



Institute of Strategic and International Studies (ISIS) Malaysia

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

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Toward Fairness

China and ASEAN look forward to a rosy future at the start of a new decade following the scheduled establishment of a free trade area

By CHEN RAN

How can countries ensure a fair business environment in the free trade area (FTA) between China and the Association of Southeast Asian Nations (ASEAN)? The question triggered wide discussion among participants at a forum on the China-ASEAN Free Trade Area (CAFTA) held on January 7-8 in Nanning, capital of southwest China's Guangxi Zhuang Autonomous Region.

With the theme of "win-win results and greater success," the event, proposed by Chinese Premier Wen Jiabao at the 12th China-ASEAN Summit in October 2009, aimed at celebrating the establishment of CAFTA, which started operation on January 1. It also sought to explore closer cooperation in trade and investment, while helping create more business opportunities for the region.

More than 400 participants—including high-level government officials from China and ASEAN member states, experts and scholars, and representatives from the private sector—attended the forum.

Events held in conjunction with the forum included the launch of a China-ASEAN business portal website, the opening of the Qinzhou Free Trade Port Area and the Nanning Bonded Logistics Center in Guangxi, and a signing ceremony for 18 proj-

ects between China and ASEAN worth a total of \$4.89 billion.

CAFTA covers a population of 1.9 billion and involves about \$4.5 trillion in trade volume. It is the world's third largest FTA after the North American Free Trade Area (NAFTA) and the European Union (EU) and the largest FTA for developing countries.

Under the CAFTA, the average tariff on goods from ASEAN countries to China has been reduced from 9.8 percent to 0.1 percent. The six original ASEAN member states, namely Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand, have slashed the average tariff on Chinese goods from 12.8 percent to 0.6 percent. By 2015, the policy of a zero-tariff rate for 90 percent of Chinese goods is expected to extend to the four newer ASEAN members—Cambodia, Laos, Myanmar and Viet Nam.

Shared concerns

"The essence of CAFTA is to ensure that access to each other's markets is unhampered by any barriers, tariff and non-tariff alike," said Pushpanathan Sundram, Deputy Secretary General of ASEAN, at the forum's opening ceremony.

With the establishment of the CAFTA, the bigger challenge, according to Pushpanathan, would be for ASEAN and

China to "collectively ensure that there is a level playing field where all parties will benefit from the CAFTA."

But different countries have different situations. How to realize trade facilitation through the newly launched CAFTA in the wake of the global economic downturn was a top concern for forum participants.

"Trade facilitation is an attempt to reform trade policy; its critical principle is transparency," said Nipon Poapongsakorn, President of the Thailand Development Research Institute.

Increased speed and other trade improvements will significantly reduce trade costs, increase foreign direct investment, promote trade competition, boost small and medium-sized enterprises (SMEs), and reduce corruption among customs officials, he noted.

"Now the tariff is down," said Lim Jock Hoi, an official from Brunei's Ministry of Foreign Affairs and Trade. "We still have to address issues related to trade facilitation from a broader perspective, such as non-tariff barriers, standards, customs cooperation and others."

Lack of connectivity and infrastructure development was another concern among participants.

Transportation infrastructure is regarded as the backbone of regional development, but the level of regional infrastructure construction is relatively low in general due to the absence of an overall plan as well as insufficient funds and technology limitations, according to Hu Dongsheng, an analyst with the China International Engineering Consulting Corporation.

Djisman Simandjuntak, Chair of the Center of Strategic and International Studies in Indonesia, echoed Hu's view, saying that building up the prospective areas of expansion with competitive infrastructure is an immediate challenge for governments in China and ASEAN.



"Its level of integration may not be as deep and broad as that of NAFTA and the EU, but CAFTA succeeds in proving that a regional trading arrangement among developing countries is possible."

—Pushpanathan Sundram,
Deputy Secretary General of ASEAN

Learning the rules

"All the nations in CAFTA should actively promote trade facilitation, based on the trade agreements for goods and services that have already been reached," said Zhang Kening, an official from China's Ministry of Commerce. "The preferential policies in CAFTA should be transferred into real actions."

Both China and ASEAN must abide by the principles of CAFTA to "implement agreements and encourage enterprises in China and ASEAN to make better use of CAFTA," Zhang said in a statement at the end of the forum. He also called for active participation by CAFTA members to ensure the ongoing process of free trade delivers benefit to all countries involved.

As the only region in China that links with ASEAN member states both by land and by sea, Guangxi Zhuang Autonomous Region has served as a gateway to cooperation between China and ASEAN over the past

10 years, said Ma Biao, Chairman of Guangxi Zhuang Autonomous Region.

The region will fully capitalize on its geographic advantages to push forward China-ASEAN cooperation, Ma said.

It will accelerate the construction of comprehensive transportation networks and create platforms for free trade through events such as the China-ASEAN Expo, the China-ASEAN Business and Investment Summit and the Pan-Beibu Gulf Economic Cooperation Forum, he said.

While strengthening trade and investment cooperation with ASEAN, it will focus on improving sub-regional cooperation mechanisms such as the Great Mekong Sub-region Economic Corridor and the Nanning-Singapore Economic Corridor, he added.

Concerning possible solutions for the development of SMEs, Zhang Yunling, Director of the Institute of Asia-Pacific Studies under the Chinese Academy of Social Sciences, said the key for their success in coping with CAFTA is to study and understand the rules and make full use of them.

A recent survey showed that the percentage of enterprises implementing CAFTA is relatively low due to their lack of understanding of FTA rules and details. Hence the government should help them in this regard, Zhang said.

"Enterprises, SMEs in particular, should not see ASEAN as purely an export market," Zhang told *Beijing Review*. "They should study regional markets, set long-term goals and find their niches. Cooperation among enterprises will be more helpful than marketing alone."

Mirzan Mahathir, President of the Asian Strategy and Leadership Institute in Malaysia, echoed Zhang's views. Mahathir said that a lot of encouragement is required to get SMEs to "look beyond their national borders." ►►

China Denounces U.S. Arms Sales

China has urged the United States to respect its national interests by ceasing to sell weapons to Taiwan, said Chinese Vice Foreign Minister He Yafei.

His remarks came during a January 9 interview with Xinhua News Agency following Washington's final approval of two American military contractors to sell weapons to Taiwan. Their sales plan was part of an arms sales package announced under the Bush administration in October 2008.

"The U.S. arms sales to Taiwan seriously contravene the principles enshrined in the three Sino-U.S. joint communiqués—in particular the August 17 Communiqué—while undermining China's national security as well as peace and stability in the Taiwan Straits," he said. "China is resolutely opposed to this move."

The August 17 Communiqué, issued by China and the United States in August 1982, stated the United States would not seek to carry out a long-term policy of arms sales to Taiwan and that it would gradually reduce overall arms sales.

The Taiwan question has always been the "most important and sensitive issue at the core of China-U.S. relations," the senior Chinese diplomat added.

China, he said, hopes the United States will cooperate to advance bilateral ties—rather than damage them.

China and Africa

Chinese Foreign Minister Yang Jiechi visited five African countries—Kenya, Nigeria, Sierra Leone, Algeria and Morocco—as well as Saudi Arabia between January 5-14, as China and its African partners begin carrying out the joint initiatives that they agreed on more than two months ago.

China stands ready to implement the follow-up actions of the Fourth Ministerial Conference of the Forum on China-Africa Cooperation (FOCAC), along with FOCAC member states, Yang said at a meeting with Sierra Leone's President Ernest Bai Koroma.

At the FOCAC event held in early November 2009 in Sharm el-Sheikh, Egypt, Chinese Premier Wen Jiabao declared eight measures, including providing \$10 billion in concessional loans to African countries, to promote Sino-African relations.

During Yang's visit, Morocco announced its decision to recognize China as a market economy—a move the Chinese foreign minister believed would give impetus to trade between the two countries.

This was Yang's first foreign trip in 2010, the 20th consecutive year China's foreign minister has made his first trip of year to Africa.



ZHANG ALIN

1. SEALING THE DEAL: Chinese and ASEAN partners sign agreements on 18 projects worth a total of \$4.89 billion in Nanning on January 7

2. MORE CHOICES: Customers shop at the Wulitong Vegetable Wholesale Market in Nanning on January 1, the day the China-ASEAN Free Trade Area was officially launched

3. SHIFTING INTO HIGH GEAR: A cargo ship docks at a berth at the Qinzhou Free Trade Port in Guangxi. The port is the only free trade port in west China and the closest one to ASEAN member states



CELEBRATION: China and ASEAN member countries hold a ceremony to celebrate the establishment of the China-ASEAN Free Trade Area on January 7 in Nanning, capital of southwest China's Guangxi Zhuang Autonomous Region

"It is important to assist SMEs through incentives, concessionary funding and opportunities to network with potential partners so that they can make the changes necessitated by implementation of CAFTA," he said.

More work to do

Yi Xiaozhun, China's Vice Minister

of Commerce, said China's investment in ASEAN countries will rise rapidly as the global economy recovers and firms become more eager to go abroad.

"With full consideration of the economic development levels and market capacities of both sides, CAFTA will help advance regional economic integration by eliminat-

ing barriers to trade and investment," Yi said. "Both sides should make the most of investment funds and other resources while stepping up infrastructure construction to meet the needs of further trade cooperation."

"Its level of integration may not be as deep and broad as that of NAFTA and the EU, but CAFTA succeeds in proving that a regional trading arrangement among developing countries is possible as long as the parties are open, flexible, understand each other's sensitivities and have a strong political will to achieve the vision they have set for themselves," said ASEAN Deputy Secretary General Pushpanathan.

Subash Pillai, Director for Market Integration in the ASEAN Economic Community Department under the ASEAN Secretariat, said the Nanning forum gave participants an idea of what is in store for further collaboration between China and ASEAN.

"I believe the three agreements [i.e. agreements on trade in goods, trade in services and investment] under CAFTA are only the tip of the iceberg," he said. "There is a lot more we can do together." ■

(Reporting from Nanning, Guangxi Zhuang Autonomous Region. Watch video on CAFTA's inauguration at www.bjreview.com)

A Road to Free Trade

By LU JIANREN

The concept of CAFTA dates back to the Fourth China-ASEAN Summit in November 2000. At the summit, ASEAN member nations raised concerns that China's exports would be dramatically strengthened after it entered the World Trade Organization (WTO), thus threatening their interests, as the ASEAN economy was export-oriented.

To allay their concerns, Chinese leaders proposed the establishment of a free trade area between China and ASEAN to promote economic integration and mutual benefit. The two sides went on to establish an expert panel to research its feasibility.

In March 2001, the panel issued a report enthusiastically endorsing the move. Then, at the Fifth China-ASEAN Summit later that year, China and the 10 ASEAN member countries formally announced that they would jointly establish a free trade area.

In November 2002, the two sides signed the Framework Agreement on

Comprehensive Economic Cooperation. Thus the stage was officially set for progress. To enjoy the benefits of free trade sooner rather than later, both sides formulated an "early harvest program" in the agreement, as requested by ASEAN member countries.

Under the plan, all sides agreed to cut tariffs on some 600 products (mostly agricultural products) as of January 1, 2004. It was also pledged that tariffs on these products traded between China and the six original members of ASEAN members—Brunei, the Philippines, Indonesia, Malaysia, Thailand and Singapore—would be reduced to zero by 2006. In addition, Viet Nam announced it would eliminate all tariffs on the early harvest products by January 2008. Laos and Myanmar would go on to follow suit by January 2009, and, Cambodia, by January 2010.

In October 2003, China and Thailand began to implement the agreement they had signed on mutual exemption of tariffs on imported fruits and vegetables, as a prelude to CAFTA's early harvest program.

In November 2004, China and ASEAN signed the Agreement on Trade in Goods, regulating a cut in tariffs on about 7,000 other items beginning from July 2005; while adopting a fresh dual track

policy for newer ASEAN members—Viet Nam, Laos, Cambodia and Myanmar. At the same time, both sides signed the Agreement on Dispute Settlement Mechanism.

In January 2007, the two parties signed the Agreement on Trade in Services. In it, they promised to open bilateral trade at a level higher than that of the WTO in more than 60 different services sectors. In July of that same year, the agreement entered into force.

In August 2009, China and ASEAN signed the Investment Agreement, opening investment markets to each other. By then, the main legal frameworks of CAFTA had all been established.

Finally, on January 1, 2010, CAFTA became a full reality. China and the six original ASEAN member countries have slashed tariffs on more than 90 percent of traded goods to zero. China's average tariff on ASEAN goods has decreased from 9.8 percent in 2009 to 0.1 percent, while the six original ASEAN member countries' average tariff on Chinese goods has shrunk from 12.8 percent to 0.6 percent. The four newer ASEAN member states are, in turn, expected to achieve the goal of zero tariffs on 90 percent of Chinese goods by 2015. ■

Cashing In On Free Trade

The China-ASEAN Free Trade Area (CAFTA) is, of course, not a zero-sum game. Responding to concerns over escalating competition associated with free trade, ASEAN Secretary General Surin Pitsuwan said in a press release issued at ASEAN's official website on January 7 that CAFTA would help energize the economies of all parties by creating more opportunities for regional trade and investment. Edited excerpts follow:



CAFTA aims to bring the countries together in a mutually dependent and beneficial relationship in an increasingly borderless global environment. It signifies the beginning of a deeper dimension

in ASEAN-China trade relations. Its establishment also comes at an opportune time to boost regional recovery from the global economic crisis. China's phenomenal growth has had positive effects on ASEAN's own expansion.

China's economic growth and strong investment expansion are energizing the region and providing ASEAN with an expanding, diversified market in an environment of slowing growth in its tra-

ditional partners. The completed CAFTA gives ASEAN a strong edge in terms of lower tariffs and more open services opportunities coupled with investment expansion.

ASEAN has the capacity to be the supply chain for China's booming economy, which has been propelled by the gradual trade liberalization under CAFTA. The landscape of trade between ASEAN and China has changed in the last decade due also to fall in tariffs.

Records show trade between ASEAN and China grew by an average of more than 20 percent annually between 2003 and 2008, mainly in electrical and electronic products, fuel and fuel products, plastics, rubber and vegetable oils. Electrical and electronic products accounted for more than one third of

ASEAN exports to China, while machinery and equipment were close to one fifth of the total.

In addition, CAFTA positions ASEAN to take advantage of the next phase of China's growth, as its expanding middle-class consumption trends are expected to predicate the next wave of economic expansion. ASEAN also needs to organize and prepare itself in terms of a stable and hospitable investment climate, a well trained work force and improved logistics to take advantage of the new investment prospects arising from this next wave of China's expansion.

Although it is generally acknowledged certain industries will face competitive pressures in the transition of CAFTA, overall, the benefits from the growing trade between ASEAN and China would be translated into more jobs, more spending power and greater synergies between the two regions.

Greater governmental efforts may need to be expended to strengthen the capacity of domestic firms to compete, but this should be short-term, and does not remove the incentive to innovate and cut costs. There are also built-in mechanisms in CAFTA, such as safeguard actions in the face of serious injury to domestic industries. CAFTA has also been implemented gradually, and products located on the sensitive lists are only slated for later liberalization.

The momentum of free trade will provide greater encouragement for greater Chinese investment into ASEAN, particularly in transport and infrastructure. China has recently launched a \$10-billion infrastructure investment fund to improve road, railway, airlines and information telecommunications links between China and ASEAN.

It is also providing a \$15-billion credit facility to promote regional integration and regional connectivity. With China's global investment strategy just beginning to take off—and judging from the \$52.1 billion in FDI (foreign direct investment) outflows from China in 2008—there will certainly be more investments along the value chain in ASEAN.

There are adjustment pains, but weighing in the gains CAFTA is necessary for ASEAN to learn to weather competitive pressures so as to survive in an increasingly difficult, global economic environment.

If history is to judge CAFTA, its capacity to add greater value to all parties' economic development will ultimately weigh in its favor. ■



ONWARD AND UPWARD: An exhibitor showcases Burmese handicrafts at a China-Myanmar border trade fair in Muse, Myanmar, on December 18, 2008

A New Asian Alliance

The inauguration of the China-ASEAN Free Trade Area caps 10 years of fruitful efforts

By LU JIANREN



It was not only the birth of a new decade. January 1 also witnessed a day of celebration on the mainland and beyond after Beijing and its partners in the Association of

Southeast Asian Nations (ASEAN) fully established the China-ASEAN Free Trade Area (CAFTA).

Covering an area of 14 million square km and encompassing a population of some 1.9 billion people, CAFTA has emerged as the world's most populous free trade area (FTA). This is underscored by statistics such as its GDP of \$6 trillion, and trade volume of \$4.5 trillion.

Successful beginnings

In all, it took a mere decade from the conception of CAFTA to its final completion. This, however, is hardly unheard of when it comes to setting up an FTA living up to World Trade Organization (WTO) requirements with only two members.

Nevertheless, forging a free trade alliance of 11 members with different economic levels in 10 years is still something truly remarkable. More importantly, CAFTA is a large FTA that conforms to WTO regulations while featuring a perfect integration of free trade in goods and services and investment liberalization. This represents only one more reason to make this progress one worth learning from.

Not surprisingly, it is no secret that CAFTA's biggest significance lies in its promotion of bilateral trade between China and ASEAN.

Since the China-ASEAN Agreement on Trade in Goods came into effect in 2005, according to China's Ministry of Commerce, China has leapt from being ASEAN's sixth largest trading partner to its third largest trading partner. ASEAN, meanwhile, has stood as China's fourth largest trading partner for many consecutive years.

In fact, bilateral trade volume rose to \$231.1 billion in 2008, up from \$78.2 billion in 2003, representing an average annual

growth rate of 24.2 percent.

Under even the greatest strains from the global financial crisis, the fall of China-ASEAN trade volume was far lower than that between China and other regions and nations. Within the first three quarters of 2009, the China-ASEAN trade volume was still close to \$150 billion.

These figures have decisively demonstrated CAFTA's resilience and leadership in the face of the financial crisis. China's huge import market, for one thing, notably eased economic recessions among ASEAN member states resulting from shrinking demand for foreign exports.

Indeed, the establishment of CAFTA has also accelerated the bilateral investments between China and ASEAN.

Since China and ASEAN officially began to negotiate an FTA in November 2002, bilateral investments have surged. By the end of 2008, ASEAN's actual investments in China had hit \$52 billion, accounting for 6 percent of the total foreign investment volume in China.

In recent years, Chinese business giants have been eager to establish an international presence. Since the China-ASEAN Investment Agreement was signed in 2009,

they have increasingly regarded ASEAN nations as destinations for foreign direct investment. In 2008, China's direct investment in ASEAN reached \$2.18 billion—up by 125 percent from the previous year.

Beyond this, CAFTA intends to help reduce poverty, which, as of now, is a serious regional problem, among all member countries. Income disparities between urban and rural areas, coupled with inadequate development, are prevalent in many countries in the region.

CAFTA plans to address these inequities with tariff reductions on agricultural exports and imports. The growth of trade in fruits, vegetables and meat will lead to the development of agriculture and animal husbandry. CAFTA is also expected to help boost the economic growth of its member states, thus enabling them to devote more resources to poverty alleviation.

Moreover, CAFTA will seek to promote further integration within the East Asian region. It has thus far directly stimulated the development of the Japan-ASEAN FTA and the South Korea-ASEAN FTA. It has additionally inspired efforts to seek an FTA between China, Japan and South Korea, as well as an FTA for greater East Asia.

The success of CAFTA's establishment speaks to the quality of its innovation. Its "early harvest program," for example, deals with agriculture, the most contested area in free trade negotiations. But from the beginning, Chinese officials proactively planted seeds for cooperation. "Let the ASEAN countries pick the peaches first," was a remark heard more than once from Chinese negotiators.



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Agricultural exports have proven highly competitive among many less-developed ASEAN countries. Thus, the "early harvest program" has enabled them to benefit first. Now, not only has the program been learned and applied by many other FTAs, it has also been used in the Doha Round negotiations of the WTO.

Another innovation has included a two-track approach to states relative to their levels of economic development. As the 10 ASEAN nations differ dramatically in terms of their economic prosperity, in other words, CAFTA has adopted two timetables. The slower track will be offered to the four less developed countries — Viet Nam, Laos, Myanmar and Cambodia. They can enjoy a transitional period of three to five years.

Incremental steps have been a plus, too. This began through gradual tax cuts in trade in goods, to the progressive opening up of the services market, followed by the step-by-step liberalization of investments. Companies in CAFTA member countries, meanwhile, are accepting the opening of the market in a gradual, calibrated way.

There can be no question this new arrangement will benefit both sides. China and ASEAN member countries are mostly developing countries; thus CAFTA does not represent the interests of one country over any other member nations. This is, by far, one of the most unique aspects to this particular FTA.

A bright future amid challenges

But CAFTA naturally has its shortcomings. The most prominent is that ASEAN countries' trade with China will revert from a surplus to deficit. For many years, ASEAN

Trade between China and ASEAN rose to \$231.1 billion in 2008, up from \$78.2 billion in 2003, representing an average annual growth rate of 24.2 percent

nations have maintained huge trade surpluses with China. These have generated increases in employment and foreign exchange reserves in ASEAN countries. With the acceleration of tariff cuts within CAFTA, however, this advantage is disappearing.

From January to October 2009, ASEAN enjoyed a trade surplus of \$940 million to China — a sharp drop compared to \$6.28 billion during the same period in 2008. In addition, it is believed Beijing will soon turn to trade surplus in its trade with ASEAN. Its competitive manufactured goods will be exported to ASEAN in large numbers thanks to the zero-tariff policy in CAFTA. At the same time, Chinese companies will soon get familiar with and make full use of CAFTA's preferential policies.

As a result, ASEAN officials have begun to worry about trade imbalances. Big changes in trade volume may also lead to trade remedy measures and non-tariff barriers, with disputes following.

Another challenge includes addressing concerns by some ASEAN countries that they will not be able to weather many aspects of CAFTA. Associations of some industries in Indonesia, for example, have requested that the government delay the implementation of CAFTA's zero-tariff policy. They voiced fears that the influx of cheap Chinese goods would deal a heavy blow to industries including textiles, clothing and shoes — industries that flourish in the archipelago nation.

On the other hand, some vulnerable industries in China will also suffer from impacts. In fact, every FTA brings opportunities as well as challenges. Only those adaptable can survive, though measures should be implemented to offset negative impacts as much as possible.

The last major challenge is how to turn a potentially big market into a burgeoning market. Although CAFTA has a collective population of nearly 2 billion, the per-capita income of many countries remains quite low. Domestic demand will not increase unless people get richer through the free market.

Also, China, Indonesia, the Philippines, Viet Nam and other CAFTA members all possess sizeable surpluses in their labor forces. This factor has challenged the ability of employers and governments to increase incomes and, thus, generate spending power.

There are other problems of course. But thus far, the completion of CAFTA has been a success, and will likely do far more good than harm, in both the short term and the long term. Indeed, as long as China and ASEAN countries work in concert, the future looks bright. ■



(Left)
A RIVER RUNS THROUGH IT:
Local business people load goods ashore from Viet Nam in a border trade zone in Dongxing, Guangxi, on January 1

CUSTOMARY WORK:
Chinese workers and entrepreneurs queue for customs inspection in Dongxing, Guangxi, on January 1, before travelling on to neighboring Southeast Asian countries

MANIA ON THE MAINLAND

Think the U.S. real estate bubble was bad? China's could be worse

By Dexter Roberts

BEIJING

Li Nan has real estate fever. A 27-year-old steel trader at China Minmetals, a state-owned commodities company, Li lives with his parents in a cramped 700-sq.-ft. apartment in west Beijing. Li originally planned to buy his own place when he got married, but after watching Beijing real estate prices soar, he has been spending all his free time searching for an apartment. If he finds the right place—preferably a two-bedroom in the historic Dongcheng quarter, near the city center—he hopes to buy immediately. Act now, he figures, or live with Mom and Dad forever. In the last 12 months such apartments have doubled or tripled in price, to about \$400 per square foot. “This year they’ll be even higher,” says Li.

Millions of Chinese are pursuing property with a zeal once typical of house-happy Americans. Some Chinese are plunking down wads of cash for homes: Others are taking out mortgages at record levels. Developers are snapping up land for luxury high-rises and villas, and the banks are eagerly funding them. Some local officials are even building towns from scratch in the desert, certain that demand won't flag. And if families can swing it, they buy two apartments—one to live in, one to flip when prices jump further.

And jump they have. In Shanghai,



DOUG KANTER/THE NEW YORK TIMES/REDUX



prices for high-end real estate were up 54% through September, to \$500 per square foot. In November alone, housing prices in 70 major cities rose 5.7%, while housing starts nationwide rose a staggering 194%.

The real estate rush is fueling fears of a bubble that could burst later in 2010, devastating homeowners, banks, developers, stock markets, and local governments. "Once the bubble pops, our economic growth will stop," warns Yi Xianrong, a researcher at the Chinese Academy of Social Sciences' Finance Research Center. On Dec. 27, China Premier Wen Jiabao told news agency Xinhua that "property prices have risen too quickly." He pledged a crackdown on speculators.

UNAFFORDABLE PRICES

Despite parallels with other bubble markets, the China bubble is not quite so easy to understand. In some places, demand for upper middle class housing is so hot it can't be satisfied. In others, speculators keep driving up prices for land, luxury apartments, and villas even though local rents are actually dropping because tenants are scarce. What's clear is that the bubble is inflating at the rich end, while little low-cost housing gets built for middle and low-income Chinese. In Beijing's Chaoyang district—which represents a third of all residential property deals in the capital—homes now sell for an average of nearly \$300 per square foot. That means a typical 1,000-sq.-ft. apartment costs about 80 times the average annual income of the city's residents. Koyo Ozeki, an analyst at U.S. investment manager Pimco, estimates that only 10% of residential sales in China are for the mass market. Developers find the margins in high-end housing much fatter than returns from building ordinary homes.

How did this bubble get going? Low interest rates, official encouragement of bank lending, and then Beijing's half-trillion-dollar stimulus plan all made funds readily available. City and provincial governments have been gladly cooperating with developers: Economists estimate that half of all local government revenue comes from selling state-owned land. Chinese consumers, fearing inflation will return and outstrip the tiny interest they earn on their savings, have pursued property ever more aggressively.

Ordos' new housing now mostly lies empty, waiting for buyers

Companies in the chemical, steel, textile, and shoe industries have started up property divisions too: The chance of a quick return is much higher

than in their primary business. "When you sit down with a table of businessmen, the story is usually how they got lucky from a piece of land," says Andy Xie, an independent economist who once worked in Hong Kong as Morgan Stanley's top Asia analyst. "No one talks about their factories making money these days."

HOMES BUILT ON SAND

Newly wealthy towns are playing the game with a vengeance. Ordos is a city of 1.3 million in China's Inner Mongolia region. It has gotten rich from the discovery of a big coal seam nearby. An emerging generation of tycoons, developers, and local officials will go to any length to invent a modern Ordos. So 16 miles from the old town, a new civic center is emerging from the desert that could easily pass for the capital of a midsize country. An enormous complex houses City Hall and the local Communist Party headquarters, each 11 stories tall with sweeping circular driveways. Nearby loom a fortress-like opera house and a slate-gray,

CHINESE WHO HAVE THE MONEY ARE DESPERATELY SNAPPING UP APARTMENTS FOR FEAR PRICES WILL RISE FURTHER

modernist public library. Thousands of villas and apartment towers stretch into the distance, all built by local developers in the hope that Ordos' recently prosperous will buy the places to be near the new center of power. Workers get bused daily to the new city hall, but the housing is still largely unoccupied. "Why would anyone go there?" asks Zhao Hailin, a street artist in the old town. "It's a city of empty buildings" (Ordos officials would not comment for this story.)

The central government now faces two dangers. One is the anger of ordinary Chinese. In a recent survey by the People's Bank of China, two-thirds of respondents said real estate prices were too high. A serial drama with the ironic name *The Romance of Housing*, featuring the travails of families unable to afford apartments, was one of the most popular shows on Beijing Television until broadcasting authorities pulled it off the airwaves in November. The official reason was that the show was too racy (one woman got an apartment by becoming the mistress of a corrupt local official), but online chat rooms speculated that the show was cut

because it was upsetting to people unable to afford apartments.

The debate has become even more charged following injuries and deaths related to real estate. A woman from Chengdu committed suicide by torching herself when her former husband's three-story factory and attached living space were demolished to make way for a new road. A man in Beijing suffered severe burns in a similar protest over his home. In early December five professors at Peking University wrote to the National People's Congress calling for changes to a land seizure and demolition law and accusing developers of usurping the government's role when taking land for construction. The law is leading to "mass incidents" and "extreme events," the professors warned.

The second danger is that Beijing will try, and fail, to let the air out of the bubble. Pulling off a soft landing means slowly calming the markets, stabilizing prices, and building more affordable housing. To discourage speculation, the State Council, China's cabinet, is extending, from two years to five, the period during which a tax is levied on the resale of apartments. Tighter rules on mortgages may follow. Beijing also plans to build apartments for 15 million poor families.

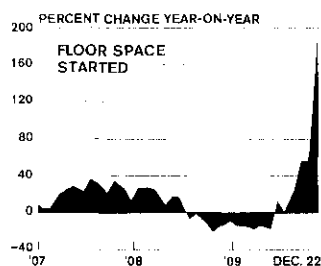
KEY TO GROWTH

The government is reluctant to crack down too hard because construction, steel, cement, furniture, and other sectors are directly tied to growth in real estate; in November, for example, retail sales of furniture and construction materials jumped more than 40%. At the December Central Economic Work Conference, an annual policy-setting confab, officials said real estate would continue to be a key driver of growth.

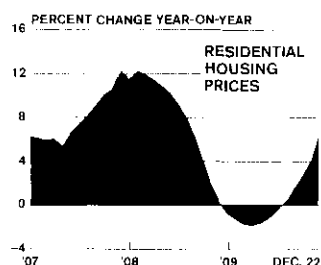
The worst scenario is that the central authorities let the party go on too long, then suddenly ramp up interest rates to stop the inflationary spiral. Without cheap credit, developers won't be able to refinance their loans, consumers will no longer take out mortgages, local banks' property portfolios

LAND RUSH

Construction is booming ...



...and prices have rebounded...



...but investors fear a bubble



*33 real estate and construction companies
Data: UBS, Bloomberg

will sour, and industrial companies that relied on real estate for a chunk of profits will suffer. It's not encouraging that the Chinese have been ham-handed about stopping previous real estate frenzies. In the 1990s the government brutally ended a bubble in Shanghai and Beijing by cutting off credit to developers and hiking rates sharply. The measures worked, but property prices plunged and economic growth slowed.

Analysts are divided over the probabilities of such a crash, but even real estate executives are getting nervous. Wang Shi, chairman of top developer Vanke, has warned repeatedly in recent weeks about the risk of a bubble. In his most recent comments he expressed fear that the bubble might spread far beyond Beijing, Shanghai, and Shenzhen.

PROFIT VS. SOUL

One difficulty in handicapping the likelihood of a nasty pull-back is the opacity of the data. As long as property prices stay high, the balance sheets of the developers look strong. And no one knows for sure how much of the more than \$1.3 trillion in last year's bank loans funded real estate ventures. Analysts figure a substantial portion of that sum went into property, much of it indirectly. Banks often lend to state-owned companies for industrial purposes. But the state companies can then divert the funds to their own real estate businesses—or relend the money to an outside developer. Meanwhile, the big banks may be cutting back on their real estate risk by selling loans to smaller local banks and credit co-ops.

For now, the party continues. On Dec. 12, Beijing developer Soho China celebrated a record-breaking year with a gala at the China Central Place JW Marriott. Guests dined on crab and avocado timbale, white bean soup, and beef tenderloin with wild mushrooms (Soho would not comment for this story). After a dance performance, a panel debated "The Balance Between Profit and Soul." When a writer joked he could not afford an apartment—and was still waiting for Soho Chairman Pan Shiyi to give him one—the crowd of 600 well-heeled developers, entrepreneurs, and consultants laughed appreciatively. If the bubble bursts, few will be laughing. ■ BWI

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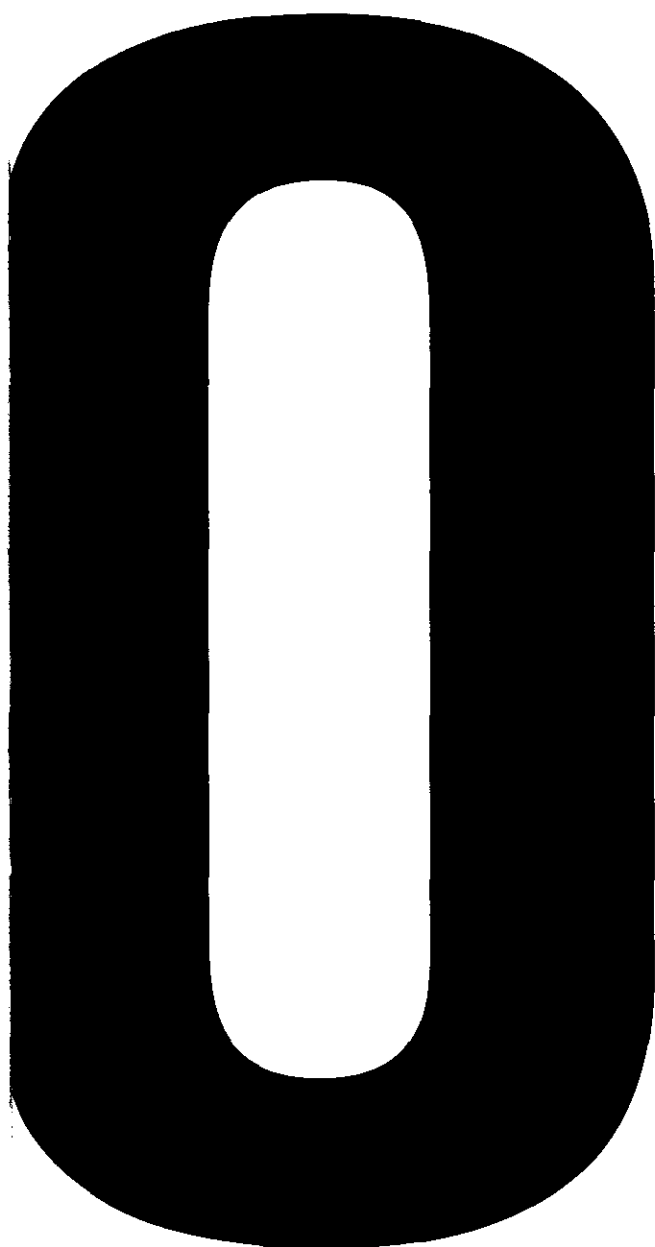
A Recipe For Trouble

Lax lending by Chinese banks has played a major role in the runup of property prices on some parts of the mainland. A December report by Fitch Ratings says tighter rules imposed by China's bank regulator contributed to a slowdown in new loans in the second half of 2009. The rating agency also noted an increase in off-balance sheet transactions, such as repackaging of loans into wealth management products and the sale of loans to other financial institutions—activities that represent "a growing pool of hidden credit risk."

To read a Bloomberg story on the Fitch report, go to
<http://bx.businessweek.com/china-business/reference/>

ENDLESS

IN DEPTH



Technology,
politics,
and
lower
demand
will yield
a bumper
crop of
crude

By Stanley Reed

Illustration
by Daniel Hertzberg

Not many people think of the Netherlands as oil country, but a billion-barrel field lies under a nine-mile strip of grazing land along the Dutch-German border. When oil prices cratered in the 1990s, Royal Dutch Shell and ExxonMobil shut the Schoonebeek field down. Company executives reckoned that its thick, hard-to-extract crude wasn't worth the trouble, even though only about 25% of Schoone-

beek's oil had been produced. The main evidence of the town's petroleum past was an old-fashioned bobbing oil pump, known as a nodding donkey, which still stands in a parking lot near a bakery.

Now higher prices and technological advances are spurring a new joint venture of Shell, Exxon, and the Dutch government to pump Schoonebeek's reserves once more. New wells drilled horizontally are

coming in contact with more of the oil. Steam injected into the rock loosens up its molasses-like crude so it can be brought to the surface more easily. Shell won't say what price it needs to make such efforts profitable, but experts estimate \$40 to \$50 per barrel will do. At a current price of \$80, the field is a clear winner. "We wouldn't do this if the price was really low," says Michael Lander, the Shell executive running the project. The venture is expected to produce 120 million barrels from the reopened western section of Schoonebeek over 20 years. If another section of the field is developed, the recovery rate—the share of oil that gets pumped out—would approach 50%. The industry average is 30%-35%.

PRESSURE TO INNOVATE

Schoonebeek will not flood the world with crude. But its success presents a stiff challenge to those who argue that oil production is in irreversible decline. Consumer demand, technology, and global politics are shifting in a way that could spell a future of oil abundance, not of catastrophic dearth. As Leonardo Maugeri, a senior executive at Italian oil major ENI, puts it: "There will be enough oil for at least 100 years."

Many analysts and industry executives have little doubt that there's plenty of oil in the ground. "Only about 32% of the oil [in reserves] is produced," says Val Brock, Shell's head of business development for enhanced oil recovery. Shell estimates 300 billion barrels and maybe more might be squeezed out of existing fields, much of it once thought beyond retrieval. Peter Jackson, Cambridge Energy Research Associates' London-based senior director for oil industry activity, has reviewed data from the world's biggest fields.

His conclusion: 60% of their reserves remain available.

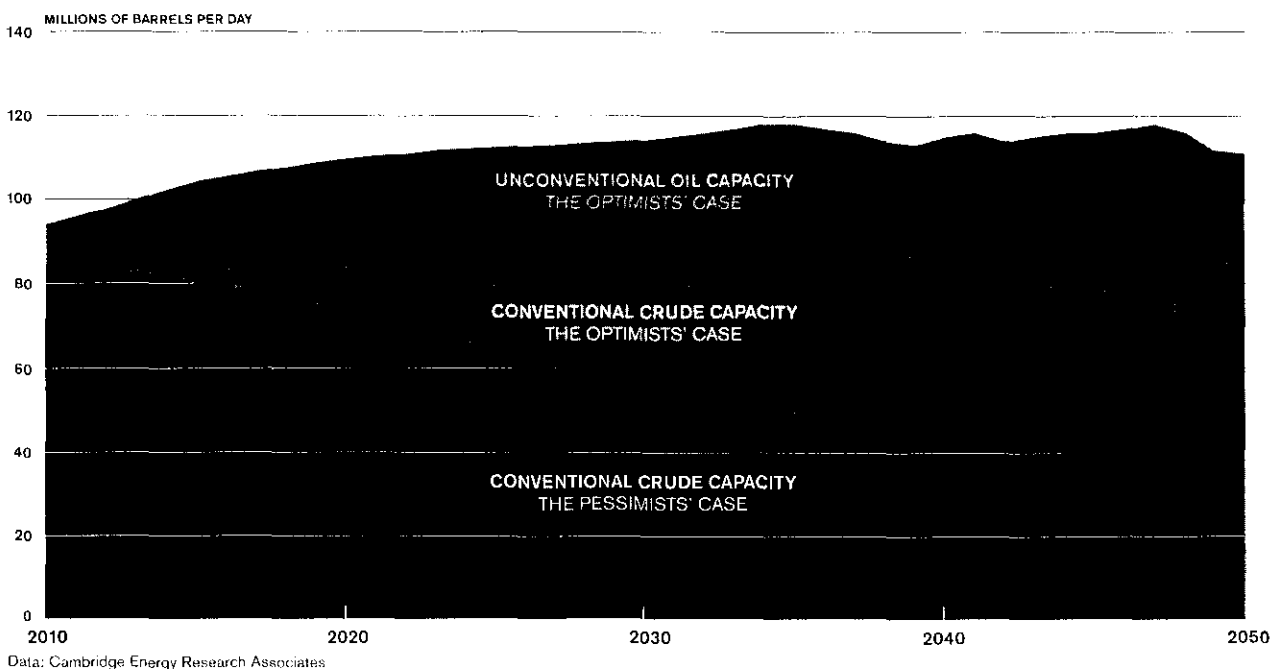
The fact that there's still oil for the taking is driving Shell and other majors to come up with new technologies, which are expensive to develop but worth it when crude is riding high. While the price has fallen considerably from the peak of \$147 per barrel in 2008, it is still far above what many oilmen expected a few years ago. "You will see companies going into the deep water, going into the arctic, using the best technology," says Maugeri, who sees the oil industry as a dynamic system that responds rapidly to changes in the economic and political environment.

Even if the new technologies add just a few percentage points to the recovery rate, such gains add years to global supply and boost the industry's profits. So the technology of coaxing oil out of the ground is constantly improving. Heating up heavy oil, as at Schoonebeek, is one new trick. Companies can add heavy polymers to the water they blast into a production site to push more oil out; the polymers add weight to the water and increase the pressure on deposits. (Shell is trying such technology on the Marmul field in Oman.) Another tactic is to inject soap into the ground to break the surface tension that makes leftover oil cling to the rock.

Simple methods can help mature oil fields produce more and even uncover bigger reserves than imagined. A study of fields in Indonesia by Cambridge Energy found that it wasn't uncommon for them to produce more than double initial estimates. Petroleum engineers help the fields live longer just by drilling new wells or installing better pumps. "As a field ages, the operators learn more ... that allows them to tweak their op-

THE ARGUMENT FOR AND AGAINST OIL ABUNDANCE

Optimists think the age of oil will last far longer as the industry exploits unconventional sources and learns to maximize production from established fields. According to this theory, daily oil capacity will stay at a high level until 2060 and then only decline gradually. In contrast, pessimists argue that production has already peaked out and will decline sharply through 2050.



HOW TO MAKE THE OIL FLOW

A combination of old technologies and brand new approaches could extract more oil than thought possible.

WATER OR GAS INJECTION

Pumping large volumes of water or natural gas into a field keeps pressure up and pushes more crude petroleum from the rocks. Fields under water injection typically have recovery rates up to 35%.

THERMAL

One of the new "enhanced recovery" techniques, this uses steam, electricity, or underground combustion to soften heavy oil and make it easier to pump out. The recovery rate using thermal techniques can go as high as 55%.

CHEMICAL

This new method uses polymers to boost the power of water pressure and loosen trapped oil. Other chemicals, such as surfactants, make it easier to break oil free from rocks. This is in early development. Recovery rate: about 55%.

CARBON DIOXIDE

Utility plants and oil fields both emit CO₂. Oil companies want to pump the CO₂ into wells to create enough pressure to force out oil. A kind of Holy Grail of enhanced recovery, this technique is only being used at a few sites.

Data: Royal Dutch Shell

erations," explains Leta K. Smith, a Houston-based analyst for Cambridge Energy.

Sharp falls in production can be arrested. Output at Samotlor, Russia's largest field, was plummeting in the late 1990s. The field's owner, TNK-BP, formed in 2003, has since managed to boost production by a third. Adjusting the placement of the pumps in the wells yielded big gains, while three-dimensional seismic technology gave a better glimpse of the oil-bearing structures under the ground.

IRAQ'S WILD CARD

Pumping the oil that's already discovered isn't the whole story. Explorers, sometimes financed by hedge funds and private equity firms, are finding troves in the deep water off Brazil, West Africa, and even the U.S. At the same time, old and new oil powers—Russia, Brazil, Angola, Nigeria, and Kazakhstan—are ramping up their capacity with the aid of Total, ExxonMobil, BP, and other majors. These projects could eventually add 5 million barrels to global daily output.

