The world's tallest building, indoor skiing, palm-shaped islands

ABU DHABI

SIZE OF ECONOMY: \$141 billion
MAIN EARNER: Oil and natural gas
POPULATION: 1.75 million
SOCIETY: Conservative
KNOWN FOR: Proposed Louvre and Guggenheim branches, bailing out Dubai

QATAR

SIZE OF ECONOMY: \$53 billion
MAIN EARNER: Natural gas and oil
POPULATION: 1.51 million
SOCIETY: Conservative
KNOWN FOR: Arabic television network al-Jazeera, I.M. Pei's Museum of Islamic Art, Education City, U.S. military bases

SAUDI ARABIA

SIZE OF ECONOMY: \$468 billion
MAIN EARNER: Oil
POPULATION: 26.2 million
SOCIETY: Strict
KNOWN FOR: Birthplace of Islam, world's largest oil exporter, ban on female drivers

BAHRAIN

SIZE OF ECONOMY: \$16 billion
MAIN EARNER: Oil, banking
POPULATION: 807,000
SOCIETY: Relatively open
KNOWN FOR: Play spot for Saudis

KUWAIT

SIZE OF ECONOMY: \$112 billion
MAIN EARNER: Oil and natural gas
POPULATION: 3.1 million
SOCIETY: Conservative
KNOWN FOR: Strong ties to the U.S.

military forces. Now the country wants to become a regional cultural and media hub. Last year Qatar hosted a version of the Tribeca Film Festival, while private investors put together a \$200 million fund to jump-start the local film industry. While there have been some cutbacks on salaries and benefits at state-run news network al-Jazeera, according to disgruntled employees, the operation continues to set the news agenda across the Middle East.

Some of Qatar's development play-book—eye-catching modern architecture, a well-run state-owned airline—has clearly been copied from Dubai. Qatar also benefits from a pool of skilled foreign workers, many of whom moved there after first working in its glitzier rival.

Still, Qatar insists it is not trying to become the next Dubai. Emir Hamad bin Khalifa al-Thani, Qatar's ruler, doesn't want to make his country a global capital, so much as use his nation's gas resources to move what was once a tribal, Bedouin society into the modern world with Muslim culture and values intact. Qatar, say state officials, will never try to do the kind of high-volume business that put Dubai on the map but also made it so vulnerable to a speculative bubble. "Dubai is all about numbers and bringing in huge infrastructure projects," says Stuart Pearce, head of the Qatar Financial Centre. "When investors look at Qatar they see stability. Doha doesn't have a whole lot of office buildings that it needs to fill."

Other countries in the gulf are spinning the same line: cherry-picking the best of Dubai while avoiding the worst. Saudi Arabia, the region's behemoth, has ambitious plans for new development, and Riyadh, its capital and biggest city, is bound to host the central bank for a proposed future gulf single currency. But for all its shopping malls and skyscrapers, Riyadh will never be the region's financial center so long as there is no place for investment bankers to celebrate their deals by popping champagne corks. Most global professionals don't want to live in a country where alcohol is illegal and women can't drive. Despite its present problems, they're more likely to stick with Dubai, which launched a \$1 billion financial-services center in 2004, and where you can openly practice whatever faith you choose, including nightclubbing.

Kuwait may be less conservative than Saudi Arabia, but its ban on alcohol is also a major stumbling block to becoming a tourism and professional services hub.



Bahrain—another of Dubai's challengers in financial services—has a thriving banking industry and the most ethnically and religiously diverse local population in the gulf. But its tolerant feel is threatened by tensions between the elite Sunni minority and the less powerful Shi'ite majority, as well as Islamist political parties that have benefited from the kingdom's tentative experiments with democratic elections.

And then there's Abu Dhabi, capital of the United Arab Emirates. Dubai's staid big brother has re-exerted political and financial control over its profligate sibling, mostly because it has an interest in Dubai's success. Dubai's port and airport are among the largest in the world, and serve the UAE's economic needs without Abu Dhabi—a 45-minute drive away—having to expand its own infrastructure.

The truth is, the unelected leaders of the Middle East have been happy to learn from Dubai's successes and failures without having to take such risks themselves. In part, that's because Dubai is not more but less politically free than other places in the region. Sheik Mohammed al-Maktoum, the Emir of Dubai, is able to take daring risks not just because he is a hereditary ruler, but because he is unaccountable to the vast majority of Dubai residents, 95% of whom are foreign and who live in Dubai subject to his favor. Other places in the gulf have larger native populations, or more active national assemblies than Dubai. While rulers in those places are

Study time Six U.S. universities have satellite campuses in Qatar's state-built Education City

no doubt authoritarian, they still have to tread more carefully with public opinion, or at least the opinion of the conservative religious, military and business circles that keep them in power.

But Dubai's rulers know change is coming. No longer wowed by shopping malls with indoor ski slopes or hotels with gigantic aquariums, investors have begun to demand transparency. Last month, Barclays won the city's first foreclosure case. That could open the door to a flood of legal cases and more financial turbulence, but will also reassure investors that Dubai is learning from its mistakes. To keep attracting foreign residents with the skills to run a modern economy—and to better educate its own citizens so they can play a bigger role in that economy—the gulf's cities will also have to open up more. Dubai could well lead the way. "Dubai has been proving naysayers wrong for so long that I'm wary of being pessimistic," says Jim Krane, author of *City of Gold: Dubai and the Dream of Capitalism*. "It's certainly in a deep hole. [But] the entire world has a stake in its success."

Progress will be slow. A recent government reshuffle has moved power away from technocratic experts and outside consultants, and back into the hands of the royal family, especially the crown

prince, Sheik Hamdan. But without oil money of its own, Dubai has little choice but to listen to its foreign creditors and stakeholders. And wealthy as they are, the leaders of the gulf countries also know their societies have to eventually change too, says economist Sfakianakis. Oil generates wealth, but the oil industry doesn't generate many jobs. Even in rich Saudi Arabia, unemployment is officially 11.6%—and that's among men only. Some 65% of the population in the broader Middle East is younger than 30. For the region's governments to create jobs for all those young people, they will have to continue opening up to the private sector, foreign investment, and perhaps edge toward democracy. "The attraction of Dubai to the other Middle Eastern countries was a state model of development without democracy, but that's not sustainable anymore," says Krane. "You may see some kind of compromise in Dubai, a renegotiation in the relationship between the ruler and the people, where the government develops some kind of tax, in exchange for giving the people a larger voice."

That won't happen easily. This week the owners of Burj Khalifa indefinitely closed its observation deck, the highest in the world, due to unspecified electrical problems. Like Dubai itself, the problem will, eventually, be solved. And the view then, say the city's boosters, will be fantastic. —WITH REPORTING BY MARIA ABI-HABIB/DUBAI