The most surprising action is unfolding in Iraq, which has just cut deals with ExxonMobil, BP, and Shell as well as with Chinese and Russian companies. If all these ventures meet their targets, Iraq could produce as much as 12 million barrels a day, putting it in the super league with Saudi Arabia and Russia. Given the political and logistical obstacles Iraq faces, that seems unrealistic anytime soon. But 6 million barrels a day seems attainable within 10 to 15 years. That level would turn Iraq into OPEC's No. 2 producer after Saudi Arabia.

Moderating global demand can also stretch the supply of crude. After the oil shocks of the 1970s, efficiency gains and a switch by factories to natural gas prompted a nearly 10% drop in global oil consumption in the early 1980s.

The price spike of 2008 may lead to similar results. Lester Brown, president of the Earth Policy Institute in Washington, an environmental group, notes that the U.S. car fleet shrank by 4 million in 2009, thanks to scrapping and reduced sales. He expects that shrinkage to continue, reducing the U.S. fleet by 25 million cars by 2020. He also sees a cultural change occurring in which more people, especially the young, don't see owning a car as a necessity. "We are now

looking at something new, a shift in the way people think about automobiles," he says. "That means less oil use."

U.S. oil consumption dropped by 9% over the last two years. The recession certainly hurt demand, but many analysts think oil use in the West has peaked and will not rebound to previous levels. The Energy Dept. sees the consumption of oil-based fuel in the U.S. flattening out in the coming decades. "Are people going to use energy differently in the next [growth] phase?" asks Goran Trapp, head of global oil trading at Morgan Stanley in London. "If so, the people forecasting [strong] demand increases are going to be surprised."

China is one key to answering Trapp's question. Even as the mainland devours oil and coal, the government is pursuing a green agenda. China has the world's top solar panel industry, a power plant in Beijing is one of the world's most efficient, and auto emission standards there are now tougher than those in the U.S. China's official policy mandates that alternate sources support 15% of the country's energy needs by 2020, up from 9% now. So China's petroleum consumption will keep increasing, but perhaps at not so steep a rate as expected. A nasty oil shock is always possible. But the case for bountiful oil is strong. **BW**

—With John Carey in Washington and Dexter Roberts in Beijing

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Every Last Drop

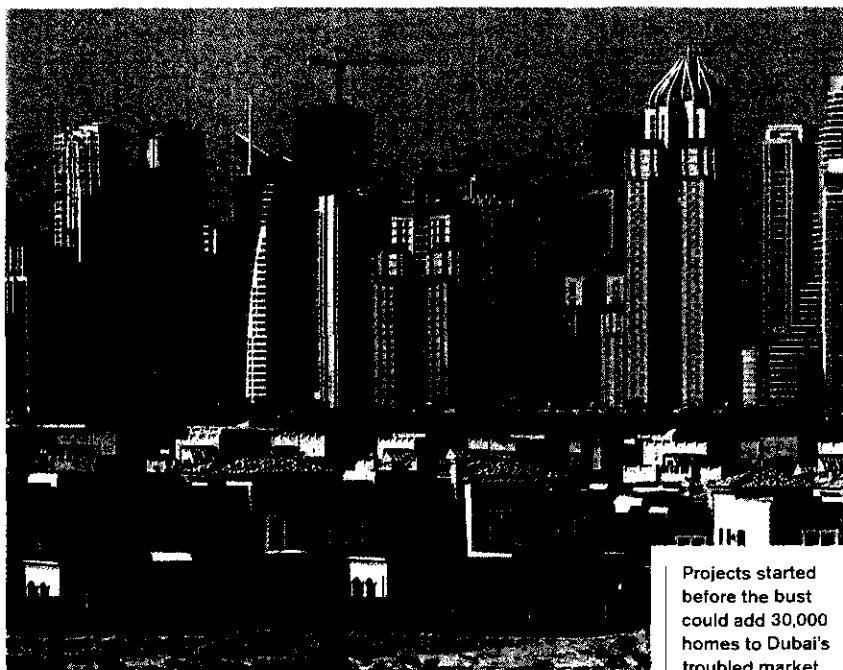
In a draft of an article that appeared in the October 2009 edition of *Scientific American*, Leonardo Maugeri predicts that new technological breakthroughs will boost the oil recovery rate from around 35% at present to more than 50% by 2030. "If my estimates are correct, we will have oil for the rest of the 21st century," writes Maugeri, a senior vice-president at Italian energy company ENI.

To read Maugeri's article, go to <http://bx.businessweek.com/oil-and-gas/reference/>



Dubai: The First Foreclosure

Barclays' landmark case paves the way for other lenders to go after homeowners in default



Projects started before the bust could add 30,000 homes to Dubai's troubled market

By Zainab Fattah

With plunging values, missed mortgage payments, and abandoned homes, Dubai's housing market is a lot like others around the world. Except for one thing: There have been no foreclosures in the emirate. Until now.

Barclays recently won the sheikdom's first foreclosure case in a local court. The decision, based on a 2008 law, paves the way for others to pursue claims. Lenders hold \$16 billion of residential mortgages. Tamweel P.J.S.C., Dubai's biggest mortgage bank, has several foreclosure cases pending. "Banks will be more aggressive," says Antoine Yacoub, a Dubai-based banking analyst at Moody's Investors Service. "Once they see a precedent has been set, they will be encouraged to push more cases through."

For much of the past decade the

emirate was one of the world's hottest property markets. Residential real estate prices quadrupled from 2002—the year Dubai first allowed foreign residents to own property—to mid-2008. The boom was fueled by a growing expatriate workforce and speculation. Prospective buyers routinely stood in long lines to snag homes in new developments, even before construction began. Investors frequently flipped apartments, using profits to buy more properties. Some apartments changed hands two or three times before ground was broken.

The global financial crisis has sent Dubai

property values down 52% over the past year, says Deutsche Bank. High-rises stand empty. Some foreign residents who can't pay their mortgage bills have simply abandoned their homes and fled the country, ditching their cars at the airport parking lot. That's because borrowers are required to write postdated checks when they take out a home loan—and people until recently could be jailed for bouncing a check in Dubai. Some 12% of the 27,000 residential mortgages in the sheikdom could go into default within 12 to 18 months, according to September estimates by Moody's.

Not long ago there was no formal system for dealing with defaults. Lenders avoided the courts, discouraged by the ambiguity of the legal process and a culture that frowns on forcing people from their homes. To help buyers, lenders usually try to work out troubled loans, extending payment terms or allowing borrowers to return some of their investment properties. Even so, many loans have been left in limbo.

The 2008 law should impose some structure on the process. It requires lenders to give homeowners 30 days' notice of their intent to pursue foreclosure. If the court finds in favor of the lender, Dubai's Land Dept. auctions off the property, with the proceeds going to pay off the loan.

Lenders may be selective in using the new law. Britain's Standard Chartered Bank, a big mortgage lender in Dubai, says foreclosure is "a legitimate course of action" but not its "preferred approach." As in the U.S., banks are reluctant to dump foreclosed proper-

ties on the market for fear of driving down prices, says Saud Masud, a Dubai-based real estate analyst at UBS. New projects, started before the bust, will add up to 30,000 housing units to the market in 2010, according to Deutsche Bank. "Mass auctions may reprice the property market in a meaningful way," Masud says. "It's a slippery slope." **BW**

12%

The share of Dubai's 27,000 residential mortgages that could go into default within 12 to 18 months

Data: Moody's Investors Service

We did it!

The rich world's quiet revolution: women are gradually taking over the workplace



AT A time when the world is short of causes for celebration, here is a candidate: within the next few months women will cross the 50% threshold and become the majority of the American workforce. Women already make up the majority of university graduates in the OECD countries and the majority of professional workers in several rich countries, including the United States. Women run many of the world's great companies, from PepsiCo in America to Areva in France.

Women's economic empowerment is arguably the biggest social change of our times. Just a generation ago, women were largely confined to repetitive, menial jobs. They were routinely subjected to casual sexism and were expected to abandon their careers when they married and had children. Today they are running some of the organisations that once treated them as second-class citizens. Millions of women have been given more control over their own lives. And millions of brains have been put to more productive use. Societies that try to resist this trend—most notably the Arab countries, but also Japan and some southern European countries—will pay a heavy price in the form of wasted talent and frustrated citizens.

This revolution has been achieved with only a modicum of friction (see pages 49-51). Men have, by and large, welcomed women's invasion of the workplace. Yet even the most positive changes can be incomplete or unsatisfactory. This particular advance comes with two stings. The first is that women are still under-represented at the top of companies. Only 2% of the bosses of America's largest companies and 5% of their peers in Britain are women. They are also paid significantly less than men on average. The second is that juggling work and child-rearing is difficult. Middle-class couples routinely complain that they have too little time for their children. But the biggest losers are poor children—particularly in places like America and Britain that have combined high levels of female participation in the labour force with a reluctance to spend public money on child care.

Dealing with the juggle

These two problems are closely related. Many women feel they have to choose between their children and their careers. Women who prosper in high-pressure companies during their 20s drop out in dramatic numbers in their 30s and then find it almost impossible to regain their earlier momentum. Less-skilled women are trapped in poorly paid jobs with hand-to-mouth child-care arrangements. Motherhood, not sexism, is the issue: in America, childless women earn almost as much as men, but mothers earn significantly less. And those mothers' relative poverty also disadvantages their children.

Demand for female brains is helping to alleviate some of these problems. Even if some of the new theories about warm-hearted women making inherently superior workers are bunk (see Schumpeter, page 48), several trends favour the more educated sex, including the "war for talent" and the

growing flexibility of the workplace. Law firms, consultancies and banks are rethinking their "up or out" promotion systems because they are losing so many able women. More than 90% of companies in Germany and Sweden allow flexible working. And new technology is making it easier to redesign work in all sorts of family-friendly ways.

Women have certainly performed better over the past decade than men. In the European Union women have filled 6m of the 8m new jobs created since 2000. In America three out of four people thrown out of work since the "mancession" began have been male. And the shift towards women is likely to continue: by 2011 there will be 2.6m more female than male university students in America.

The light hand of the state

All this argues, mostly, for letting the market do the work. That has not stopped calls for hefty state intervention of the Scandinavian sort. Norway has used threats of quotas to dramatic effect. Some 40% of the legislators there are women. All the Scandinavian countries provide plenty of state-financed nurseries. They have the highest levels of female employment in the world and far fewer of the social problems that plague Britain and America. Surely, comes the argument, there is a way to speed up the revolution—and improve the tough lives of many working women and their children?

If that means massive intervention, in the shape of affirmative-action programmes and across-the-board benefits for parents of all sorts, the answer is no. To begin with, promoting people on the basis of their sex is illiberal and unfair, and stigmatises its beneficiaries. And there are practical problems. Lengthy periods of paid maternity leave can put firms off hiring women, which helps explain why most Swedish women work in the public sector and Sweden has a lower proportion of women in management than America does.

But there are plenty of cheaper, subtler ways in which governments can make life easier for women. Welfare states were designed when most women stayed at home. They need to change the way they operate. German schools, for instance, close at midday. American schools shut down for two months in the summer. These things can be changed without huge cost. Some popular American charter schools now offer longer school days and shorter summer holidays. And, without going to Scandinavian lengths, America could invest more in its children: it spends a lower share of its GDP on public child-care than almost any other rich country, and is the only rich country that refuses to provide mothers with paid maternity leave. Barack Obama needs to measure up to his campaign rhetoric about "real family values".

Still, these nagging problems should not overshadow the dramatic progress that women have made in recent decades. During the second world war, when America's menfolk were off at the front, the government had to summon up the image of Rosie the Riveter, with her flexed muscle and "We Can Do It" slogan, to encourage women into the workforce. Today women are marching into the workplace in ever larger numbers and taking a sledgehammer to the remaining glass ceilings. ■

ing countries, can take effect outside the UN process. That could mark a new pluralism in climate politics, allowing coalitions of the willing to form for specific purposes—such as slowing deforestation, or stemming emissions from shipping.

There are risks to slicing up the problem into smaller pieces. Bundling everything together, so that all parties need to offer some give in order to get their take, is a time-honoured format for negotiations; and stepping back from doing everything in one forum may mean doing less overall. But the world has twice, at Kyoto and at Copenhagen, tried to deal with the problem in one go, and failed. Smaller groups such as the G20 or the Major Economies Forum offer a better prospect for haggling over difficult issues. The UN process still has a role, in ensuring a workable and trusted system of accounting for car-

bon, and in debating and approving or rejecting agreements whose details will largely be worked out elsewhere.

Many problems lie ahead—and not just as a result of Copenhagen's failures. The main danger lies in the American Senate, which at some point over the next few months will decide whether to approve or reject legislation to set up a cap-and-trade system to put a price on carbon. That will have more impact than any international conference, including Copenhagen, on the future levels of greenhouse-gas emissions. But global negotiations will need to continue—and the participants need to learn one useful lesson from Copenhagen. Climate change is too big a problem to be swallowed in a single bite. Smaller groups, dealing with more manageable-sized chunks, have a better chance. ■

Japan's two lost decades

An end to the Japanese lesson

Japan has taught the world a great deal about coping with the financial crisis. Now the West is on its own



"NEW Year rally expected on Tokyo market next week." That was a typically boosterish Japanese newswire headline on December 29th 1989, the day that one of the world's biggest ever asset-price bubbles reached bursting point.

Exactly 20 years later the Japanese are still paying the price for such hubris (see page 52). The Nikkei 225 index, which peaked at 38,916, now languishes at just over one-quarter of that level (though once again there is talk of a New Year rally). Japan's economy has barely grown in nominal terms after two "lost decades", and is again suffering from deflation. Where Japan was once bearing down on America, it now feels the hot breath of China on its neck. Remember "Japan as Number One"? These days the country's chief claim to fame is having a gross government debt burden approaching 200% of GDP.

For the Japanese this has all been deeply troubling. But in the past two years, as the Western world has faced many of the same problems that Japan has been grappling with since 1989 (the collapse of asset prices, a surge in distressed debt and a looming threat of deflation), Japan has provided some useful lessons on how governments should, and should not, tackle potentially systemic financial meltdowns.

Thanks to the precedent set by Japan, many of these lessons were quickly put into practice. Acting far more swiftly than the Japanese authorities did (the Japanese had the misfortune of having to learn through trial and error), Western policymakers provided liquidity to their banks and forced them to rebuild capital, while pumping in generous doses of fiscal stimulus to offset the collapse in private-sector demand. And like the Bank of Japan, they slashed interest rates and took extraordinary measures to try to keep credit flowing. The efficacy of these steps has led to growing optimism about the world economy.

So what is the Japanese lesson now? In many ways, the analogy is no longer terribly helpful. That is partly because the pupils are in a worse pickle than the teacher ever was. The most vulnerable countries, such as Greece, now face a risk that Japan never did: that markets will lose faith in their creditwor-

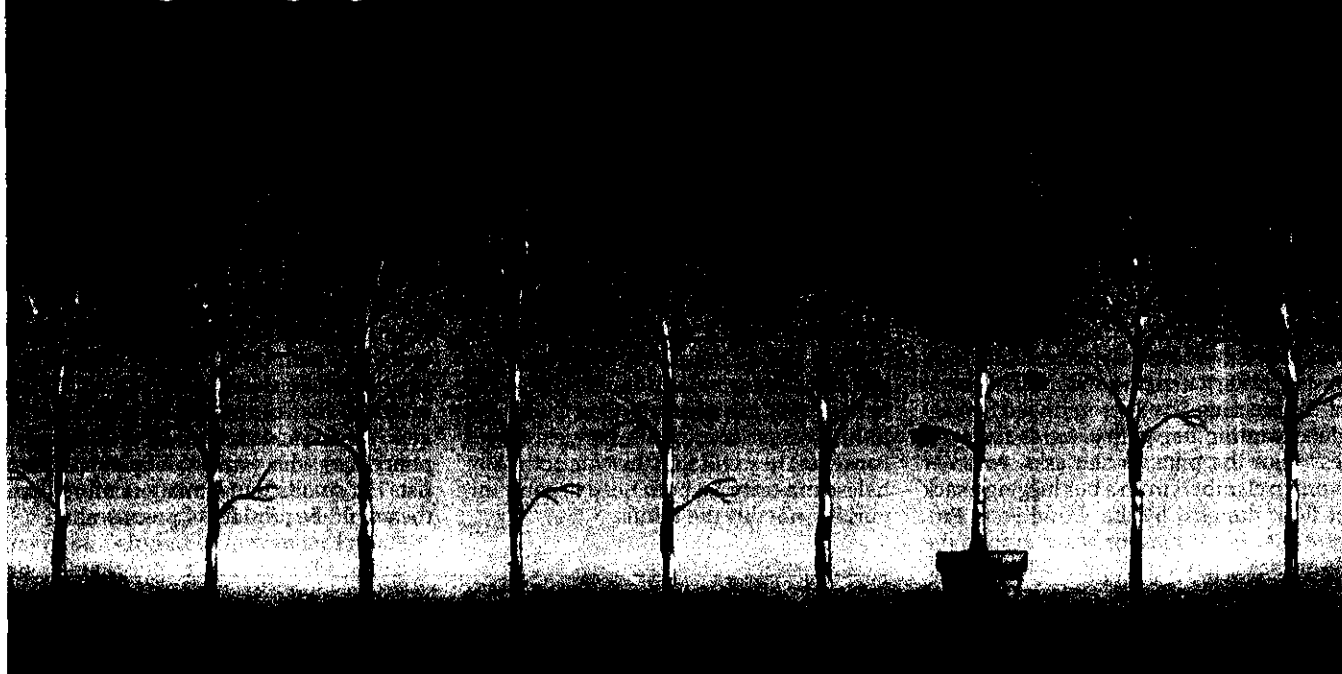
thiness. Japan, for all its woes, has benefited from a huge pool of domestic savings and investors happier to keep their money at home than abroad. Meanwhile, the scale of the global upheaval makes Japan's problems, which had little impact overseas and took place against a backdrop of global growth, look small by comparison. And with huge deficits in so many nations, the risk of a sudden loss of fiscal credibility is more acute than it ever was in Japan.

But there are other ways in which the pupils are in better shape. That is partly because they have less rigid systems. In the more adaptable Western economies there has been less resistance to structural changes in order to maintain productivity. There are also usually fewer political barriers to dealing with bad private-sector debts than there were in Japan. Moreover Westerners are also reaping the rewards of having acted more decisively than the Japanese did—especially when it came to pumping money into the economy and cleaning up financial balance-sheets. With fewer zombie banks, fewer signs of entrenched deflation and much earlier signs of growth, the West is in uncharted territory: it has arguably already got to a stage that Japan never really did.

Nothing more will I teach you today

That makes it very difficult to keep on drawing particular lessons from Japan's sad plight. It does, however, still leave a general lesson common to all economic disasters: don't be suckered by false signs of economic recovery. In Japan's case, such hopes have led it repeatedly to tighten fiscal policy before private demand was strong enough to sustain a recovery. That entrenched deflation. Japan also left its banks too short of capital to cope with subsequent shocks.

Policymakers in the developed world still have an enormous task on their hands. Many banks have huge write-downs to make on their loans, economies are burdened with excess capacity and households' debt levels remain high. It would be disastrous to tighten policy too soon, as Japan's example shows. But Japan provides no useful guidance on when the right time would be. For that, there is only trial and error. And the more errors there are, the more the West's next decade may look like Japan's two lost ones. ■



Counting their blessings

Developing countries have come out of the recession stronger than anyone had expected. This will have profound consequences for the rest of the world

THE political and social consequences of the worst economic crisis since the Great Depression have been milder than predicted. In developing countries, at least, governments have not fallen in a heap, as they did after the Asian crisis of 1997-98. They have not battled their own people on the streets, as happened in Europe during the 1930s. Social-protection programmes have survived relatively unscathed. There have been economic-policy shifts, naturally, but no panicky retreat into isolation, populism or foreign adventures. The good news has not been spread evenly, of course: some countries have ridden the storm more successfully than others. And these are only first-round effects: things could still get worse. So far, though, resilience has been the order of the day.

This was not expected a year ago. Then, it seemed likely that normal rules would apply—that when the rich world sneezes, developing countries get swine flu. In the fourth quarter of 2008, when rich economies were contracting by 5% to 10% a year, real GDP fell at an average annualised rate of around 15% in some of the world's most dynamic economies, including Singapore, South Korea and Brazil. The fall in Taiwan's industrial output—down by a third during 2008—was worse than America's worst annual fall during the Depression.

Emerging markets seemed likely to suf-

fer disproportionately because of their trade and financial links with the West. Exports in that dreadful last quarter of 2008 fell by half in the Asian tigers at an annualised rate; capital flows to emerging markets went over a cliff as Western banks "deleveraged". The Institute of International Finance (IIF), a think-tank in Washington, DC, forecast that net private capital flows into poor countries in 2009 would be 72% lower than at their peak in 2007, an unprecedented shrinkage.

As people peered ahead into 2009, no forecast looked too dire. "The end of globalisation" was a common refrain. Some thought emerging markets would turn inward to protect themselves from the conta-

gion of the West. Others forecast that hundreds of millions of people would be tipped into hunger. The IMF's managing director, Dominique Strauss Kahn, fretted that unless governments did the right things at the right time, there was a "threat of civil unrest, perhaps even of war".

At the start of 2010 there are indeed a billion hungry people, for the first time in 40 years. But the other forecasts now look excessively gloomy. Whereas the last three months of 2008 saw one disaster after another, the end of 2009 was a period of healthy recovery, as measured by capital, bond and stockmarkets.

During 2009 the largest developing-country stockmarkets recouped all the losses they had suffered during 2008 (see table below). October 2009 saw the largest monthly inflow into emerging-market bond funds since people started tracking the numbers in 1995. Russia's central bank estimated that the country would attract \$20 billion of capital inflows during the fourth quarter, compared with capital outflows of \$60 billion in the first nine months. The IIF now reckons that net private capital flows to developing countries will more than double in 2010 to \$672 billion (still a long way below their peak). So much new money is flooding into emerging markets that calls for capital controls are echoing around the developing world.

This craze for emerging-market paper could perhaps prove a bubble. But as a measure of reputational change, it is accurate. Countries that were disaster zones at the start of 2009 achieved gold-rush status by the end of it. This turnaround reflects a resilient economic performance during the recession. It also reflects a stunning degree of political and social cohesion. ►►

V for vigour

Stockmarkets, % change on previous year, \$ terms

	2008	2009
Brazil	-55	+142
China	-68	+125
India	-62	+88
Indonesia	-57	+114
Malaysia	-42	+46
Mexico	-40	+56
South Korea	-56	+61
Taiwan	-47	+78

Source: Thomson Reuters

The most important economic reason for this is that emerging markets were less affected by the rich world's recession than seemed likely early in 2009. Big populous countries—China, India, Indonesia—did not tip into recession; they merely suffered slower growth. Brazil and the Asian tigers saw output fall but bounced back. The pattern, though, was variable. The Baltic states endured a depression; Mexico suffered from its dependence on America; eastern Europe was harder hit than Asia; poor African countries suffered more than middle-income Asian ones.

Overall, the loss of output in emerging markets during 2007 was somewhat greater than it had been in the Asian crisis of 1997-98, but less than had been expected and much less than the fall in world GDP (see chart 1). Emerging markets benefited from their own economic-stimulus programmes and from policy activism in rich countries. Rich-country bail-outs and monetary loosening stemmed worldwide financial panic and helped stoke an appetite for emerging-market exports and assets. In addition, some developing countries built up big cushions of foreign-exchange reserves after the Asian crisis which afforded them some protection.

Surprising stability

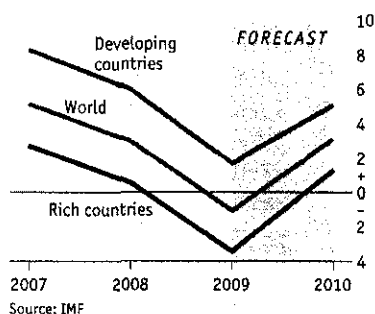
This economic resilience has had big political and social benefits. Politically, the most striking feature of the crisis is how little instability it caused. The worst slump in decades has so far led to the fall of just one emerging-market government: Latvia's (Iceland's government also collapsed). Other east-European governments have come under pressure, notably Hungary's.

But two of the biggest emerging markets—India and Indonesia—held national elections in 2009, and both were won by the ruling party. This was unusual in India, which traditionally votes against incumbents. In another emerging giant, Brazil, the outgoing president is likely to leave office in 2010 with poll ratings in the stratosphere (Luis Inácio Lula da Silva's favourability ratings stayed above 60% for most of 2009). The global crisis seems to have consolidated, not undermined, the popularity of large developing-country governments, presumably because the economic crisis was perceived to have begun elsewhere and been dealt with efficiently.

Contrast that with what happened during the Asian crisis of 1997-98. Widespread rioting in the wake of abrupt devaluation led to the fall of Suharto's 30-year dictatorship in Indonesia. Devaluation added to popular discontent in the Philippines, culminating in the overthrow of President Joseph Estrada. There was mass discontent in Thailand as millions of urban workers lost their jobs and wandered back to their villages. Financial collapse in Russia produced a political crisis and led to the sack-

A bigger bounce

GDP, % change on previous year



ing of the prime minister, Sergei Kiriyenko. A couple of years later, Argentina defaulted on its debt and ran through three presidents in ten days at the turn of 2001-02. ("What did you do for Christmas?", ran the contemporary joke. "I was president.") In country after country, governments reacted to financial stress and plunging currencies by imposing emergency austerity measures which brought them into conflict with rioters on the streets. That has been much rarer this time.

The second striking feature of the crisis has been that, with one or two exceptions, it seems not to have caused any fundamental shift of popular opinion. There has been no upsurge of angry pessimism, nor any significant backlash against capitalism or free markets. That doubtless explains much of the political composure.

Compared with people in the West, those in big emerging markets seem in almost sunny mood. In China, India and Indonesia, according to the Pew Global Attitudes Project in Washington, DC, more than 40% of respondents say they are satisfied with their lives (in China the figure is 87%). In France, Japan and Britain, the share is below 30% (see chart 2 on next page). This is unusual: measures of "life satisfaction" tend to rise with income, so you would expect levels to be lower in emerging markets, as they were in 2002-03. The reversal of that pattern may reflect a sense in those countries of their quick recovery.

It is true that the overall levels hide some disturbing trends. A study of Bangladesh, Indonesia, Jamaica, Kenya and Zambia by the Institute of Development Studies at the University of Sussex found that people there said they were saving less, celebrating together less often and thought that neighbourly support was declining. People also thought children and old people were being abandoned more often. But, overall, such concerns are as great or greater in rich countries.

The mood in emerging markets is both unusual and consequential. To see how, compare what is happening there with trends in parts of the West. Americans, for example, seem to be hankering for isola-

tionism. According to Pew's polling, 49% of Americans now think their country should mind its own business internationally. That is more than 30 points higher than when the question was first asked in 1964. Jim Lindsay of the Council on Foreign Relations points out worrying parallels between what is happening now and America's reaction to the Great Depression, which sparked a period of introspection that ended only with the second world war. Developing countries are not suffering such anger or frustration.

That same resilience informs their attitudes to markets. Arvind Subramanian, of the Petersen Institute for International Economics in Washington, DC, argues that the recession has set off "no serious questioning of the role of the market" in developing countries. It is true that China has seen a disproportionate rise in lending to state-owned enterprises, but this is not necessarily regarded with favour. China's media have been flooded with reports of abuses by state firms, all featuring a newly popular, negative-sounding term *guojin mintui*, which means "the state advances and the private sector retreats".

Asked "Are you better off under free markets?", people in emerging markets are more likely to say yes than those in rich ones. The share of respondents who think they are better off fell in 2009 by between four points (Germany) and ten points (Spain). In most emerging markets, the share either rose (in India and China) or stayed flat (in Brazil and Turkey). No sign of an anti-capitalist backlash there.

The combination of political stability and popular composure has given emerging markets what might be called "policy space" in which to act. They have used it to the full—and mostly for the better. This, in turn, has enhanced their reputations for economic management.

Little big spenders

At the start of 2009 falls in foreign-trade taxes, remittances, aid, commodity prices and capital inflows all threatened developing countries' fiscal positions, and their social spending especially. For a few, the threat materialised: 20 countries, many in eastern Europe, signed standby arrangements with the IMF and tightened fiscal policy. But by and large, the slash-and-burn approach to crisis management associated with previous bouts of economic trouble was avoided. For the first time in a global recession, emerging markets were free to loosen fiscal policy.

Some produced big stimulus programmes. China's is the best known, but Russia, Hong Kong, Kazakhstan, Malaysia, Vietnam, Thailand, Singapore, Brazil and Chile also unveiled large anti-crisis budgets or counter-cyclical spending programmes. As a share of GDP, stimulus spending by the emerging-market mem- »

bers of the G20 was larger than spending by the rich members. In that sense, emerging markets did more than their Western counterparts to combat global recession. Even countries that could not afford emergency programmes like China's let their fiscal balances deteriorate as counter-cyclical spending got under way. In Africa, oil importers let their budget deficits rise from 2.2% of GDP in 2008 to 6% in 2009.

By ring-fencing social spending, developing countries managed to protect some of their poorest people. Brazil expanded the coverage of its assistance programme for the poor, called Bolsa Familia, by over 1m households to 12m. India expanded to the whole country a programme that guarantees 100 days' employment on public works each year to any rural household that wants it. China's massive stimulus programme may have forestalled disaster in the migrant-labour force. Half the 140m labourers working in Chinese cities returned home in early 2009; a fifth stayed there, and another fifth could not find work when they returned to the cities. But as spending on infrastructure started to kick in, employment surged; by the middle of the year, joblessness among rural migrant workers was down to less than 3%. Beyond China, fear of social unrest associated with jobless migrants (as in 1997-98) has not materialised. A forthcoming study of 11 countries by Oxfam, a British NGO, found that migrants took new jobs, often at lower wages or with longer hours. In Vietnam some were even given money to stay in the cities by their families in the countryside—a kind of reverse remittance. But there was no mass return to the villages.

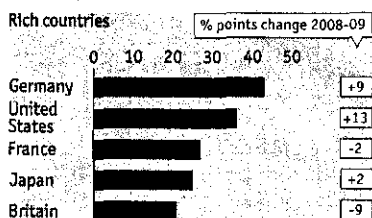
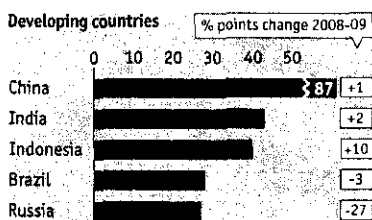
Flexibility is strength

The Oxfam study describes the myriad ways in which countries resisted the recession. Remittances held up better than expected. Parents refused to take their children out of class, or else switched them from private to public schools. Some even cut down on their own food to keep children in education. There were outright job losses in some parts of countries' economies, such as export sectors and mining. But the commoner reaction to falling demand was to cut hours and wages, reduce benefits and insist on more flexible working conditions. In other words, the main result of the slowdown was not unemployment (though there was some) but a move towards more flexible labour markets.

How long this can go on is unclear. Cash-transfer and make-work schemes are expensive: most poor countries cannot afford them. Worse, the poorest were more vulnerable than middle-income countries anyway because of the food-price spike of 2007-08: hence the rise in the number of hungry people to 1 billion, the highest figure since 1970. In general, the informal sector (home workers, ragpickers, street ven-

Miserable rich

People "satisfied with national conditions", 2009, %



Source: Pew Global Attitudes Project

dors) has been hit harder than the formal sector and is beyond the reach of government anti-poverty programmes. Although developing countries have done what they can, it would be wrong to think their people have escaped the recession entirely.

It is worth adding that not all the actions of developing-country governments have been equally enlightened. Emerging markets have been the worst sinners in a new round of protectionism. Whether you look at the number of new trade-damaging measures tracked by the World Trade Organisation, or the numbers of sectors or trading partners hurt, Russia, China and Indonesia are all among the top five protectionists; Argentina is in the top ten. Rich countries have been slightly less destructive. Still, as Simon Evenett, a professor of trade at the University of Saint Gallen, Switzerland, points out, this is not as dreadful as it might have been, or as it was in the 1930s. Only four countries have implemented restrictions affecting more than a quarter of their product lines: across-the-board tariff barriers are not the fashion. But as growth picks up and fights for market share increase, these restrictions could lay a basis for further trade disputes.

The tectonic consequence

When the Earth's tectonic plates grind against one another, they do not always move smoothly; sometimes they slip. A year after the West's slump began to spread to emerging markets, it has become clear that the recession has been a moment of tectonic slippage, a brief but powerful acceleration in the deep-seated movement of economic power away from rich nations towards emerging markets.

Since 2007, according to Goldman Sachs, the biggest emerging markets—Brazil, Russia, India and China—have accounted for 45% of global growth, almost twice as much as in 2000-06 and three times as

much as in the 1990s. It used to be said that although emerging markets were contributing an expanding share of world growth, they could not claim to be the real engine for the global economy because final demand for their exports lay in America. But that argument is weaker now that China has overtaken America as the main market for the goods of the smaller Asian exporters. The recession showed that economic power is leaching away from the West faster than was thought.

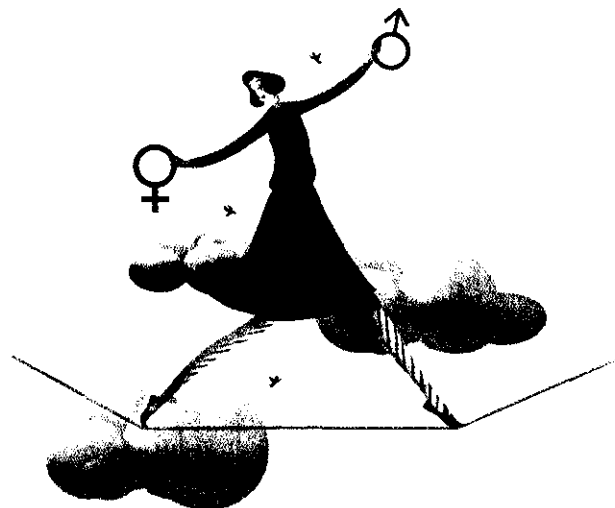
Previous recessions have left most developing countries with their reputations for economic management in tatters, and with credibility to regain in capital markets. This time, it is the rich whose reputations have been damaged. The fiscal response of many emerging markets has enhanced their credibility, and they find themselves with an unexpected reputation for fiscal prudence. The debt-to-GDP ratio of the 20 largest emerging markets is only half that of the top 20 rich nations. Over the next few years rich countries' debt will rise further, so emerging markets' indebtedness will be only one-third of theirs by 2014. Already there are signs that financial markets are rewarding them for good behaviour. Sovereign-risk spreads have been lower in the biggest emerging markets than in some euro-zone countries; in 2009, Hong Kong did more initial-public offerings than New York or London.

At the start of the crisis, a Mexican minister sighed: "At least this time it's not our fault." The comment was laden with sad irony: like everyone else, he expected that Mexico's innocence would make no difference and that emerging markets would be hammered anyway. But they have not been. So far the story of global recession in emerging markets has had that rarest of themes: virtue rewarded. ■



Schumpeter | Womenomics

Feminist management theorists are flirting with some dangerous arguments



THE late Paul Samuelson once quipped that "women are just men with less money". As a father of six, he might have added something about women's role in the reproduction of the species. But his aphorism is about as good a one-sentence summary of classical feminism as you can get.

The first generations of successful women insisted on being judged by the same standards as men. They had nothing but contempt for the notion of special treatment for "the sisters"; and instead insisted on getting ahead by dint of working harder and thinking smarter. Margaret Thatcher made no secret of her contempt for the wimpish men around her. (There is a joke about her going out to dinner with her cabinet. "Steak or fish?" asks the waiter. "Steak, of course," she replies. "And for the vegetables?" "They'll have steak as well.") During America's most recent presidential election Hillary Clinton taunted Barack Obama with an advertisement that implied that he, unlike she, was not up to the challenge of answering the red phone at 3am.

Many pioneering businesswomen pride themselves on their toughness. Dong Mingzhu, the boss of Gree Electric Appliances, an air-conditioning giant, says flatly, "I never miss. I never admit mistakes and I am always correct." In the past three years her company has boosted shareholder returns by nearly 500%.

But some of today's most influential feminists contend that women will never fulfil their potential if they play by men's rules. According to Avivah Wittenberg-Cox and Alison Maitland, two of the most prominent exponents of this position, it is not enough to smash the glass ceiling. You need to audit the entire building for "gender asbestos"—in other words, root out the inherent sexism built into corporate structures and processes.

The new feminism contends that women are wired differently from men, and not just in trivial ways. They are less aggressive and more consensus-seeking, less competitive and more collaborative, less power-obsessed and more group-oriented. Judy Rosener, of the University of California, Irvine, argues that women excel at "transformational" and "interactive" management. Peninah Thomson and Jacey Graham, the authors of "A Woman's Place is in the Boardroom", assert that women are "better lateral thinkers than men" and "more idealistic" into the bargain. Feminist texts are suddenly full of references to tribes of mon-

keys, with their aggressive males and nurturing females.

What is more, the argument runs, these supposedly womanly qualities are becoming ever more valuable in business. The recent financial crisis proved that the sort of qualities that men pride themselves on, such as risk-taking and bare-knuckle competition, can lead to disaster. Lehman Brothers would never have happened if it had been Lehman Sisters, according to this theory. Even before the financial disaster struck, the new feminists also claim, the best companies had been abandoning "patriarchal" hierarchies in favour of "collaboration" and "networking", skills in which women have an inherent advantage.

This argument may sound a little like the stuff of gender workshops in righteous universities. But it is gaining followers in powerful places. McKinsey, the most venerable of management consultancies, has published research arguing that women apply five of the nine "leadership behaviours" that lead to corporate success more frequently than men. Niall FitzGerald, the chairman of Reuters and a former boss of Unilever, is as close as you can get to the heart of the corporate establishment. He proclaims, "Women have different ways of achieving results, and leadership qualities that are becoming more important as our organisations become less hierarchical and more loosely organised around matrix structures." Many companies are abandoning the old-fashioned commitment to treating everybody equally and instead becoming "gender adapted" and "gender bilingual"—in touch with the unique management wisdom of their female employees. A host of consultancies has sprung up to teach firms how to listen to women and exploit their special abilities.

The new feminists are right to be frustrated about the pace of women's progress in business. Britain's Equality and Human Rights Commission calculated that, at the current rate of progress, it will take 60 years for women to gain equal representation on the boards of the FTSE 100. They are also right that old-fashioned feminism took too little account of women's role in raising children. But their arguments about the innate differences between men and women are sloppy and counterproductive.

People who bang on about innate differences should remember that variation within subgroups in the population is usually bigger than the variation between subgroups. Even if it can be established that, on average, women have a higher "emotional-intelligence quotient" than men, that says little about any specific woman. Judging people as individuals rather than as representatives of groups is both morally right and good for business.

Caring, sharing and engineering

Besides, many of the most successful women are to be found in hard-edged companies, rather than the touchy-feely organisations of the new feminist imagination: Areva (nuclear energy), AngloAmerican (mining), Archer Daniels Midland (agribusiness), DuPont (chemicals), Sunoco (oil) and Xerox (technology) all have female bosses. The Cranfield School of Management's Female FTSE100 Index reveals that two of the industries with the best record for promoting women to their boards are banking and transport.

Women would be well advised to ignore the siren voices of the new feminism and listen to Ms Dong instead. Despite their frustration, the future looks bright. Women are now outperforming men markedly in school and university. It would be a grave mistake to abandon old-fashioned meritocracy just at the time when it is turning to women's advantage. ■



Female power

Across the rich world more women are working than ever before. Coping with this change will be one of the great challenges of the coming decades

THE economic empowerment of women across the rich world is one of the most remarkable revolutions of the past 50 years. It is remarkable because of the extent of the change: millions of people who were once dependent on men have taken control of their own economic fates. It is remarkable also because it has produced so little friction: a change that affects the most intimate aspects of people's identities has been widely welcomed by men as well as women. Dramatic social change seldom takes such a benign form.

Yet even benign change can come with a sting in its tail. Social arrangements have not caught up with economic changes. Many children have paid a price for the rise of the two-income household. Many women—and indeed many men—feel that they are caught in an ever-tightening tangle of commitments. If the empowerment of women was one of the great changes of the past 50 years, dealing with its social consequences will be one of the great challenges of the next 50.

At the end of her campaign to become America's first female president in 2008, Hillary Clinton remarked that her 18m votes in the Democratic Party's primaries represented 18m cracks in the glass ceiling. In the market for jobs rather than votes the

ceiling is being cracked every day. Women now make up almost half of American workers (49.9% in October). They run some of the world's best companies, such as PepsiCo, Archer Daniels Midland and W.L. Gore. They earn almost 60% of university degrees in America and Europe.

Progress has not been uniform, of course. In Italy and Japan employment rates for men are more than 20 percentage points higher than those for women (see chart 1). Although Italy's female employment rate has risen markedly in the past decade, it is still below 50%, and more than

20 percentage points below those of Denmark and Sweden (chart 2, next page). Women earn substantially less than men on average and are severely under-represented at the top of organisations.

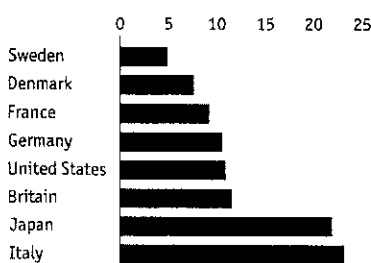
The change is dramatic nevertheless. A generation ago working women performed menial jobs and were routinely subjected to casual sexism—as “Mad Men”, a television drama about advertising executives in the early 1960s, demonstrates brilliantly. Today women make up the majority of professional workers in many countries (51% in the United States, for example) and casual sexism is for losers. Even holdouts such as the Mediterranean countries are changing rapidly. In Spain the proportion of young women in the labour force has now reached American levels. The glass is much nearer to being half full than half empty.

What explains this revolution? Politics have clearly played a part. Feminists such as Betty Friedan have demonised domestic slavery and lambasted discrimination. Governments have passed equal-rights acts. Female politicians such as Margaret Thatcher and Mrs Clinton have taught younger women that anything is possible. But politics is only part of the answer: such discordant figures as Ms Friedan and Lady Thatcher have been borne aloft by subterranean economic and technological forces.

The rich world has seen a growing demand for women's labour. When brute strength mattered more than brains, men had an inherent advantage. Now that brainpower has triumphed the two sexes are more evenly matched. The feminisation of the workforce has been driven by ►►

The Swedish work ethic

Difference between male and female employment rates, 2008, percentage points



Source: Eurostat

► the relentless rise of the service sector (where women can compete as well as men) and the equally relentless decline of manufacturing (where they could not). The landmark book in the rise of feminism was arguably not Ms Friedan's "The Feminine Mystique" but Daniel Bell's "The Coming of Post-Industrial Society".

Demand has been matched by supply: women are increasingly willing and able to work outside the home. The vacuum cleaner has played its part. Improved technology reduced the amount of time needed for the traditional female work of cleaning and cooking. But the most important innovation has been the contraceptive pill. The spread of the pill has not only allowed women to get married later. It has also increased their incentives to invest time and effort in acquiring skills, particularly slow-burning skills that are hard to learn and take many years to pay off. The knowledge that they would not have to drop out of, say, law school to have a baby made law school more attractive.

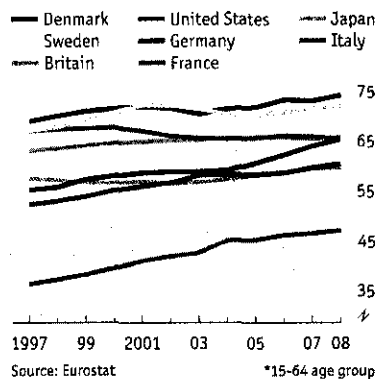
The expansion of higher education has also boosted job prospects for women, improving their value on the job market and shifting their role models from stay-at-home mothers to successful professional women. The best-educated women have always been more likely than other women to work, even after having children. In 1963, 62% of college-educated women in the United States were in the labour force, compared with 46% of those with a high school diploma. Today 80% of American women with a college education are in the labour force compared with 67% of those with a high school diploma and 47% of those without one.

This growing cohort of university-educated women is also educated in more marketable subjects. In 1966, 40% of American women who received a BA specialised in education in college; 2% specialised in business and management. The figures are now 12% and 50%. Women only continue to lag seriously behind men in a handful of subjects, such as engineering and computer sciences, where they earned about one-fifth of degrees in 2006.

One of the most surprising things about this revolution is how little overt celebration it has engendered. Most people welcome the change. A recent Rockefeller Foundation/Time survey found that three-quarters of Americans regarded it as a positive development. Nine men out of ten said they were comfortable with women earning more than them. But few are cheering. This is partly because young women take their opportunities for granted. It is partly because for many women work represents economic necessity rather than liberation. The rich world's growing army of single mothers have little choice but to work. A growing proportion of married women have also discovered

Rising force

Female employment rate*, %



that the only way they can preserve their households' living standards is to join their husbands in the labour market. In America families with stay-at-home wives have the same inflation-adjusted income as similar families did in the early 1970s. But the biggest reason is that the revolution has brought plenty of problems in its wake.

Production versus reproduction

One obvious problem is that women's rising aspirations have not been fulfilled. They have been encouraged to climb onto the occupational ladder only to discover that the middle rungs are dominated by men and the upper rungs are out of reach. Only 2% of the bosses of Fortune 500 companies and five of those in the FTSE 100 stockmarket index are women. Women make up less than 13% of board members in America. The upper ranks of management consultancies and banks are dominated by men. In America and Britain the typical full-time female worker earns only about 80% as much as the typical male.

This no doubt owes something to prejudice. But the biggest reason why women remain frustrated is more profound: many women are forced to choose between motherhood and careers. Childless women in corporate America earn almost as much as men. Mothers with partners earn less and single mothers much less. The cost of motherhood is particularly steep for fast-track women. Traditionally "female" jobs such as teaching mix well with motherhood because wages do not rise much with experience and hours are relatively light. But at successful firms wages rise steeply and schedules are demanding. Future bosses are expected to have worked in several departments and countries. Professional-services firms have an up-or-out system which rewards the most dedicated with lucrative partnerships. The reason for the income gap may thus be the opposite of prejudice. It is that women are judged by exactly the same standards as men.

This Hobson's choice is imposing a high cost on both individuals and society.

Many professional women reject motherhood entirely: in Switzerland 40% of them are childless. Others delay child-bearing for so long that they are forced into the arms of the booming fertility industry. The female drop-out rate from the most competitive professions represents a loss to collective investment in talent. A study of graduates of the University of Chicago's Booth School of Business by Marianne Bertrand and her colleagues found that, ten years after graduating, about half of the female MBAs who had chosen to have children remained in the labour force. It also leaves many former high-flyers frustrated. Another American study, this time of women who left work to have children, found that all but 7% of them wanted to return to work. Only 74% managed to return, and just 40% returned to full-time jobs.

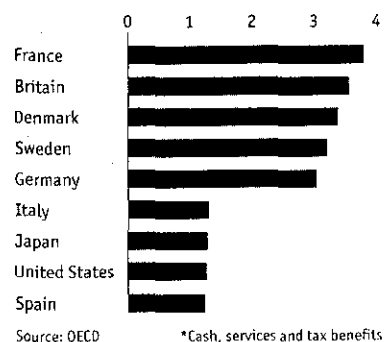
Even well-off parents worry that they spend too little time with their children, thanks to crowded schedules and the ever-buzzing BlackBerry. For poorer parents, juggling the twin demands of work and child-rearing can be a nightmare. Child care eats a terrifying proportion of the family budget, and many childminders are untrained. But quitting work to look after the children can mean financial disaster. British children brought up in two-parent families where only one parent works are almost three times more likely to be poor than children with two parents at work.

A survey for the Children's Society, a British charity, found that 60% of parents agreed that "nowadays parents aren't able to spend enough time with their children". In a similar survey in America 74% of parents said that they did not have enough time for their children. Nor does the problem disappear as children get older. In most countries schools finish early in the afternoon. In America they close down for two months in the summer. Only a few places—Denmark, Sweden and, to a lesser extent, France and Quebec—provide comprehensive systems of after-school care.

Different countries have adopted different solutions to the problem of combining ►

Household expenditure

Public spending on family benefits*
% of GDP, 2005



*Cash, services and tax benefits

► work and parenthood. Some stress the importance of very young children spending time with their mothers. Austria, the Czech Republic, Finland and Hungary provide up to three years of paid leave for mothers. Germany has introduced a "parent's salary", or *Elterngeld*, to encourage mothers to stay at home. (The legislation was championed by a minister for women who has seven children.) Other countries put more emphasis on preschool education. New Zealand and the Nordic countries are particularly keen on getting women back to work and children into kindergartens. Britain, Germany, Japan, Switzerland and, above all, the Netherlands are keen on mothers working part-time. Others, such as the Czech Republic, Greece, Finland, Hungary, Portugal and South Korea, make little room for part-time work for women. The Scandinavian countries, particularly Iceland, have added a further wrinkle by increasing incentives for fathers to spend more time caring for their children.

The world's biggest economy has adopted an idiosyncratic approach. America provides no statutory paid leave for mothers and only 12 weeks unpaid. At least 145 countries provide paid sick leave. America allows only unpaid absence for serious family illness. America's public spending on family support is low by OECD standards (see chart 3 on the previous page). It spends only 0.5% of its GDP on public support for child care compared with 1.3% in France and 2.7% in Denmark.

It is difficult to evaluate the relative merits of these various arrangements. Different systems can produce similar results: anti-statist America has roughly the same proportion of children in kindergartens as statist Finland. Different systems have different faults. Sweden is not quite the paragon that its fans imagine, despite its family-friendly employment policies. Only 15% of senior managers are women, compared with 11% in America. Three-quarters of Swedish women work in the public sector; three-quarters of men work in the private sector. But there is evidence that America and Britain, the countries that combine high female employment with reluctance to involve the state in child care, serve their children especially poorly. A report by Unicef in 2007 on children in rich countries found that America and Britain had some of the lowest scores for "well-being".

A woman's world

The trend towards more women working is almost certain to continue. In the European Union women have filled 6m of the 8m new jobs created since 2000. In America three out of four people thrown out of work since the recession began are men; the female unemployment rate is 8.6%, against 11.2% for men. The Bureau of Labour Statistics calculates that women make up more than two-thirds of employ-

ees in ten of the 15 job categories likely to grow fastest in the next few years. By 2011 there will be 2.6m more women than men studying in American universities.

Women will also be the beneficiaries of the growing "war for talent". The combination of an ageing workforce and a more skill-dependent economy means that countries will have to make better use of their female populations. Goldman Sachs calculates that, leaving all other things equal, increasing women's participation in the labour market to male levels will boost GDP by 21% in Italy, 19% in Spain, 16% in Japan, 9% in America, France and Germany, and 8% in Britain.

The corporate world is doing ever more to address the loss of female talent and the difficulty of combining work with child care. Many elite companies are rethinking their promotion practices. Addleshaw Goddard, a law firm, has created the role of legal director as an alternative to partnerships for women who want to combine work and motherhood. Ernst & Young and other accounting firms have increased their efforts to maintain connections with women who take time off to have children and then ease them back into work.

Home-working is increasingly fashionable. More than 90% of companies in Germany and Sweden allow flexible working. A growing number of firms are learning to divide the working week in new ways—judging staff on annual rather than weekly hours, allowing them to work nine days a fortnight, letting them come in early or late and allowing husbands and wives to share jobs. Almost half of Sun Microsystems's employees work at home or from nearby satellite offices. Raytheon, a maker of missile systems, allows workers every other Friday off to take care of family business, if they make up the hours on other days.

Companies are even rethinking the structure of careers, as people live and

work longer. Barclays is one of many firms that allow five years' unpaid leave. John Lewis offers a six-month paid sabbatical to people who have been in the company for 25 years. Companies are allowing people to phase their retirement. Child-bearing years will thus make up a smaller proportion of women's potential working lives. Spells out of the labour force will become less a mark of female exceptionalism.

Faster change is likely as women exploit their economic power. Many talented women are already hopping off the corporate treadmill to form companies that better meet their needs. In the past decade the number of privately owned companies started by women in America has increased twice as fast as the number owned by men. Women-owned companies employ more people than the largest 500 companies combined. Eden McCallum and Axiom Legal have applied a network model to their respective fields of management consultancy and legal services: network members work when it suits them and the companies use their scale to make sure that clients have their problems dealt with immediately.

Governments are also trying to adjust to the new world. Germany now has 1,600 schools where the day lasts until mid-afternoon. Some of the most popular American charter schools offer longer school days and shorter summer holidays.

But so far even the combination of public- and private-sector initiatives has only gone so far to deal with the problem. The children of poorer working mothers are the least likely to benefit from female-friendly companies. Millions of families still struggle with insufficient child-care facilities and a school day that bears no relationship to their working lives. The West will be struggling to cope with the social consequences of women's economic empowerment for many years to come. ■



The next generation



Deflation in Japan

To lose one decade may be misfortune...

TOKYO

Twenty years on Japan is still paying its bubble-era bills

FOR many Japanese the boom years are still seared on their memories. They recall the embarrassing prices paid for works by Van Gogh and Renoir; the trophy properties in Manhattan; the crazy working hours and the rush to get to the overcrowded ski resorts at the weekend, only to waste hours queuing at the lifts.

The bust, when it came, was less perceptible. The world did not come crashing down after December 29th 1989, the last trading day of that decade, when the stock-market peaked. The next year Japanese buyers were still paying record prices for Impressionist art at Christie's. It was not until 1991 that the property bubble burst. There was no Lehman-style collapse or Bernie Madoff-type fraud to hammer home the full extent of the hubris.

But once the Nikkei 225 hit 38,916 points 20 years ago this week, life began to leach out of the Japanese economy. In the third quarter of 2009 nominal GDP—though still vast by global standards—sank below its level in 1992, reinforcing the impression of not one but two lost decades. Deflation is back in the headlines. On December 29th the Nikkei stood at 10,638, 73% below its peak, though an expansionary budget drafted on December 25th has given it a recent lift. Urban property prices have fallen by almost two-thirds. Some ski apartments are worth just one-tenth of what the “bubble generation” paid for them.

What effect has this steady erosion of value had on the psychology of Japanese people? The bust did not lay waste to Japan, after all, as the Depression did to America in the 1930s. Homelessness and suicide have risen, and life has got much harder for young people seeking good jobs. But Japan still has ¥1,500 trillion (\$16.3 trillion) of savings, its exporters are world-class, and many of its citizens dress, shop and eat lavishly. As a senior civil servant puts it: “Japanese people have never really felt that they are in crisis, even though the economy is slowly withering away.”

For individuals the damage lies below the surface. One of the first bubbles to pop, says Peter Tasker of Arcus Research, who

has written several books on the bust, was a psychological one: confidence. Instead of getting angry, people lost faith in Japan's economic prowess. “It became all about declining expectations and how society coped with it,” Mr Tasker says.

The mood among investors swiftly turned risk-averse. Remarkably, retail investors were among the first to get out of the stockmarket and were net sellers of equities from 1991 to 2007, says Kathy Matsui, chief strategist for Goldman Sachs in Japan. Though there have been four bear-market share-price rallies since 1989, they have all been driven by foreigners.

The Japanese parked their money instead in government-backed shelters such as the post office, which in turn invested in safe bonds. The result has been a 78% rally in ten-year government bonds since their trough in 1990 (see chart). “Fixed income has been one of the longest-duration bull markets in the world,” Ms Matsui notes.

A deflationary mindset started to take hold. With prices falling, even inert money in the bank or post office earned, in real terms, a small tax-free return. Once the banking system began to look frail, there was a boom in the sale of safes for people to keep their cash at home. A long period of zero interest rates led a few to hunt for higher yields abroad. The mythical figure of Mrs Watanabe—housewives in Japan manage the family money—invested in New Zealand dollars and Icelandic kronur. These days she is placing large bets on Brazilian bonds, leading to the quip that although Tokyo failed to secure the 2016 Olympics, the Japanese will finance the games in Rio de Janeiro anyway. Yet individual Japanese investors are still only gingerly returning to their own stockmarket.

The most pernicious effects of the bust, economists say, have been transmitted via ►►

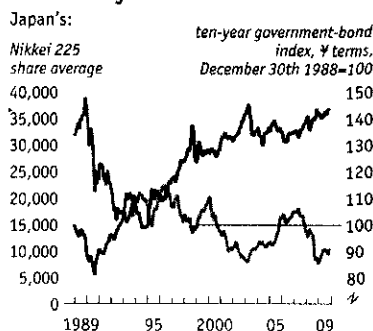
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Twice decayed



Source: Thomson Reuters

banks and businesses. Banks found themselves loaded down with non-performing loans. Belatedly they faced up to many of their losses, restructured and consolidated. But according to Takuji Aida, an economist at UBS in Japan, long-term yields remained very low because of deflationary expectations, thereby flattening the yield curve (the difference between short- and long-term interest rates). That prevented banks from earning their way out of crisis, so lending remains weak.

Companies, meanwhile, have been focused on paying down debt, as well as coping with deflation in the domestic econ-

omy and competition from cut-price imports. Large exporters were forced to restructure and enjoyed a long boom from 2002 to 2007. But firms in more protected areas of the domestic economy have fared badly: profitability, wages and investment have declined in the past decade.

This has fed back to households. As firms cut back, the proportion of full-time contract jobs has fallen from almost 80% of the labour force in 1990 to 66% in 2007, according to the OECD. The proportion of lower-paid non-regular jobs has risen correspondingly. This is partly down to the increasing role of women in the workforce,

as declining wages and benefits force families to rely on two incomes. But there are long-term social costs to this extended income drought. "The slow wear-and-tear of the recession has made people much less confident of their ability to finance children," Mr Tasker says.

A weak culture of consumer borrowing means that people have been forced to rely even more on their savings—or those of their parents. But as society ages, growth in the stock of savings has dwindled. Savings are bound to fall as more people retire. For the younger generation the next decade may be even tougher than the past two. ■

Buttonwood

Choosing between workers and creditors

THE air of immediate crisis is over. The monetary and fiscal doctors wheeled out the crash trolley and applied an electric shock to the global economy's chest. The patient is recovering but is still rather too dependent on the drug of government support. The coming year will be dominated by a debate about how quickly that support can be taken away.

Two shocks have reduced the standard of living of Western economies. One is a terms-of-trade shift. Thanks mainly to China, the prices of the manufactured goods that rich countries sell have fallen; those of the commodities they buy have risen. The other is a "leverage" shock, in which the credit crisis has stopped people from borrowing to finance consumption.

In response to this second shock, governments have deliberately taken on the debts of the private sector. In most cases it has been assumed that governments have almost limitless capacity to assume such burdens. But you can see welfare states as national Ponzi schemes in which governments grant benefits and take on spending responsibilities, confident in the expectation that the next generation of citizens will pick up the bill.

Such promises have worked so far because of continued economic growth and rising populations. But with populations starting to fall in some countries, and the tax base shrinking in others, the strain is starting to show. The financial crisis has piled on further stress. Iceland, a tiny island state, was overwhelmed by the debts of its banks. Dubai has shown that the distinction between government debt and the debt of government-controlled entities can be a fuzzy one. Greece has been downgraded by two rating agencies, Fitch and Standard & Poor's.

All this may lead to a turbulent year in the currency markets. The idea of the

"law of volatility" is that you can control risks in some parts of the system but not in them all. A zero-interest-rate policy has supported risky assets, particularly equities, while quantitative easing, by allowing central banks to buy government bonds, has prevented massive fiscal deficits from pushing up bond yields.

But having taken those two steps the authorities cannot also prop up their currencies, even if they had the desire to do so. In the absence of inflationary pressure, a depreciating currency seems a painless way of boosting the prospects of a country's exporters. So the American and British authorities have been happy to let the dollar and sterling slide.

Of course, not all currencies can depreciate. Some must rise. By rights this should be those of the emerging Asian economies. But China in particular is unwilling to let the yuan appreciate as fast as the markets, or its trading partners, would like. That puts even more pressure on the losers in this game of deflationary pass-the-parcel. Brazil has reimposed a levy on capital imports to weaken the real. Japan's new government has been pressuring the central

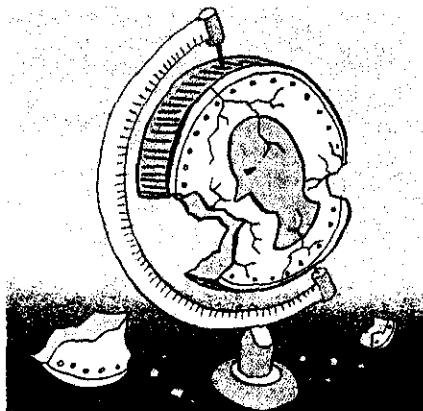
bank to ease monetary policy further in the face of the strengthening yen.

In Europe the single currency has removed the old escape route of devaluation. Countries that have seen faster-than-average cost growth must accordingly face years of austerity if their manufacturing sectors are to remain competitive against Germany, let alone Asia.

But will electorates be willing to swallow such unpleasant medicine? The temptation, as in Britain, is to attempt to solve the crisis by raising taxes, rather than cutting spending, especially if those taxes can be aimed at an unpopular group like bankers. However, a high-tax strategy in a world of highly mobile labour and capital seems doomed to failure in the long run. The pain is likely to fall on the broad mass of the population.

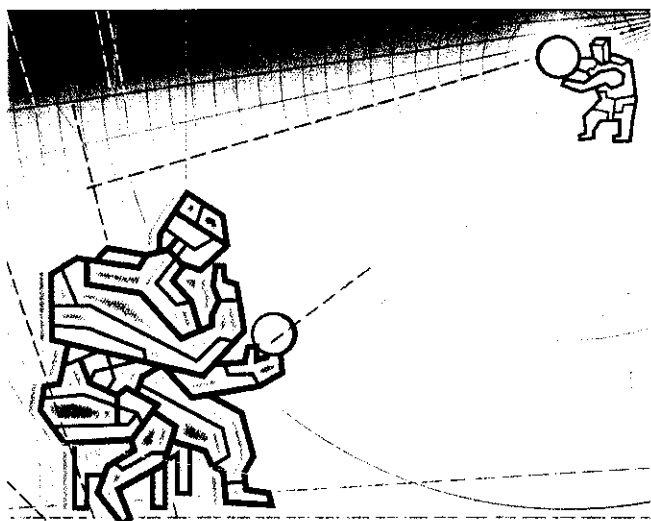
The battle then is between taxpayers and public-sector workers, with the former broadly represented by right-wing parties (the Republicans in America, the Conservatives in Britain) and the latter by left-wing ones (the Democrats and Labour). Even if the right-wing parties win the argument in the legislature, they could still lose on the streets, if strike action forces governments to back down.

The gold standard broke down in the 1930s because countries would not pay the political price, in the form of austerity, to maintain the link. They chose domestic workers over foreign creditors. The Bretton Woods system broke down because America was unwilling to bear the burden of being the linchpin of the system. Now, the system that prevailed in the 1980s, 1990s and 2000s, in which creditors trusted central banks to maintain the value of debtor countries' currencies, is breaking down as well.



Economics focus | New-year irresolution

How to combat the natural tendency to procrastinate



EACH New Year's Day lots of people make plans to do more exercise or give up smoking. But by January 2nd many of them have not moved from the sofa or are lighting another cigarette. Such triumphs of optimism over experience are common enough. But like other examples of repeated procrastination, they are hard to explain using standard economic models.

These models recognise that people prefer to put off unpleasant things until the future rather than do them today. Asked on January 1st to pick a date for that first session in the gym, say, you may well choose to start in two weeks' time rather than tomorrow. But the standard models also assume that your choices about future actions are "time-consistent"—they do not depend on when you are asked to make the choice. By January 14th, in other words, you should still be committed to going to the gym the next day. In the real world, however, you may well choose to delay your start-date again.

In a 1999 paper* on the economics of procrastination, Ted O'Donoghue and Matthew Rabin pointed out that people are often unrealistically optimistic about their own future likelihood of doing things—such as exercise or saving—that involve costs at the time they are done, but whose benefits lie even further ahead. Mr O'Donoghue and Mr Rabin showed that this sort of behaviour can be explained if people are time-inconsistent. "Present-biased" preferences mean that people will always tend to put off unpleasant things until tomorrow, even if the immediate cost involved is tiny. As long as they are unsure of the precise extent of this bias, they believe (incorrectly) that they will in fact "do it tomorrow". But since they feel this way at each point in time, tomorrow never quite comes. Such a model can therefore explain endless procrastination.

It can also suggest ways to change behaviour. A recent NBER paper by Esther Duflo, Michael Kremer and Jonathan Robinson argues that a tendency to procrastinate may explain why so few African farmers use fertiliser, despite knowing that it raises yields and profits. In trials on the farms of maize farmers in western Kenya, the three economists found that using half a teaspoon of fertiliser per plant increased seasonal profits by an average of 36% per acre, even if farmers made no other changes to their farming techniques. Doing so after it was clear that the seeds had sprout-

ed eliminated most of the risk of paying for fertiliser in a year of poor weather. Only 9% of the farmers believed fertiliser would not increase their profits. Yet only 29% had used any in either of the two preceding seasons.

When asked why, almost four-fifths of farmers said that they did not have enough money to buy fertiliser for the land they farmed. Yet fertiliser was readily available in multiples of a kilogram, so even poor farmers earned enough to buy fertiliser for at least a fraction of their fields. Better intentions made little difference: virtually all farmers said they planned to use fertiliser the following season, but only 37% actually did so.

The reason for this gap between intent and action, the economists argue, is that many farmers are present-biased and procrastinate repeatedly. Right after the harvest, when farmers are cash-rich, most can afford to buy fertiliser. But going to town to buy it imposes a small cost: a half-hour walk, say, or a bus ticket. So farmers postpone the purchase, believing they will make it later. But they overestimate their ability to put aside enough money to do that, ensuring that their plans to buy fertiliser meet much the same fate as a typical new-year resolution.

A model of such preferences generates several interesting predictions. It suggests that a tiny discount—enough to make up for the small costs associated with buying fertiliser—should induce present-biased farmers to make the purchase. The model also suggests that a given discount would be more effective if offered immediately after the harvest rather than just before the next planting period, by which time it would be useful only for those farmers who had no problems with saving money.

Solving St Augustine

The economists devised a scheme in which farmers paid the full market price for fertiliser, but had it delivered to their homes by a non-governmental organisation at no additional cost. A subset received this "discount" at harvest time, while another group were also offered free delivery, but only when planting time was imminent. Still others were offered a 50% subsidy on the market price, an approach commonly taken by governments to encourage fertiliser use. As the model of time-inconsistent preferences predicted, the offer of free delivery early in the season pushed up usage of fertiliser by 11 percentage points over a control group who were not offered anything. The same discount late in the season, however, had a statistically insignificant effect. A 50% subsidy later in the season, a much costlier policy than free delivery, pushed up usage by about as much as the early discount.

Interestingly, nearly half of a group of farmers who were offered a choice picked early rather than late free delivery. Early delivery means advance payment, with any interest that might have been earned in the interim being forgone. Many farmers, it seemed, were well aware of their own tendency to procrastinate and were looking for a way to force themselves to buy fertiliser.

Such devices can help other procrastinators, too. In recent field trials in the Philippines some smokers who wanted to quit were offered a "commitment contract". Those who signed up put money into a zero-interest bank account. If they passed a test certifying that they were nicotine-free six months later, they got their money back. If not, it went to charity. The contract increased the likelihood of quitting by over 30% over a control group. Those new-year resolutions need not turn to ash. ■

* See papers referred to in this article at www.economist.com/procrastination

Bubble warning

Markets are too dependent on unsustainable government stimulus. Something's got to give



THE effect of free money is remarkable. A year ago investors were panicking and there was talk of another Depression. Now the MSCI world index of global share prices is more than 70% higher than its low in March 2009. That's largely

thanks to interest rates of 1% or less in America, Japan, Britain and the euro zone, which have persuaded investors to take their money out of cash and to buy risky assets.

For all the panic last year, asset values never quite reached the lows that marked other bear-market bottoms, and now the rally has made several markets look pricey again. In the American housing market, where the crisis started, homes are priced at around fair value on the basis of rental yields, but they are overvalued by almost 30% in Britain and by 50% in Australia, Hong Kong and Spain.

Stockmarkets are still shy of their record peaks in most countries. The American market is around 25% below the level it reached in 2007. But it is still nearly 50% overvalued on the best long-term measure, which adjusts profits to allow for the economic cycle, and is on a par with two of the four great valuation peaks in the 20th century, in 1901 and 1966.

Central banks see these market rallies as a welcome side-effect of their policies. In 2008, falling markets caused a vicious circle of debt defaults and fire sales by investors, pushing asset prices down even further. The market rebound was necessary to stabilise economies last year, but now there is a danger that bubbles are being created (see page 61).

Forever blowing bubbles?

Aside from high asset valuations, the two classic symptoms of a bubble are rapid growth in private-sector credit and an outbreak of public enthusiasm for particular assets. There's no sign of either of those. But the longer the world keeps its interest rates close to zero, the greater the danger that bubbles will appear—most likely in emerging markets, where growth keeps investors optimistic and currency pegs import loose monetary policy, and in commodities.

Central banks have a range of tools they can use to discourage the growth of bubbles. Forcing banks to adopt higher capital ratios may curb speculative excesses. As Ben Bernanke, chairman of the Federal Reserve, argued this week, the rise in American house prices could have been limited through better regulation of the banks. The most powerful tool, of course, is the interest rate. But central banks are wary of using it to pop bubbles because it risks crushing growth as well. And, with the world economy in its current fragile state, they are rightly unwilling to jack up interest rates now.

But even if governments judge that the risks posed by raising rates now outweighs that of keeping them low, investors still have plenty of reasons to worry. The problem for them is not just that valuations look high by historic standards. It is also that the current combination of high asset prices, low interest rates and massive fiscal deficits is unsustainable.

Interest rates will stay low only if growth remains slow. But if economies grow slowly, then profits will not rise fast enough to justify current share prices and incomes will not rise far enough to justify the prevailing level of house prices. If, on the other hand, the markets are right about the prospects for economic growth, and the current recovery is sustained, then governments will react by cutting off the supply of cheap money later this year.

It doesn't add up

But the more immediate risks may be posed by fiscal policy. Many governments responded to the crisis by, in effect, taking the debt burden off the private sector's balance-sheets and putting it on their own. This caused a huge gap to open up in government finances. Deficits in America and Britain, for instance, stand at more than 10% of GDP.

Most developed-country governments have managed to finance these deficits fairly easily so far. In the early stages of the crisis, investors were happy to opt for the safety of government bonds. Then central banks resorted to quantitative easing (QE), a polite term for the creation of money. The Bank of England, for example, has bought the equivalent of one year's entire fiscal deficit. There are signs, however, that private-sector investors' appetite for government debt may be just about sated, as they contemplate the vast amount of government bonds that are due to be issued this year and the ending of QE programmes. The yields on ten-year Treasury bonds and British gilts have both risen by more than half a percentage point since late November.

Investors (along with this newspaper) would like to see governments unveil clear plans for reducing those deficits over the medium term, with the emphasis on spending cuts rather than tax increases. But politicians are nervous about the likely reaction of electorates, not to mention the short-term economic impact of fiscal tightening, and are proving reluctant to specify where the cuts will be made.

Markets have already tested the ability of the weakest governments to bear the burden of their debt. Dubai had to turn to its wealthy neighbour, Abu Dhabi, for help. In the euro zone, doubts have been raised about the willingness of Greece to push through the required austerity measures. Electorates are likely to chafe at the cost of bringing down government deficits, especially if the main result is to repay foreign creditors. That will lead to currency crises and cross-border disputes like the current spat between Iceland, Britain and the Netherlands over the bill for compensating depositors in Icelandic banks (see page 45). Such disputes will lead to further outbreaks of market volatility.

Investors tempted to take comfort from the fact that asset prices are still below their peaks would do well to remember that they may yet fall back a very long way. The Japanese stock market still trades at a quarter of the high it reached 20 years ago. The NASDAQ trades at half the level it reached during dot-com mania. Today the prices of many assets are being held up by unsustainable fiscal and monetary stimulus. Something has to give. ■

Water pricing in China Bottling it

BEIJING

Consumers defend their subsidies

MANY Chinese cities are short of water, yet encourage wastage by selling it at heavily subsidised prices. Recent moves by several cities to bring in higher tariffs have shown how prickly water-users can be about rising prices, even at what seemed an opportune time. From February until November last year, China's consumer-price index fell each month compared with a year earlier, the first such falls since December 2002.

Inflation having ebbed as a public concern, several cities decided it was safe to push for more expensive water. In June Shanghai raised residential water prices for the first time in seven years, by 25%. In November Beijing put up the price of water for commercial use by nearly 50%. On December 22nd it raised the price for households by 8% as the first stage of a 24% increase by 2013. Beijing, despite several years of drought—eased somewhat in 2008 by a new water channel from the neighbouring, and no less parched, province of Hebei—had not increased residential prices since 2004 (see chart).

Beijing's government says 80% of the city's households use less than ten cubic metres of water a month. For these a 24% price increase would mean a tiny extra monthly outlay—under nine yuan (\$1.32). But this has not stopped the grumbling.

Unfortunately for the government, inflation worries have resurfaced. In November the consumer-price index rose for the first time since January, by 0.6% over a year earlier. In Beijing the city's biggest snowfall in more than 50 years this week pushed up vegetable prices. Higher water tariffs for businesses, some residents fret, could nudge other prices up. In October one newspaper, *Southern Daily*, had warned



At least it's cheap

that water-price increases could become a "powder keg" for anti-government unrest.

Even China's state-controlled press has aired complaints, many of them directed at the public hearings held in various cities to discuss water-price proposals. Trumpeted as evidence of a new democratic openness, such hearings have since 1998 been a requirement in China when utility prices are raised. Several Chinese commentators, however, have dismissed the recent sessions as window-dressing. The handful of consumer "representatives" permitted to attend, they claimed, are often officials or else too well-off to represent those worst affected. In Harbin, a city in the north-east, one representative who opposed price increases became something of a media celebrity last month, after he threw down a bottle of mineral water in disgust at not being given the time, he alleged, to express his views at a hearing.

Several newspaper articles have also pointed out that price increases alone might not be sufficient to encourage more frugal use. Beijing's average domestic water-consumption per person has barely changed in the past decade even though prices more than doubled between 2001 and 2004. Without more open accounting by the state-run water companies, some media commentators have argued, the extra money might simply go to waste. *China Daily*, an English-language newspaper, said officials had given few details of the rising costs they hoped to offset with the price increases.

An attempt on January 4th by a central-government spokesman to defend the recent hearings has prompted yet more scorn. As one newspaper put it, if all the hearings were held according to the rules, then the rules themselves are a problem. ■

The China-ASEAN free-trade agreement Ajar for business

TOKYO

More breadth than depth

A DECADE after it was first mooted, the world's largest free-trade area by population came broadly into effect on January 1st. The agreement between China and the ten-country Association of South-East Asian Nations (ASEAN) covers nearly 1.9 billion people. In terms of economic value, this is the third-largest regional agreement, after only the EU and NAFTA, the North American Free-Trade Agreement. ASEAN has similar agreements with Australia and New Zealand. The dream of an Asia-wide free-trade area with ASEAN at the core is, in some quarters, alive and well.

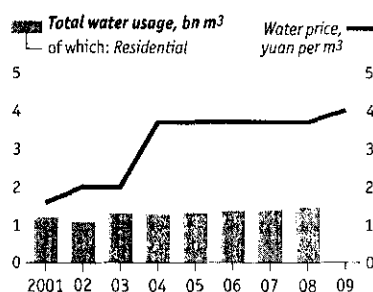
The Chinese press is epiphanic about the "glad tidings" of the deal, which brings easier access to South-East Asia's raw materials and the promise of crunchy new markets for manufactured goods to replace soggy ones in the United States and Europe. As for ASEAN, the deal sends the "strong signal" that South-East Asia is open for business, says one of its senior apparatchiks.

The splash is not all that it seems. Tariffs have been coming down for years, helping drive brisk growth in China-ASEAN trade. On January 1st the six richest ASEAN members eliminated remaining tariffs and barriers to investment on 90% of products. But the poorest four ASEAN members, Vietnam, Cambodia, Laos and Myanmar, will not need to cut tariffs to the same levels till 2015. Meanwhile, every country may list dozens of sensitive areas where tariffs can still apply, from ports to cars to popcorn. And with no rigorous mechanism for settling disputes, doubts remain about whether the deal will have real teeth. This level of free trade falls well short of the EU or NAFTA. For all that, not everyone in South-East Asia is happy. Many firms fear Chinese competition. In particular, Indonesia, which wanted to reopen parts of the deal, has not readied itself for freer trade.

As Robert Sutter of Georgetown University points out, however, it is possible to exaggerate China's impact on ASEAN, where trade is in fact highly diversified. Last year ASEAN traded more with both Japan and the EU than it did with China. South Korea, Australia and India are also important. What is more, ASEAN's deficit (by its own figures) with China is matched by a surplus with America. That suggests much of Chinese-ASEAN trade is part of the same supply chains for Western markets.

Constant thirst

Beijing water usage and price



Source: Beijing Municipal Bureau of Statistics

Banyan | From the charm to the offensive

China's smile diplomacy shows its teeth



IF A single impulse has defined Chinese diplomacy over the past decade, it is its smile: near and far, China has waged a charm offensive. With its land neighbours, India excepted, China has amicably settled nearly all border disputes; it has abjured force in dealing with South-East Asian neighbours over still unsettled maritime boundaries. On the economic front, the free-trade area launched on January 1st between China and the Association of South-East Asian Nations is the world's biggest, by population. China's smiling leaders promise it will spread prosperity.

Farther afield, China has scattered roads and football stadiums across Africa. By the hundreds, it has set up Confucius Institutes around the world to spread Chinese language and culture. More than anything, the Beijing Olympics were designed to showcase gentle President Hu Jintao's notions of a "harmonious world". In all this, the leaders appear not simply to want to make good a perceived deficit in China's soft power around the world. A more brutal calculus prevails: without peace, prosperity and prestige abroad, China will have no peace and prosperity at home. And without that, the Chinese Communist Party is dust.

Yet of late smiles have turned to snarls. The instances appear unrelated. Last month China bullied little Cambodia into returning 22 Uighurs seeking political asylum after bloody riots and a brutal crackdown in Xinjiang last summer. On December 25th, despite China's constitutional guarantee of freedom of speech, a veteran human-rights activist, Liu Xiaobo, received a long prison sentence for launching a charter that called for political freedoms. Western governments had urged leniency.

Britain had also called for clemency for Akmal Shaikh, a Briton caught smuggling heroin into Xinjiang. Mr Shaikh seems to have been duped by drugs gangs. His family insist he suffered mental problems and delusions. Yet the courts refused a psychiatric evaluation. Britain's prime minister, Gordon Brown, said he was "appalled" by Mr Shaikh's execution. In turn, China lashed out at this supposed meddling and ordered Britain to "correct its mistakes". Sino-British relations, painstakingly improved in recent years, have come unravelling.

It is harder to complain of foreign meddling when Chinese actions have global consequences. During the Asian financial crisis of 1997-98 the Chinese held the yuan steady as currencies all

about them crumbled. Not only did that avert a round of tit-for-tat devaluations. The regional respect China earned, its diplomats argue, paved the way for the charm offensive that soon followed. New-found respect gave China a taste for more.

In contrast, during this downturn many complain that China's dogged pegging of its currency to the dollar harms others. As the world's fastest-growing big economy, with the biggest current-account surplus and foreign reserves, its currency ought by rights to be rising. By several yardsticks the yuan is undervalued and Americans and Europeans fear this leaves them with the pain of global rebalancing. ASEAN furniture-makers and nail foundries also beg for relief from the mercantilist advantage that a manipulated currency gives China.

Most striking of all were China's actions at the Copenhagen summit on climate change, where the world's biggest emitter appeared churlish. In a bid to avoid being pinned down to firm commitments, China insisted that all figures and numerical targets be stripped out of the final accord, even those that did not apply to China. Further, China's prime minister, Wen Jiabao, at first did not deign to sit down with President Barack Obama on the final day, sending relatively junior officials instead. China may have got a deal it liked, but at the cost of a public-relations disaster.

Some think this a prelude to a prickly, more unpleasant China in the decade ahead, but it is too soon to conclude that. More likely, China will now try to patch up relations with Britain, and keep putting a positive gloss on Copenhagen. Peace and prosperity is still the calculus. China is spending billions cranking up its state media to go global, taking Mr Hu's message of "harmony" to a worldwide audience.

A powerful whiff

But the message of harmony will ring hollow abroad if it is secured by muzzling voices at home. Besides, there is now less goodwill to go around. A smile is fresh at first, but loses its charm if held for too long. One problem with China's smile diplomacy, says the man who coined the phrase, Shi Yinhong of Renmin University in Beijing, is that China's global impact—its demand for resources, its capacity to pollute—is so much greater than a decade ago. "For all we may smile, you can still smell us," he says.

That even applies in places, such as Africa, where enthusiasm for China was once unbounded. China has more than a presentational problem. For instance, it sends Africa both destabilising arms and peacekeepers, the one generating demand for the other. China's manufactures destroy local industries. Many Africans resent Chinese firms' deals with their unpleasant leaders and blame them when leaders pocket the proceeds. China's clout makes a mockery of two guiding tenets of its charm offensive: relations on the basis of equality; and non-interference.

That calls for a new diplomacy. China's presentational problems with the old one speak of an abiding lack of sophistication, and an attachment to a ritualistic diplomacy ill-suited to fast-moving negotiations, such as in Copenhagen, where the outcome is not pre-cooked. Over the case of Mr Shaikh, the official press indulged in the predictable and puerile ritual of railing about the historical indignity of the Opium War. Yet even many Chinese recognise that the world—and even drug-pushing British gunboat-diplomacy—has changed, and that it may be time to move on. Banyan demands that China correct its mistakes. ■



Also in this section

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Innovation in global health

A spoonful of ingenuity

NEW YORK

New ideas for raising money for medical care—and spending it

IN THE old days, the job of eradicating disease fell to governments and inter-governmental bodies. Then charities, often led by celebrities or entrepreneurs, joined in. Finally, in the Western world at least, governments accepted the need to pool their efforts with those of private donors, big and small. The effort still seems unequal to the task. Every year, nearly 11m children die before the age of five because of a mixture of poor nutrition and preventable disease. Many of the United Nations' Millennium Development Goals (calling, for example, for a plunge in child and maternal mortality by 2015) look unattainable.

The good news is that more imaginative ways of raising and spending money are now on the horizon. How well they do will depend on many details—like the quality of information flowing between poor places and the governments, firms and individuals that want to help.

The change in funding is already dramatic. In 1990 more than two-thirds of the \$5.6 billion spent on global health assistance came from governments (see chart 1). By 2007, when total funding for health reached nearly \$22 billion, government spending still made up the lion's share. Look closer, though, and it emerges that the

yeast which leavened this bread was “non-traditional” financing. In 2007 private money from firms and charities like the Gates Foundation eclipsed the total from all sources spent in 1990.

As a case of the new sort of money-raising, take UNITAID, an agency founded by France, Brazil and three other countries, which is hosted by the World Health Organisation in Geneva and calls itself a “facility” for the purchase of drugs to fight important diseases. UNITAID's main income comes from a charge on air tickets, levied by a dozen states; combined with cash contributions from other countries, this has raised \$1.5 billion in the past four years.

This month, a private foundation linked to UNITAID will start raising money directly from the public. With help from most of the world's air-ticket issuers and internet-travel portals, passengers will be invited to give a couple of dollars, or so, to the fight against disease every time they book a flight online. UNITAID hopes that, within a few years, this plan will raise between \$600m and \$1 billion a year. If so, it will merit its name, MassiveGood.

Tiny private contributions are not just a complement to large donors, says Philippe Douste-Blazy, UNITAID's boss. In a new book*, he and a co-author argue that “building solidarity” by involving the general public will be an essential part of any successful effort to combat disease.

What else will be needed? Begging for

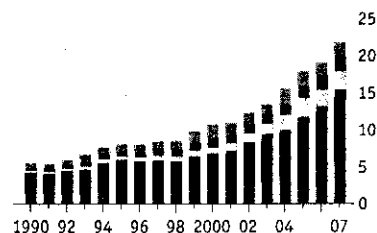
more money will never work, argues Sir Richard Feachem, a British-born health specialist who is now a professor at the University of California. He should know: as the former boss of the Global Fund to Fight AIDS, Tuberculosis and Malaria, a big international agency, he often banged the drum for more donor money—and took flak from critics who said the fund was not transparent enough. In his view, the best way for any agency to get more money is to show that the sums it already spends are well used. He thinks that calls for clever fund-raising, cautious spending and the precise measurement of outcomes. And happily, there is progress on all three.

As well as appealing to the charity of ordinary people, agencies are finding new ways to raise money from lenders. A trail has been blazed by the GAVI alliance, a public-private partnership that funnels money towards vaccines for neglected diseases in the poor world. It has raised more than \$1 billion in short-term financing by issuing bonds backed by sovereign ►►

Raising it

Development assistance for health
By funding source, \$bn

United States Corporate donations
Other governments Other private philanthropy
Gates Foundation Other



Source: The Institute for Health Metrics and Evaluation, University of Washington

*Power in Numbers: UNITAID, Innovative Financing, and the Quest for Massive Good, by Philippe Douste-Blazy and Daniel Altman, Public Affairs, New York, Publication forthcoming

pledges of aid money in future years. By making a big sum available today, rather than promising a trickle over a long period, the project has helped to create the economies of scale that make widespread vaccination possible. The Global Fund also has new ideas; this year it will launch its own exchange-traded fund—based on an index of firms investing in health and development—aimed at both traditional investors and “socially responsible” ones.

Another approach is to encourage firms to pool patents, which lowers the cost and accelerates the pace of drug development. Clever researchers at modest institutions may benefit from knowledge gained in more prestigious places. Under pressure from the WHO and anti-poverty activists, the drugs industry has started to relax its patent-protection policy. GlaxoSmithKline (GSK), a British drugs giant, said early in 2009 that it was ready to share certain patents (but not those for HIV). GSK and Pfizer, an American rival, then announced they would combine their patents for HIV into a joint research effort, called viiv. In December UNITAID launched its own plan to create a global pool for HIV patents. The agency's board will hold a final vote on this in February; Mr Douste-Blazy expects viiv and some other big firms to take part.

The medicine goes down

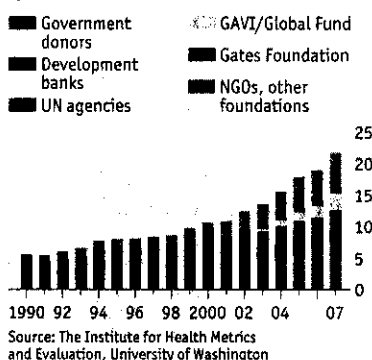
Also in the pipeline are several market-based innovations that aim to make spending more efficient. That is one result of the emergence of the new sort of agency, GAVI and the Global Fund, and NGOs and charities (see chart 2). UNITAID and the charitable foundation of Bill Clinton, a former American president, have transformed the market in treatments for children with AIDS, by aggregating demand and encouraging suppliers to cut costs and develop formulations that are easier to take. Roughly three-quarters of the children now taking AIDS medicine get their supplies thanks to these two groups.

Another idea is the Affordable Medicines Facility-Malaria (AMFm), to be rolled out by the Global Fund by mid-2010. In Africa and southeast Asia malaria parasites have grown resistant to older drugs like chloroquine. Artemisinin, a drug made from a Chinese plant, does work but the ideal formulation (an Artemisinin Combination Therapy, or ACT, which involves other drugs too) can cost \$10 a treatment—ten or more times the cost of straight artemisinin or older drugs.

The Global Fund is going to spend \$216m over two years subsidising the cost of ACT to wholesale buyers who will then supply it to ten hard-hit countries. By insisting that the benefits be passed down the supply chain, it intends to reduce the retail price to only 20 to 50 cents. The fund will spend another \$127m on marketing, training and other support for the effort.

Spending it

Development assistance for health
By channel of assistance, \$bn



ACT is already being produced by private firms; the hope is that a dramatic expansion of the market will lead to big economies of scale and much lower costs.

Sceptics fear that middlemen will pocket the subsidy, or that there will be leakage to other markets; some fret that 50 cents is too pricey to compete with chloroquine for people earning \$1 a day. But pilot projects suggest the new policy may work.

Yet another incentive-based approach bubbling up is Advance Market Commitments (AMC). Because the victims of most neglected diseases are poor, drugs firms cannot count on enough profitable customers to recoup their investments. The AMC mechanism offers drugs firms a huge carrot by subsidising the initial purchase of new vaccines for the poor, if they vow to sell those vaccines cheaply in future.

Here too, critics abound. Some argue that such a system could reward mediocre, rapid inventions, while penalising possibly better ones that might take longer to get to market. Some economists question the price and volume assumptions used in developing the AMCs. In the end, though, much of this information is unknowable in advance. Arguing that a successful effort could accelerate vaccination by many years, GAVI has forged ahead. Last year it launched a \$1.5 billion AMC programme to reward the first firm to find an adequate vaccine for pneumococcal disease.

The hardest area to improve is measurement and evaluation. A lack of transparency has already led to several scandals. The Global Fund has been criticised for not checking on national-government spending. Product Red, a branding campaign co-founded by Bono, a rock singer, directs some of the cash raised by retail sales (Dell, American Express, the Gap and other big firms are members) to the Global Fund. But recently, questions were asked about how much of this money is spent on overheads.

To overcome such doubts, Mr Douste-Blazy wants the MassiveGood campaign to be more transparent. He wants online donors to be able to track their \$2 gifts right

down to the pills received in a remote village. He says he is working with Google on ideas that could produce such a tracking system within two years. His co-author, Daniel Altman, a former Economist journalist, thinks that online monitoring, plus the network that MassiveGood has launched on Facebook, could tighten the link between donors and recipients.

Nobody opposes transparency, but some quibble with that heady vision. Prashant Yadav, a logistics specialist at Massachusetts Institute of Technology, says tracking pills may be a mistake. What if an NGO needs a lorry, or to spend money cultivating market demand for a useful drug? He thinks charities should link financing to health outcomes, rather as media firms link spending on advertising to verifiable changes in shopping behaviour.

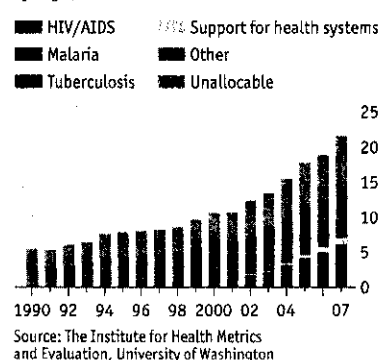
The World Bank's Nicole Klingenstein advocates independent financial and technical audits; another good idea, she says, would be to simplify the hundreds of measurement and evaluation forms that donors demand from officials in poor countries. Several international bodies are working on a unified health-funding platform, to be rolled out in four or five countries this year.

Improving measurement will not be easy. Ask Christopher Murray of the University of Washington, whose team labours over an annual report on development spending on health. As Chart 3 shows, billions of dollars are impossible to allocate.

For all the new ideas, the problems of funding global health remain grave. The flurry of innovative schemes should help, both by persuading official donors that money is being spent wisely and by attracting funds from the vastly bigger pool of global private capital. But perhaps change will come only when poor countries themselves demand better ways to test the results of health spending. External funding can be a catalyst, but the developing world will have to mobilise its own money and willpower to tackle humanity's great scourges. ■

Proving it

Development assistance for health
By target, \$bn



Schumpeter | Making a success of failure

America's enlightened treatment of bankrupt firms remains a model to the world



THE American model has seldom looked so tarnished. America's unemployment rate is 10%. Soup kitchens are doing a flourishing business in New York and other great cities. Companies that were once a byword for swashbuckling entrepreneurialism have bitten the dust.

But in one respect at least America remains a beacon for the rest of the world: its treatment of corporate bankruptcy. This may sound cockeyed. America's excessive appetite for risk helped plunge the world into recession (though over-leveraged European banks also did their bit). And America's consumers are defaulting on their debts at astronomical rates—and expecting the rest of society to pick up the bills for their profligacy. But countries that want to avoid unnecessary corporate carnage would nevertheless be foolish to ignore the American example.

America's enlightened attitude to corporate bankruptcy is designed to put economic resources back to productive use as quickly as possible. This means distinguishing between potentially viable companies and terminally ill ones. The potentially viable can file for "Chapter 11", which lets them restructure under court supervision. The terminally ill can file for "Chapter 7", which focuses on liquidating their assets and distributing them among creditors. It also means putting pressure on the courts to deal with bankruptcy as quickly as possible. Chrysler and General Motors were both in the hands of "new owners" within 45 days of filing for bankruptcy. It also means treating bankrupts relatively leniently, not as sinners to be flagellated but rather as unfortunates who should be given a second chance.

America's generosity to capitalism's losers has served it remarkably well. It has not only prevented giant companies such as United Airlines and General Motors from going into premature liquidation, throwing thousands of people out of work. It has also helped provide America with its entrepreneurial edge. Bankruptcy is an occupational hazard for entrepreneurs; even those with plenty of business experience under their belts fail much more often than they succeed. America's leniency towards bankrupts encourages novices to start their own businesses and allows people who have failed to start again.

The good news is that a growing number of countries are following America's lead. Britain has introduced a succession of En-

terprise Acts since 2002 that are designed to make it easier for failed entrepreneurs to start new businesses. In 2007 China adopted a new bankruptcy law—its first since 1949 and 11 years in the making—that makes it easier to restructure insolvent firms.

The credit crunch has speeded up the pace of reform. The World Bank's annual "Doing Business" report provides a wealth of examples of improvements. Many governments are trying to shake up their lethargic legal systems in order to speed up bankruptcy proceedings. The reforms also touch upon the more fundamental question of trying to save viable businesses from premature liquidation. Dozens of countries are trying to give companies more opportunities to reorganise before they finally reach for the revolver. France and Germany were among the first to do this. But the idea has also spread to eastern Europe and Asia and may even be reaching the bankruptcy-averse Muslim world (last year ten Middle Eastern and north African countries signed a joint declaration on planned reforms).

Moving towards a more enlightened treatment of bankruptcy will not be easy, particularly for poor countries with inefficient legal systems and retributive attitudes to debt. The World Bank reports that the majority of reforms have taken place in rich countries: since 2004 59% of them have improved their systems compared with 33% of poorer countries in East Asia, 22% in Latin America, 16% in the Middle East and 13% in South Asia. And poorer countries have an enormous distance to travel. In rich countries, bankruptcy proceedings take less than two years on average. In South Asia they take an average of four-and-a-half years. In many countries—Turkey is a notorious example—legal fees can eat up almost all the value of a business.

It beats flagellation

Attitudes to debt are also difficult to change. America threw off the old world's hostility to failed businessmen along with British rule. Back in the 1830s one of the things that most struck Alexis de Tocqueville about the country was "the strange indulgence which is shown to bankrupts", which, he said, diverged "not only from the nations of Europe, but from all the commercial nations of our time." The generous provisions of Chapter 11 only reinforced a longstanding legal prejudice. In 1934, for example, the Supreme Court declared that bankruptcy laws ought to "give the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt."

True, giving a clear field to the honest but unfortunate also opens the way to all sorts of chancers. America's generous treatment of corporate bankrupts has been widely abused by common spendthrifts—so much so that Congress tightened the law in 2005 to restrict access to the system. Britain's attempt to emulate the American example has also led to an epidemic of freeloading. In 2006 only about a quarter of the people who filed for bankruptcy could remotely be described as entrepreneurs.

That is irritating, but governments should nevertheless continue to rehabilitate bankruptcy. Making it easier to close a business may not sound as inviting as announcing yet another "enterprise fund" or "innovation initiative", but it is more vital to reviving the world's moribund economy. In the short term enlightened bankruptcy laws reduce unemployment by keeping viable companies alive. In the longer term they boost rates of entrepreneurship. The best way to get more people to start businesses is to make it easier to wind them up. ■

The danger of the bounce

Once again, cheap money is driving up asset prices

THE opening of the Burj Khalifa, the world's tallest building, in Dubai on January 4th had symbolic as well as architectural significance. Skyscrapers have long been associated with the ends of financial booms. The Empire State Building opened in 1931, two years after the Wall Street crash. The Petronas towers in Kuala Lumpur were unveiled in 1998, in the depths of the Asian crisis. Such towers are commissioned when money is cheap and optimism about economic growth is at its height; they are often finished when the champagne has gone flat.

The past three decades have been good for skyscraper-building. The cost of borrowing money, in nominal terms, has fallen sharply (see chart 1 on the next page). Small wonder that one bubble after another has appeared in financial markets, with the subjects of investors' dreams ranging from emerging markets and technology stocks in the 1990s to residential housing in the decade just ended. Nor is it surprising, with money so cheap, that consumers and companies have indulged in regular borrowing sprees.

When investors borrow money in order to buy assets, they push prices even higher. But this also makes markets vulnerable to sudden busts, as investors sell assets to pay their debts. The credit crunch of 2007-08 was the result of this process, with the debts greater and the price swings more violent than at any time in the past 30 years.

Critics argue that central banks, by focusing on consumer- rather than asset-price inflation, have encouraged bubbles to grow by keeping interest rates too low. By intervening when markets fall, but doing little to curb them when they rise, they have offered investors a one-way bet.

Such critics are worried that, in their eagerness to bring the credit crunch to an end, the authorities may be making the same mistake again. Official short-term interest rates are below 1% in much of the developed world. Emerging markets, through their currency pegs, tend to import these

easy-money policies, even though most of them are growing faster than the rich economies are.

Low rates have certainly persuaded investors to move money out of cash. Investors withdrew \$468.5 billion from money-market funds in the course of 2009. The "carry trade"—borrowing in low-yielding currencies to invest in high-yielding ones—is back in full swing. The Australian dollar has been a popular beneficiary.

Equity markets have rebounded strongly: the MSCI world index is more than 70% higher than its March low. Even bigger gains were seen in emerging markets, with the Brazilian, Chinese and Indonesian bourses all more than doubling, in dollar terms, last year. Those rallies have by themselves helped boost economic sentiment and have brought to a halt the vicious spiral of 2008, in which falling markets forced investors to offload assets at fire-sale prices.

At the same time, in the English-speaking markets of America, Australia and Britain, the stabilisation of house prices has bolstered consumers' balance-sheets. Again, low interest rates have been a crucial supporting factor.

Optimists argue that the markets are now in a sweet spot. The global economy is recovering, with most developed countries coming out of recession in the third quarter of 2009. The authorities, concerned about the fragility of the recovery, will be reluctant to raise interest rates in the near term. Thus investors have been given a licence to buy risky assets.

Spotting the signs

Is this policy approach creating yet another set of bubbles? Some, including Alan Greenspan, chairman of the Federal Reserve during the euphoria of the 1990s and early 2000s, believe that bubbles can be spotted only in retrospect. Others, such as Jeremy Grantham of GMO, a fund-management group, argue that they can be identified by a surge in prices (and valuations) to way above their previous trends.



In the model of market madness outlined by Hyman Minsky, a 20th-century American economist, and by Charles Kindleberger in his book "Manias, Panics, and Crashes", bubbles start with a "displacement"—a shock to the financial system, perhaps in the form of a new technology such as railways or the internet. This provides the "narrative"—the rationale that persuades investors to join in. They start to believe that this time around things will be different and that asset prices can reach new heights.

The next stage is rapid growth in credit, which inflates the bubble. As investors borrow money to buy the asset in ques- ➤

tion, the resulting price rise makes the narrative more credible. At the peak, however, investors no longer pay much attention to fundamentals, buying simply on the belief that prices must rise further. This stage is marked by very high valuations and by popular enthusiasm for asset purchases—marked in the 1920s by shoeshine boys passing on share tips and in the early 2000s by the popularity of property programmes on television.

Eventually, like a Ponzi scheme, a bubble runs out of new buyers. Prices slump. "Euphoria" gives way to the final stage, "revelation"—until the cycle can begin again.

How do today's markets look in the light of that model? The best place to start is in the developed world. There has been a "displacement", in that the credit crunch caused central banks to slash rates and led governments to unveil schemes to support banks, guarantee assets and allow budget deficits to soar. Whereas investors were highly risk-averse in late 2008, they have been encouraged to take their money out of cash and to invest in higher-yielding assets like equities and corporate bonds.

But although money is cheap, there has been no sign of the private-sector credit growth that marks bubble phases. Indeed, small businesses still complain that bank loans are hard to find. In the euro area, the broad measure of money supply has even fallen in the past 12 months. In America, broad money grew at an annualised rate of only 1.2% in the six months to November.

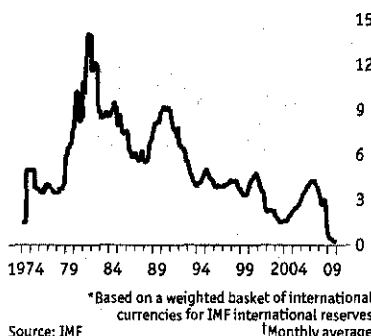
As further evidence that there is no bubble, bulls point to the relatively modest level of prospective price-earnings ratios; the MSCI world index is trading on a multiple of 14 based on prospective earnings in 2010, according to Société Générale, around the long-term average. However, prospective multiples can be very dependent on the optimism of the analysts who make the forecasts—and such analysts are in the business of selling shares.

A better long-term measure is the cyclically adjusted price-earnings ratio, which averages profits over the previous ten years (see chart 2). On this measure, valuations are nowhere near the 2000 peak. They are, however, still pretty high by historical standards; Smithers & Co, a firm of consultants, reckons they are nearly 50% above their long-term average. Even now, after a dismal decade for shares, Wall Street is offering a dividend yield of only just over 2%, compared with a long-term average of 4.5%.

In housing, a measure based on rents shows that American prices are back to fair

Free money

IMF Special Drawing Right* interest rate†, %



value but prices in Britain, France, Spain and Australia are all 30-50% above their historic averages. Low mortgage rates (and government schemes to head off foreclosures) have stopped prices falling to the lows of previous downturns.

That said, although prices remain higher than average, private investors have shown little of the enthusiasm they exhibited in past bubbles. Activity in the housing market is subdued. Investors withdrew \$36 billion from developed-market equity funds in the course of 2009, according to EPFR Global, a data group.

Emerging optimism

More plausible candidates for bubble status can be found in emerging markets. The rally in the developed markets has been driven by relief that a second Depression has been avoided, rather than by any great optimism about a new era. But emerging-market exports have survived the crisis remarkably well. They were clobbered in late 2008, when the collapse of Lehman Brothers sent the corporate sector into shock and many businesses slashed their order books. Crucially, however, China experienced not much more than a mild slowdown and recovered to grow by around 8% in 2009.

As investors look to the future, emerging markets have many advantages over their developed rivals. One, plainly, is higher potential rates of economic growth. Another is that many emerging economies have stronger fiscal positions than their Western rivals; they are the creditors financing the American budget deficit.

The balance of power has already shifted. In 2003 the stockmarkets of America, Britain and Japan formed 73% of the value of the MSCI all-country index; by the end of 2009 this proportion was just 59%. Enthusiasts like Jerome Booth of Ashmore, a fund-management group, argue that this trend will continue, because emerging economies' stockmarkets are underweighted in world indices, given their share of global GDP. As the world rebalances, Mr Booth argues, investors from

emerging economies will increasingly want to channel their savings to their own markets, rather than financing Western governments. Western investors are already showing an interest in these markets: investors shifted \$64.5 billion into emerging-market funds last year.

This optimism explains why emerging markets now trade at a premium (measured by the ratio of market prices to the accounting value of assets) over developed markets. In the past, such premiums have usually presaged a setback.

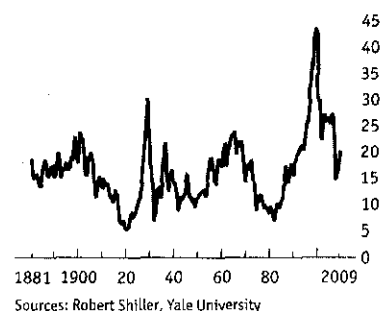
In addition, emerging markets are seeing much faster credit growth than their developed rivals. In China, for example, broad-money growth in the 12 months to November was almost 30%. Such growth is the logical result of pegging a currency to the dollar, and thus importing a monetary policy which may be right for America but which is too loose for the fast-growing Chinese economy. Some of that credit growth is leaking into asset markets. The Chinese premier, Wen Jiabao, said in late December that the government would use taxes and interest rates to stabilise the property market. House prices in Hong Kong are more than 50% above fair value, according to *The Economist's* estimate. Though they are not yet back at 2007 valuations, it is easy to imagine that emerging markets will develop bubbles if a combination of low interest rates and pegged currencies continues.

Another area where a bubble might be developing is in gold. Gold is an unlikely cause of euphoria, given that investors use it as a bolthole when they worry about inflation, currency depreciation or financial chaos. But the metal has seen a speculative peak before, most notably in 1980, when its price touched \$835 an ounce, before losing two-thirds of its nominal value over the next 20 years.

The main rationale for buying gold at the moment is that, in the face of the credit crunch, most governments would like to see their currencies depreciate to boost their exports. If paper money is being "debased", that is bullish for gold, an asset that central banks cannot create more of and that is no one else's liability.

Not cheap

S&P 500 price-earnings ratio, cyclically adjusted



Correction In "Women in the workforce" (January 2nd) we said that a study of female MBAs from the University of Chicago's Booth School of Business by Marianne Bertrand and others had found that about half of those with children remained in the labour force ten years after graduating. In fact 77% stayed in the labour force ten to 16 years after graduating; 51% were in full-time work. Apologies.

► The gold bugs may be right. But the price has already quadrupled from its low and suffers from no real valuation constraints; it has no yield or earnings against which to measure it, so it is hard to say when it is "expensive". Dylan Grice, an analyst at Société Générale, has mischievously suggested that, if the Bretton Woods system (under which the Fed was obliged to exchange its stock of dollars for gold with other central banks) were operating today, bullion would trade at \$6,300 an ounce.

An age-old problem

It seems likely that, if developed countries keep interest rates low for a long time, bubbles will emerge somewhere. The argument against tightening policy now is a strong one, given the fragile state of the economic recovery. But to central banks it always is, whether the economy is healthy or not.

It is hard to imagine any circumstances in which the authorities will have the foresight (or the courage) to prick a bubble. It cannot be done when the economy is weak. And when the economy is strong, as it was in the late 1990s, central banks argue that higher asset prices are justified (back then, by the productivity improvements brought by the internet). Central bankers tend to see higher asset prices as a validation of their policies and to shy away from "second guessing" the markets.

Ben Bernanke, the Fed's chairman, argued in a recent speech that better regulation, rather than tighter monetary policy, would have been the key to pricking the American housing bubble in the past decade. Plans for preventing future bubbles may depend on controlling the banks, rather than setting the general level of interest rates. Higher loan-to-value ratios would avoid the excesses of subprime lending while higher capital ratios would prevent banks lending too much at the peak of the cycle.

If the authorities can do little to stop a bubble inflating, what can they do if markets suffer a further relapse? Interest rates cannot be reduced further and it is hard to see the markets tolerating even bigger budget deficits. That leaves quantitative easing (QE), the policy under which central banks create money to buy assets, usually government bonds. Even that may have its limits, if private investors decide to sell government bonds as fast as central banks try to buy them.

Bears argue that the global economy is already far too dependent on government stimulus. "Every basis point of [American] growth in [the third quarter] came from government stimulus, directly and indirectly," says David Rosenberg of Gluskin Sheff, a Canadian asset-management firm. Schemes such as "cash for clunkers" temporarily boosted car sales but these quickly slipped again once government subsi-



dies stopped. The latest example occurred when pending American home sales fell by 16% in November in anticipation of the end of a homebuyers' tax credit (which has since been extended until the end of April).

These subsidies depend, in large part, on the ability of governments to fund huge deficits at relatively low cost. And that is perhaps the biggest issue of the moment.

A matter of life and debt

On the one hand, the gap between short-term interest rates and long-term bond yields is extraordinarily high. That allows banks, in particular, to borrow at low rates from the central banks and invest the proceeds in government debt; the same trick was used to rebuild bank profits in the early 1990s. Russell Napier, a market historian and an analyst at CLSA, a broker, thinks that purchases by a combination of Asian central banks and developed-world commercial banks are causing a bubble to develop in government-bond markets.

Investors may be looking to Asia for inspiration. Japan has run huge deficits for 20 years and still has ten-year bond yields of

under 1.5%. If investors think the American economy is in for a similar period of stagnation, then Treasury-bond yields of almost 4% (see chart 3) look attractive.

On the other hand, some point to the huge growth in central banks' balance-sheets and to the use of QE. This indirect monetisation of the budget deficit is, in their view, just another way of debasing the currency. The Fed's entry for "total factors supplying reserve funds" has jumped from \$942 billion in the week before the collapse of Lehman Brothers to almost \$2.3 trillion. In Britain, the Bank of England's QE programme has, in effect, financed the entire government deficit for one year.

But both the Fed and the Bank of England seem to be winding down their QE programmes and these may not be around to support bond prices next year. However, there is scant trace of any rapid reduction in budget deficits, at least in Britain and America. Governments that have attempted to tackle them, such as Ireland's, have faced protests and strikes.

As a rule, governments find it far easier to increase their debt than to reduce it. In the absence of rapid economic growth, debt reduction usually means a period of austerity, a hard thing to swallow, especially when the creditors are foreign. Iceland's president has just refused to approve a deal repaying debts to Britain and the Netherlands in the face of public opposition.

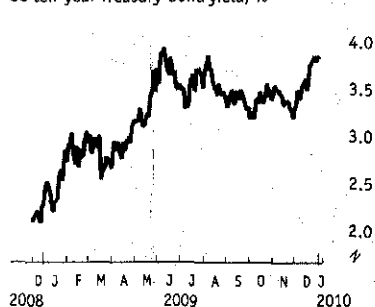
Governments also fear that premature fiscal tightening might only send the economy back into recession. That was the mistake made by the Roosevelt administration in 1937 and by the Japanese in 1997, when they raised the consumption tax.

Finance ministers may be unwilling to take unpopular courses of action until the rating agencies downgrade their debt or the market forces the issue, by pushing bond yields sharply higher. Already, there have been signs of market impatience with some countries, such as Greece, which have been slow to address the problem. Investors may eventually demand coherent strategies from the Americans and the British; PIMCO, probably the most influential private-sector bond investor, said this week that Britain faced a cut in its credit rating without a credible debt-reduction plan.

The markets are beset by a series of contradictions. They are dependent on extraordinary amounts of government stimulus. But that stimulus is in turn ultimately dependent on the willingness of markets to finance governments at low rates. They should be willing to do so only if they believe that growth prospects are poor and inflation will stay low. But if they believe that, investors should be unwilling to buy equities and houses at above-average valuations. At some time—maybe in 2010—those contradictions will have to be resolved. And that will trigger another nasty bout of volatility. ■

Paying the price

US ten-year Treasury-bond yield, %



Source: Thomson Reuters



China's export prospects

Fear of the dragon

HONG KONG

China's share of world markets increased during the recession. It will keep rising

MANY people start the new year by resolving to change their old ways. Not China. On December 27th Zhong Shan, the country's vice-minister of trade, declared that China will continue to increase its share of world exports. Figures due out on January 11th are expected to show that China's exports in December were higher than a year ago, after 13 months of year-on-year declines. China's exports fell by around 17% in 2009 as a whole, but other countries' slumped by even more. As a result China overtook Germany to become the world's largest exporter and its share of world exports jumped to almost 10%, up from 3% in 1999 (see chart).

China takes an even bigger slice of America's market. In the first ten months of 2009 America imported 15% less from China than in the same period of 2008, but its imports from the rest of the world fell by 33%, lifting China's market share to a record 19%. So although America's trade deficit with China narrowed, China now accounts for almost half of America's total deficit, up from less than one-third in 2008.

Trade frictions with the rest of the world are hotting up. On December 30th America's International Trade Commission approved new tariffs on imports of Chinese steel pipes, which it ruled were being unfairly subsidised. This is the largest case of its kind so far involving China. On December 22nd European Union gov-

ernments voted to extend anti-dumping duties on shoes imported from China for another 15 months.

Foreigners insist that the main reason for China's growing market share is that the government in Beijing has kept its currency weak. But there are several other reasons why China's exports held up better than those of its competitors during the global recession. Lower incomes encouraged consumers to trade down to cheaper goods, and the elimination of global textile quotas in January 2009 allowed China to increase its slice of that market.

How high could China's market share go? Over the ten years to 2008 China's exports grew by an annual average of 23% in

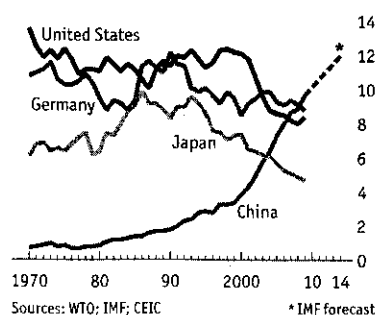
dollar terms, more than twice as fast as world trade. If it continued to expand at this pace, China might grab around one-quarter of world exports within ten years. That would beat America's 18% share of world exports in the early 1950s, a figure that has since dropped to 8%. China's exports are likely to grow more slowly over the next decade, as demand in rich economies remains subdued, but its market share will probably continue to creep up. Projections in the IMF's World Economic Outlook imply that China's exports will account for 12% of world trade by 2014.

Its 10% slice this year will equal that achieved by Japan at its peak in 1986, but Japan's share has since fallen back to less than 5%. Its exporters were badly hurt by the sharp rise in the yen—by more than 100% against the dollar between 1985 and 1988—and many moved their factories abroad, some of them to China. The combined export-market share of the four Asian tigers (Hong Kong, Singapore, South Korea and Taiwan) also peaked at 10% before slipping back. Will China's exports hit the same barrier as a result of weakening competitiveness, or rising protectionism?

An IMF working paper published in 2009 calculated that if China remained as dependent on exports as in recent years, then to sustain annual GDP growth of 8% its share of world exports would rise to about 17% by 2020. To consider whether that was feasible, the authors analysed the global absorption capacity of three export industries—steel, shipbuilding and machinery. They concluded that to achieve the required export growth, China would have to reduce prices, which would be increasingly hard to manage, whether through productivity gains or a squeeze in profits. In many export industries, particularly steel, margins are already wafer-thin. ►►

Export expertise

Share of world exports, % of total



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► However, China's future export growth is likely to come not from existing industries but from higher-value products, such as computer chips and cars. Japan's exports also moved swiftly up the value chain, but whereas this was not enough to support durable gains in its market share, China has the advantage of capital controls that will prevent its exchange rate rising as abruptly as Japan's did in the 1980s. When China does eventually allow the yuan to rise, it will do so gradually.

Another big difference is the vastness of China's economy. China consists, in effect, of several economies with different

wage levels. As Japan moved into higher-value exports, rising productivity pushed up wages, making old industries, such as textiles, uncompetitive. In China, as factories in the richer coastal areas switch to more sophisticated goods, the production of textiles and shoes can move inland where costs remain cheaper. As a result China may be able to remain competitive in a wider range of industries for longer.

Foreign hostility to China's export dominance is growing. Paul Krugman, the winner of the 2008 Nobel economics prize, wrote recently in the *New York Times* that by holding down its currency to sup-

port exports, China "drains much-needed demand away from a depressed world economy". He argued that countries that are victims of Chinese mercantilism may be right to take protectionist action.

From Beijing, things look rather different. China's merchandise exports have collapsed from 36% of GDP in 2007 to around 24% last year. China's current-account surplus has fallen from 11% to an estimated 6% of GDP. In 2007 net exports accounted for almost three percentage points of China's GDP growth; last year they were a drag on its growth to the tune of three percentage points. In other words, rather than being a ►

Buttonwood

The Iceland saga is a harbinger of crises to come

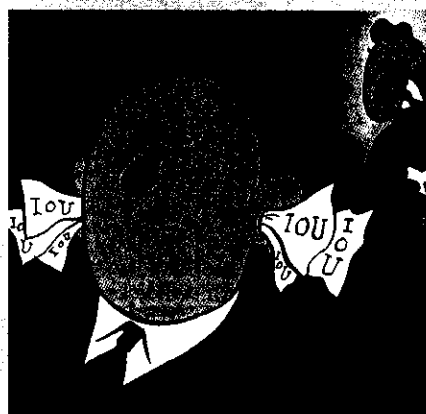
THERE are many ways to decide whether to repay your debts but a national referendum is surely a first. That is what is going to happen in Iceland after its president refused to sign a bill paying €3.8 billion (\$5.5 billion) to the British and Dutch governments over 15 years.

Given that a quarter of the Icelandic population has signed a petition opposing such payments, it is not difficult to imagine how such a poll will turn out. "Vote for lower incomes" is not going to be a very popular slogan. And the Icelanders will only be the first. Around the world governments have assumed the debts of their private sectors. That is an easy commitment to make in the short term. Paying the money back is another matter. If the debt is large enough, the result will be years of austerity. Electorates will choke at the cost.

Countries will initially be reluctant to default on their sovereign debt (although there have been plenty of examples in the past). But things are different in cases where there is scope for a state to question its responsibility to repay. That was the case with the debts of Dubai World, which the city-state claimed were not government-backed (Abu Dhabi, Dubai's fellow emirate, eventually agreed to help out). And it is also the case with Iceland.

The dispute dates back to the expansion of Icelandic banks such as Landsbanki into the European savings market. Under brand names like Icesave, these banks offered online accounts with high interest rates that were often the best available in the market. Avaricious savers known as "rate tarts" shifted their money into such accounts with the help of comparison websites.

Landsbanki's products were not covered by the domestic deposit-insurance schemes of the target countries. Under a



passport system covering the European Economic Area (a broader, watered-down version of the European Union), investors were supposedly covered by the Icelandic deposit-insurance scheme.

The problem was that the banks took on liabilities that far outgrew Iceland's GDP. When Landsbanki collapsed, the insurance scheme was inadequate to cover its debts. That prompted a row between governments over who was responsible for clearing up the mess. The British and Dutch governments have compensated their domestic depositors in Icesave for their losses, and are claiming the money back from the Icelandic government. The legal position is far from clear. Do such insurance schemes actually carry a state guarantee? Yet the British and Dutch governments have some powerful weapons on their side, such as the ability to block Iceland's accession to the EU.

There is a recognised concept in international finance of "onerous debt", which says that a population should not be responsible for debts run up by murderous or kleptocratic dictators. But it is hard to make that case for Iceland, a democracy

that benefited from open markets in other countries to indulge in an acquisition spree. During the banking boom Reykjavik resembled a gold-rush town.

In a sense, however, the rights and wrongs of the case are neither here nor there. This is a classic example of what happens in a debt crisis. It is perfectly natural for the Icelanders to resent having to cripple their finances in order to pay "rich foreigners". If they are unique, it is only that the costs of their defiance are clearer than normal. Fitch, a ratings agency, immediately downgraded Iceland's debt and loans from international donors may be affected.

All too often in history countries have been allowed to become serial defaulters without suffering that much in the way of penalty. In "This Time is Different", their book on financial crises, Carmen Reinhart and Kenneth Rogoff point out that Spain defaulted seven times in the 19th century and Portugal six. In the 20th century, European nations (including Russia) managed 16 defaults between them.

A more subtle way of getting rid of at least part of your foreign debt is to allow your currency to depreciate. This option is only available to the likes of America and Britain, which have been allowed to borrow in their domestic currencies and seem already to be exploiting this fact.

Creditors used to be alive to these dangers and insisted on international agreements that required countries to safeguard the value of their currencies. But this is mainly a world of floating exchange rates. Combine these with democracy and countries have a licence to abuse foreign creditors. They have always had the motive to do so. The credit crunch has given them the opportunity.

► drain on global demand, China helped pull the world economy along during the course of last year.

Foreigners look at only one side of the coin. China's imports have been stronger than its exports, rebounding by 27% in the year to November, when its exports were still falling. America's exports to China (its third-largest export market) rose by 13% in the year to October, at the same time as its exports to Canada and Mexico (the two countries above China) fell by 14%.

Some forecasters, such as the IMF, expect China's trade surplus to start widening again this year unless the government makes bold policy changes, such as revaluing the yuan. However, Chris Wood, an analyst at CLSA, a brokerage, argues that China is doing more for global rebalancing than America. Rebalancing requires that China spends more and America saves more. Mr Wood argues that China is doing more to boost domestic consumption (for example, through incentives to stimulate purchases of cars and consumer durables, and increased health-care spending) than America is doing to boost its saving. America's total saving rate fell in the third quarter of last year to only 10% of GDP, barely half its level a decade ago. Households saved more, but this was more than offset by increased government "dissaving".

Strong growth in China's spending and imports is unlikely to dampen protectionist pressures, however. China's rising share of world exports will command much more attention. Foreign demands to revalue the yuan will intensify. A new year looks sure to entrench old resentments. ■

Alternative mutual funds

The feeling is mutual

CHICAGO

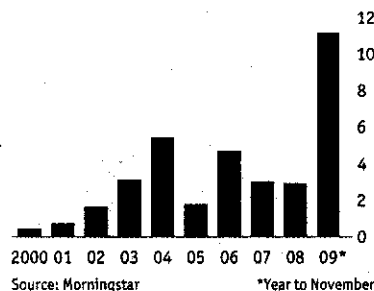
Hedge-fund managers look to retail investors

MUTUAL funds have mimicked hedge funds for years, offering "alternative" strategies such as taking long and short positions on shares. Now a growing number of hedge funds are returning the compliment. A year ago AQR, a prominent hedge fund in Greenwich, Connecticut, launched its first mutual fund; six more have since followed, the latest on January 5th. In April, Permal Group, a fund of hedge funds, launched a tactical-allocation mutual fund. In June, Bull Path Capital Management converted a long-short equity hedge fund into a mutual fund.

Hedge-fund managers have offered mutual funds before. The first wave came back in 2005, according to Nadia Papagianis of Morningstar, a research firm, when

Alt key

Alternative mutual funds
Net flows, \$bn



infatuation with hedge funds was near its peak. Managers offered mutual funds as a way to include individuals without the cash to invest in hedge funds themselves.

Investors now seem hungry for products that shield them from market swings, as alternative strategies should, but that lack hedge funds' most infuriating traits. Mutual funds have neither lockups nor fees of one-fifth of profits. Complaints about a lack of transparency are countered by mutual funds' reporting requirements. Fears of illiquidity and leverage are calmed by mutual funds' rules on both. American alternative mutual funds were wildly popular in 2009. Net flows from January to November reached \$11.2 billion, nearly quadruple those for all of 2008 (see chart).

Hedge funds, for their part, are keen to tap new sources of capital. David Kabiller of AQR says that his firm's mutual funds are not merely a reaction to market mayhem. But he admits that they help broaden AQR's base of investors. The minimum investment in one of AQR's hedge funds is \$5m. The minimum for its diversified-arbitrage mutual fund is \$5,000.

Whether these alternative mutual funds offer much more than their staid brethren is another question. By definition, mutual funds have less freedom than hedge funds, so there is less scope for hedge-style mutual funds to earn outsize returns. Attempts to protect investors from market swings may come to nought. Morningstar compared the average performance of long-short mutual funds with that of a portfolio of stocks and bonds. For the six years ending in September the correlation was almost total.

Many of the new mutual funds are too young to judge. Hedge-fund managers—in America and elsewhere—seem likely to continue offering new types of funds. Half of European hedge funds in a recent HedgeFund Intelligence survey had already launched or were planning funds that comply with UCITS rules, equivalent to America's mutual funds. And these new products, offering more transparency, lower fees and no lockups, may yet light the path for hedge funds themselves. ■

The jobs market for economists

Applied thinking

ATLANTA

The effect of the recession

YOUNG economists are a disarmingly friendly lot, ever ready to smile at strangers. Or so a casual visitor to the latest annual meetings of the American Economic Association (AEA), held in Atlanta between January 3rd and 5th, might conclude. But the ubiquitous smiles may just reflect the fear of unintentional rudeness to a potential employer. As well as hosting over 150 sessions where academic economists present and discuss their latest research, the AEA meetings are also an enormous annual job fair.

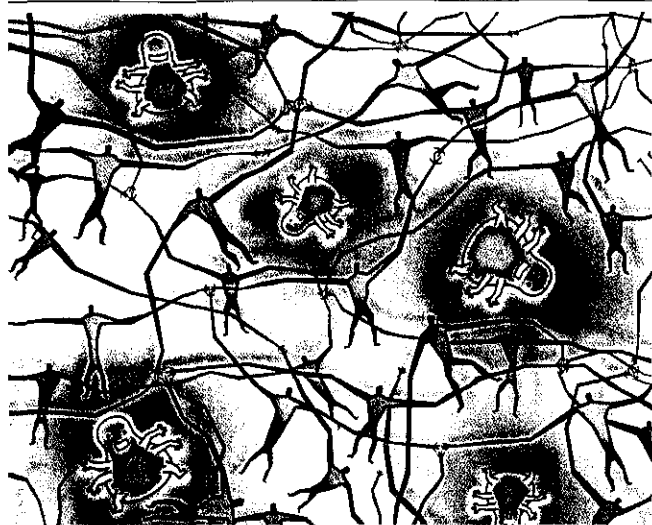
Even this specialised slice of the labour market is feeling the effects of the downturn. Shrivelled endowments at many private American universities and budget cuts at many public ones mean fewer academic jobs. The IMF, which snapped up over 40 new PhDs last year, is likely to Hoover up far fewer this year. The overall number of advertisements on the AEA's job site fell by 21% in 2009, after only a slight drop in 2008. Non-academic job listings were down by 24%.

According to walras.org, an online database of job openings for PhDs in economics, the number of jobs advertised in the last four months of the year, when almost all jobs for newly minted economists are listed, was 1,285 in 2009, down by 21% on 2008's figure. American economics departments churned out an average of 948 PhDs each year between 2006 and 2008. Add the number of candidates from European universities, which walras.org reckons is more than 350, and the supply of economists may exceed demand.

It is not all bad news. Advertisements for economists from financial employers, and from the federal government, increased in 2009. Xavier Gabaix of New York University's Stern School of Business points out that far fewer universities have formal hiring freezes in place than in 2009. Some smaller universities and colleges smell an opportunity, seeing the downturn as their best shot at getting a person who might normally have headed for an Ivy League place. Nicola Lacetera of Case Western Reserve University reckons that more path-breaking ideas may emerge if the recession funnels some clever people into less prestigious places, where they can concentrate on unconventional approaches to the questions that interest them. All the same, it is safest in this climate to bestow smiles on all and sundry.

Economics focus | Worth a hill of soyabeans

How the internet can make agricultural markets in the developing world more efficient



WHEN the internet took off in the mid-1990s, it was often claimed that it would improve price transparency, cut out middlemen and make markets more efficient. There is plenty of anecdotal evidence for this, just as there is for similar claims about mobile phones. Empirical data on the impact of these new technologies increasingly support the thesis.

Macroeconomic studies suggest that the internet and mobile phones boost growth. The effect is bigger in developing countries than developed ones, due to the paucity of existing communications infrastructure. The effect also seems to be bigger for the internet than for mobile phones. In a study published in 2009, Christine Zhen-Wei Qiang of the World Bank found that an increase of ten percentage points in mobile-phone adoption increased growth in GDP per person by 0.8 percentage points in a developing country, and by 0.6 percentage points in a developed one. For dial-up internet access, the figures were 1.1 percentage points and 0.75 percentage points respectively; for broadband internet, 1.4 percentage points and 1.2 percentage points.

Critics of such analyses contend that it is difficult to tell whether the adoption of new technologies is promoting growth, or vice versa. Researchers have responded by examining detailed microeconomic data to show how the spread of technology directly affects the prices of particular goods.

By examining historical data for the price of fish as mobile-phone coverage was extended down the coast of Kerala in southern India between 1997 and 2001, for example, Robert Jensen of Harvard University showed that access to mobile phones made markets much more efficient, eliminating wasted catches and thereby bringing down consumer prices by 4% and increasing fishermen's profits by 8%. Similarly, Jenny Aker of the University of California at Berkeley analysed grain markets in Niger to see how the phasing-in of mobile-phone coverage between 2001 and 2006 affected prices. She found that it reduced price variations between one market and another by at least 6.4%, and more in remote and hard-to-reach markets. With transaction costs cut, prices for consumers were lower and profits for traders higher.

In a forthcoming paper*, Aparajita Goyal of the World Bank has carried out a corresponding study for the internet by examining how the gradual introduction of internet kiosks providing

price information affected the market for soyabeans in the central Indian state of Madhya Pradesh. Farmers in the region sell their soyabeans to intermediaries in open auctions at government-regulated wholesale markets called *mandis*, a system that was set up in order to protect farmers from unscrupulous buyers. The intermediaries then sell on the produce to food-processing companies. The problem with this approach for the farmers is that the traders have a far better idea about the prices prevailing in different markets and being offered by processing companies. With only a few traders at each *mandi*, they can easily collude to ensure that they pay less than the fair market price; they can then boost their profits by selling on the beans at a higher price.

ITC Limited, an Indian company that is one of the largest buyers of soyabeans, felt it was paying over the odds, but was unable to monitor the traders closely. Starting in October 2000 it began to introduce a network of internet kiosks, called e-choupal, in villages in Madhya Pradesh. (*Choupal* means "village gathering place" in Hindi.) By the end of 2004 a total of 1,704 kiosks had been set up, each of which served its host village and four others within a five-kilometre (three-mile) radius. The kiosks displayed the minimum and maximum price paid for soyabeans at 60 *mandis*, updated once a day, along with agricultural information and weather forecasts. ITC also posted the price it was prepared to pay for soyabeans of a particular quality bought direct from farmers at 45 "hubs" (mostly in the same towns as *mandis*). By setting up the kiosks, ITC enabled farmers to check that the prices being offered at their local *mandi* were in line with prices elsewhere. It also gave them the option to sell direct.

Bean there, done that

To evaluate the impact all of this had on prices, Ms Goyal used historical data from *mandis* and the locations and installation dates of the kiosks. She found that the presence of kiosks in a district was associated with an instant and persistent increase of 1.7% in the average price paid at *mandis* in that district. As expected, the availability of price information increased the level of competition between the traders, raising prices and reducing the variation in prices between nearby *mandis*. Farmers' profits increased by 33%, and the cultivation of soyabeans increased by an average of 19% in districts with kiosks. And by buying some produce direct, ITC reduced its costs, which paid for the kiosks.

All this supports the anecdotal evidence that the internet can indeed make agricultural markets more efficient, just as mobile phones can. But whereas the expansion of mobile-phone access is now rapid and commercially self-sustaining—even very poor farmers can benefit from having a phone, and find the money to buy one—the same is not true of the internet. Its use requires a higher degree of literacy, for one thing, and computers cost more than handsets. The e-choupal approach, in which a company pays for the kiosks, offers one model; another is for entrepreneurs to resell access to the internet from village kiosks, which is how mobile phones first caught on. Ms Qiang's figures suggest that in the long run, the internet could have an even greater impact on economic growth than mobile phones did. But that will depend upon finding sustainable business models to encourage its spread in the poorest parts of the world. ■

* "Information, Direct Access to Farmers, and Rural Market Performance in Central India", by Aparajita Goyal. American Economic Journal: Applied Economics, forthcoming. http://www.aeaweb.org/forthcoming/output/accepted_APP.php

The earthquake in Haiti

Hell on earth

Why the outside world—and especially the United States—must respond



EARTHQUAKES can be measured and mapped, but it will be days and perhaps weeks before the scale of the human suffering unleashed on Haiti this week by the collision of the Caribbean and North American plates can be known. The pictures reaching the outside world are horrific and heart-rending: whole districts reduced to dust; the trapped, the dead, the wounded, the dazed, in their hundreds and thousands, jumbled together in the rubble and in the streets. The hope is that many more people than expected have survived. The fear is that it turns out to be the worst natural disaster since the Kashmir earthquake of 2005, when 86,000 died, or even the Indian Ocean tsunami of 2004 that killed 230,000.

Haiti is unusually ill-equipped to cope. That is partly because the earthquake struck the capital, Port-au-Prince, knocking out such institutions as the country possessed. The devastation included the parliament, the cathedral, the only two fire stations, hospitals and schools, the tax office, the prison and the headquarters of the United Nations mission, which had been trying to build a nation out of a failed state (see page 37). So Haitians are almost entirely dependent on what the outside world can do. The priority in the coming hours must be rescue, medical care and emergency feeding. It helps that the airport is just about open, and that Haiti is close to the United States.

But Haiti's vulnerability—and hence its suffering—is not just an act of God. The poorer, more crowded third of the island of Hispaniola, it was once the heart of the world's richest sugar colony, providing France with a quarter of its wealth in the late 18th century. That wealth came from 700,000 African slaves who made up 85% of the population. Their war for freedom brought independence in 1804. But the legacy of slavery has

scarred Haiti ever since. It is a place of subsistence farming, where four-fifths are poor and a few are very rich. Long misgoverned, it was meddled in by the United States, often with the best of intentions but the worst of outcomes. The latest outside intervention came in 2004 with the ousting of Jean-Bertrand Aristide, an elected president turned despot. Since then, under the care of the UN, Haiti made modest progress. A Brazilian-led peacekeeping mission brought a fragile security. At a cruel stroke, nature has now undone all this.

Common humanity and self-interest

Haiti's emergency will continue long after the last survivor has been lifted from the rubble. Millions will need help for years. Some outside will object that decades of foreign aid has achieved little except to enrich a few of the politicians. But there are two reasons for outsiders—and especially the United States and Haiti's neighbour in Hispaniola, the Dominican Republic—to do as much as possible to help the stricken country start afresh. One is common humanity. It is not Haiti's fault that geography has been so cruel. The other is self-interest.

A failed state of 9m people in the Caribbean is a danger to its neighbours. Haiti was already a source of illegal migrants and a crossroads for drugs. Unless the rudiments of government and a modern economy can be swiftly set up, both problems will only get worse. That means a massive aid effort, focused on more robust housing, hospitals and schools. Help from the diaspora of 1m Haitians in the United States will be vital. (Barack Obama rightly promised Haiti "unwavering support" and halted the deportation of Haitians living illegally in America.) But Haitians themselves, and especially their political leaders, will have to pull together. Elections due this year will have to be postponed; René Préval, the president, remains popular, and should lead the reconstruction. But all this is for the weeks ahead. Just now the task is to save lives. ■

China's battered image

Bears in a China shop

The "peaceful rise" hits some turbulence; but China's economy is not about to crash



THE thunderous applause that China has become used to has suddenly been drowned by catcalls. Celebration that it had seen the light on climate change turned to condemnation of its spoiling role at Copenhagen. Foreign complaints about the jailing of a human-rights activist and the execution of a mentally disturbed British drug-smuggler recalled the bad old days of hectoring from Western governments. Barack Obama is (at last) due to meet the Dalai Lama, and his government has gone through with the sale of arms to Taiwan. And Google, an

internet giant that had been notoriously willing to tailor its services in China to repressive local regulations, has said it may quit the market (see page 25). Even China's strongest suit, its booming economy, has been damned. Rather than cheering China's success in shrugging off the "Great Recession" of 2009, some analysts say China's prosperity comes at the expense of the rest of the world and claim that, anyway, it is heading for a crash. One describes it as "Dubai times 1,000, or worse".

Two Chinese bubbles, in other words, seem about to pop. One is a confection of naive optimism that the rise of a continent-sized, authoritarian power could be accommodated in the global system without serious strains. The other is a "bubble economy", characterised by excessive lending, overinvest- ►

ment and overvalued share and house prices. The obvious comparison is to Japan in the 1980s. When this bubble bursts, argue pessimists, China will suffer a prolonged slump similar to Japan's after its bust two decades ago.

It is tempting to link the two bubbles: the myth of China's smooth ascent is exploding because its economic miracle has proved partly illusory. In fact, China's government may be right to see the economic gloom as in part wishful thinking from outsiders repelled by its repressive political system. The truth is, the economy is not yet a Japan-style bubble.

China has defied the pessimists many times in recent years. In 2008, when America stumbled, they argued that China's export-led economy would be struck by a collapse in American spending. Instead, the two decoupled from each other. When China's government announced its stimulus package in November 2008, the pessimists claimed that it contained little new money. In fact, it turned out to be perhaps the biggest and most successful intentional monetary and fiscal stimulus in history. (Strangely, the same critics are now complaining that the regime pumped too much money into the economy.)

China's statistics are notoriously dodgy. But the claim that the recovery is a fake does not stand when so many hard numbers are pointing sharply upwards. Car sales jumped by 53% in 2009. Industrial profits rose by 70% in the three months to November compared with a year earlier. The most recent trade figures show exports up by 18%, year on year, and imports up by a staggering 56%. Imports, which can be checked against trade partners' data, confirm that domestic demand is robust.

There are many alarming similarities between China today and Japan in the late 1980s—but there are also big differences. For instance, Japan's property boom was fuelled mainly by credit. By contrast, one quarter of Chinese homebuyers pay cash, and the average mortgage covers only 50% of a property's value. And unlike Japan in the 1980s, China is a poor country in the early stages of development. Its high investment-to-GDP ratio is often flagged as evidence of overinvestment, yet its capital stock per person is only 5% of America's or Japan's.

As for overcapacity, most of last year's investment boom went into infrastructure, not manufacturing. Unlike Japan, which built "bridges to nowhere", China really does need more infrastructure. Nor is the country on the verge of financial crisis—and even if share and house prices do collapse, the result is likely to be a pause, not a prolonged period of Japanese-style stagnation (see page 61).

No three-bears economy

That does not mean China has a Goldilocks economy. Bank lending is growing too fast, which may be fine if it is flowing into useful investments, but not if it is fuelling asset prices. The risk of bubbles and excess capacity will grow unless policy is tightened soon. The People's Bank of China has just raised banks' reserve requirements, but it needs to act more boldly to lift interest rates and curb bank lending. That means that the yuan must be allowed to rise. China's main excuse for holding down the yuan—to support battered exporters—is no longer tenable in light of the rebound in exports. Recent warnings about an imminent Chinese crash are premature, but unless China acts, the bears will one day be proved right.

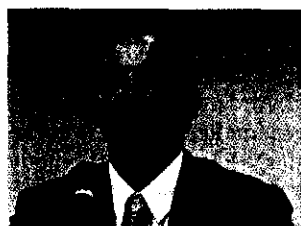
Before then, however, the continued rise of the Chinese economy will exacerbate the diplomatic and political trials its government has faced in recent weeks. China's growing economic clout brings with it demands that the country should play a more responsible role in global affairs. The exchange rate and carbon emissions are only two areas in which its policies will be expected to take into account the interests of the world as a whole as well its own citizens'. And at home, the government may not be able indefinitely to rely on economic advance to buy off demands for greater political freedom.

This week the Chinese blogosphere, usually intensely nationalistic and sensitive to any pinprick from a foreign government, journal or company, rallied to Google's defence. For China's government, that may be more ominous than a shelf of gloomy brokers' reports—and another reminder that politics, not the economy, remains China's biggest problem. ■

Tony Blair and Britain's Iraq inquiry

Weapons inspection

The right questions to ask the former prime minister



THERE have already been so many inquiries into the Iraq war (including one in the Netherlands that this week judged the invasion to have been illegal), and it was all so long ago, that many people thought the latest British probe, under Sir John Chilcot, would prove pointless. In fact it has already been informative, not least because some of the soldiers, spooks and diplomats who have given evidence have grown franker since retirement. On January 12th Sir John's panel questioned Alastair Campbell, formerly the government's main spin doctor. His testimony was a telling rehearsal for the imminent appearance of the star witness: his old boss, Tony Blair.

Despite his nominal job description, Mr Campbell helped to construct and purvey the controversial case for war. "No-

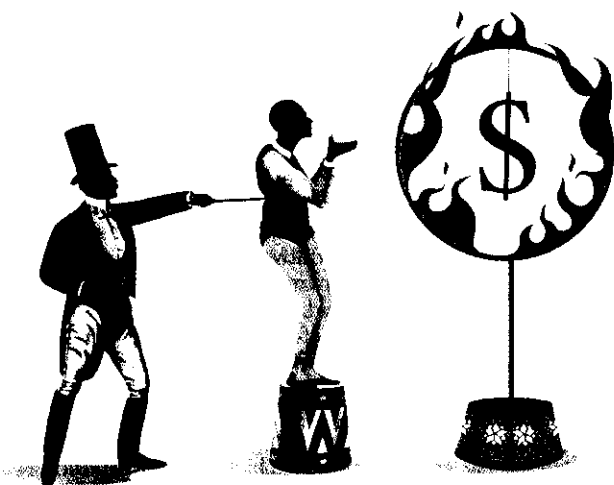
body was really saying that Saddam Hussein did not have weapons of mass destruction [WMD]," he observed this week. That is true. Saddam's record of making and using such weapons, the hunches of UN inspectors and the fact that the dictator continued to frustrate them and act guilty until the very end all made it seem that he still retained some WMD.

But there are weapons and there are weapons. The nuclear kind is by far the most terrifying; and the evidence presented by Britain and America that Saddam was actively and rapidly pursuing a nuke has come to seem especially dodgy. When they question Mr Blair about WMD, Sir John and his colleagues should concentrate on nuclear weapons—and in particular on the government's assertion that Saddam might develop one "in between one and two years". These nuclear allegations, which helped Mr Blair call the threat from Iraq "serious and current", need further probing.

A second focus should be on how raw intelligence was ►►

Schumpeter | Driven to distraction

Two and a half cheers for sticks and carrots



THIS is bonus season in the financial world. That means, of course, that it is bonus-bashing season everywhere else. The righteously outraged have no shortage of arguments on their side, from the mind-boggling size of the bonuses to the fact that the banks were recently rescued with public money. But if they want to mix a bit of theory with their spleen they now have a book to help them: Daniel Pink's "Drive: The Surprising Truth About What Motivates Us". It seems that bankers are not just slaves to greed. They are also slaves to a discredited management theory: the idea that the best way to motivate people is to use performance-related rewards.

Mr Pink's argument is hardly new. Eminent management theorists have been dismissing payment-by-results as simplistic and mechanical ever since Frederick Taylor tried to turn it into the cornerstone of scientific management in the early 20th century. But Mr Pink's book is nevertheless well-timed. The widespread fury about bonuses is sparking a wider debate about the way bankers and other lavishly remunerated people are paid. "Drive" is a decent summary of the anti-Taylorist school of thinking. And Mr Pink, once Al Gore's chief speechwriter and now a prolific management writer, is a highly motivated self-publicist.

Mr Pink argues that the rich world is in the middle of a management revolution, from "motivation 2.0" to "motivation 3.0" (1.0 in this schema was prehistoric times, when people were motivated mainly by the fear of being eaten by wild animals). In the age of routine production it made sense for organisations to rely on sticks and carrots or "extrinsic motivators", as he calls them. But today, with routine jobs being outsourced or automated, it makes more sense to rely on "intrinsic rewards", or the pleasure we gain from doing a job well. Look at the success of collaborative marvels such as Wikipedia, Firefox or Linux, which were created by volunteers. Or look at the rise of social entrepreneurs or the movement to promote "low-profit" limited-liability firms.

Mr Pink argues that carrots and sticks are not only outdated, but can also be counterproductive—motivation killers and creativity dampeners. Paying people to give blood actually reduces the number who are willing to do so. Providing managers with financial rewards can encourage them to game the system or, even worse, to engage in reckless behaviour.

So how should firms motivate people? Mr Pink argues that the answer is to give them more control over their own lives and thus allow them to draw on their deep inner wells of diligence and drive. Software companies such as Atlassian and—of course—Google are giving workers time to pursue their own projects. Even low-tech firms such as Whole Foods and Best Buy are giving people more control over how and with whom they work.

How convincing is all this? Mr Pink insists that all he is doing is bringing the light of science to bear on management: "There's been a mismatch between what science knows and what business does." But this argument depends on a highly selective reading of the academic literature. Four reviews of research on the subject from the 1980s onwards have all come to the same conclusion: that pay-for-performance can increase productivity dramatically. A study of an American glass-installation company, for example, found that shifting from salaries to individual incentives increased productivity by 44%. More recent research on workers at a Chinese electronics factory also confirms that performance-related pay (especially the threat of losing income) is an excellent motivator (see page 66).

Linking pay to performance does not just increase motivation. It also helps to recruit and retain the most talented. The world's brightest students are overwhelmingly attracted to organisations that make extensive use of performance-related rewards such as partnerships and share options. Firms are adept at using these rewards to encourage long-term loyalty: people work in the salt mines for years in the hope of becoming partners or senior managers. Companies that eschew extrinsic rewards risk lumbering themselves with sluggish dullards.

Self-determined to do better

What about Mr Pink's other worries, about creativity and "self-determination"? It is certainly true that creative people value the intrinsic things in life. But an enthusiasm for intrinsic rewards can go hand in hand with a taste for extrinsic gain. American universities attract star professors from all around the world by the simple expedient of paying them lots of money. Successful writers employ agents to get the highest possible advances (Mr Pink himself probably hopes to make some money from his book). Creative centres such as Hollywood and Silicon Valley are also hotbeds of payment-by-results. It is true that some of the world's best companies are putting more emphasis on "purpose". But it is quite possible to mix this with pay-for-performance; indeed, companies that Mr Pink lauds, such as Google and Whole Foods, are highly skilled at using sticks and carrots.

All this suggests that Mr Pink has it backwards: far from abandoning sticks and carrots organisations are making ever more use of them. Companies are keener than ever on holding bosses' feet to the fire by linking their pay to performance through stock options and the like and on firing them if they fail. But they are also trying to widen pay differentials further down the organisation: about 90% of American firms use merit pay, for example.

There is no doubt that sticks and carrots can be badly used. They can encourage risky behaviour, as they have in the banking system, or persuade policemen to focus on minor traffic infractions rather than violent criminals, as they have in Britain. But properly managed they can be immensely powerful tools for boosting productivity and attracting the right people. For all the battering he has taken over the past hundred years, Frederick Taylor still has the edge over his critics. ■



Not just another fake

BEIJING

The similarities between China today and Japan in the 1980s may look ominous. But China's boom is unlikely to give way to prolonged slump

CHINA rebounded more swiftly from the global downturn than any other big economy, thanks largely to its enormous monetary and fiscal stimulus. In the year to the fourth quarter of 2009, its real GDP is estimated to have grown by more than 10%. But many sceptics claim that its recovery is built on wobbly foundations. Indeed, they say, China now looks ominously like Japan in the late 1980s before its bubble burst and two lost decades of sluggish growth began. Worse, were China to falter now, while the recovery in rich countries is still fragile, it would be a severe blow not just at home but to the whole of the world economy.

On the face of it, the similarities between China today and bubble-era Japan are worrying. Extraordinarily high saving and an undervalued exchange rate have fuelled rapid export-led growth and the world's biggest current-account surplus. Chronic overinvestment has, it is argued, resulted in vast excess capacity and falling returns on capital. A flood of bank lending threatens a future surge in bad loans, while markets for shares and property look dangerously frothy.

Just as in the late 1980s, when Japan's economy was tipped to overtake America's, China's strong rebound has led many to proclaim that it will become number

one sooner than expected. In contrast, a recent flurry of bearish reports warn that China's economy could soon implode. James Chanos, a hedge-fund investor (and one of the first analysts to spot that Enron's profits were pure fiction), says that China is "Dubai times 1,000, or worse". Another hedge fund, Pivot Capital Management, argues that the chances of a hard landing, with a slump in capital spending and a banking crisis, are increasing.

Scary stuff. However, a close inspection of pessimists' three main concerns—overvalued asset prices, overinvestment and excessive bank lending—suggests that China's economy is more robust than they think. Start with asset markets. Chinese share prices are nowhere near as giddy as Japan's were in the late 1980s. In 1989 Tokyo's stockmarket had a price-earnings ratio of almost 70; today's figure for Shanghai A shares is 28, well below its long-run average of 37. Granted, prices jumped by 80% last year, but markets in other large emerging economies went up even more: Brazil, India and Russia rose by an average of 120% in dollar terms. And Chinese profits have rebounded faster than those elsewhere. In the three months to November, industrial profits were 70% higher than a year before.

China's property market is certainly

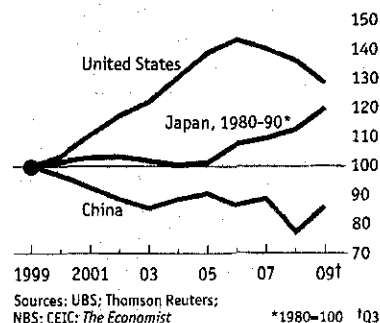
hot. Prices of new apartments in Beijing and Shanghai leapt by 50-60% during 2009. Some lavish projects have much in common with those in Dubai—notably "The World", a luxury development in Tianjin, 120km (75 miles) from Beijing, in which homes will be arranged as a map of the world, along with the world's biggest indoor ski slope and a seven-star hotel.

Average home prices nationally, however, cannot yet be called a bubble. On January 14th the National Development and Reform Commission reported that average prices in 70 cities had climbed by 8% in the year to December, the fastest pace for 18 months; other measures suggest a bigger rise. But this followed a fall in prices in 2008. By most measures average prices have fallen relative to incomes in the past decade (see chart 1).

The most cited evidence of a bubble—and hence of impending collapse—is the ratio of average home prices to average annual household incomes. This is almost ►

Still in the basement

Ratio of house prices to average income



► ten in China; in most developed economies it is only four or five. However, Tao Wang, an economist at UBS, argues that this rich-world yardstick is misleading. Chinese homebuyers do not have average incomes but come largely from the richest 20-30% of the urban population. Using this group's average income, the ratio falls to rich-world levels. In Japan the price-income ratio hit 18 in 1990, obliging some buyers to take out 100-year mortgages.

Furthermore, Chinese homes carry much less debt than Japanese properties did 20 years ago. One-quarter of Chinese buyers pay cash. The average mortgage covers only about half of a property's value. Owner-occupiers must make a minimum deposit of 20%, investors one of 40%. Chinese households' total debt stands at only 35% of their disposable income, compared with 130% in Japan in 1990.

China's property boom is being financed mainly by saving, not bank lending. According to Yan Wang, an economist at BCA Research, a Canadian firm, only about one-fifth of the cost of new construction (commercial and residential) is financed by bank lending. Loans to homebuyers and property developers account for only 17% of Chinese banks' total, against 56% for American banks. A bubble pumped up by saving is much less dangerous than one fuelled by credit. When the market begins to crack, highly leveraged speculators are forced to sell, pushing prices lower, which causes more borrowers to default.

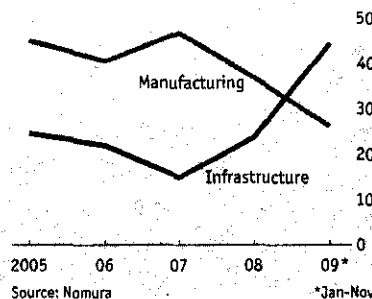
Even if China does not (yet) have a credit-fuelled housing bubble, the fact that property prices in Beijing and Shanghai are beyond the reach of most ordinary people is a serious social problem. The government has not kept its promise to build more low-cost housing, and it is clearly worried about rising prices. In an attempt to thwart speculators, it has reimposed a sales tax on homes sold within five years, has tightened the stricter rules on mortgages for investment properties and is trying to crack down on illegal flows of foreign capital into the property market. The government does not want to come down too hard, as it did in 2007 by cutting off credit, because it needs a lively property sector to support economic recovery. But if it does not tighten policy soon, a full-blown bubble is likely to inflate.

The world's capital

China's second apparent point of similarity to Japan is overinvestment. Total fixed investment jumped to an estimated 47% of GDP last year—ten points more than in Japan at its peak. Chinese investment is certainly high: in most developed countries it accounts for around 20% of GDP. But you cannot infer waste from a high investment ratio alone. It is hard to argue that China has added too much to its capital stock

Chugging along a better track

China's fixed-asset investment
% increase on previous year



when, per person, it has only about 5% of what America or Japan has. China does have excess capacity in some industries, such as steel and cement. But across the economy as a whole, concerns about over-investment tend to be exaggerated.

Pivot Capital Management points to China's incremental capital-output ratio (ICOR), which is calculated as annual investment divided by the annual increase in GDP, as evidence of the collapsing efficiency of investment. Pivot argues that in 2009 China's ICOR was more than double its average in the 1980s and 1990s, implying that it required much more investment to generate an additional unit of output. However, it is misleading to look at the ICOR for a single year. With slower GDP growth, because of a collapse in global demand, the ICOR rose sharply everywhere. The return to investment in terms of growth over a longer period is more informative. Measuring this way, BCA Research finds no significant increase in China's ICOR over the past three decades.

Mr Chanos has drawn parallels between China and the huge misallocation of resources in the Soviet Union, arguing that China is heading the same way. The best measure of efficiency is total factor productivity (TFP), the increase in output not directly accounted for by extra inputs of capital and labour. If China were as wasteful as Mr Chanos contends, its TFP growth would be negative, as the Soviet Union's was. Yet over the past two decades China has enjoyed the fastest growth in TFP of any country in the world.

Even in industries which clearly do have excess capacity, China's critics overstate their case. A recent report by the European Union Chamber of Commerce in China estimates that in early 2009 the steel industry was operating at only 72% of capacity. That was at the depth of the global downturn. Demand has picked up strongly since then. The report claims that the industry's overcapacity is illustrated by "a startling figure": in 2008, China's output of steel per person was higher than America's. So what? At China's stage of industrialisation it should use a lot of steel. A more

relevant yardstick is the America of the early 20th century. According to Ms Wang of UBS, China's steel capacity of almost 0.5kg (about 1lb) per person is slightly lower than America's output in 1920 (0.6kg) and far below Japan's peak of 1.1kg in 1973.

Many commentators complain that China's capital-spending spree last year has merely exacerbated its industrial overcapacity. However, the boom was driven mainly by infrastructure investment, whereas investment in manufacturing slowed quite sharply (see chart 2). Given the scale of the spending, some money is sure to have been wasted, but by and large, investment in roads, railways and the electricity grid will help China sustain its growth in the years ahead.

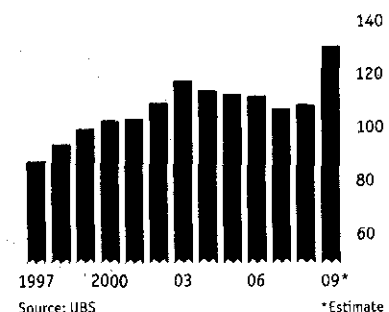
Some analysts disagree. Pivot, for instance, argues that China's infrastructure has already reached an advanced level. It has six of the world's ten longest bridges and it boasts the world's fastest train; there is little room for further productive investment. That is nonsense. A country in which two-fifths of villages lack a paved road to the nearest market town still has plenty of scope for building roads. The same goes for railways. Again, a comparison of China today with the America of a century ago is pertinent. China has roughly the same land area as America, but 13 times more people than the United States did then. Yet on current plans it will have only 110,000km of railway by 2012, compared with more than 400,000km in America in 1916. Unlike Japan, which built "bridges to nowhere" to prop up its economy, China needs better infrastructure.

It is true that in the short term, the revenue from some infrastructure projects may not be enough to service debts, so the government will have to cover losses. But in the long term such projects should lift productivity across the economy. During Britain's railway mania in the mid-19th century, few railways made a decent financial return, but they brought huge long-term economic benefits.

The biggest cause for worry about China is the third point of similarity to Japan: the recent tidal wave of bank lending. Total ►►

Deluge after the drought

China's bank credit as % of GDP



► credit jumped by more than 30% last year. Even assuming that this slows to less than 20% this year, as the government has hinted, total credit outstanding could hit 135% of GDP by December. The authorities are perturbed. This week they increased banks' reserve requirement ratio by half a percentage point. They have also raised the yield on central-bank bills.

However, too many commentators talk as if Chinese banks have been on a lending binge for years. Instead, the spurt in 2009, which was engineered by the government to revive the economy, followed several years in which credit grew more slowly than GDP (see chart 3 on the previous page). Michael Buchanan, of Goldman Sachs, estimates that since 2004 China's excess credit (the gap between the growth rates of credit and nominal GDP) has risen by less than in most developed economies.

Even so, recent lending has been excessive; combined with overcapacity in some industries, it is likely to cause an increase in banks' non-performing loans. Ms Wang calculates that if 20% of all new lending last year and another 10% of this year's lending turned bad, this would create new bad loans equivalent to 5.5% of GDP by 2012, on top of 2% now. That is far from trivial, but well below the 40% of GDP that bad loans amounted to in the late 1990s.

Much of the past year's bank lending should really be viewed as a form of fiscal stimulus. Infrastructure projects that have little hope of repaying loans will end up back on the government's books. It would have been much better if such projects had been financed more transparently through the government's budget, but the important question is whether the state can afford to cover the losses.

Official gross government debt is less than 20% of GDP, but China bears argue that this is an understatement, because it excludes local-government debt and the bonds issued by the asset-management companies that took over banks' previous non-performing loans. Total government debt could be 50% of GDP. But that is well below the average ratio in rich countries, of around 90%. Moreover, the Chinese government owns lots of assets, for example shares of listed companies which are worth 35% of GDP.

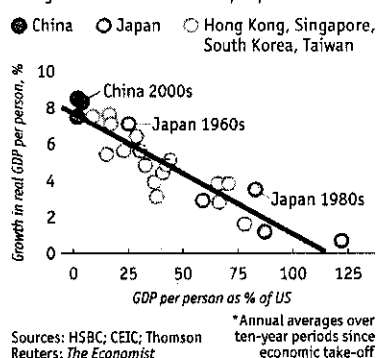
Ying and yang

Even if, as argued above, concerns about a financial crash in China are premature, the risks of a dangerous bubble and excessive investment will clearly increase if credit continues to expand at its recent pace. The stitching on the Chinese economy could fray and burst. Would that imply the end of China's era of rapid growth?

Predictions that China is heading for a prolonged Japanese-style slump ignore big differences between China today and Japan in the late 1980s. Japan was already a

Still on the starting line

GDP growth rates and income per person*



mature, developed economy, with a GDP per person close to that of America. China is still a poor, developing country, whose GDP per person is less than one-tenth of America's or Japan's. It has ample room to play catch-up with rich economies by adding to its capital stock, importing foreign technology and boosting productivity by shifting labour from farms to factories. This would make it easier for China to recover from the bursting of a bubble.

Chart 4 examines the relationship between growth rates and income per head for six Asian economies. Each plot shows a country's growth rate and GDP per person relative to America's for successive ten-year periods, starting when their rapid growth took off. It illustrates how growth rates slow as economies catch up with America, the technological leader. The fact that China's GDP per head is much lower than Japan's in the 1980s suggests that its growth potential over the next decade is much higher. Even though China's labour force will start shrinking after 2016, rapid productivity gains mean that its trend GDP growth rate is still around 8%, down from 10% in the past decade.

Japan's stockmarket and land-price bubbles in the early 1960s offer a better (and more cheerful) analogy to China than the 1980s bubble era does. Japan's economy was poorer then, although relative to America its GDP per person was more than double China's today, and its trend rate of growth was around 9%. According to HSBC, after the bubble burst in 1962-65, Japan's annual growth rate dipped to just under 6%, but then quickly rebounded to 10% for much of the next decade.

South Korea and Taiwan, which experienced big stockmarket bubbles in the 1980s, are also worth examining. In the five years to 1990, Taipei's stockmarket surged by 1,600% (in dollar terms) and Seoul's by 700%, easily beating Tokyo's 450% gain in the same period. After share prices slumped, annual growth in both South Korea and Taiwan slowed to around 6%, but soon regained its previous pace of 7-8%.

The higher a country's potential growth

rate, the easier it is for the economy to recover after a bubble bursts, so long as its fiscal and external finances are in reasonable shape. Rapid growth in nominal GDP means that asset prices do not need to fall so far to regain fair value, bad loans are easier to work off and excess capacity can be more quickly absorbed by rising demand. The experience of Japan in the 1960s suggests that if China's bubble bursts, it will hurt growth temporarily but not lead to prolonged stagnation.

However, it is Japan's experience after the 1980s that most influences the thinking of policymakers in Beijing. Many blame Japan's deflation and its lost decades of growth on the fact that its government caved in to American demands for an appreciation of the yen. In 1985 central banks in the big rich economies agreed, in the Plaza Accord, to intervene to push down the dollar. By 1988 the yen had risen by more than 100% against the greenback. One reason why policymakers in Beijing have resisted a big rise in the yuan is that they fear it could send their economy, like Japan's, into a deflationary slump.

The wrong lesson

Yet Japan's real mistake was not that it allowed the yen to rise, but that it had previously resisted an appreciation for too long, so that when it did happen the yen soared. A second error was that Japan tried to offset the adverse economic effects of a strong yen with over-lax monetary policy. If policy had been tighter, the financial bubble would have been smaller and its aftermath less painful.

This offers two important lessons to China. First, it is better to let the exchange rate rise sooner and more gradually than to risk a much sharper appreciation later. Second, monetary policy should not be too slack. Raising reserve requirements is a small step in the right direction. Despite the bears' growling, China's economic collapse is neither imminent nor inevitable. But if it continues to draw the wrong lesson from the tale of Japan, then one day its economy may look just as tatty. ■



► away with it is baffling).

More importantly for their public image, banks are lowering their "compensation ratios". Investment banks used to give half their net revenues to employees. This year it will be closer to 40%.

Even so, the absolute numbers will still look indefensible, especially to the millions of Americans without a job. That leaves the banks destined to please no one: the public will see the pay numbers as disgracefully large, employees as disappointingly low. The mood on Wall Street is part frustration (that the cut in compensation

ratios, the charitable giving and so on have failed to soften hearts); part fear (over possible defections to hedge funds); and part anger (over what financiers see as the Obama administration's fanning of anti-bank sentiment).

All three emotions were heightened this week. Andrew Cuomo, New York's attorney-general, demanded detailed information on pay policies from big banks. The Federal Deposit Insurance Corporation, meanwhile, said it would assess pay structures in calculating contributions to its deposit-insurance fund. And compensation

featured heavily when the bosses of four big banks testified at the first hearing of the Financial Crisis Inquiry Commission.

But the biggest blow was news of a special levy on large financial institutions to cover forecast taxpayer losses of \$17 billion on the Troubled Asset Relief Programme (TARP). The "Financial Crisis Responsibility Fee" will last a minimum of ten years and snare around 50 bankers and insurers with assets of more than \$50 billion. Each will pay 0.15% of its eligible liabilities, measured as total assets minus capital and deposits (or, for insurers, policy ►►

Buttonwood

The link between exchange rates and asset markets

FOR 100 years after 1870 governments and central bankers struggled to maintain a system of fixed exchange rates. When the Bretton Woods agreement collapsed in the early 1970s the three leading economies of America, Germany and Japan accepted that their currencies would float against each other. So it has been ever since.

The period since the Bretton Woods system fell apart has also seen enormous bubbles in asset markets, a huge expansion of the financial sector and a rapid rise in consumer debt. These developments are no coincidence. Floating exchange rates and booming asset markets have reinforced each other.

Previous exchange-rate systems had been linked, directly or indirectly, to gold. The aim was to put a constraint on the ability of governments to debase their currencies by printing money. The corollary was that countries found it hard to fund trade deficits for long.

With floating exchange rates, the trade constraint was removed. This allowed America to enjoy its long-running deficit. But as Richard Duncan pointed out in his prescient book "The Dollar Crisis", published in 2003, it also let other countries run huge surpluses.

This was no longer a zero-sum game. Surplus countries built up their foreign-exchange reserves. These either translated into bubbles at home (for example, Japan in the 1980s) or fuelled them abroad (America in the past decade).

The move to fiat money (paper not backed by gold) created the huge expansion in global money supply that the pessimists had predicted. According to Mr Duncan, under Bretton Woods global foreign-exchange reserves grew by 55% between 1949 and 1969. They then grew by almost 2,000% between 1969 and 2000. This extra money was used to push up as-

set, rather than consumer, prices.

Freed from the need to defend their currencies, and with consumer inflation a minor problem over the past 20 years, central banks could afford to let interest rates drift steadily lower. Even countries with pegged exchange rates, such as Latvia and China, "imported" the loose monetary conditions of the developed world. This policy put a floor under asset prices and eventually created the conditions for the credit crunch of 2007-08. Only by lowering rates almost to zero have the authorities managed to stabilise matters again.

This process helps explain why equity and house prices reached peaks in recent years that were unknown under fixed exchange-rate systems. It also suggests why floating rates did not deter cross-border investment.

In the first half of the 20th century foreign investment was largely in the form of bank deposits and government bonds. This was partly due to investor caution and partly due to capital controls. The yields on such instruments were fairly low,

making investors very sensitive to any exchange-rate changes. A burst of depreciation could wipe out years of profits.

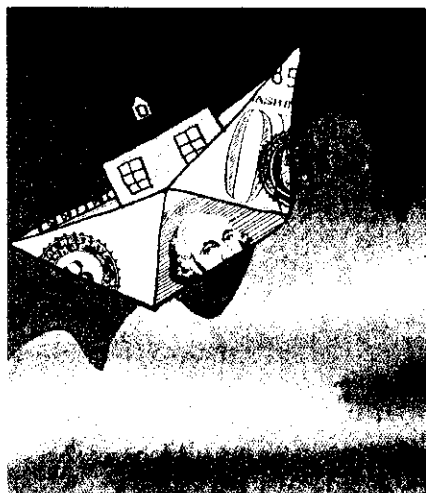
Furthermore, shifts in exchange rates, when they came, tended to be big. Devaluation was seen as a national humiliation, so was resisted until the last minute. By that stage the exchange rate was well out of line with the fundamentals.

Since 1970 exchange-rate moves in developed markets have generally been dwarfed by asset-price shifts. (The exceptions have occurred in countries that have tried to maintain currency pegs.) Currency risk has been of such little concern to institutional investors that many do not bother to hedge it. Indeed a popular tactic has been the "carry trade", borrowing low-yielding currencies to buy higher-yielding (and higher-risk) currencies.

It is no mystery why developed countries abandoned fixed rates. By anchoring the currency, governments forced the real economy to absorb shocks. This implied wage cuts or higher unemployment, all for the benefit of creditors. But in a democracy the votes of debtors tend to overwhelm the interests of creditors.

This battle is about to be re-enacted in the euro zone, where higher-cost countries have tied themselves to a new gold standard, in the form of the hyper-efficient German export machine. That implies the need to keep the lid on deficits and wage growth.

But a floating-rate system is not a free lunch either. It has been accompanied by a rise in debt burdens that will be a dead-weight on economies for many years. The credit crunch has shifted the burden of servicing that debt from the private to the public sector. An era of austerity, which the floating-rate system was designed to avoid, is going to occur after all.



Economics focus | Digging out of debt

The rich world's debt reduction has barely begun

DELEVERAGING is an ugly word for a painful process. But few things matter more for the world economy than whether, and how fast, the rich world's borrowing is cut back. History suggests that severe financial crises are usually followed by long periods of debt reduction—in which credit falls relative to the size of the economy. This time, too, that process is under way. Banks have been furiously reducing leverage. Consumer credit in America has fallen for ten consecutive months, the largest and longest drop on record. But how much further is there to go?

A new report by the McKinsey Global Institute, a research arm of the consulting firm, tries to offer an answer. It begins by comparing the recent evolution of debt levels in ten big rich economies and four large emerging ones. Ratios of total debt to GDP (including debt owed by households, government, non-financial businesses and the financial industry) vary widely, with America's, at just under 300%, lower than many others. But with a few exceptions, such as Germany and Japan, most rich countries saw a huge rise over the past decade. Britain and Spain were the most extreme, with an increase in their total-debt ratios of more than 150 percentage points apiece, to 465% and 365% respectively.

The debt piled up in different places in different countries. With the exception of Japan, which was dealing with the aftermath of its own earlier asset bust, government debt as a share of GDP was mostly flat or falling. Nor, with the exception of commercial property and leveraged buy-outs, did the rich world's firms go on a debt binge. Corporate leverage, measured as debt to book equity, was stable or falling in most countries before the crisis. Financial-sector debt rose as a share of GDP in most countries, especially Britain and Spain, and some pockets of finance (such as investment banks) saw a huge increase in leverage. But outside Germany and Japan, where it fell, the most striking jump was in household debt. Most rich countries saw a rise of more than 40% in the ratio of household debt to disposable income. Even there, though, the rise was not uniform. In America middle-income households built up most debt. In Spain poorer people did.

The picture McKinsey paints is one of concentrated (albeit large) credit excesses rather than economy-wide debt binges. As a result, the debt-reduction process will differ by sector and by country. Judged by ratios of total debt to GDP, deleveraging has barely started. As of June 2009 these ratios had fallen only in America, Britain and South Korea, and not by much at that. But the composition of debt has shifted sharply, as government borrowing has soared while private debt has fallen. The financial sector has cut back the most. By mid-2009 financial leverage in most countries had fallen to around its average in the 15 years before the crisis.

To pinpoint where more squeezing is likely, the study examined how far the level and growth of debt in different sectors were out of line with other countries and with his-

torical averages. It also looked at measures of borrowers' capacity to service their debts and their vulnerability to income shocks. On this basis it could assess where the chances of more deleveraging over the next couple of years are high, moderate or low (see chart). Half of the ten rich countries in the report's sample have one or more sectors that are "highly" vulnerable to more debt reduction. Not surprisingly, these include households in America, Britain, Spain and, to a lesser degree, Canada and South Korea, as well as commercial property in America, Britain and Spain. With a high risk of more corporate and financial deleveraging as well, Spain has the rockiest road ahead. No country in the sample has much chance of government-debt reduction over the next couple of years.

Changing gear

Assigning the odds of further deleveraging is not the same as gauging its likely economic impact. To do that, the study looks to history. It finds 32 examples of sustained deleveraging (at least three consecutive years in which ratios of total debt to GDP fell by at least 10%) in the aftermath of a financial crisis. In some cases the debt burden was reduced by default. In others it was inflated away. But in about half the cases—which the report regards as the most appropriate points of comparison—the deleveraging came through a prolonged period of belt-tightening, where credit grew more slowly than output. The message from these episodes is sobering. Typically deleveraging began about two years after the beginning of the financial crisis and lasted for six to seven years. In almost every case output shrank for the first two or three years of the process. (Countries which defaulted or inflated their debt away saw bigger recessions at first, but had higher output growth than the belt-tighteners by the end.)

Worse, there are several reasons why today's mess could be more protracted than previous episodes. First, the scale of indebtedness is higher. The highest debt ratio in the report's group of

belt-tighteners was 286%, in Britain after the second world war. Today more than half the rich countries in the McKinsey sample have debt totalling more than 300% of GDP. Second, the number of countries afflicted simultaneously means that rapid expansions of exports, which have supported output in the past, are harder to achieve. Third, big increases in public debt, while cushioning demand in the short term, increase the overall debt reduction that will eventually be needed. Once private deleveraging is done, the public sector will need to cut back.

In theory that sounds simple. In practice it will be fiendishly hard to get the balance right. Investors may worry about the sustainability of public debt long before private-debt reduction is over, forcing a lot of belts to be tightened at once. The most painful bits of deleveraging could well lie ahead. ■

Stand and delever

Likelihood of deleveraging, as of Q2 2009

Country	Household	Corporate		Government	Financial institutions
		Non-CRE*	CRE*		
Spain	High	Low	Low	Low	Low
Britain	High	Low	Low	Low	Low
US	High	Low	Low	Low	Low
South Korea	High	Low	Low	Low	Low
Canada	High	Low	Low	Low	Low
Italy	High	Low	Low	Low	Low
Japan	Low	Low	Low	Low	Low
Switzerland	Low	Low	Low	Low	Low
Germany	Low	Low	Low	Low	Low
France	Low	Low	Low	Low	Low
India	Low	Low	Low	Low	Low
China	Low	Low	Low	Low	Low
Brazil	Low	Low	Low	Low	Low
Russia	Low	Low	Low	Low	Low

Source: McKinsey Global Institute

*Commercial real estate; includes public and private real-estate investment vehicles

Leviathan stirs again

The return of big government means that policymakers must grapple again with some basic questions. They are now even harder to answer

FIFTEEN years ago it seemed that the great debate about the proper size and role of the state had been resolved. In Britain and America alike, Tony Blair and Bill Clinton pronounced the last rites of "the era of big government". Privatising state-run companies was all the rage. The Washington consensus reigned supreme: persuade governments to put on "the golden straitjacket", in Tom Friedman's phrase, and prosperity would follow.

Today big government is back with a vengeance: not just as a brute fact, but as a vigorous ideology. Britain's public spending is set to exceed 50% of GDP (see chart 1 on next page). America's financial capital has shifted from New York to Washington, D.C., and the government has been trying to extend its control over the health-care industry. Huge state-run companies such as Gazprom and PetroChina are on the march. Nicolas Sarkozy, having run for office as a French Margaret Thatcher, now argues that the main feature of the credit crisis is "the return of the state, the end of the ideology of public powerlessness".

"The return of the state" is stirring up fiery opposition as well as praise. In America the Republican Party's anti-government base is more agitated than it has been at any time since the days of the Gingrich revolution in 1994. "Tea-party" protesters have been marching across the country with an amusing assortment of banners and buttons: "Born free, taxed to death" and "God only requires 10%". On January 19th Scott Brown, a Republican, captured the Massachusetts Senate seat long held by the late Ted Kennedy, America's most prominent supporter of big-government liberalism.

Many European countries have devoted a high proportion of their GDP to public spending for years. And many governments cannot wait to get out of their new-found business of running banks and car companies. But the past decade has clearly produced changes which, taken cumulatively, have put the question of the state back at the centre of political debate.

The obvious reason for the change is the financial crisis. As global markets collapsed, governments intervened on an unprecedented scale, injecting liquidity into their economies and taking over, or otherwise rescuing, banks and other companies that were judged "too big to fail". A few months after Lehman Brothers had collapsed, the American government was in

charge of General Motors and Chrysler, the British government was running high street banks and, across the OECD, governments had pledged an amount equivalent to 2.5% of GDP.

The crisis upended conventional wisdom about the relative merits of governments and markets. Where government, in Ronald Reagan's aphorism, was once the problem, today the default villain is the market. Free-marketeers such as Alan Greenspan, the former head of the Federal Reserve, have apologised for their ideological zeal. A line from Rudyard Kipling sums it up best: "The gods of the market tumbled, and their smooth-tongued wizards withdrew".

Yet even before Lehman Brothers collapsed the state was on the march—even in Britain and America, which had supposed-

ly done most to end the era of big government. Gordon Brown, Britain's chancellor and later its prime minister, began his ministerial career as "Mr Prudent". During Labour's first three years in office public spending fell from 40.6% of GDP to 36.6%. But then he embarked on an Old Labour spending binge. He increased spending on the National Health Service by 6% a year in real terms and boosted spending on education. During Labour's 13 years in power two-thirds of all the new jobs created were driven by the public sector, and pay has grown faster there than in the private sector (see chart 2).

In America, George Bush did not even go through a prudent phase. He ran for office believing that "when somebody hurts, government has got to move". And he responded to the terrorist attacks of September 11th 2001 with a broad-ranging "war on terror". The result of his guns-and-butter strategy was the biggest expansion in the American state since Lyndon Johnson's in the mid-1960s. He added a huge new drug entitlement to Medicare. He created the biggest new bureaucracy since the second world war, the Department of Homeland Security. He expanded the federal govern- ▶



ment's control over education and over the states. The gap between American public spending and Canada's has tumbled from 15 percentage points in 1992 to just two percentage points today.

The public's demands

The expansion of the state in both Britain and America met with widespread approval. The opposition Conservative Party applauded Mr Brown's increase in NHS spending. Mr Bush met no significant opposition from his fellow Republicans to his spending binge. It was clear that, when it came to their own benefits, suburban Americans wanted government on their side. A banner at one of those tea-parties sums up the confused attitude of many of the so-called anti-government protesters: "Keep the government's hands off my Medicare."

The demand for public services will soar in the coming decades, thanks to the ageing of the population. The United Nations points out that the proportion of the world's population that is over 60 will rise from 11% today to 22% in 2050. The situation is especially dire in the developed world: in 2050 one in three people in the rich world will be pensioners, and one in ten will be over 80. In America more than 10,000 baby-boomers will become eligible for Social Security and Medicare every day for the next two decades. The Congressional Budget Office (CBO) calculates that entitlement spending will grow from 9% of GDP today to 20% in 2025. If America keeps its distaste for taxes, it will face fiscal Armageddon (see chart 3 on next page).

The level of public spending is only one indication of the state's power. America's federal government employs a quarter of a million bureaucrats whose job it is to write and apply federal regulations. They have cousins in national and supranational capitals all round the world. These regulators act as force multipliers: a regulation promulgated by a few can change the behav-



iour of entire industries. Periodic attempts to build "bonfires of regulations" have got nowhere. Under Mr Bush the number of pages of federal regulations increased by 7,000, and eight of Britain's ten biggest regulatory bodies were set up under the current government.

The power of these regulators is growing all the time. Policymakers are drawing up new rules on everything from the amount of capital that banks have to set aside to what to do about them when they fail. Britain is imposing additional taxes on bankers' bonuses, America is imposing extra taxes on banks' liabilities, and central bankers are pondering ingenious ways to intervene in overheated markets. Worries about climate change have already led to a swathe of new regulations, for example on carbon emissions from factories and power plants and on the energy efficiency of cars and light-bulbs. But, since emissions are continuing to grow, such regulations are likely to proliferate and, at the same time, get tighter. The Kerry-Boxer bill on carbon emissions, which is now in the Senate, runs to 821 pages.

Fear of terrorism and worries about rising crime have also inflated the state. Governments have expanded their ability to police and supervise their populations. Britain has more than 4m CCTV cameras, one for every 14 people. In Liverpool the police have taken to using unmanned aerial drones, similar to those used in Afghanistan, to supervise the population. The Bush administration engaged in a massive programme of telephone tapping before the Supreme Court slapped it down.

Another form of the advancing state is more insidious. Annual lists of the world's biggest companies have begun to feature new kinds of corporate entities: companies that are either directly owned or sub-

stantially controlled by the state. Four state-controlled companies have made it into the top 25 of the 2009 Forbes Global 2000 list, and the number is likely to grow. Chinese state-controlled companies have been buying up private companies during the financial crisis. Russia's state-controlled companies have a long record of snapping up private companies on the cheap. Sovereign wealth funds are increasingly important in the world's markets.

This is partly a product of the oil boom. Three-quarters of the world's crude-oil reserves are owned by national oil companies. (By contrast, conventional multinationals control just 3% of the world's reserves and produce 10% of its oil and gas.) But it is also the result of something more fundamental: the shift in the balance of economic power to countries with a very different view of the state from the one celebrated in the

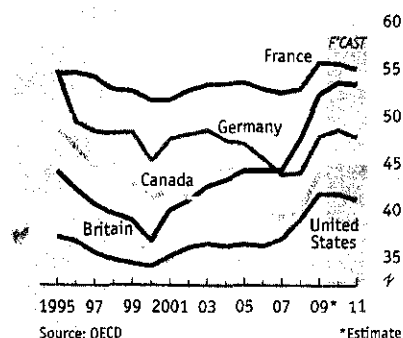
Washington consensus. The world is seeing the rise of a new economic hybrid—what might be termed "state capitalism".

Under state capitalism, governments do not so much reject the market as use it as an instrument of state power. They encourage companies to take advantage of global capital markets and venture abroad in search of opportunities. Malaysia's Petronas and China's National Petroleum Corporation run businesses in some 30 countries. But they also use them to control the economy at home—to direct resources to favoured industries or reward political clients. Politicians in China and elsewhere not only make decisions about the production of cars and mobile phones; they are also the hidden hands behind companies that are scouring the world for the raw materials that go into them.

The revival of the state is creating a series of fierce debates that will shape policymaking over the coming decades. Governments are beginning to cut public spending in an attempt to deal with surging deficits. But the inevitable quarrels ►►

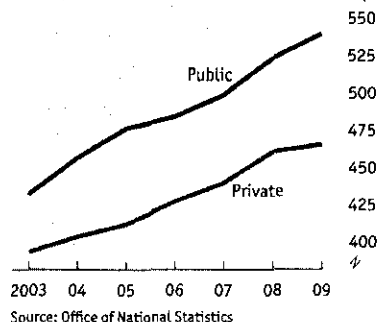
1 The shape of the beast

Total government spending, % of GDP



2 Where the money is

British gross median weekly earnings
Full-time workers, £



over cuts will be paltry compared with those about the growth of entitlements. America's deficit, boosted by recession, is already hovering at a post-war high of 12% of GDP, and the American economy depends on the willingness of other countries (particularly China) to fund its debt. The CBO calculates that the deficit could rise to 23% of GDP in the next 40 years if it fails to tackle the yawning imbalance between revenue and expenditure.

Crises can be the midwives of serious thinking. The stagflation of the 1970s prepared the way for the Reagan and Thatcher revolutions. More recently, several countries have dealt with out-of-control spending by introducing dramatic cuts: New Zealand, Canada and the Netherlands all reduced public spending by as much as 10% from 1992 onwards.

In the early 1990s Sweden faced a home-grown economic crisis that foreshadowed many of the features of the global crisis. The property bubble burst and the government stepped in to save the banks and pump up demand. Public debt doubled, unemployment tripled and the budget deficit increased tenfold. The Social Democrats were elected in 1994 and re-elected twice thereafter on a programme of raising taxes and slashing spending.

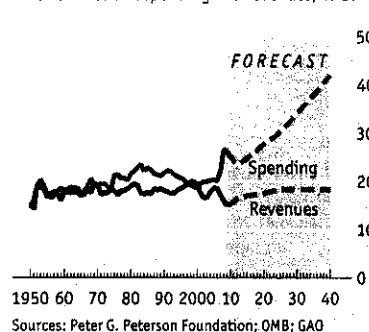
This points to an irony: a crisis which promotes state growth in the short term may lead to pruning in the longer term. In Britain power is almost certain to shift from Labour to the Conservatives, who are much keener on cutting public spending. In America the Republicans will make big gains in the mid-term elections and Mr Obama, already sobered by his loss in Massachusetts, will have to move to the centre.

But pruning will still be more difficult than it has ever been before. Getting the public sector to do "more with less" is harder after two decades of public-sector reforms. Across the OECD more than 40% of public goods are provided by the private sector (thanks to privatisation and contracting out) and 75% of public officials are on some sort of pay-for-performance scheme. The ageing of the population makes earlier reforms look easy. Governments will have to ask fundamental questions—such as whether it makes sense to let people retire at 65 when they are likely to live for another 20 years.

The rise of state capitalism is fraught with problems. It may be hard to argue with China's 30 years of hefty economic growth and \$2.3 trillion in foreign-currency reserves. But subordinating economic decisions to political ones can come with a price-tag in the long term: politicians are reluctant to let "strategic" companies fail,

Cheques in the post

America's federal spending and revenues, % GDP



and companies become adjuncts of the state patronage machine. Giving the imprimatur of the state to global companies is also fraught with risks. America's Congress prevented Dubai from taking over American ports on grounds of national security.

Anatomising failure

The most interesting arguments over the next few years will weigh government failure against market failure. The market-failure school had been gaining strength even before the credit crunch struck. The rise of cowboy capitalism in Russia under Boris Yeltsin persuaded many people—not least the Chinese—of the importance of strong government. And the threat of global warming is an obvious example of how government intervention is needed to deter people from overheating the world. Advocates of market failure have also been advancing a broad range of arguments for using the government to "nudge" people's behaviour in the right direction.

But the fact that markets are prone to sometimes spectacular failure does not mean that governments are immune to it. Government departments are good at expanding their empires. Thus a welfare state

that was designed to help people deal with unavoidable risks, such as sickness and old age, is increasingly in the business of trying to eliminate risk in general through a proliferating health-and-safety bureaucracy. Government workers are also good at protecting their own interests. In America, where 30% of people in the public sector are unionised compared with just 7% in the private sector, public-sector workers enjoy better pension rights than private-sector workers, as well as higher average pay.

The public sector is subjected to all sorts of perverse incentives. Politicians use public money to "buy" votes. America is littered with white elephants such as the John Murtha airport in Jonestown, Pennsylvania, which cost hundreds of millions of dollars but serves only a handful of passengers, including Mr Murtha, who happens to be chairman of a powerful congressional committee. Interest groups spend hugely to try to affect political decisions: there are 1,800 registered lobbyists in the European Union, 5,000 in Canada and no fewer than 15,000 in America. Mr Bush's energy bill was so influenced by lobbyists that John McCain dubbed it the "No Lobbyist Left Behind" act.

These perverse incentives mean that governments can frequently spend lots of money without producing any improvement in public services. Britain's government doubled spending on education between fiscal 1999 and fiscal 2007, but the spending splurge coincided with a dramatic decline in Britain's position in the OECD's ranking of educational performance. Bill Watkins of the University of California, Santa Barbara, calculates that, once you adjust for inflation and population growth, his state's government spent 26% more in 2007-08 than in 1997-98. No one can argue that California's public services are now 26% better.

"The question that we ask today," said Barack Obama in his inaugural address, "is not whether our government is too big or too small, but whether it works." This is clearly naive: with deficits soaring, nobody can afford to ignore the size of government. Mr Obama's appeal for pragmatism has some value: conservative attempts to roll back government regulations have led to disaster in the finance industry. But left-wing attempts to defend entitlements and public-sector privileges willy-nilly will condemn the state to collapse under its own weight. Policymakers will not be able to give a serious answer to Mr Obama's question of whether "government works" without first asking themselves some more fundamental questions about what the state should be doing and what it should be leaving well alone. ■



model cost \$218 to build and the latest only \$170, despite its superior performance. Assembly costs are minimal—just \$6.50 for the current iPhone. Even though the parts in high-end smart-phones differ widely, their total construction cost often falls in a narrow range of \$170-180 (see chart). Makers apparently set a budget and see what they can fit in, says Mr Rassweiler.

Most smart-phones' retail prices (before operator subsidies) are around \$500-\$600. Not all of the difference is profit. There are many other costs, such as research, design, marketing and patent fees, as well as the retailer's own costs. But the big gap between the cost of building a smart-phone and its price in the shops should widen further as ever more previously discrete components are packed on to a single main microchip. Howard Curtis of UBM Technisights predicts that as software and mobile services come to represent more of a smart-phone's overall value, this too will widen the gap between manufacturing costs and selling prices.

What this gap demonstrates is that for smart-phones, like most other electronic

Sum of the parts

Cost of components*, 2009, \$

	Palm Pre	Apple iPhone†	Toshiba T601	Motorola Droid
Integrated circuits	83.96	91.38	68.39	60.83
Display/touchscreen	38.80	34.65	35.30	35.25
Mechanical‡	19.63	17.80	21.88	20.23
Camera	7.50	9.35	12.80	14.25
Battery	4.25	5.07	4.71	4.25
Other	16.51	11.82	30.60	44.30
Total	170.65	170.07	173.68	179.11

Source: iSuppli

*Latest data available †3GS 16GB

‡Includes electromechanical

devices, most of the value lies not in manufacturing but in all the services and intellectual property it takes to create and market such products. That is something for politicians to ponder: instead of making empty promises about saving ailing manufacturers they might instead consider how best to promote the growth of high-value service industries. ■

long ago, it was a city that needed everything and attracted everyone. Immigrants flooded in from the rest of China, anxious to seize a unique opportunity. Few laws, if any, restrained business. Factories could be opened anywhere. Even the most qualified people found they could get better jobs by moving to Shenzhen.

That has changed. China has begun to develop large corporations that attract talented employees. Shenzhen itself has at least two global leaders, the telecoms giants Huawei and ZTE. Land has become harder to find and, inevitably, more expensive. One of the last big parcels was not divided up for small businesses but transferred to BYD, a fast-growing manufacturer of cars and batteries. Many laws have been enacted to protect workers and the environment, making it more costly and complex to start a business. As factories have moved away, so has low-skilled labour.

In some respects this is good news. Small firms with slipshod standards are being replaced by bigger, better ones. Where people are creating companies, they are doing so out of choice, not economic necessity. But not all the news is so positive. The study also examined two other things. Only 9% of the respondents said the technology they hoped to use in their new venture was truly innovative—less than one year old. That makes Shenzhen more engaged in innovation than Brazil or Russia, but far less than Japan or Israel, and thus more vulnerable to competition.

The study also showed a sharp recent decline in the interest of private investors. That is, at least in part, a reasonable response to the financial crisis. But it is nonetheless a real problem, because the Chinese banks lean heavily toward large state-controlled companies. Shenzhen has become a global synonym for business creation, but there is reason to wonder how much longer it will remain so. ■

Capitalism in China

The spirit of enterprise fades

HONG KONG

The cradle of China's start-up firms is showing its age

CHINA'S remarkable resurgence began three decades ago with the designation of Shenzhen, just north of Hong Kong, as a "special economic zone". Businesses in the zone were free to re-engage with overt capitalism and make profits by satisfying customers, not the state. The result was the transformation of a farming village into a city of 9m people, bustling with production lines and sewing machines, making everything from iPods to Nikes, in a burst of entrepreneurial zeal.

But that may describe its past more accurately than its future. Inevitably, prosperity has affected people's attitudes and the local business environment. A study by the Shenzhen Academy of Social Sciences and the Chinese University of Hong Kong, released on January 18th, shows a precipitous drop in the fraction of the population involved in starting new businesses, from 12% in 2004 to 5% in 2009. "It's not so special anymore," says Kevin Au, a professor of management at Chinese University.

Five other medium-sized Chinese cities that are part of a separate study show similar results, says Mr Au. Collectively, their levels of enterprise differ little from those seen in western Europe, which is to say slightly weaker than in Britain, much less

so than in America, but much stronger than in Japan. The strongest signs of enterprise in China can be observed in very poor, rural areas that are just beginning to develop beyond agriculture.

There are any number of explanations for what is happening in Shenzhen. Not



Chinese capitalism at work: the thrill is gone



Base camp Basel

Regulators are trying to make banks better equipped against catastrophe

THE world's banking system is both mindbogglingly complex and too vital to fail. After only a year's deliberation, the finest minds in governments, regulatory bodies and central banks have decided how to improve the way it is supervised. Their answer, it appears, is thicker insulation and better preparation against folly and accident. In December, under instruction from the G20, the Basel club of bank supervisors published new proposals on capital and liquidity "buffers". These could be in force by the end of 2012.

The speed of the reaction is impressive and most of the proposals look sensible. Yet a feeling remains that the fine minds have evaded the really difficult question. If the banking system resembles a line of climbers roped together, then regulators are busy making the clothes warmer, the maps more accurate, the rations more filling and the whistles louder. Unfortunately none of that is any good if someone falls over the edge, as a handful of banks are wont to do in financial crises. Unless a way is found to solve this problem, taxpayers will remain destined to rescue the flakiest firms time and time again.

In part the focus on capital and liquidity buffers reflects the poverty of the alternatives. Breaking up banks is hard and of uncertain benefit. Having public-sector

bureaucrats run them is as unattractive as leaving the discredited masters of the universe in charge. And despite promises that regulators will be cleverer and central bankers more alert, banks are certain to get into trouble again, as they always have. The way to protect taxpayers, the argument goes, is to compel banks to have buffers thick enough to withstand higher losses and longer freezes in financial markets before they call for state help.

The proposals have already been dubbed "Basel 3"—which tells you regulators have been here twice before. Alas, the record of bank-capital rules is crushingly bad. The Basel regime (European and American banks use either version 1 or 2) represents a monumental, decades-long effort at perfection, with minimum capital requirements carefully calculated from detailed formulae. The answers were precisely wrong. Five days before its bankruptcy Lehman Brothers boasted a "Tier 1" capital ratio of 11%, almost three times the regulatory minimum.

That poses an obvious question for bank supervisors: if they have already tried and failed to make capital rules foolproof, why should they do better this time? They do not just have to worry about rules being too slack. If they overreact to the financial crisis and devise rules that are too

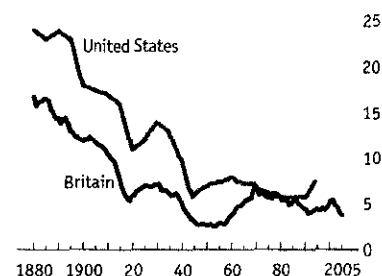
strict, they may endanger the recovery. And how can supervisors deal with the basket-case banks, for which no reasonable buffer will be adequate?

In the days when banks (and their customers) could not rely on governments to save them, they carried huge buffers to protect themselves against losses and drops in confidence. In the late 19th century a typical American or British bank had an equity buffer—ie, core capital—equivalent to 15-25% of its assets (see chart 1). As recently as the 1960s British banks held more than a quarter of their assets in low-risk, liquid form, such as cash or government bonds.

Over time governments have supplied more protection against disaster. First came liquidity support by central banks; deposit insurance followed; in the latest crisis governments have given all creditors a blanket implicit guarantee. As a result, banks have been prepared to let their insulation wear thin. Going into the crisis, some Western institutions' core capital

Padding is for wimps

Banks' equity, % of assets



Source: "Banking on the State" by Piergiorgio Alessandri and Andrew Haldane, Bank of England, November 2009

► was 3% of their assets or less, and less than a tenth of those assets were liquid. Government support may also have given banks an incentive to grow much bigger, so that most European countries now underwrite banking systems several times larger than their GDPs. As Andrew Haldane of the Bank of England has noted, the world has come a long way since 1360, when a banker in Barcelona was executed in front of his failed firm.

Such extensive government guarantees render redundant the normal laws of companies' capital structure, which dictate that high leverage and over-reliance on short-term borrowing are a suicidal combination. A bank can operate with almost no equity, safe in the knowledge that it will still be able to borrow and raise deposits cheaply, because creditors know they are guaranteed. Furthermore, if a bank knows the state will always provide liquidity if markets dry up, it has a big incentive to rely on short-term borrowing (which is typically cheaper than long-term funds). It follows that if banks in a state-backed system are to have safety buffers, the state must determine their thickness and quality.

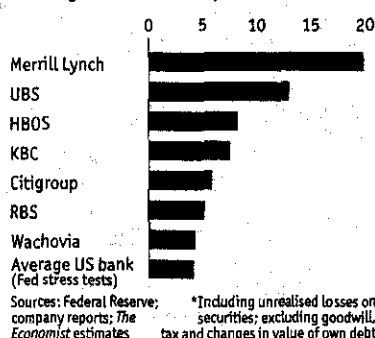
Third time lucky?

Since 1988 global capital rules have been set by the Basel Committee, a club of regulators which relies on national authorities to implement its standards. Basel 2, a souped-up version of the original rules, has been introduced by most European banks in the past two years. America's big banks are on track to implement it by next year. It involves two stages. The first is defining capital: crudely, the gap between assets and liabilities. The second is comparing this with assets. Since not all assets are the same, the rules adjust them for risk, often using complicated modelling: a government bond is regarded as absolutely safe and so needs no capital behind it, but a risky property loan requires lots. The rules say that Tier 1 capital—supposedly, in the main, common equity and equity-like instruments—must be at least 4% of a bank's risk-adjusted assets.

However, the definition of Tier 1 capital was far too lax. Many of the equity-like instruments allowed were really debt. In effect, the fine print allowed banks' common equity, or "core" Tier 1, the purest and most flexible form of capital, to be as little as 2% of risk-adjusted assets. In hindsight, says one regulator, this was "very, very low... unacceptably low". Furthermore, investors lost confidence in the way assets were adjusted for risk to compute a capital ratio. For instance, dodgy mortgage securities

Eating up capital

Peak cumulative losses* as % of risk-weighted assets, 2006–present



could be held with little capital against them, on the basis that credit-rating agencies had graded them triple-A. Risk-adjusted according to Basel 2, they were judged almost as safe as government bonds.

The new proposals go a long way to remedying these failures. The definition of capital will be much stricter. In essence, only pure equity will be included and that after deducting spurious benefits such as tax assets and including nasties such as short-term losses on securities. According to some estimates, that alone could wipe out much of the equity of several European banks, although the changes are likely to be introduced slowly. José María Roldán, of the Bank of Spain, who chairs the Basel club's implementation committee, says "the more revolutionary we are", the greater the need for a "slower transition".

At the same time, risk-adjustment will become less dependent on firms' own internal models, be harder on investment banks and encourage banks to cross-examine the credit ratings of their assets. For good measure the Basel club has also proposed a new liquidity regime that would require banks to be able to withstand a 30-day freeze in credit markets and force them to become less reliant on short-term wholesale funding. The tests, says an American official, are tough and have been "informed" by the crisis.

The big question: how much?

None of this really answers the all-important question of how much capital banks need. There is a trade-off between safety and economic growth: a bank that took no risks at all would not be much use in providing credit to companies or individuals. Getting this trade-off right is difficult. A 2009 study for Britain's Financial Services Authority concluded that because periodic meltdowns do so much damage, banking systems should ideally be better capitalised and less volatile than they were before the crisis. The Basel club plans to do its own impact study over the next six months. "It is incredibly important" to get the trade-off right, says Peter Sands, chief

executive of Standard Chartered.

Part of the answer, however, is plain: banks should have sufficient capital to survive a crisis as severe as the one Western financial systems have just suffered. This is the sum of two parts. The first is the minimum below which a typical bank loses the confidence of depositors, other creditors and its counterparties. This is largely a matter of mass psychology: the rule of thumb in the markets is that it has perhaps doubled to about 4% of risk-adjusted assets. This already has semi-official endorsement: both America's and Britain's recent "stress tests" used this as the floor.

On top of this, banks need enough capital to avoid breaching the 4% minimum in a market meltdown. Here, the experience of the crisis has already produced some guidance. The results of America's stress tests suggest that the country's big banks will, through their underlying losses, have eaten up capital worth about 4% of risk-weighted assets. A recent Bank of England study of banking crises since the late 1980s in Japan, Finland, Norway and Sweden found that the average bank ate up 4.5% of risk-adjusted assets.

Adding these two elements together implies that a typical bank should run with core equity capital of 8-9% of risk-adjusted assets, which would be eaten away to 4% during a crisis. Not surprisingly, most big banks are near this point after a bout of equity-raising. America's four largest banks have core capital of \$400 billion, almost twice as much as a year ago.

The view of most, but not all, regulators is that the absolute level of capital in the system is approaching acceptable levels. They still want to add more bells and whistles. Capital requirements for risky trading operations could rise by as much as three times. In anticipation of this, pure-play investment banks such as Goldman Sachs are running with core capital of more than 10% of risk-adjusted assets. To augment the capital rules, bad-debt provisions are likely to be more forward-looking. And how the new capital range is managed is still up for debate. Central banks, with their renewed desire to avert credit bubbles, are likely to take a keen interest. The Basel proposals include sanctions on firms that are close to the capital floor, preventing them from paying dividends.

Working out whether banks have already pre-empted the proposed liquidity requirements is more difficult. Some banks, such as Belgium's Dexia and Britain's HBOS, still rely heavily on state funding. But overall a dramatic shift towards long-term funding has taken place. Three-quarters of the balance-sheets of America's four biggest banks are now funded by equity, long-term debt or deposits.

Yet for all this, a single, horrible truth exists. Because most big banks are too interconnected to fail, and could be brought ►►

Correction: In an article on China's economy ("Not just another fake", January 16th), we quoted a UBS report: "China's steel capacity of almost 0.5kg per person is slightly lower than America's output in 1920 (0.6kg) and far below Japan's peak of 1.1kg in 1973." All those figures should be tonnes, not kilograms.

► down by a counterparty, the system is only as strong as its weakest member. Although the average American bank ate up about 4% of risk-adjusted assets in losses during the crisis, the worst banks consumed far more (see chart 2 on the previous page). Citigroup, HBOS and Belgium's KBC, for example, lost 6-8% of risk-adjusted assets. At the crazy end of the spectrum, Merrill Lynch, which had lots of dodgy securities that were marked-to-market (so that losses were recognised upfront), lost 19%. It would have needed a core-capital ratio of 23% to avoid falling through the 4% floor. UBS lost 13%, implying that it would have required a ratio of 17%.

In part, cautions Bernard de Longeville of Standard & Poor's, this reflects the fact that the outlier banks' calculations of risk-adjusted assets were out of whack. For example, subprime securities were treated as fairly safe. But nonetheless it is probably true that even with the right denominator, these firms would have needed capital ratios of far above 8-9% at the start of the crisis to avoid failure. The Bank of England's research of other crises points to similar conclusions: the worst failed bank would have needed a core-capital ratio of 18% to stay above a 4% minimum.

Clearly, regulators could simply raise all banks' capital to a level that would keep even the outliers from failure. But that would be prohibitively expensive. For America's four giant banks, raising core capital to 20% of risk-adjusted assets could require them to raise an additional \$30 billion-odd of annual income (to provide a return on that extra capital). If pushed through to customers, that might raise the weighted average interest rate they charge by roughly a percentage point, from 6% now. That would hurt economic growth.

An obvious answer to the problem of outliers is to impose losses on the riskiest banks further up banks' capital structures, so that creditors rather than taxpayers suffer. Most banks already have additional slices of capital above equity. For example, at the end of 2008 Britain's firms had core capital (tangible common equity) of about £200 billion (\$290 billion), and on top of this another £200 billion of "quasi-capital" consisting of such exotica as hybrid capital and "Tier 2" securities. In essence these are junior forms of debt which in a bankruptcy would be hit before senior creditors, depositors and customers.

The trouble with these instruments, however, is that if they end up bearing losses, the entire bank is usually judged to be in default, causing a stampede of counterparties, depositors and other senior creditors who fear they will lose too as the bank is wound up, destabilising the system as a whole. In the jargon, these instru-

ments are unable to bear losses while a bank is a "going concern".

Ideally, then there would be a layer of creditors who could absorb losses while the bank remained in business. The most concrete idea so far is "contingent convertible" capital, or Cocos: debt that converts into equity if a bank gets into trouble. In November Britain's Lloyds, which took over HBOS and was bailed out by the state in 2008, issued a Coco bond equivalent to 1.6% of risk-adjusted assets. It pays a coupon, like a normal bond, unless the bank's core capital falls below 5% of risk-adjusted assets. At that point the coupon is cancelled and the bond converts into equity, boosting the bank's ability to absorb losses while remaining a going concern. According to a London banker, people "all over the City are working" on similar ideas. Goldman Sachs has indicated it would consider issuing Cocos bonds.

Cocos sound too good to be true, which is precisely what worries some observers. The idea "has the feeling of being a silver bullet," says a lukewarm American regulator. Lloyds is paying a fairly high coupon of 10-11% to attract buyers to this novel security. That is almost as expensive as equity. And executives at other banks and some regulators worry that under extreme stress complex instruments rarely work as intended. Triggering the bond itself could cause a run: counterparties could take it as a signal that the bank was in severe trouble. Cocos's defenders tend to dismiss this risk—wrongly. In a crisis the degree of uncertainty about worst-case losses and mistrust of banks' accounts becomes so high that counterparties run after any admission of trouble.

There are other niggles. The capital ratio at any given moment is highly dependent on when managers write down bad debts. A European bank boss paints a nightmare picture of Cocos investors buying insurance "wrappers", offloading the risk to another

counterparty, in much the same way that American International Group, a once-mighty insurer, became a rubbish dump for the "tail risks" no one else wanted. If that happened to Cocos, they might merely shift losses from one place to another—and save taxpayers nothing in the end.

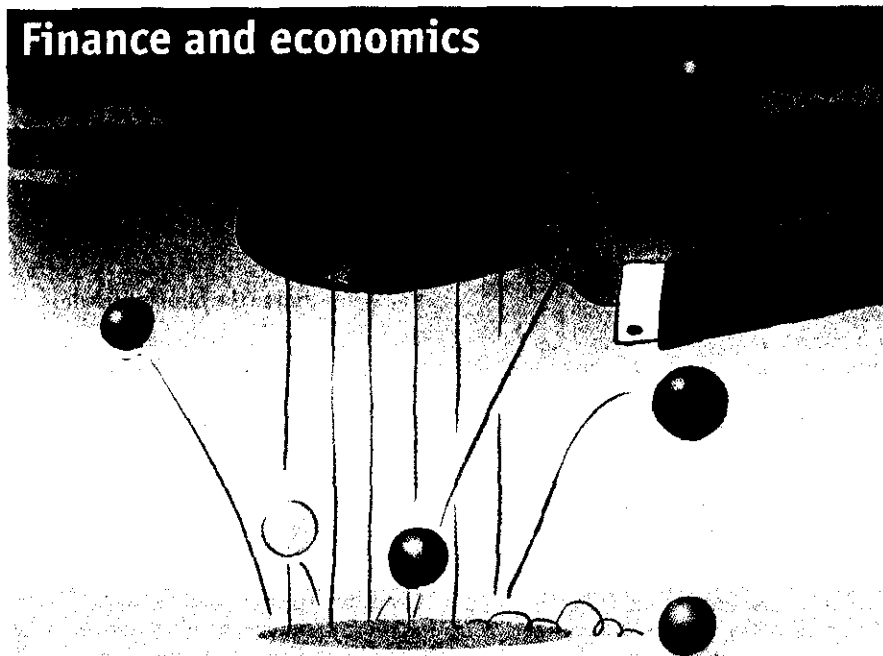
Between going and gone

Cocos deserve a chance, but there is an alternative. This is to try to create a middle state for banks between going concern and gone: a partial bankruptcy. Over the past year there has been much talk about creating "special resolution regimes" and "living wills" for failing banks. Many of these ideas are well-meaning waffle, little better than glorified contingency planning. Also of little use are some more macho notions doing the rounds. Simply giving a resolution authority the right to beat up all creditors would ensure that any bank at risk of falling under its auspices would face a run.

One option is to ring-fence the deposit-taking parts of banks and offer them a full guarantee. This would amount to a stealthy reimposition of the Glass-Steagall act, the Depression-era law that separated American commercial and investment banks, and would be hugely complicated. The alternative is to force banks to issue bonds that would automatically suffer partial losses in the event of state intervention, a little like Cocos. Either way, the objective would be to guarantee enough of an institution's balance-sheet to avoid a run, while leaving enough of it without a guarantee to protect taxpayers from even the outlier banks.

That is not an easy balance to strike. But the risk now is that regulators retreat into designing cleverer ways to make the average bank safer, while ignoring the greater question. That is not how to make regulation cleverer, but how to protect taxpayers from a huge bill when all the precautions fail and a bank steps into the void. ■





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The world economy

Pulling apart

WASHINGTON, DC

The world's big economies were all hit by the recession. Now the field is spreading

A YEAR ago almost every economy in the world was being walloped. The degree of pain varied. In rich countries output plunged; in China and some other emerging economies growth slowed sharply. But the slump was as striking for its synchronicity as its severity.

The opposite seems true of the recovery. China's rebound began earliest and has been the most spectacular (see next story). America's economy began growing in the middle of 2009 and seems to have accelerated sharply in the final months of the year. Initial GDP estimates for the fourth quarter are due on January 29th, and many analysts expect annualised GDP growth to have shot up to 5.5% or more. News from the euro zone and Japan is rather gloomier. Germany emerged from recession before America, but its number-crunchers recently suggested that growth fell back to zero in the fourth quarter. The Japanese recovery also seems to be fading.

Shifting growth patterns could have big consequences for asset prices. Sustained strength in emerging economies, for instance, could push up commodity prices further, while a rapid rebound in America's economy relative to Europe's could strengthen the dollar more against the euro. So a lot rides on what is driving the divergence, and whether it lasts.

In America soaring GDP growth is likely to be a one-quarter wonder, driven by a rebuilding of firms' shrivelled inventories.

Output growth will slow in 2010—the question is by how much. Optimists argue that every deep post-war recession has been followed by a vigorous recovery and that growth will be well above its trend rate in 2010. But a gloomier outcome seems all too plausible. There are few signs of job growth. Much household-debt reduction still lies ahead. And there is the risk of a correction in stockmarkets.

But even a sluggish American recovery will outpace other big rich economies. The euro zone faces two different but equally painful problems. Former bubble economies such as Spain and Ireland are suffering a painful hangover. Germany, like Japan, is bedevilled by chronically weak domestic demand. Consumers are reluctant to spend and, so far, buoyant export growth has not incited firms to invest, despite hopes to the contrary.

The degree to which America outperforms the others will depend, in large part, on whether, and how, different countries tighten monetary and fiscal policy. There is a lot of talk about fiscal discipline within the euro zone, not least because financial markets are punishing Europe's peripheral economies for their profligacy. Greece this month announced an unprecedented fiscal squeeze over the next three years. But Greece makes up only 3% of euro-area GDP, and rapid fiscal consolidation is much less likely in the big economies. The junior partner in Germany's coalition gov-

ernment is pushing for tax cuts in 2011; France is railing loudly against the idea of cutting its deficit any time soon.

America's budget outlook is rather more uncertain, especially in the light of the Republicans' unexpected Senate victory in Massachusetts. The current stimulus package will stop boosting GDP growth by midyear. Thanks to the requirement that they balance their budgets, states are furiously cutting spending. Although the House of Representatives has passed an additional \$150 billion-worth of job-boosting stimulus, the Senate has not yet done so. And if Congress does nothing, the Bush-era tax cuts expire at the end of the year. That seems unlikely, but political gridlock could cause America's fiscal boost to fade unexpectedly sharply.

Policy decisions will also influence the relative strength of the recoveries in the emerging economies versus the rich world. Though China's private demand strengthened a lot in the second half of 2009, growth is still largely driven by a government-directed lending boom. China's short-term prospects thus depend on how quickly the government damps down the lending frenzy. Fears of tighter credit in China weighed on stockmarkets this week but the signs still point to very gradual tightening—and scant dampening of growth—in China and the rest of the emerging world.

Powerful structural factors will continue to reinforce the relative strength of the emerging world. Jonathan Anderson of UBS points out that even if you exclude China and India, emerging economies grew some four percentage points faster than rich economies during the recession, about the same growth gap that existed before the crisis. Some emerging economies, especially those that relied on foreign debt finance, will face prolonged problems. The ►►

World Bank argues in a new report that tighter financial conditions, thanks to tougher regulation and higher risk aversion, could reduce developing countries' trend growth by 0.2-0.7 percentage points over the next five to seven years. Even so, the hit to potential growth in the rich world is likely to be bigger.

Persistent relative strength in emerging economies, especially China, suggests that commodity prices will stay stable or firm. It also means their currencies should rise against the dollar, though the pace will depend, more than anything, on China's decisions about the yuan. Within the rich world, the growing transatlantic growth divide has helped buoy the dollar versus the euro: it is up by more than 5% from its lows in November. Will that rally continue? The answer depends as much on the likely policy mix as today's growth differentials. Other things being equal, tighter

fiscal policy suggests loose monetary policy for longer and a weaker currency. So relative fiscal discipline in America would push the dollar down, and vice versa.

A multi-speed recovery could also affect imbalances between countries' current-account surpluses and deficits. America's current-account deficit and China's current-account surplus have both halved from their peaks as a result of the crisis, to around 3% and 6% of GDP respectively. Whether that reduction continues depends first on oil prices and second on the pattern of global demand. Imbalances will only stay low as the global economy recovers if surplus economies, especially China but also countries like Germany and Japan, rely on domestic demand while the big borrowers, especially America, cut their budget deficits and save more. Economies are now growing at different rates. They must also grow in different ways. ■

China's economy

Central heating

HONG KONG

Is China growing too fast?

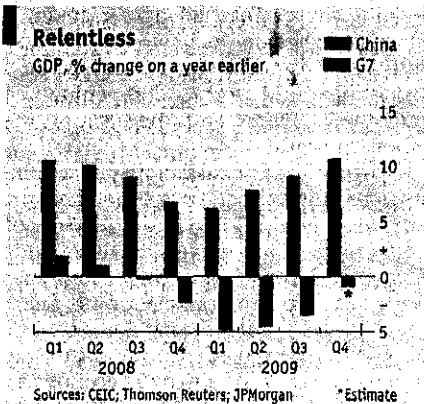
BEIJING recently suffered its lowest temperature in 59 years, but the economy is sweltering. Figures published on January 21st showed that real GDP grew by 10.7% year on year in the fourth quarter. Industrial production jumped by 18.5% in the year to December, while retail sales increased by 17.5%, boosted by government subsidies and tax cuts on purchases of cars and appliances. In real terms, the rise in retail sales last year was the biggest for over two decades.

A year ago many economists were fretting about unemployment and deflation. Now, with indecent haste, they have shifted to worrying that the Chinese economy is overheating and inflation is taking off. The 12-month rate of consumer-price inflation rose to 1.9% in December, an abrupt change from July when prices were 1.8% lower than a year before.

The recent rise in inflation was caused mainly by higher food prices as a result of severe winter weather in northern China. In many cities, fresh-vegetable prices have more than doubled in the past two months. But Helen Qiao and Yu Song at Goldman Sachs argue that it is not just food prices that risk pushing up inflation: the economy is starting to exceed its speed limit. If, as China bears contend, the economy had massive overcapacity, there would be little to worry about: excess supply would hold down prices. But bottlenecks are already appearing. Some provinces report electricity shortages, and stocks of coal are low. The labour market is also tightening, forcing firms to pay higher wages.

If the economy's slack is shrinking fast, then the extraordinarily rapid growth in money and credit over the past year could quickly spill into inflation. The growth in bank credit slowed to 32% in the year to December, but that is still far too fast. The central bank has started to drain liquidity by lifting banks' reserve requirements, and some banks have been told to reduce their lending. The bank will probably not raise official interest rates until inflation breaches 3%, but that could be as soon as February.

In 2009 government officials gave three reasons for holding the yuan stable against the dollar: falling exports, weak GDP growth and negative inflation. Now, with double-digit growth in both GDP and exports, and inflation rapidly rising, it has no excuse.



American banks

Through FICC and thin

NEW YORK

A possible end to the pain for lenders

POLITICIANS tend to tar all bankers with the same brush. The results unveiled this week by America's financial giants were, however, far from uniform. Citigroup and Bank of America (BoFA) posted thumping quarterly losses. Morgan Stanley eked out a modest gain. Wells Fargo and JPMorgan Chase made healthy profits. Goldman Sachs was expected to report a glittering set of numbers as *The Economist* went to press.

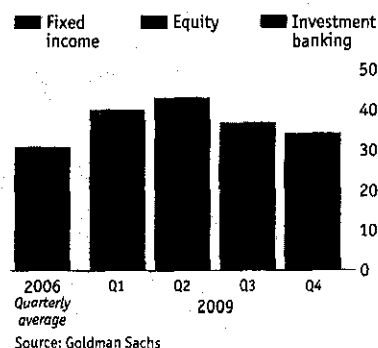
The differences were partly down to one-off hits. Citi, for instance, had to swallow \$6.2 billion in after-tax charges related to repayment of its federal bail-out funds. Behind the noise, however, some trends are emerging. Loan losses appear to be stabilising. For some, the worst may even be over. At BoFA, America's biggest lender, net write-offs fell by 13% in the fourth quarter, the first decrease in nearly four years. Across the industry, credit-card delinquencies are flattening out.

Nevertheless, the mood is cautious. In a call with analysts, Jamie Dimon, JPMorgan Chase's boss, hinted at the possibility of a double-dip recession. Even if the recovery continues, loan losses could remain high for some time. They lingered at peak rates for six quarters in the 1991-92 downturn, says Chris Whalen of Institutional Risk Analytics. One wild card is mortgage modification: banks may yet be forced to reduce the principal owed on some loans.

The outlook is cloudy in investment banking, too. Merger advice is picking up smartly, but capital-markets revenues fell in the fourth quarter, thanks to a big drop in fees from fixed income, currencies and commodities (FICC), previously the heart of the rebound (see chart).

Not so fixed

US banks' revenues, \$bn



Economics focus | Invested interests

China aside, most Asian economies need to invest more, not consume more

ASIA'S current-account surpluses have been widely (if unfairly) blamed for causing the global financial crisis. Large inflows of foreign money helped inflate America's housing bubble, the argument runs. Many Western economists say that Asians should squirrel away less of their income and consume much more. But a more rigorous analysis suggests that in most Asian economies it is investment, not consumption, that is too low.

Even economists who believe that most of the blame for the crisis lies in Washington, D.C., argue that Asian economies need to shift from exports and investment to consumption as their new engine of growth. In "The Next Asia", a recently published book, Stephen Roach, chairman of Morgan Stanley in Asia, calculates that consumption in emerging Asian economies fell from 65% of GDP in 1980 to 47% in 2008. American consumer spending, by contrast, accounts for more than 70% of GDP. "Until export-led growth gives way to increased support from private consumption," he argues, "the dream of an Asian century is likely to remain just that." His prescription certainly applies to China, where private consumption fell to only 35% of GDP in 2008. But what about the rest of Asia?

A country's current-account surplus is, by definition, equal to its domestic saving minus its domestic investment. So Asian economies can reduce their surpluses by saving less (ie, consuming more) or by investing more. Which route is appropriate depends in part on why their current-account surpluses widened during the past decade. In China the blame lies entirely with saving, which rose faster than its investment rate. (India's saving rate climbed just as steeply, but it was matched by an even bigger jump in investment, which kept its current account in deficit.)

In all the smaller emerging Asian economies, however, saving has either fallen or remained broadly unchanged as a share of GDP. The reason these countries have large current-account surpluses is because investment plunged after the 1997-98 Asian crisis and did not recover (see chart). Malaysia's investment rate, for example, fell from 44% of GDP in 1995 to an estimated 19% last year. Thailand's dropped from 41% to 21%.

The widespread belief that Asian households do not spend is also flawed. According to a study by Eswar Prasad of Cornell University, private consumption accounts, on average, for 58% of GDP in emerging Asia outside China. That is lower than in America, which has been overconsuming for years, but it is slightly higher than in Japan or the European Union. In the eight years to

2008, investment accounted for half of China's GDP growth and private consumption for less than one-third. But in most other Asian economies the relative shares were almost exactly the reverse, with consumption the dominant source of growth.

A report by the Asian economics team at Barclays Capital concludes that to reduce their excess saving, most Asian economies need to invest more rather than consume more. Higher investment, especially in infrastructure, they argue, would not only reduce current-account surpluses but also boost growth and living standards. Better roads and railways would help farmers get their produce to cities and enable manufacturers to export their goods abroad. Clean water and sanitation could raise the quality of human capital, thereby lifting labour productivity.

Do unto others

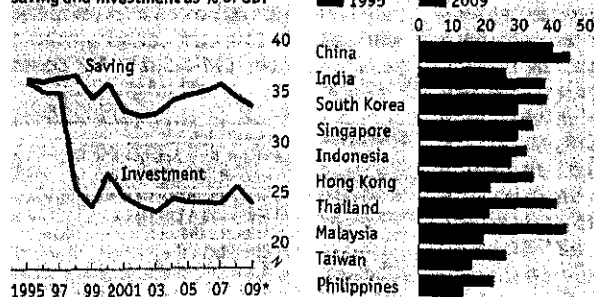
Investment in the smaller Asian economies has certainly fallen sharply, but does that really mean it is too low? These economies could simply have been overinvesting in the 1990s. The goal of economic policy should be to maximise households' well-being and hence their consumption—but over time, not just today. Consuming too much today will make the next generation poorer. By investing (and saving), a country sacrifices current consumption but future output and consumption will be higher. The optimal level of investment is the rate that generates the highest sustainable level of consumption over time. That, in turn, depends on a country's "marginal product of capital", or how much output is produced by new investment. The higher this measure, the more it should invest. Assuming extra investment increases output by progressively smaller amounts as the capital stock expands, then at some point extra investment will reduce, not increase, the long-run sustainable level of consumption.

Calculating the marginal product of capital is devilishly difficult. However, it is likely to be higher in emerging economies than in developed ones, because their capital stock is much smaller in relation to their labour force. Estimates by Yuwa Hedrick-Wong, an economic adviser at MasterCard, suggest that in China, India, Indonesia and Thailand capital per person is only 2-6% of that in America. This means there is huge scope to boost productivity by giving workers new machines and better infrastructure. The optimal rate of investment will therefore be much higher than in developed economies, and may even justify the pace of China's investment of more than 45% of GDP. Yet in Taiwan, Malaysia, the Philippines and Thailand investment is no higher (and in some cases lower) as a share of GDP than in Japan or the euro area. This helps explain why these countries' growth rates have slowed over the past decade. Mr Hedrick-Wong finds that among emerging economies, those that invest a bigger share of GDP tend to enjoy faster growth.

More developed economies, such as South Korea and Singapore, where both the rate of investment and the capital-to-labour ratio are relatively high, are probably not underinvesting. But Indonesia's investment rate (27% of GDP) looks much too low given its tiny capital stock. Barclays Capital argues that it needs to raise it to India's rate of 38% if it wants to achieve annual GDP growth of 8%. In the Philippines, which probably has the worst infrastructure in the region, investment is running at only 15% of its GDP. It is no coincidence that the Philippines has the highest rate of consumption (about 80% of GDP) in emerging Asia but one of the lowest growth rates. Higher consumption may suit the West, but more investment is in Asia's longer-term interests. ■

Plunge pools

Emerging Asia ex-China and India saving and investment as % of GDP



Sources: Morgan Stanley; HSBC; CEIC

* Estimate

Banyan | Japan's love-bubbles for China

Hatoyama's advances to China raise fundamental questions about regional security



WHAT our colleague, Charlemagne, calls “bubbles of optimism” over China have been popping in Western capitals, as China has taken a hard line against internal dissent, proven unhelpful in efforts to tackle both climate change and Iran’s growing nuclear threat, manipulated its currency and launched cyber-attacks on Western computer networks. China, muscling its way to global prominence, is not quite the partner the West had been cultivating. Striking, then, that in Japan the bubble of optimism, among the country’s new leaders, is only inflating.

Soon after the Democratic Party of Japan (DPJ) swept into office nearly five months ago, the prime minister, Yukio Hatoyama, unveiled a vision for an East Asian Community (EAC). For all that it was dreamy and disjointed, it had at its heart a rapprochement between Japan and China leading towards regional integration. Asia, Mr Hatoyama reaffirmed, was Japan’s “basic sphere of being”. As for integration, fraternity was to be the glue.

Then late last year the DPJ’s secretary-general, Ichiro Ozawa, travelled to Beijing at the head of a 639-strong mission, including 143 parliamentarians with whom a beaming President Hu Jintao took the trouble to be photographed, each in turn. Mr Hu doesn’t smile like that for Westerners. Back in Tokyo, Mr Hatoyama horrified sticklers for imperial protocol by insisting that Mr Hu’s heir-apparent, Xi Jinping, pay an impromptu call on Emperor Akihito. Now rumours suggest Mr Hatoyama may make a visit of remorse, the first by a Japanese prime minister, to Nanjing, site of a massacre by Japanese forces in 1937. In return (and at less political cost), Mr Hu may pay respects to the nuclear victims of Hiroshima. Japan under the DPJ seems to get on better with China than it does with its ally and security guarantor, the United States. Relations with the United States are strained over the relocation of a military base for American marines on Okinawa, leading to worries over the future of the two countries’ alliance, keystone to security in the western Pacific.

Economic logic argues for closer ties with China, which has already overtaken America as Japan’s biggest trading partner, and is about to overtake Japan’s economy to become the world’s second-biggest. After not one but arguably two “lost decades”, an ageing population cannot drive demand in Japan. It must hitch itself to the Chinese juggernaut. A strategic vision, too, lurks some-

where in the idea of an EAC. Mr Hatoyama has committed Japan to cutting greenhouse-gas emissions by a quarter by 2020. He thinks Japan can lead Asia towards a low-carbon future.

But contradictions lurk too. The idea makes a nod to China’s rise. Yet it assumes Japan’s rightful lead in proposing a new regional architecture, while impressing Japan’s technological prowess on China. The impulse is deeper-seated than Mr Hatoyama might admit. The story of modern Japan is of the use of Western arms and technology to overturn China’s centuries-old regional dominance. China now intends to restore the natural order, and does not need directions from others, least of all Japan. It has made only the minimum polite noises about an EAC. As for the green technology that Japan can share, both sides say it is a good thing but are infuriatingly sparing with the details. Besides, since the December summit in Copenhagen, China has hinted it might go its own way on climate change.

Popular Japanese attitudes towards China suffer from the same doublethink. In one recent poll, most of those questioned wanted a “warmer” political relationship with their big neighbour. But most also wanted the prime minister to visit Yasukuni, Tokyo’s militarist shrine, on remembrance day. That is one issue guaranteed to send China-Japan relations into the cooler. A sense of Japanese superiority over coarse, authoritarian China is also widespread. More than one Japanese professor has told Banyan that Japan is the true guardian of Chinese culture.

History wars, still far from resolved, point to the limits of rapprochement. So too do maritime disputes over territory. But a huge constraint is the fiscal one. Greying Japan is burdened with deflation, stagnant growth and a national debt close to 200% of GDP. Japan lacks the resources (and the will) for the kind of bold strategic moves, putting Japan at the heart of Asia, at which Mr Hatoyama and Mr Ozawa hint. Even a more autonomous security policy, out from under America’s wing, is almost a non-starter. Japan has cut its defence spending in recent years, to just 1% of GDP. It has grown more dependent on the United States, not less.

Behind China’s smile

This is where strains over the alliance really matter for the security of the whole region, not least because of Taiwan. On January 24th the Okinawan township picked, after painful years of talks, by the United States and Japan’s previous government as the destination for the relocated marine base elected a mayor resolutely opposed to the move. Popular concerns about the “occupation mentality” of American forces are valid. But Mr Hatoyama, according to colleagues, was sleepwalking when he reopened the issue. Now he cannot go back. Local politics and national security are on a collision course. Mr Hatoyama has said he will decide over the base by May. But moving it anywhere else in Japan will face local resistance too.

As Yoichi Funabashi, editor of *Asahi Shimbun* puts it, if the new administration bungles relations with Washington, it will look diplomatically inept at a time when power relations in Asia are shifting fast. That might spell the end of the hapless Mr Hatoyama. So it is hardly cynical to assume that one aim behind China’s outbreak of smiling is to drive a wedge between a slightly clueless Japan and its longstanding protector. After all, Japan would be its base were America to come to Taiwan’s rescue in the event of a mainland attack. ■

► though, is that the virus of jihadism may spread southward into the rest of Africa, especially into northern Nigeria, where a group dubbed the "Black Taliban" has battled with Nigerian forces. Mr Abdulmutalab does not seem to have been radicalised in Nigeria, but his attack highlights the risk.

Send diplomats, not soldiers

Al-Qaeda likes to boast that its *jihad* caused America's financial crisis, citing the vast cost of the wars in Afghanistan and Iraq. Stabilising those lands is vital to avoid giving jihadists a victory—but America should perhaps be wary of an overt military response to every al-Qaeda threat. Intervention may neutralise terrorist cells, but it can breed resentment and resistance.

"Our strategy and focus has been almost exclusively on killing and capturing terrorists," says Bruce Hoffman of Georgetown University. "We cannot fight this war as we have until now. We will be exhausted financially and in terms of manpower." Better, he says, to help local governments stop al-Qaeda from taking root and to try to curb radicalisation. Such ideas point to counter-terrorism assistance and more emphasis on the political dynamics of Arab and Muslim countries.

But aid and diplomacy will not solve everything. Local leaders may be too weak, disliked or disinclined to share the West's aims. In Afghanistan President Hamid Karzai has done little to curb corruption. For many Pakistanis, the bigger threat is India rather than militancy; indeed, Pakistan has for years used jihadists as a tool of its foreign policy. Similarly, Yemen's priorities are firstly to crush the Shia rebellion and secondly to stop secession in the south; President Ali Abdullah Saleh got help from veterans of Afghanistan's anti-Soviet *jihad* to win a civil war in the 1990s.

The London conferences on Yemen and Afghanistan have been grappling with these dilemmas. The one on Yemen started the process of unlocking \$5 billion of aid promised in 2006 in return for political reform and curbing corruption. The aim, said Britain, was to "to prevent Yemen becoming a failed state." The task in Afghanistan is to reassemble a state that has already failed in the midst of a growing insurgency. The Afghan meeting is expected to announce the expansion of Afghan security forces; a plan for them to take over from Western troops; measures to woo Taliban fighters, and hints of future talks with some of their leaders.

Counter-terrorism officials, meanwhile, are refining what Britain calls the four "Ps" of fighting terrorism: prevent the radicalisation of Muslims; pursue terrorists and disrupt their plots; protect targets to make attacks harder; and prepare government agencies to minimise the impact of any attack. There now probably needs to be a fifth P: persevere. ■

Scarcity and globalisation

A needier era

The politics of global disruption, and how they may change

THE 1990s was "the age of abundance", argued Brink Lindsey in a book of that title. Round the world, incomes were rising; capital markets were processing endless flows of money and investment; technological gains meant that ever more information was available ever more cheaply. And politics in the age of abundance, Mr Lindsey claimed, was all about values. In America this was the period of the "culture wars" over abortion and gun ownership; internationally, there was a huge expansion in concern over human rights.

The 2010s, it is sometimes said, will be an age of scarcity. The warning signs of change are said to be the food-price spike of 2007-08, the bid by China and others to grab access to oil, iron ore and farmland and the global recession. The main problems of scarcity are water and food shortages, demographic change and state failure. How will that change politics?

In the domestic debates of some rich democracies, things are shifting already. In Europe the talk is of how to distribute the pain of cutting public debts. In America the return of mad-as-hell populism looks like a turn away from the politics of abundance (see page 39). Now, a report for the Brookings Institution, a think-tank in Washington, DC, and the Centre on International Co-operation at New York University* looks at international politics in an age of want.

The sort of problems governments increasingly face, they say, will be much less predictable than those associated with old great-power rivalries. Pressure from demography, climate change and

shifts in economic power builds up quietly for a long time—and then triggers abrupt shifts.

They claim that the current global system is ill-designed for such a world. It is not just that the foreign policies of big countries are in flux. Rather, the way states deal with new threats is, in the jargon, "stove-piped". As a UN panel said in 2004, "finance ministers tend to work only with the international financial institutions, development ministers only with development programmes."

The authors say that what is needed is not merely institutional tinkering but a different frame of mind. Governments, they say, should think more in terms of reducing risk and increasing resilience to shocks than about boosting sovereign power. This is because they think power may not be the best way for states to defend themselves against a new kind of threat: the sort that comes not from other states but networks of states and non-state actors, or from the unintended consequences of global flows of finance, technology and so on.

What would all that mean in practice? They cite the Intergovernmental Panel on Climate Change (IPCC) and the Global Alliance for Vaccines and Immunisation as the sort of institutions they want more of: bodies that use technical expertise—leaving aside the IPCC's mistake over the melting of Himalayan glaciers—to induce countries to recognise their mutual interests. Such agencies can promote foresight, and help governments think harder about the consequences of failure (unlike traditional diplomacy, which likes muddling along). They propose an Intergovernmental Panel on Biological Safety along the lines of the IPCC to improve biosecurity; they also suggest boosting the G20 by giving it a secretariat and getting national security chiefs together.

Many of these ideas may go nowhere; national sovereignty is hugely resilient. But to those who call the whole exercise pointless, they cite Milton Friedman, who, when monetarism was being mocked in the 1970s, replied "our basic function [is] to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes the politically inevitable."



Ideas are in short supply, too

* "Confronting the Long Crisis of Globalization". By Alex Evans, Bruce Jones and David Steven. Brookings/CIC. A member of *The Economist* served on an editorial board that reviewed an early draft of the paper.

Tackling deflation in Japan

Can Kan?

TOKYO

A new finance minister wants the Bank of Japan to target inflation

THE situation has “completely changed,” says an ebullient Keisuke Tsumura, an elected official in the newish government’s Cabinet Office. The Bank of Japan (BoJ) “has redefined its understanding of price stability. Some market participants now regard it as de facto inflation-targeting.”

That would be something to get excited about. Since the start of Japan’s deflationary era in 1999, the BoJ has stoutly resisted calls to set an inflation target against which it can be judged—and by which it can be embarrassed if it misses. Its inflation objective is defined in the loosest terms, as a rate between zero and 2%, with no time-frame to achieve it and no penalty for failure.

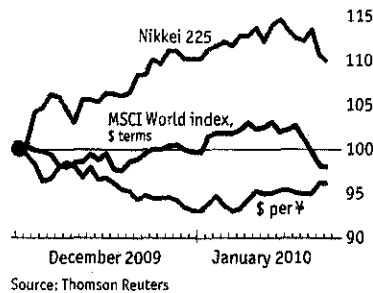
But in November Naoto Kan, who has since become Japan’s finance minister, made what aides proudly call his “deflation declaration”, urging the BoJ to redouble its efforts to combat falling prices. Days later the BoJ offered ¥10 trillion (\$112 billion) of virtually interest-free liquidity to the banking system to fight deflation. A few weeks after that it indicated it would not tolerate an inflation rate at or below zero. Was it setting a more explicit goal? Mr Kan and his aides clearly hoped so.

The markets at first joined the celebratory mood. Foreign investors have long shunned Japanese stocks, but they sensed the possibility of a big rally if the BoJ stepped up its provision of liquidity, weakening the yen and boosting the earnings of exporters. As the yen came off its highs, investors piled into shares (see chart). But since then the yen has rebounded with barely a squeak from the BoJ. After its board met on January 26th, the bank made it clear it still sees consumer prices, excluding fresh food, falling until the end of the 2011 fiscal year (albeit at a slightly slower pace than it had predicted three months ago). Its growth projections were left largely unchanged.

So it may not be long before Mr Kan is on the warpath again. One reason is political: with upper-house elections due in July, his party, which has had a patchy start in government, badly needs economic recovery. Another reason is administrative: Mr Kan is a long-standing critic of unaccountable bureaucracies and is thought to be eager to give the BoJ a target that it can be judged by. A third reason is that fiscal constraints mean the BoJ may have to work even harder to prevent deflation and juice up the economy. A threatened ratings

Ups and downs

Stockmarket and currency performance
December 1st 2009=100



downgrade this week by Standard & Poor’s—strangely underplayed in the national media—highlighted the frailty of Japan’s public finances.

But talk of inflation-targeting makes Mr Kan and his team look naive. The BoJ’s loose, self-set goals remain. One critic dismisses it as toy inflation-targeting. “It’s like giving a schoolchild the right to choose his own homework,” says Stephen Church of Japaninvest, a financial consultancy. ■

World trade

Fading trading

After a sharp revival, global trade growth is slowing again

IN, OUT, shake it all about. Last year was a terrible one overall for global trade. Volumes fell by 14.4%, according to the World Bank. But that figure masks whipsawing activity throughout the year. The Netherlands Bureau for Economic Policy Analysis reckons that the volume of world exports fell by 10.6% in the first quarter of 2009, grew only slightly in the second and bounced by 3.5% in the third quarter. Bernard Hoekman, director of the bank’s trade group, says the three months to September saw a “sharp v-shaped recovery”.

There are two worries to spoil this improving picture. One is what happened after the third quarter. Mr Hoekman believes that there was a “distinct slowdown” in the pace of recovery towards the end of 2009. Preliminary figures suggest that the volume of world trade expanded by just 1.1% in November, less than the October increase of 1.4% and much less than the 5.4% rise in September. The bank reckons that the value of world trade (which is also affected by price and exchange-rate fluctuations) fell slightly in November. A rebound in shipments in and out of some of the world’s busiest ports also faded (see chart). Why would the resurgence have fiz-

zled? The best explanation is that third-quarter growth was buoyed by the rebuilding of inventories, which were slashed in the depths of the crisis. That effect may have ebbed.

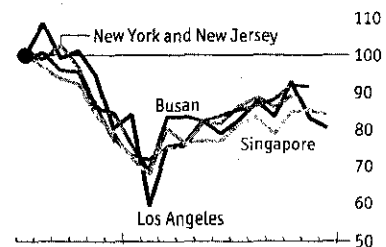
The second worry is for the rich world. Growth in global demand in recent months has come disproportionately from emerging economies. True, everyone has benefited from China’s remarkable stimulus spending. The World Bank’s economists point out that China’s share of world imports has grown from around 10% in mid-2008 to over 12% last year. This has pulled along leading producers of capital goods, like Germany, whose exports grew by a healthy 3.3% in the three months to September. Chinese demand has also boosted Japan’s exports, which grew by 12.1% in the year to December. China has replaced America as Japan’s biggest market.

But stronger growth in developing markets is on the whole better news for producers of basic consumer goods than it is for rich-world exporters. The ten countries whose foreign sales grew fastest in the three months to October were all developing and emerging economies, including several eastern European countries, Indonesia and South Africa. The fastest-growing rich exporter was Australia, which sends nearly a quarter of the goods it sells abroad to China and India. Nine of the ten countries whose imports grew most rapidly were also emerging economies.

This may change if rich-world growth picks up, increasing demand for the more sophisticated goods that industrialised countries export. According to the IMF’s latest projections on January 26th, rich countries’ GDP will grow by 2.1% this year and 2.4% in 2011, after shrinking by 3.2% in 2010. The fund now expects the world economy as a whole to grow by 3.9% this year, up from its October prediction of 3.1%. Faster expansion is good for all exporters although growth in both output and trade will be hurt unless calls for protectionism, which are likely to increase if unemployment remains high, are resisted. Even so, the v-shape may prove to have been a one-quarter phenomenon. ■

Choppy waters

Container traffic, TEUs*, July 2008=100



Growth Cheer for the New Year

After a period of slow and in some instances negative growth, the Asean-5 countries are expected to show stronger numbers this year.

THE good news is that all the Asean-5 economies are expected to register positive and higher growth rates this year compared with 2009. This is according to the forecast made by the International Monetary Fund (IMF), which expects Indonesia to top the group with a growth rate of 4.7%. This is followed by Singapore with 4.1%, Thailand (3.7%), the Philippines (3.2%) and Malaysia (2.5%).

These expected growth rates, however, pale in comparison with that forecasted for the Chinese economy (9%), and the Indian economy (6.4%). Malaysia's growth is also expected to be lower than that of South Korea (3.6%) and Hong Kong (3.5%) in 2010.

China and India have registered positive and relatively higher growth rates than the Asean-5 countries

throughout the current global financial crisis that started in the summer of 2007. India's growth was 7.3% in 2008 and although it dropped to 5.4% in 2009, was still impressive compared to all the Asean-5 countries.

Malaysia, Singapore and Thailand registered negative growth rates while the Philippines grew by about 1% in 2009. Only Indonesia achieved respectable growth of 3.9% in 2009, but this was lower than the 6.1% it posted in 2008.

China has outperformed the rest of the East Asian countries and India by growing at 9% in 2008 and 8.5% in 2009.

It appears then that although these economies are in the same region and in relative terms close to one another, the global financial crisis that originated from the centre of global capitalism in New York has affected them differently.

The relatively stupendous performances of China and India are to some extent due to their large sizes, their relatively extensive neo-liberal reforms and their judicious management of their monetary and fiscal policies, external trade and financial positions, and stimulus packages.

Being large economies, their stimulus packages may have helped to boost domestic demand and avert a sharper fall

REAL GDP GROWTH RATES IN THE ASEAN-5 AND SELECTED ASIAN ECONOMIES (PERCENTAGE CHANGE IN REAL GDP)

COUNTRY	2006	2007	2008	2009	2010	2011	2012	2013	2014
Indonesia	5.5	6.3	6.1	3.9	4.7	5.0	5.5	6.0	6.3
Malaysia	5.8	6.2	4.6	-3.6	2.5	4.1	5.5	6.0	6.0
Philippines	5.4	7.1	3.8	0.9	3.2	3.8	4.5	4.5	4.5
Thailand	5.2	4.9	2.6	-3.4	3.7	4.5	5.0	6.0	6.0
Singapore	8.4	7.8	1.1	-3.3	4.1	4.3	4.2	4.6	4.6
Hong Kong	7.0	6.4	2.4	-3.6	3.5	3.9	4.3	4.3	4.3
South Korea	5.2	5.1	2.2	-1.0	3.6	5.2	4.9	4.6	4.5
India	9.8	9.4	7.3	5.4	6.4	7.3	7.6	7.9	8.0
China	11.6	13.0	9.0	8.5	9.0	9.7	9.8	9.7	9.5

SOURCE: IMF, WORLD ECONOMIC OUTLOOK DATA BASE, DECEMBER 2009 (LAST UPDATED OCT 23, 2009) [HTTP://WWW.IMF.ORG/EXTERNAL/DATA.HTM](http://www.imf.org/external/data.htm)

in their Gross Domestic Product (GDP). This may have helped to compensate for the drop in exports caused by a fall in demand for their goods and services in the United States and Europe.

It appears that all the Asean-5 countries, except for Indonesia and the Philippines, registered negative real GDP growth rates in 2009. This is probably because they are export-dependent economies; as demand for their exports contracted in the US and Europe, so did their economies.

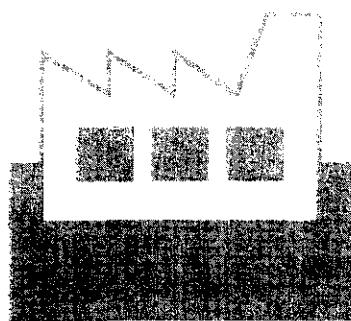
The stimulus packages in Malaysia, Thailand and Singapore were not sufficient to generate positive growth in 2009. In the case of the Philippines, its stimulus package and remittances were only able to generate a growth rate of about 1% in that year.

Some of the Asean-5 countries are also dependent on trade in financial services with the US and Europe and this is especially true of Singapore, whose real GDP grew by only 1.1% in 2008 and contracted by 3.3% in 2009.

The Indonesian economy was able to register positive and relatively higher growth rates (compared with the other Asean-5 countries) throughout the crisis because of its relatively lower dependence on exports and because its growth was driven more by domestic demand, that is, both public and private consumption.

It was able to register a positive growth rate of 3.9% in 2009 when the other Asean-5 countries were contracting or only growing by 1%. It is anticipated that with the expected rebound in the global economy in mid-2010 and with the concomitant increase in exports and foreign direct investment (FDI) inflows, together with increased public spending and investment, the Indonesian economy will grow by 4.7% in 2010.

The IMF expects the Malaysian economy to have contracted by 3.6% in 2009, probably due to a decrease in exports and investments. In second-quarter 2009, Malaysia recovered from the crisis probably because of the increase in public and private consumption induced largely by the



stimulus packages.

However, the increased public expenditure was not sufficient to avert a contraction and, furthermore, the increased public spending has left Malaysia with a widening fiscal deficit.

When the world economy recovers in mid-2010, the increased demand for Malaysia's exports and expected increased inflow of FDI will probably push Malaysia's growth rate to 2.5%, which is much lower than the rates it registered between 2006 and 2008.

In 2008, Malaysia's growth rate was 4.6%, probably due to a surge in commodity prices. In 2006 and 2007, growth was 5.8% and 6.2% respectively, probably because demand for Malaysia's manufactured exports was still strong from the US. Malaysia is not expected to register a growth rate of more than 6% until 2013.

Singapore's growth rate suddenly fell to 1.1% in 2008 and contracted by 3.3% in 2009. This was after the economy had grown by 8.4% in 2006 and 7.8% in 2007. The contraction was probably due to its over-dependence on trade in manufactured goods and financial services with the US and Europe.

Among the Asean-5 countries, Singapore is more deeply integrated with the US financial markets. The stimulus package introduced by the government created domestic demand that was small in comparison to total demand, most of which is external demand originating from its trading partners.

Although Singapore has been ranked as the most business-friendly economy in the world by the World Bank, it has suffered from a sharp drop in the demand for electronic and process

engineering products. The collapse in world trade has also had a devastating effect on the wholesale trade and transport and storage services in Singapore, which has one of the busiest ports in the world.

With the expected recovery in the world economy this year, Singapore is expected to grow by 4.3%.

The Thai economy contracted by 3.4% in 2009, probably because of the downturn in the US, Europe and Japan. It introduced two successive stimulus packages in 2009 to generate domestic demand through private consumption, and extended support for the poor and lower income groups.

Thailand rebounded in the second quarter of 2009 after contracting sharply in the first quarter. As the country is very dependent on the US economy – exports constitute about 70% of its GDP – its future growth rates will depend on external demand and how successful the fiscal stimulus packages are in generating domestic demand.

The confidence of investors will also depend on political stability in Thailand and some recommend that the state play a larger role in the economy.

The Philippines, which had registered 5.4% growth in 2006, 7.1% in 2007 and 3.8% in 2008, was only able to grow by about 1% in 2009. It could have contracted if not for the increase in domestic demand, which was probably helped by excessive public spending and remittances.

The IMF has recommended that its fiscal deficit be kept at about 3.5% of GDP. The global recovery, coupled with increases in remittances and public spending, is expected to push growth up from about 1% in 2009 to 3.2% in 2010.

While there is concern that the Asean-5 countries are too dependent on exports and need to rebalance their economies, there is much to cheer as all Asean-5 countries are expected to do better next year. This may translate into more jobs and less poverty. **mb**

THE WRITER IS PROFESSOR AND CHAIR OF BUSINESS AT MONASH UNIVERSITY, MALAYSIA

SCOPE InternationalList



FORESTS SAVE THE DAY

BY STEFAN THEIL

CLIMATE THE COPENHAGEN TALKS may have been a flop, but there was one piece of good news: a plan for rich states to pay poor ones to stop destroying tropical forests. That's key, because deforestation represents about 15 percent of annual greenhouse-gas emissions—more than all the world's cars, trucks, planes, trains, and ships combined. While countries couldn't agree on binding targets, it was the first time they'd made halting deforestation central to the climate fight.

The agreement followed new evidence showing that deforestation can actually be reversed—which runs counter to longstanding predictions that nothing could stop it. In 2009 Brazil, long the world's worst offender, saw its pace of jungle clearing plummet to a third of its historical rate.

That's due in part to the recession, as falling commodity prices made clear-cutting for farms less profitable. But Brazil has also stepped up protection, and is reaping the benefits of rising living standards, which have reduced subsistence farming. As the bulk of destruction shifts to big agro, not millions of individual farmers, it becomes easier for government and NGOs to target perpetrators—just what Brazil has done.

The plausibility of reforestation also got a recent boost from studies showing that some tropical forests have bounced back on once cleared land. Biologists long believed that such “secondary forests” were nearly worthless, regenerating slowly and offering little of the biodiversity of their old-growth predecessors. But evidence from Costa Rica and Panama

shows that tropical forests can recover 90 percent of their original biodiversity in as little as 20 years. What's more, there may be many more of these fast-regrowing areas than previously assumed, and protecting them could do as much to cut emissions as preserving old-growth jungle. According to McKinsey & Co., protecting and restoring both types of forests is a much cheaper way to cut CO₂ than, say, switching to renewable energy: \$1 spent on forest measures buys as great a CO₂ reduction as \$6 invested in emerging technologies, such as solar power.

None of this denies the alarming pace of ongoing destruction, especially in Asia. But for the first time the world seems to be getting serious about stopping it—and might just put its money where its trees are.



CHINA'S GROWING GLUTS

BY RANA FOROOHAR

TRADE MOST PEOPLE ASSUME China emerged triumphant from the financial crisis: it's still growing 8 percent a year, is flush with cash, and didn't even feel the credit crunch, thanks to a trillion dollars in new bank lending in 2009. But the easy money has led to overconfidence, producing major industrial surpluses; China is making

much more than it needs. A recent EU Chamber of Commerce in China report found that aluminium factories are operating at just 67 percent of capacity, and steel at 72 percent—yet Beijing is ramping up production. The same goes for green technology; the country uses only 70 percent of its available wind power, yet more turbines are on the way. All this could result in a destabilizing bout of global deflation as the glut of cheap Chinese goods drives down prices. Combined with another banking crisis—some experts expect 30 percent of new loans to go bad next year—the result could be both a slowdown in China and a global trade war.

FROM TOP: KADIR VAN LOHUIZEN—NORR, RYAN PYLE

SCOPE The Big Idea

IN PRAISE OF A WEAKER DOLLAR

BY RANA FOROOHAR

IT'S TAKEN FOR GRANTED THAT AMERICA enjoys a huge advantage from the fact that the dollar is the world's global reserve currency, representing more than 60 percent of the money held in central banks. The euro, a distant second, represents only 26 percent of reserves. But a new and contrarian report from the McKinsey Global Institute (MGI) calls that old wisdom into question.

The Idea: How could it be a bad thing to be the world's currency of last resort? "It makes the dollar much higher in value than it really should be, and thus hurts both exporters and American companies that compete with importers," says Richard Dobbs, an MGI director and author of the report. In the past it was assumed that the lower borrowing costs resulting from the dollar's favored position, as well as the benefits accrued from the ease of doing business in the world's most liquid currency, would easily offset this problem. Not so, says McKinsey.

The Evidence: According to MGI, in

2007 and 2008 the net benefit to the U.S. of the dollar as a reserve currency was a mere \$40 billion to \$70 billion a year—just 0.3 to 0.5 percent of GDP. What's more, in the worst-case scenario run by McKinsey, the dollar effect actually became negative in 2009, costing America about \$5 billion a year. McKinsey believes up to 1 million U.S. jobs have been lost due to an overvalued currency, a

trend that's been exacerbated this year as jittery investors fled to the dollar as a safe haven. Indeed, the report suggests that export-oriented U.S. firms might gain ground on European competitors and be in a position to help offset high unemployment if the dollar was allowed to depreciate by about 10 percent. Exchange rates can make or break companies; McKinsey notes that the profits of Korean powerhouse Samsung are twice that of the top nine Japanese competitors combined, in part because the Korean currency is so much cheaper than the Japanese.

The Conclusion: A weaker dollar is likely coming, whether the U.S. government favors it or not. A survey of global executives found that only 18 percent expect the dollar to be the main global reserve by 2025 (with most expecting a basket currency system to take its place). The good news is that the demise of the dollar could make America richer.



FROM TOP: GEORGE GEORGIOU—PANOS, EROS HOAGLAND—NEW YORK TIMES-REDAUX



SECURE UNEMPLOYMENT

BY JERRY GUO

A CENTRAL TENANT OF COUNTERINSURGENCY IS THAT JOB CREATION LEADS TO decreased violence. This makes intuitive sense—after all, a busy foreman should have less motivation or time to plan a suicide attack. But new research from Iraq and the Philippines suggests there is in fact a positive relationship between unemployment and security. According to coauthor Jacob Shapiro, a Princeton political scientist, an increase in unemployment in Iraq from 12 to 13 percent is associated with a 2.7 percent decrease in insurgent attacks. This translates into seven fewer attacks per district per quarter (and 18 in Baghdad)—nothing to sneeze at.

The scientists are still trying to puzzle out why the correlation occurs. One current hypothesis is that with more people out of a job, the financial rewards of cooperating with Iraqi or U.S. forces suddenly become more attractive. This rethinking of how insurgents work comes at a time when the U.S. plans to divert more funding to spur local war-zone economies in Afghanistan and Pakistan. But if Shapiro's report is any indication, sprinkling the countryside with short-term jobs is unlikely to help.

Snap Out of It!

The dangers of economic pessimism.

BY DANIEL GROSS



SINCE 2007 THE consensus of the economic establishment—bankers, policymakers, CEOs, stock analysts, pundits—has been catastrophically wrong.

They didn't see the economic storm clouds gathering. When the raindrops began to fall, they failed to forecast the deluge. As a result, throughout 2008, executives, investors, and consumers chased the economy down—cutting back after things unexpectedly got worse; cutting back again when the roof fell in.

The Great Panic of 2008 may have destroyed blind optimism. But if excessive optimism was the near-fatal pose in 2008, blind pessimism has emerged as the reflexive post-bust crouch. And it has led the economic establishment to miss yet another inflection point. While we were wringing our hands about America's financial and industrial crisis, we ignored a parallel narrative that was emerging: the repairing of balance sheets, an embrace of reality, a nascent recovery. The same folks who chased the recession down now are likely to chase the recovery up.

Even as the economy started improving, corporate America continued to prepare for Armageddon for much of 2009. Inventories of manufactured goods fell in 10 of the first 11 months of 2009. Between October 2008 and October 2009, retailers slashed inventories from \$500 billion to \$432 billion. Translation? Pessimistic about their ability to sell stuff, companies cut way back on their orders. But when consumer demand finally materializes, retailers will be caught flat-footed and miss out

on sales. Like when you go into the local Gap, ready to spend, but it doesn't have the jeans you want in your size.

Excessive pessimism in other areas has been more costly. Virtually all the market geniuses who hung on as the Dow was scythed in half between October 2007 and March 2009 failed to call the market turn. Most hedge-fund managers have chased the 60 percent rally since March, not led it. Economic forecasters similarly missed the dramatic turn in the overall economy this spring. Having failed to forecast that the economy would shrink at a 6 percent annual rate through the first quarter of 2009, economists also failed to project it would start growing again at a decent pace in June. And they're still behind the curve. My bold prediction for 2010 is that the consensus of the forecasters surveyed by the Philadelphia Federal Reserve, which projects the economy will grow only 2.4 percent in 2010, is too pessimistic, perhaps by half.

As late as August, even the most cockeyed optimist would have projected that, within four months, Bank of America, Citi, and Wells Fargo would return nearly \$100 billion in borrowed funds to the taxpayers. But they did. On Dec. 23, the same day Citigroup and Wells Fargo paid back \$45 billion in TARP funds, six smaller banks also exited the program. A year from now, the only TARP we care about may be the one rolled out when it rains during baseball games.

I don't expect all the pessimists to be swayed by a quarter or two of good

results. There are those who can't fathom recovery for ideological and political reasons, the fools who believe—despite the evidence of the past 16 years—that the economy and the markets favor Republican presidents and policies over Democratic ones. Some pundits, meanwhile, have staked their professional reputations on the proposition that Keynesian economics no longer work and that the U.S. is in terminal decline.

Then there's a large population of nonideologues who may not fully embrace the narrative of economic recovery because they don't feel it yet in their paychecks, portfolios, or home values. Try telling a laid-off autoworker in Michigan or a laid-off magazine editor in Brooklyn that things are better. But they may soon be in for pleasant surprises, too. For all the advances of information technology, big economic turns always take us unawares. In 2007 all indicators flashed green—until the bottom suddenly fell out. In this environment, things can look awful, until a new order unexpectedly comes in or a few deals break in your firm's

favor. All of a sudden, things seem much better. We're in a Missouri economy now, one in which recovery has to be shown, not told. Economic conditions may be improving, but it still may take more than a few quarters of growth before people fully commit to recovery, both financially and psychologically. If credit means belief, since the credit crisis began two years ago, belief has been in short supply. Maybe it's time for a little blind faith.

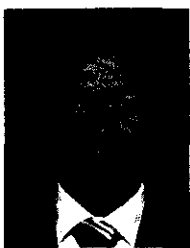
A year from now, the only TARP we care about may be the one rolled out when it rains during baseball games.

NEWSEEEK:

Don't Waste a Crisis

Debt may be a good thing for Europe.

BY STEFAN THEIL



WHEN GOVERNMENTS around the world rushed to save banks, bail out companies, and pump up their economies, it seemed to presage a new dawn of big government.

In Europe, the expansion of state powers and spending snuffed out more than a decade of economic liberalization and welfare-state reform. The very idea of reform has become associated with the trust-the-markets mindset so thoroughly discredited by the financial crisis. And if that weren't enough, the funneling of taxpayers' billions to banks (and wealthy bankers) has poisoned the atmosphere for any future reform debate.

Big government, however, has run into a wall faster than anyone expected, thanks to an unprecedented run-up in public debt and deficits. In Europe, several governments are on the brink of a deficit crisis, including Ireland, Greece, Britain, and Spain. According to the EU Commission, EU-wide deficits will average 7.5 percent this year, the result of stimulus spending, rising jobless payments, and declining tax revenues. Deficits are exploding just as the demographic crunch is starting to hit many European countries' pay-as-you-go welfare systems, which use the wages of citizens working now to support the jobless, the sick, and the retired. In France and Germany, that pool of current workers has begun to shrink. Rising costs—and fewer working-age people

to pay them—are a second crisis fueling deficits and debt. Together, they put governments' backs against the wall.

And that's a good thing. The likely turn of events is that all this pressure on government spending will boost the cause of economic reform in Europe, to the surprise of everyone who hoped for (or feared) a renaissance of state power. That would come as welcome news for Europe's future competitiveness, on which jobs, economic recovery, and so much else depends.

The big beneficiary could be Europe's sickly southern tier, which has long been falling behind more competitive neighbors like Germany. Already, some of these countries are tackling deep-seated problems. Greece has been an economic basket case for decades, gaining entry into the club of countries using

the euro only by faking its official economic statistics. Now that it's closer to the embarrassing step of asking the IMF for emergency help, it is finally beginning to tackle the structural flaws of a state-run economy calcified by corruption and patronage. Spain, whose collapsing bub-

All this pressure on government spending will end up boosting the cause of economic reform.

ble economy in real estate and tourism has produced 20 percent unemployment, just announced plans for a wave of labor-market reforms.

Big countries, too, will be forced to restart reform. Germany, responding to the run-up in crisis-related spending with a constitutional amendment requiring balanced budgets by 2016, is just beginning the debate over how that mandate should be met—including annual

budget cuts beginning this year. No doubt some taxes will be raised, but the bulk will have to come from paring the size of the state.

It often takes a crisis before most politicians even think of risking reelection for necessary but unpopular policy change. Johnny Munkhammar, in his astute 2007 study of the modern history of economic reform, shows how crises have triggered reforms in the past. In Germany it took a decade of crippling mass unemployment before then-chancellor Gerhard Schröder launched an unpopular but effective overhaul of the country's luxurious jobless programs in 2001. Ireland and New Zealand are former basket cases for which liberalization became the only route to growth. In Sweden, a 1990s banking crisis accelerated a reform marathon that has turned a stagnant, overregulated economy into one of Europe's most competitive, while keeping intact many elements of the country's welfare state.

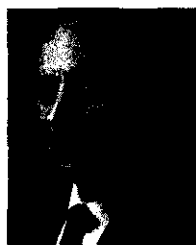
A look at economic history also teaches that recovery will come not from jobs and innovation created by government, nor by big companies that receive bailouts and enjoy state protection, but from small companies and entrepreneurs thriving on open markets and a lighter hand of regulation. That does not preclude—in fact, it requires—strong guarantees of competition and rules that prevent the abuse of market freedoms at the cost of consumers or taxpayers. The crisis hasn't changed this equation, or else you'd see those countries that opened up their economies in the past—such as most of Eastern Europe—reversing course in the crisis. They aren't. For the cause of sane, prosperity-producing policies, there may sometimes be nothing as good as a crisis.

NEWSEEEK:

What Caused the Great Recession?

It's finally ending. Let the blaming begin.

BY JACOB WEISBERG



AS THE FINANCIAL crisis of 2008-09 draws to a close, narratives of the meltdown are flooding bookstores, think tanks are cranking out white papers, and four different congressional committees are investigating what went wrong. Now that the debate over how to prevent the next collapse has begun, it might not be a bad idea to figure out how the last one happened. The only near-consensus is on the question of what triggered the not-quite-a-depression. In 2007 the housing bubble burst, leading to a high rate of defaults on subprime mortgages. Exposure to had mortgages doomed Bear Stearns in March 2008 and then led to a banking crisis that fall. A global recession became inevitable once the government decided not to rescue Lehman Brothers. But right about here, agreement ends.

There are no strong candidates for what logicians call sufficient conditions—a single factor that would have caused the crisis in the absence of any others. There are, however, a number of plausible necessary conditions—factors without which the crisis would not have occurred. Most analysts find former Fed chairman Alan Greenspan at fault, for varying reasons. Conservatives tend to blame Greenspan for keeping interest rates too low between 2003 and 2005 as the real-estate bubble inflated, spurring a frenzy of irresponsible borrowing.

Liberal analysts are more likely to focus on the way that Greenspan's aversion to regulation turned innovative financial products into lethal weapons. In this view, the emergence of an unsupervised market for more and more exotic

derivatives—credit default swaps (CDSs), collateralized debt obligations (CDOs), CDSs on CDOs—allowed heedless financial institutions to put the entire financial system at risk. Fed chairman Ben Bernanke also echoes this view, attributing the crisis to regulatory failure.

A bit further down on the list are factors that didn't cause the crisis but enabled it or made it worse than it might have been. These include global savings imbalances, which put upward pressure on asset prices and downward pressure on interest rates during the bubble years; misjudgments by the bond-rating agencies Moody's and Standard & Poor's about the safety of mortgage-backed securities; a lack of transparency about the risks borne by banks, which used off-balance-sheet entities to hide what they were doing; excessive reliance on mathematical models, which under-priced unpredictable forms of risk; and a flawed model of compensation that encouraged traders and executives at financial firms to take on excessive risk.

Other analysts look to the underlying mindset that encouraged the meltdown: shortsightedness, stupidity, and greed. But those are weak explanations, unless you think human nature changed in the final decades of the 20th century to make people greedier or more foolish. A subtler psychological argument is that investors fell prey to recurring delusions about risk and bubbles, which the economists Carmen Reinhart and Kenneth Rogoff describe in their book, *This Time Is Different*. In another new book,

How Markets Fail, John Cassidy of *The New Yorker* focuses on the fallacies of free-market fundamentalism (Greenspan again). Still other writers, like Nobel Prize winner Joseph Stiglitz, in his new book, *Freefall*, point to the way globalization spread the toxicity from the U.S. mortgage market to the rest of the world. Not all such explanations fall according to ideological expectations. The conservative

jurist Richard Posner argues in his book *A Failure of Capitalism* that the free market itself is to blame for the recent troubles. Unfortunately, what these "root causes" explanations have in common is that they don't lend themselves to practical solutions.

I've left out some farther-fetched interpretations of the cause of the crisis. Libertarians and *The Wall Street Journal* editorial page continue to insist that government did it. In *I.O.U.*, the only truly entertaining book I've read on the subject, the British writer John Lanchester theorizes that after the Cold War, capitalism could go wild because Western governments no longer had to worry about competing with communism. This is a fascinating idea, with no evidence to support it.

Historians are still debating what caused the Great Depression, so it's not likely this argument will be settled any time soon. But if we haven't at least learned that our financial markets need stronger regulatory supervision to prevent bad bets by big firms from going viral, we'll be back in the same place faster than you can say "30 times leverage."

Some say it was stupidity. But that is a weak explanation, unless human nature recently changed to make people more foolish.

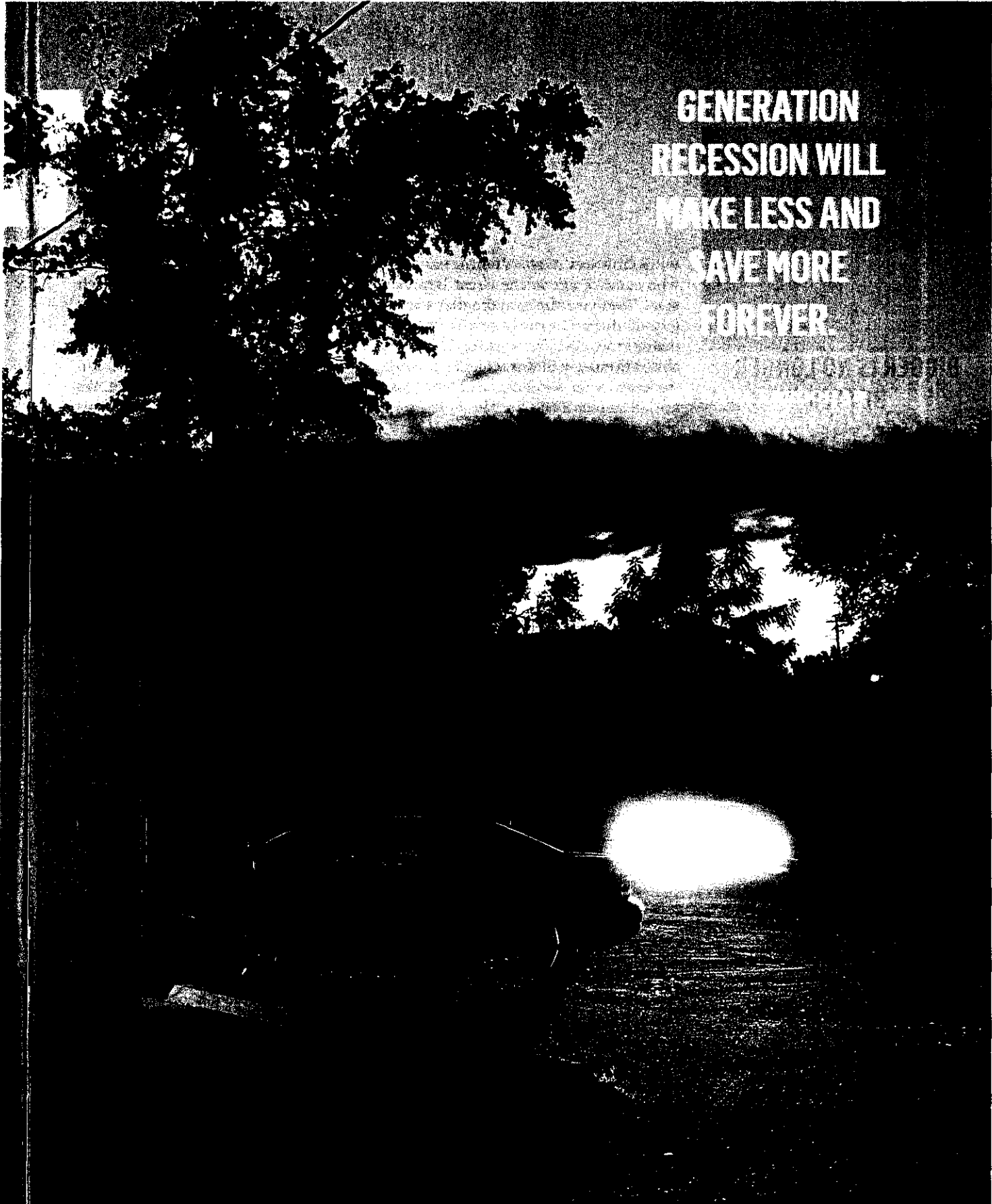
ECONOMY

SOCIETY

NOR



DOWNSCALING
DAMPENED JOB
PROSPECTS CREATE
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**GENERATION
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MAKE LESS AND
SAVE MORE
FOREVER.**

OLIVIER CULMANN—TENDANCE FLOUE



BIGGER IS NO LONGER BETTER

OVER-THE-TOP
MCMANSIONS
HAVE FALLEN OUT
OF FAVOR, AND
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SALES ACTION IN
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MARKET IS IN THE
\$250,000-AND-
UNDER CATEGORY.

WE ALL KNOW THE TYPE OF PERSON who came of age in the Great Depression. They are the grandmothers and grandfathers who can't use a tea bag too many times, yet are enjoying comfortable retirements in warm climates. And we know what the children of the 1950s are all about. They are the optimistic boomers who embodied an age of continual upward mobility and possibility. They have often spent more than they earned, because for them it has been a truism that times can only get better. It's no accident that the psychology of entire generations is shaped by the milieu in which they grew up; economic research tells us that our lifelong behaviors are determined in large part by the seismic events—good or bad—of our youth. So, given that we have just experienced the worst economic period in 70 years, it's no surprise that people have begun to wonder what sort of consumers, investors, and citizens will be bred by the Great Recession. Will there be, in effect, a "Generation Recession" of young people whose behaviors will be permanently shaped by the downturn?

The question is most pressing in the U.S., the epicenter of the crisis and the home to the world's consumers of last resort. Some optimists—pointing to a recent spate of positive economic data, including increases in car sales, upticks in factory production, and a robust stock market, say no: the downturn simply hasn't been bad enough, for long enough, to create the next Depression generation. Yet there is powerful evidence that belies this argument; a National Bureau of Economic Research (NBER) paper released this past September looking at data from 1972 to 2006 shows that even one really tough year experienced in early adulthood is enough to fundamentally change peo-

ple's core values and behaviors. Meanwhile, there's an entire body of research to show that recession babies not only invest more conservatively, they tend to make less money, choose safer jobs, and believe in wealth redistribution and more government intervention. Yet paradoxically, they are also more cynical about public institutions and, arguably, about life, embracing the European notion that success is more about luck than effort. To the extent that they grapple with unemployment, they are more likely to be more depressed and disconnected from their communities. Politically, they can skew either left or right, depending on the cultural zeitgeist and the leaders who seize the moment. Economic downturns, after all, not only created the New Deal, but also the Third Reich.

America and much of the West has now technically emerged from recession. But there's a broad feeling that psyches and behaviors will be somehow permanently altered by the crisis. There's now a booming cottage industry among consultants and investment managers to describe and capitalize on "the New Normal," which will likely be the opposite of the hypercapitalist market culture of the past 25 years. That moment was perhaps most eloquently captured by former Clinton labor secretary Robert Reich in his 2007 book, *Supercapitalism*, and it's fitting that he is now working on a book titled *After-shock*. "Every time we've had a major downturn, there have been predictions that Americans will permanently change their ways and embrace frugality," says Reich, now a professor at the University of California, Berkeley. "Since World War II, it hasn't happened." Yet Reich and many other respected academics, economists, and

investors—from George Soros to Pimco's Bill Gross to Goldman Sachs's chief economist Jim O'Neill—say that it will happen this time, not only because of the megashock of the financial crisis, but also because the global landscape has simply shifted in such a way that the American consumer will no longer be the single dominant force in the world, even if the U.S. economy continues to recover. Rather, the key emerging markets (read: China, India, Brazil, and others) will continue to emerge and become more powerful; the dollar will continue to weaken; American labor will continue to face more and more competition from abroad; and, thanks to a new era of big government, reregulation, and (possibly) protectionism, money flows will stay tight. Throw in the probable rise in inflation and you've got an inevitably slower-growth future in which Americans will also have to come to grips with average unemployment levels that will likely stay much higher than they've been in decades.

Unemployment and the specter of instability it creates will really shape the behavior of Generation Recession. A weaker dollar will make all Americans feel poorer by raising the cost of goods, but the young generation graduating and going to work now may actually end up poorer in real terms. Unemployment among 20- to 24-year-olds in the U.S. is more than 15 percent, compared with the nationwide average of 10 percent, and statistics show that for every percentage point in higher unemployment, new graduates take a 6 percent pay cut—an effect that lasts for decades. Skills loss is a huge issue, too, especially because the average duration of unemployment has increased. Although wages in the U.S. have been relatively flat since the 1970s, Genera-

tion Recession may be the first in 30 years to see theirs actually fall.

The behavioral shifts resulting from the New Normal have, of course, already begun. The personal savings rate has more than quadrupled from its 2008 low to the current rate of 4.5 percent. Research done by AlixPartners found that Americans don't want to stop there, but hope to save 15 percent of their income going forward (they won't be able to, but the desire itself speaks volumes about their sense of insecurity about the future—particularly since the number has continued to rise even as the economy has improved). Half of those surveyed by AlixPartners have stopped investing in the markets altogether, and the majority say they won't put money into stocks for another three years; 43 percent don't expect the economy to ever recover to pre-recession levels.

The disconnect between these sorts of poll results and the recently improving economic data underscores another megatrend that Generation Recession will have to deal with: the growing divide between the fortunes of big American firms and the average American worker. Markets may be up, yet unemployment, while slightly down, is still at its highest level in decades, and even the most bullish economists believe it will stay higher than average for years to come. Large U.S. firms are well into the black, in part because of the labor cost savings they've enjoyed from IT improvements and offshoring to cut expensive U.S. jobs, yet the small- and medium-size firms that generate the majority of new jobs at home have been hurt most by the financial crisis as their lines of credit have dried up. "We are in a very unique period, in which we're seeing the biggest disconnection between



NO GOOD NEWS FOR GRADUATES
UNEMPLOYMENT
AMONG 20- TO
24-YEAR-OLDS
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10 PERCENT.



**WAL-MART
IS THE NEW
BLOOMINGDALE'S**
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financial capitalism and the real economy since modern economies began in the 19th century," says Nobel laureate and Columbia economics professor Edmund Phelps, who runs the university's Center on Capitalism and Society. "That's not to say that banks don't fund some useful projects like wind farms or whatever, but increasingly they're existing in a virtual sphere in which they are more interested in funding each other, and developing complex securities, than in funding real businesses."

This division between capital and labor and the permanently high unemployment that it seems to encourage not only depresses wages, it depresses people; a large body of research shows they tend to withdraw from their communities and societies after being laid off (their spooked neighbors, encouraged to work ever harder, do too). Parental unemployment has huge negative consequences for children, making them more likely to fall behind in school, repeat grades, and exhibit anxiety disorders. During the Great Depression, such negative social consequences were partly buffered by a stronger civil society—attendance at churches, clubs, and community centers was greater than now. The worry today, say Reich, Soros, and political scientists such as Harvard's Robert Putnam, is that fearful, vulnerable people will become more easy prey for ugly class politics, being drawn, as Reich puts it, to "populist demagogues on either side of the political spectrum." Certainly during this recession there has been sniping at the usual targets of free trade and immigration. Many experts worry about the current trade and currency squabbles between the U.S. and China, which could easily spiral into the sort of protectionism that exacerbated the Great

Depression. There could also be future political wars along demographic lines, as boomers worried about health care and Social Security fight for a shrinking slice of the public pie with younger people demanding more money for education and job training.

The situation could get even uglier if, as many predict, a depressed post-crisis landscape forces Americans to let go of the mythology of upward mobility. As Brookings fellows Isabel Sawhill and Ron Haskins point out in their new book, *Creating an Opportunity Society*, this myth hasn't been true for some time: by international standards, intergenerational social mobility in the U.S. has been falling since the 1970s, and is lower than in countries such as Britain, Sweden, and Denmark. As everyone from de Tocqueville to the producers of *MTV Cribs* has observed, Americans generally have a high tolerance for inequality. Yet that tolerance may wane as we enter a new age in which young graduates can't expect to do better than their parents—and one in which Wall Street is perceived as being able to continue business as usual while Main Street struggles. "Americans are OK with inequality," says Reich, who believes we are at a tipping point, "as long as they feel the system isn't rigged."

Unfortunately that feeling seems to be associated not only with this past year's massive bailouts and half-hearted efforts to regulate finance, but with recession itself. The NBER study examining the attitudes of people ages 18 to 25 who began their adulthood in economic downturns from 1972 onward found that they all tend to believe that success in life depends more on luck than on effort, and they have less trust in public institutions.

OLIVER CULMANN—TENDANCE FLOUE

This is an unfortunate attitude to breed in a generation that will undoubtedly have to live in an age of bigger governments working with more powerful international public institutions to forestall future financial and environmental disasters. It also has real-world economic implications. As Paola Giuliano, a professor at UCLA's Anderson School of Management and one of the authors of the study, notes, "People who buy into the idea of luck over effort tend to work less hard, and that lowers productivity, which of course can lower economic growth." Indeed, this may go some way toward explaining the often mysterious growth edge that "can-do" Americans have long enjoyed over "yes, but" Europeans, who tend to mock such Type A behavior. Whether Americans will eventually follow them is an interesting question: the Conference Board recently released numbers showing that U.S. job satisfaction is at its lowest level in two decades.

All this said, there are some glimmers of hope in the New Normal. For starters, a weakening dollar and huge productivity gains made in the past year could end up being a salvation for U.S. manufacturing. McKinsey estimates the U.S. could create 1 million jobs if the dollar depreciated by just 10 percent. Indeed, Global Insight chief economist Nariman Behravesh believes that American exports will rise by 11 percent a year between 2010 and 2013, compared with just 7 percent in Germany. Smart investors like Warren Buffett have bought into the vision: his \$26 billion bet on the Burlington Northern Santa Fe rail line is clearly a gamble that in the New Normal, more American workers will be holding wrenches and loading cargo (from solar panels to bags of grain) onto trains,

à la the post-Depression generation, rather than fiddling with BlackBerrys.

And, if the current trend lines continue, Generation Recession may mirror Generation Depression in more profound ways. For example, more talented graduates may choose public service over the private sector, not least because then, as now, that's where the jobs will be. Happiness research shows that fewer choices tend to be more satisfying than endless ones. Just as our tea-bag-saving grandparents seemed to do fine with less, so might the children of this downturn. A number of consultancies, like BCG, have released studies showing that post-crisis, consumers are putting a greater value on time spent with family and friends than on money (a good thing when there's little of the latter around). There's also a glimmer of possibility that hard times might make us nicer to each other. Kathleen Vohs, a consumer psychologist at the University of Minnesota, has shown that simply thinking about money made subjects less sensitive to pain, and less likely to help each other or want to connect with strangers. Perhaps rather than stepping over each other, 1980s style, on the climb to the top, we will stop to lend a hand. Certainly, we'll be more wary of falling down the ladder of life, and thus more empathetic, than our predecessors were. Generation Depression never stopped saving, and couldn't have conceived of buying into interest-only mortgages or flat-screen televisions on credit. It's likely that the generation coming of age today will also realize that things that seem too good to be true—from jobs that come with free lattes and signing bonuses, to subprime derivatives—probably are.

With JERRY GUO in New York



OUT OF WORK
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AND PERMANENTLY
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NEIGHBORS.

NEXT ►

END OF ORANGE
The winner of Ukraine's election won't be Russia.

BY OWEN MATTHEWS
AND ANNA NEMTSOVA

IN THE WAKE OF THE economic crisis, most of the discussion has been about stimulus, reforms, and bankers' pay. Yet the big story is the reordering of power and the advent of a radically new form of globalization.

For the first time, the United States and Europe have had to rely on emerging economies to overcome a crisis. The perception that the meltdown was caused by U.S.-style capitalism has greatly diminished America's prestige. The Washington Consensus is dead, and the West no longer has a monopoly on the solutions to global governance.

Meanwhile, the crisis has highlighted fissures in Europe's architecture and the limits of integration. The lack of a coordinated response has been striking. Although the EU emerged from recession ahead of the U.S., unemployment is expected to increase in 2010 in almost every EU country. Debt levels have risen substantially as a result of the stimulus, and will be exacerbated by rising welfare costs owing to the aging population. Resurgent state intervention will worsen the rigidity of Europe's economies and hamper entrepreneurship. The picture for the next few years is of slow growth, high unemployment, and high public debt.

Also passing is an economic phase best described as "Asia and Germany make and America takes." The real cause of the crisis was not bankers' greed but imbalances in global savings, investment, and trade that have been widening for 20 years. These were the result of the symbiosis between the high-consumption, laissez-faire Anglo economies and the export-led, neo-mercantilist economies of East Asia and Germany. The enormous trade sur-

pluses accumulated by the big exporters, coupled with the widening U.S. deficits and the enormous capital flows necessary to finance them, led to a huge distortion of both interest rates and risk management. The system was unsustainable and duly collapsed.

This has sparked all kinds of discussions about the need for Anglo countries to consume less and produce and export more, and neo-mercantilists to do the opposite. Such talk is comforting, but so far the major players have done nothing to execute it. Even if leaders did decide to reverse their priorities, moreover, it's not clear they could. We are speaking, after all, of a tectonic shift in the global economic structure that would mean a similar shift in political power.

Yet that shift must come; the days of export-led growth will soon be over. This will not mean an end to globalization, but it will revolutionize the game.

China has become the point of final

assembly of a regionally integrated Asian manufacturing system. Many businesses are now reassessing their dependency on such systems, and increased transportation costs will intensify the process. Production is likely to move closer to end markets. That means a shift toward more regional and national supply chains.

The likely result is that we will see a fragmentation of economic models. The time when globalization meant Americanization is over; the compact of a market economy and political democracy has been buried. We may see a return to greater state intervention and even authoritarianism instead, as the China-Singapore model gains greater acceptance. Even


Europe has become more cautious about promoting freer markets.

The resulting world will be much more multifaceted and messy. The shift to a G20 has been welcome, but it will also mean a less wieldy system of global governance. Nationalism will rise, as even the U.S. may become less interested in securing global goods than in its own revitalization.

If it's all to turn out well, leaders must learn to play this very new and complicated game.

The fiasco of the Copenhagen climate summit underlines not only the urgency of the process, but also how hard it will be.

SMADJA is president of *Smadja & Associates Strategic Advisory*. PRESTOWITZ is president of *the Economic Strategy Institute*.



ECONOMICS POWER

GLOBALIZATION REVOLUTION

BY CLAUDE SMADJA AND
CLYDE PRESTOWITZ

NEXT ►

THE CONSERVATIVE CASE FOR GAY MARRIAGE
Why same-sex marriage is an American value.

BY THEODORE B. OLSON

DISASTER ECONOMICS

BY KATIE BAKER

HAITI HAITI'S EARTHQUAKE last week was so devastating it seemed to spell economic doom for the impoverished nation. The World Bank estimated reconstruction would cost at least 15 percent of Haiti's \$7 billion GDP. But if studies on disaster economics are any indicator, Haiti's future might not be unequivocally dire.

Researchers looking at such large-scale disasters as the 1964 Alaska earthquake, the 1994 Los Angeles earthquake, and Asian hurricanes have found that natural disasters may in fact promote economic resurgence, at least in the short term. One 2002 paper by Mark

Skidmore and Hideki Toya found that a higher frequency of disasters correlated with higher rates of capital accumulation, increases in total productivity, and overall economic growth. Similarly, China's economy saw a small bump after the Sichuan quake. A key reason: disasters draw aid money to regions that might have been ignored on the global investment scene. They also provide an opportunity to replace old infrastructures and outdated technologies. But in places where aid is slow to come, it can cripple the economy long-term (such as in post-Katrina New Orleans). Let's hope with Haiti, this won't be the case.

EUROPE'S YEMEN TEST

BY STEFAN THEIL

EU YEMEN COULD BE THE first "test case" for the European Union's new foreign-policy chief, Catherine Ashton, who has promised to more tightly coordinate EU countries' often disparate diplomacy efforts. Indeed, the impoverished, conflict-riven nation is a poster child for past ineffectiveness of European aid. Yemen has received EU assistance for decades, with Germany alone giving \$1.3 billion since 1987. But the aid has been poorly coordinated, with little lasting impact on Yemen's economic and political chaos. Now, as Europe prepares for an international conference on Yemen in London on Jan. 28, there's fresh talk of even more aid and advisers. Yet just as the U.S. has had to learn that military and counterterrorism programs alone won't help a country unless the underlying poverty

and social roots of conflict are addressed, Europeans are beginning to face the fact that their kind of development aid often fails to aid development—and that it certainly can't achieve quick results in a near-failed state like Yemen.

If Europe wants to prove its relevance, it will have to abandon the ways of the past, says Daniel Korski of the European Center for Foreign Relations. Instead, it should help defuse the conflict by bringing together warring parties—as well as donors and regional actors such as Saudi Arabia—and help broker a political solution. Nations like Germany pride themselves on their good relations with the Arab world, but they have yet to prove they can leverage those relationships to solve concrete problems. Now would be a good time to prove the critics wrong.

BY THE NUMBERS A WORLD LESS FREE

In 2009 respect for civil rights declined globally for the fourth year in a row—the longest slump in nearly 40 years—according to U.S. watchdog Freedom House. One bright spot: Asia, which saw solid gains in political and civil liberties.

7

Percentage of states where freedoms improved and governments became more permissive.

18

Percentage of states where freedoms declined and governments became more repressive.

20

Percentage of Asian states where freedoms improved, the biggest gains globally.

31

Percentage of ex-Soviet states where freedoms declined, the biggest drops globally.



Google vs. China

BUSINESS

PROSPERITY

CHINA'S SILICON CEILING

Free markets require free minds.

BY DANIEL GROSS

GOOGLE VS. CHINA REPRESENTS A clash of what may be the two most powerful forces of the first decade of the 21st century. Like China, Google has changed the terms of competition in several crucial markets, thanks to its advantages in hardware, productive capacity, and engineering brainpower. The juggernaut rolls into new industries—e-mail, GPS, smart phones, operating systems for netbooks—heedless of the competition, racking up profits and disheartening competitors.

But now one of the world's most rapidly growing companies has threatened to pull up stakes from one of the world's most rapidly growing markets. It's a move that raises many questions about Google and its future—and a larger question about China. Can China get rich without becoming free?

History suggests it can't. Until recently China, which was technologically more advanced than Europe in the middle of the last millennium, had been left behind. Historians, led by the magisterial David Landes of Harvard, have made a convincing case that the slow erosion of arbitrary authority—the Reformation, the Enlightenment, the rise of rights, constitutions, democracy—helped stoke the capitalist revolution. For the past few centuries, the developed world has been led economically by democratizing commercial empires—Britain in the 18th and 19th, and the U.S. in the 20th. Without free minds, it's difficult to have free markets, and vice versa. Trying to develop eco-

nomic while controlling the flow of information has generally been a losing bet. Either such regimes fail to grow and collapse (the Soviet bloc), or the forces of economic liberalism ultimately lead to political liberalism, as in Chile.

For the past 30 years China has been testing a new, inverted model: breakneck economic development while retaining strict limits on personal liberty. The Communist Party has wrenched the nation into the 21st century. The hardware is certainly impressive—the maglev trains, shiny new airports, and modern skyscrapers. China has displaced the U.S. as the world's largest car market, and is about to surpass longtime rival Japan as the second-largest economy. Such growth has attracted American companies, which inevitably make a series of trade-offs when they decide to head east. They accept local joint-venture partners and the risk of intellectual property theft, and learn to negotiate a commercial culture in which the government may arrest and jail a key executive, as happened with Australian mining giant Rio Tinto. As a group, the Fortune 500 has overlooked or come to terms with the lack of political freedom. After all, General Motors or KFC are in the business of selling stuff, not principles. And they have to be in China because that's where the action is. "If you don't come to the Chinese markets, other countries will," said Zheng Zeguang, director general of North American Affairs in China's Ministry of Foreign Affairs.

That's why Google came. Last summer, Google advertisements were ubiquitous in Shanghai. But Google is unlike other U.S. companies that have succeeded in China. It sells access to information. Its business model requires freedom of linking, surfing, and expression. And that's why it, along with other media and New Economy companies, hasn't done well in China. Google has 14.1 percent of the Chinese search market, compared to homegrown Baidu's 62.2 percent. Worse for Google (motto: don't be evil), doing business in Guangzhou means being complicit in activities that are antithetical to its mission. "How far do you go down the path to becoming a de facto adjunct to government control of information?" asks Zachary Karabell, author of *Superfusion: How China and America Became One Economy*.

Like Google, China is led by engineers—but the leaders were trained as civil engineers. Google's software engineers became billionaires by devising a democratic algorithm. China's civil engineers are turning the process on its head. They believe the nation is getting richer precisely because they are keeping democratic tendencies in check. In the two weeks I spent in China last November, I heard Westernized elites make all sorts of rationalizations for why the time isn't right for democratization. The main argument: in a nation of 1.3 billion people, 56 ethnic groups, and unbalanced development, encouraging free elections, civil society, and political organizing would be a recipe for chaos—and an obstacle to

SIGN OF THE TIMES THE COMPANY'S BEIJING HEADQUARTERS.

growth. One senior bureaucrat pointed out that the growth rates of South Korea, Taiwan, and Indonesia declined once they became more democratic. "When you emphasize development and efficiency, then you have a problem with the system of democracy," said Zhe Sun, director of the Tsinghua University Center for U.S.-China Relations in Beijing. For a regime whose legitimacy rests on economic progress, no such delays can be tolerated.

Yes, Shanghai feels a lot like New York. But don't presume that just because Americans and Chinese share a consuming culture that they also share a political one. As I stood in Tiananmen Square on a chilly November day, I turned to my guide. "That was really something, what happened here 20 years ago," I said. "Yes," he responded in his near-fluent English. "Those terrorists really killed a lot of soldiers."

Market forces prevail, but the government clearly has its hands on the steering wheel and its feet on the gas pedal and brakes—especially in information-intensive industries like Internet search. And so even as it welcomes investments by the Fortune 500, China engages in large-scale cyberattacks on the most technologically advanced company in the world. The crisis that plunged the world into recession has only given the Chinese more confidence in their model. In November, I met with Qian Xiaolian, vice minister of the State Council for Information of China. "To say the Chinese government controls the Internet is exaggerated," he said. (After the meeting, I fired up my laptop and was blocked from getting to Twitter, Facebook, and Andrew Sullivan's blog.) Qian enumerated all the things people can't do on the Internet: no online pornography, no attempts to incite racial discrimination, and no attempts "to violate the Chinese Constitution and subvert the state." The rules, however, are arbitrary, opaque, and subject to change.

Qian ticked off the impressive numbers—China has 338 million Netizens



as of June 2009, 700 million mobile subscribers, and 180 million blogs. That's certainly enough users to build businesses around, with or without Google.

Can China continue to grow without allowing Google—and the next Googles of the world—free rein in China? It's worked out well so far. But there are a few caveats to the story.

First, China still has a long way to go before it's considered rich. And some sympathetic analysts argue that it's not fair to hold China's civic development to American standards. The U.S. had China's present-day economic profile—per capita GDP of about \$5,000, 40 percent of the workforce in agriculture, 30 years into the process of industrializa-

largest components of the services sector—financial services, entertainment, media—remain firmly in the grip of the state. Going forward, it will become more difficult for a services-based economy to prosper with restraints on communication and expression. China faces a fundamental paradox, says Damien Ma, an analyst at the Eurasia Group. "It needs to have fairly closed information flow for political stability purposes, but doing so stifles innovation."

And that's the rub. Any type of political system can produce excellent hardware; the Soviet Union, which ruled Russia when Google cofounder Sergey Brin was born there in 1973, managed to produce nuclear weapons and satel-

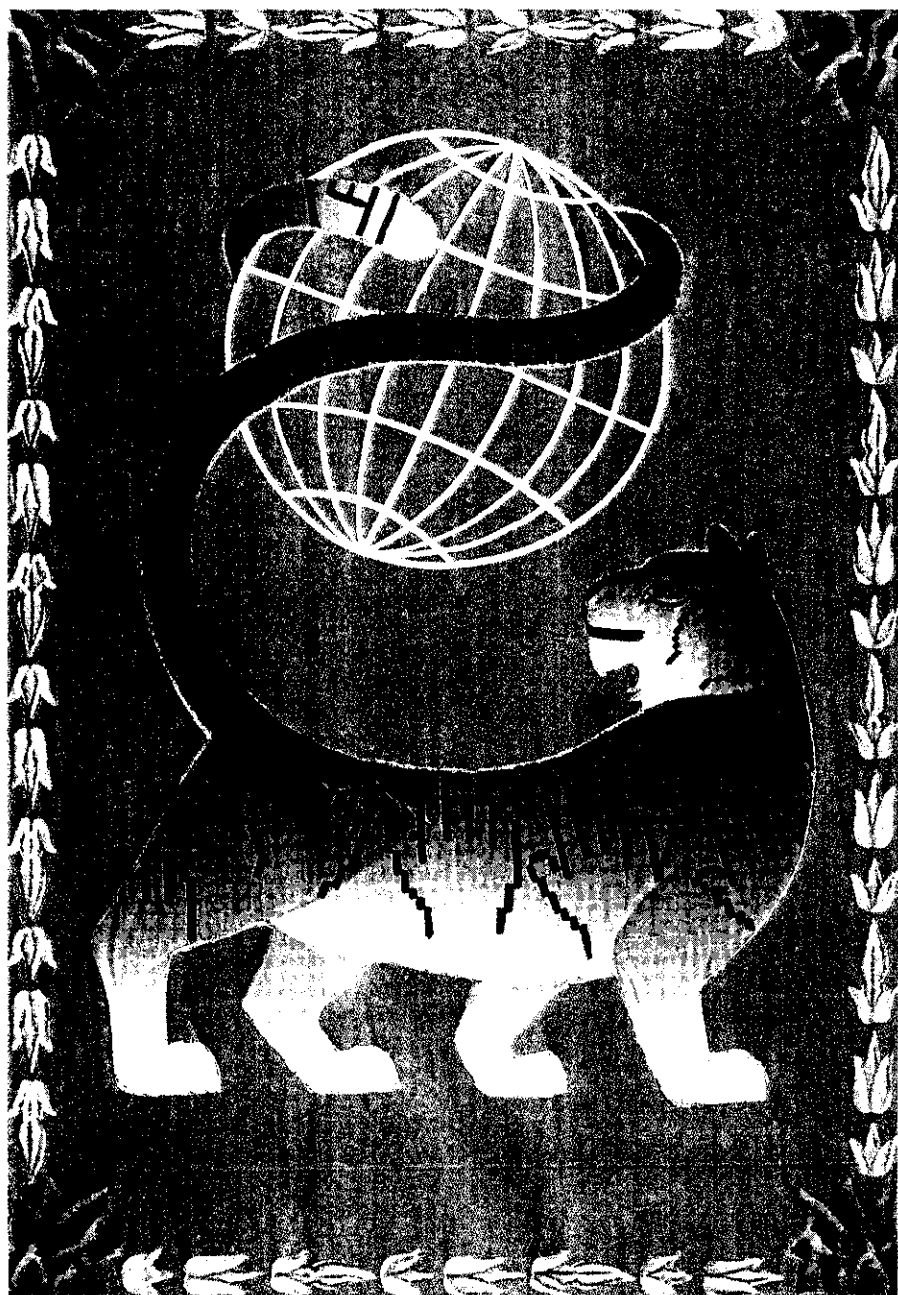
Trying to develop economically while controlling the flow of information has generally been a losing bet.

tion and urbanization—in 1900, a time when there were no direct elections for Senate, women couldn't vote, and segregation reigned in the South.

Second, much of China's extraordinary development has been based on moving peasants into manufacturing. The key to future job growth, says Stephen Green, chief economist at Standard Chartered Bank in Shanghai, will lie in the service sector. And the

lites. Likewise, China has built truly impressive hardware: some 67 bridges now span the Yangtze River, a superfast supercomputer made entirely from parts made in China, high-speed trains. But in the 21st century, a country needs great software in order to thrive. It has to have a culture that facilitates the flow of information, not just goods.

With NICK SUMMERS in New York



TRADE

Outsourcers Go Global. After cashing in on globalization's first wave, India's IT giants are discovering their continued success may depend on international expansion

BY MICHAEL SCHUMAN

ONE GLANCE AT THE TRAVEL ITINERARY OF Natarajan Chandrasekaran will tell you just how dramatically the postrecession economy is changing. Since October, when he became CEO of Indian IT firm Tata Consultancy Services (TCS), Chandrasekaran has retraced the business trips his predecessors have been making for years to New York City and London, the home cities of big banks and other companies that have traditionally outsourced computer programming and other work to Indian firms. But jaunts to the industrialized world may no longer be sufficient to keep his Mumbai-based firm growing at top speed. So Chandrasekaran is also venturing to locales Indian techies in the past rarely considered worth the cost of a plane ticket. He has already stopped in Beijing and Singapore, and early in 2010, he'll head to Montevideo, São Paulo, Mexico City and the Middle East. "You need to make sure that you're more focused on growth everywhere," he says.

India's IT sector, born out of the forces of globalization, is undertaking some globalization of its own. In search of new sources of rapid growth, the country's outsourcing giants are aggressively expanding beyond their usual stomping grounds into the developing world, setting up programming centers, chasing new clients and hiring local talent from Santiago in Chile to China's far-west metropolis of Chengdu. Through geographic diversification, Indian companies hope to regain some momentum after a dismal year, at the same time becoming even tougher competitors to IBM, Accenture and other industry leaders. India's companies "clearly realize that if we want to be global players, we need a presence in emerging markets," says Sangeeta Gupta, vice president of India's National Association of Software and Service Companies (NASSCOM) in New Delhi.

This shift is being driven by a global economy in which the U.S. is no longer the undisputed engine of growth. India's IT powers, among them companies like TCS, Infosys Technologies and Wipro, rose to prominence largely on the decisions made by American executives, who were quick to capitalize on the cost savings to be gained by outsourcing noncore

operations, such as systems programming and call centers, to specialists overseas. Focusing on the U.S. produced some spectacular results. Revenues in India's IT sector surged from \$4 billion in 1998 to \$59 billion in the country's fiscal year ended March 31. But recession has caused a dramatic deceleration as companies in the U.S. and Europe scale back technology spending. NASSCOM forecasts that the growth rate of India's exports of IT and other business services will drop to at most 7% in the current fiscal year, down from 16% last year and 29% in 2007-08.

NASSCOM's Gupta calls the crisis an "inflection point" that has jarred Bangalore into moving more quickly into markets with higher potential for economic growth. K.R. Lakshminarayana, chief strategy officer at Wipro, says that, with the West mired in "an economic reboot," his company has over the past two years opened operations centers in China, Egypt and the Philippines, while expanding others in Brazil and Romania. These markets, he says, will help Wipro achieve its primary goal: "the maintenance of velocity."

More than the crisis is driving India's IT firms into the emerging world. As their multinational clients expand into developing countries, they are finding it imperative to follow. New customers are also surfacing among large firms and financial institutions from emerging countries as they seek to professionalize their operations. A study by NASSCOM and consulting firm McKinsey figured that by 2020 about a quarter of potential IT- and business-services revenues for outsourcing firms will be generated in the so-called BRIC countries: Brazil, Russia, India and China. Although the U.S. still accounts for 60% of the export revenue of India's IT sector, emerging markets are growing faster. NASSCOM data show that the Indian IT sector's revenues from the Asia-Pacific region grew by a compounded 42% a year between the 2004 and 2008 fiscal years compared with 29% in the U.S. That's why management at Infosys is targeting a long-term restructuring of the company's revenue base, decreasing the U.S. share from the current 65% to 40%, while raising the proportion coming from the Middle East, Latin America and Asia from about 12% to 20%. "The U.S. continues to grow," says S. Gopalakrishnan, CEO of Infosys, but "we can get higher growth rates in [emerging] markets."

Tapping these more dynamic economies won't be easy, however. The very different demands encountered in the developing world are forcing an overhaul of the way India's IT firms conduct

The very different demands encountered in the developing world are forcing India's IT firms to overhaul the way they conduct business

business. Their goal for the past 30 years has been to woo clients outside India, but to transfer as much of the actual work as possible back home, where lower wages for highly skilled programmers allowed them to offer significant cost savings. With costs in other emerging economies equally low, India firms can't compete on price alone. Emerging markets also require that services be offered in languages other than English.

To adapt, Indian companies are establishing major local operations around the

world, in the process hiring thousands of Brazilians, Chinese, Eastern Europeans and others. The need to train new recruits in multiple countries is a major test for Indian management, and has sparked a few cultural conflicts as well. Cesar Castelli, the São Paulo-based president of TCS in Brazil, says that the company has had difficulties squeezing more free-spirited Brazilians into an Indian corporate environment run on strict hierarchy and a devotion to internal rules. "Indians say 'Yes' and Latins say 'Why?,'" he quips.

IT firms also have to work extra hard to woo business from emerging-market companies still unaccustomed to the concept of outsourcing. Unlike CEOs in the U.S., executives in the developing world prefer to manage their technology in-house. The fact that Indian companies are relative unknowns in many parts of the world hasn't helped. Castelli says that one problem marketing the TCS brand name in Latin America has been that *tata* in Spanish means "daddy." "Nobody knew if we were talking about our father or the company owner or what," Castelli says. "It took time to explain that Tata was an Indian IT company."

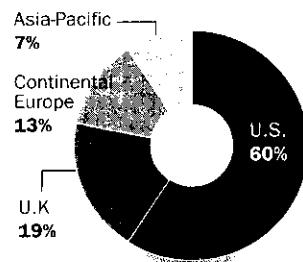
Yet these hurdles are steadily being overcome. Since opening its first emerging-markets operations centers in China and Uruguay in 2002, TCS's annual revenues from Latin America, the Middle East and the Asia-Pacific region have surged from \$160 million to \$1.2 billion, or about 20% of total sales. "The investments we've made in emerging markets have all reached a critical size," says TCS's Chandrasekaran. TCS discovered that its expansion has opened up new opportunities to lure business from international clients. After struggling to convince Spanish companies to outsource to India, TCS found them much more comfortable outsourcing to the firm's staff in Spanish-speaking Latin America. Business is coming from local companies as well. In early December, TCS launched a currency-trading network for Chinese banks, a project completed for the People's Bank of China.

India's IT giants are charging forward as quickly as they can. TCS is adding some 1,000 people a year in Latin America, where it now employs about 7,200, while in China it intends to nearly quintuple its staff to 5,000 over the next five years. "These emerging countries are now beginning to see the value of outsourcing," says Martha Bejar, Wipro's president of global sales and operations. If so, the future of India's outsourcing sector could prove as bright as its past. —WITH REPORTING BY ANDREW DOWNIE/SÃO PAULO

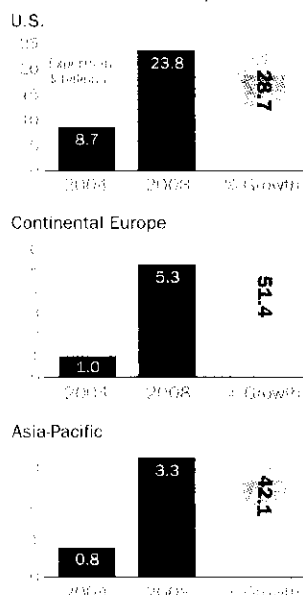
Emerging Opportunity

India's IT giants want to depend less on the U.S. as a source of growth

IT Export Revenue by Region, FY 2008



Annual Growth Rate, FY 2004-08



Source: NASSCOM